

# eJournal of Tax Research

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# **eJournal of Tax Research**

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# **eJournal of Tax Research**

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The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

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# Editorial

**Associate Editor: Dr Alexandra Evans**  
**New Production Editor: Dr Peter Mellor**

We are very happy and excited to announce the appointments of Dr Alexandra Evans as Associate Editor and Dr Peter Mellor as the new Production Editor of the *eJournal of Tax Research*.

Alex is currently a Lecturer in the School of Taxation and Business at the UNSW Business School, UNSW Sydney. She holds a Bachelor of Laws with Honours, a Master of Laws (specialising in income tax) and a PhD from Sydney Law School, The University of Sydney. She was admitted as a Solicitor in the State of New South Wales in 2005. Her research articles have all appeared in A-rated tax journals, covering both tax law and tax policy.

As an international academic journal encompassing the full range of tax law, policy and administration, the *eJournal* has been receiving a steadily growing number of submissions from all over the world. In her capacity as Associate Editor, Alex will be assisting the Co-editors to manage this increasing volume of submissions, particularly in desk reviewing submitted papers.

Peter is currently a Research Fellow in the Department of Business Law and Taxation at Monash University. He obtained his PhD in taxation law from Monash Business School, Monash University. He is an established tax law scholar with many research publications.

Peter has successfully collaborated with several Atax academics in many past and current research projects. Recently he acted as Guest Production Editor for a special issue of the *eJournal* issue on tax corruption, which was edited by Professor Chris Evans (vol. 15, no. 2, 2017). He is well known for his dedication to his work, exceptional editorial skills, and first-class quality of his editing work.

We are confident that the appointments of Alex and Peter will greatly enhance the reputation of the *eJournal of Tax Research* as a SCOPUS indexed, ABDC A-rated journal.

John Taylor, TABL, UNSW Sydney  
Binh Tran-Nam, TABL, UNSW Sydney  
September 2018

# Interpreting the Australian income tax definition of ‘ordinary income’: ritual incantation or analysis, when examined through the lens of early twentieth century linguistic philosophy?

Mark Burton\*

## ***Abstract***

This article examines the interpretation of subsection 6-5(1) of the *Income Tax Assessment Act 1997* (Cth). The High Court of Australia has concluded that subsection 6-5(1) should be understood upon the basis that it adopts some or all of the elements of the oft-quoted dictum of Sir Frederick Jordan in *Scott v Commissioner of Taxation*. The article shows that different decisions of the High Court of Australia have adopted different statements of the elements of the dictum that ought to be referred to, and some decisions of the High Court have ignored the dictum altogether. Moreover, no High Court decision has analysed the statement of Jordan CJ. This article addresses this absence of analysis by offering an analysis of that dictum having regard to the vibrant, contemporaneous linguistic philosophy of the early twentieth century. This analysis suggests that Sir Frederick Jordan’s dictum is vague and appears to incorporate unresolved contradictions.

**Key words:** income tax law, ordinary income, statutory interpretation, linguistic philosophy

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\* Associate Professor, Melbourne Law School.

## 1. INTRODUCTION

At the heart of the Australian income tax one of the core assessing provisions – subsection 6-5(1) of the *Income Tax Assessment Act* 1997 (Cth) – states that 'your assessable income includes income according to ordinary concepts, which is called ordinary income'. This 'plain language' definition was adopted in the context of common public acknowledgement that a clearer definition of 'income' was needed.<sup>1</sup> However, statutory guidance regarding the meaning of ordinary income is extremely limited.<sup>2</sup> Likewise, the extrinsic materials provide no clear guidance upon the meaning of the statutory terms.<sup>3</sup>

In the course of considering subsection 6-5(1), the High Court of Australia has emphasised the significance of the statement of Jordan CJ in *Scott*<sup>4</sup> and has indicated that several elements of his Honour's statement 'are no mere matters of ritual incantation; they identify the essential nature of the inquiry'.<sup>5</sup> Somewhat confusingly, different majority decisions in the High Court have adopted different statements of the elements to be extracted from Sir Frederick Jordan's statement<sup>6</sup> or have even ignored this 'essential nature of the inquiry' altogether.<sup>7</sup> This confusion is also manifest in the specification of the test in the lower courts,<sup>8</sup> in extrajudicial discussion<sup>9</sup> and in extrajudicial scepticism as to the basis upon which amounts are characterised for income

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<sup>1</sup> Joint Committee of Public Accounts, Commonwealth Parliament, *An Assessment of Tax*, Report No 326 (1993) 76. Prior to the enactment of the *Income Tax Assessment Act* 1997 (Cth), Australian income tax legislation at both federal and state levels referred to the general concept of 'income' without comprehensively defining that term for the purposes of the income tax legislation. The *Income Tax Assessment Act* 1915 (Cth) referred to income, providing an inclusive definition in section 3 which stated that "'Income" includes interest upon money secured by mortgage of any property in Australia'. Section 3 of the *Income Tax Assessment Act* 1922 (Cth) expanded this inclusive definition by including within the concept of 'income' some payments to members of cooperatives while excluding rebates paid to members of cooperatives as well as the component of a purchased annuity that is attributable to the purchase price of that annuity. Section 25 of the *Income Tax Assessment Act* 1936 (Cth) referred to 'income'. For the purpose of differentiating between different classes of income, all of these earlier Acts regarding income tax defined 'income from personal exertion' and 'income from property'. However, as noted in many case decisions, these definitions included 'income' on both sides of the definition and therefore did not define income itself.

<sup>2</sup> Note the definitions of 'income from personal exertion' and 'income from property', which generally have been regarded as providing little guidance regarding the concept of income because they refer to income on both sides of the definition: per Windeyer J in *Scott v Federal Commissioner of Taxation* (1966) 117 CLR 514, 524 (citing Jordan CJ in *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215, 219); note, however, the apparent reliance upon the definition of income from personal exertion in *Stone*, without reference to the earlier case law and without close analysis of the limitations of the statutory definition: *Commissioner of Taxation v Stone* (2005) 222 CLR 289, 296-297 [17].

<sup>3</sup> Chief Justice Robert French, 'Law – Complexity and Moral Clarity' (2013) 40(6) *Brief* 25, 25; the limited usefulness of the Explanatory Memorandum is critically assessed in a second article under preparation by this author.

<sup>4</sup> *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215, 220.

<sup>5</sup> *Federal Commissioner of Taxation v Montgomery* (1999) 198 CLR 639, 661 [64].

<sup>6</sup> Discussed in section 2 of this article.

<sup>7</sup> *Federal Commissioner of Taxation v McNeil* (2007) 229 CLR 656.

<sup>8</sup> *Federal Commissioner of Taxation v McNeil* [2005] FCAFC 147, 144 FCR 514, per French J, [40]; cf the fuller statement of Sir Frederick's approach by Dowsett J in *McNeil*, [2005] FCAFC 147 [207].

<sup>9</sup> G T Pagone, 'Income and Capital Distinction', paper delivered at the South Australian Convention of the Taxation Institution of Australia, 9 May 2009, 2, citing *Scott* as authority for the process for determining income specified by Dixon J in *The Commissioner of Taxes (South Australia) v The Executor Trustee and Agency Company of South Australia Limited (Carden's Case)* (1938) 63 CLR 108, 152.

tax purposes.<sup>10</sup> Writing extrajudicially, Chief Justice French opined that judicial formulations of the income concept were 'broad, but almost content-free, generalisations'.<sup>11</sup> Referring to the High Court decision in *McNeil*,<sup>12</sup> his Honour observed that the decision illustrates how '[a] simple broadly expressed provision on the one hand attracts a plethora of judicial exposition such that some would say the true meaning of the statute, if it has one, is buried in the cases'.<sup>13</sup>

This confusion regarding the terms that subsection 6-5(1) is taken to incorporate, and also the meaning of those terms, is difficult to dispel because of the absence of close analysis of the elements of Sir Frederick Jordan's statement in the High Court decisions that apparently adopt that statement.<sup>14</sup> The absence of such analysis is cause for questioning the High Court's observation that reference to the Jordan CJ definition is not a matter of ritual incantation.<sup>15</sup> If Sir Frederick Jordan's statement were to be analysed, what would this analysis reveal? Would it reveal what might hitherto have been the hidden elements of the concept of income according to ordinary concepts? Or would such analysis expose irresolvable tensions between the elements of that statement?

This article takes the High Court's rejection of ritual incantation seriously by critically analysing the elements of Sir Frederick Jordan's statement. The purpose of this analysis is to determine whether that statement provides secure foundations for the concept of income according to ordinary concepts. The reference to 'the essential nature of the inquiry'<sup>16</sup> in *Montgomery* implies that firm intellectual footings can be found in Sir Frederick Jordan's statement. The narrative here is of an objectively specified inquiry that constitutes the foundation for identification of the 'ordinary income' component of the Australian income tax base.<sup>17</sup> This narrative simultaneously draws upon and reinforces the 'orthodox' narratives of the rule of law and judicial constraint, which

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<sup>10</sup> 'I suspect, but can not verify, that most judges decide first the outcome they wish to reach and then use the appropriate maxim of interpretation to justify it, rather than first applying the maxim of interpretation to reach the outcome': Justice D Graham Hill, 'A Judicial Perspective on Tax Law Reform' (1998) 72(9) *Australian Law Journal* 685, 686.

<sup>11</sup> French, above n 3, 25.

<sup>12</sup> *Federal Commissioner of Taxation v McNeil* (2007) 229 CLR 656.

<sup>13</sup> French, above n 3, 28.

<sup>14</sup> In another paper my review of relevant High Court decisions indicates that no such analysis is to be found in the respective majority judgments in those case decisions.

<sup>15</sup> See, for example, *Foots v Southern Cross Mine Management Pty Ltd* (2007) 234 CLR 52, 73 [55]: 'British Gold Fields is a case whose authority stems more from repetition than from analysis', per Gleeson CJ, Gummow, Hayne and Crennan JJ. It is possible that this close analysis has been undertaken but not written into the relevant High Court judgments, in which case those case decisions do not transparently reflect all of the significant logical steps in reasoning to the conclusions reached. See, for example: Sir Frank Kitto, 'Why Write Judgments?' (1992) 66 *Australian Law Journal* 787; Sir Harry Gibbs, 'Judgment Writing' (1993) 67 *Australian Law Journal* 494; Stephen Gageler, 'Why Write Judgments?' (2014) 36(2) *Sydney Law Review* 189.

<sup>16</sup> *Federal Commissioner of Taxation v Montgomery* (1999) 198 CLR 639, 661 [64].

<sup>17</sup> See, for example, Matthew Kramer, *Objectivity and the Rule of Law* (Cambridge University Press, 2009) ch 2; Larry Alexander, 'The Objectivity of Morality, Rules, and Law: A Conceptual Map' (2013) 65(2) *Alabama Law Review* 501; Nicos Stavropoulos, *Objectivity in Law* (Oxford University Press, 1996). For the view that 'legislative intention' is the relevant 'object', see Richard Ekins and Jeffrey Goldsworthy, 'The Reality and Indispensability of Legislative Intentions' (2014) 36(1) *Sydney Law Review* 39.



depict judges applying more or less determinate law in a manner consistent with the rule of law.<sup>18</sup>

My argument in this article is that judicial analysis of Sir Frederick Jordan's judgment is necessary if the High Court is to move beyond ritual incantation of the statement that apparently specifies the essential nature of the inquiry into the meaning of income. Further, I suggest that such analysis is best undertaken through the lens of the vibrant debate regarding linguistic philosophy which emerged as Western philosophy worked itself through its 'linguistic turn' from the late nineteenth century.<sup>19</sup> That debate included close consideration of different accounts of linguistic meaning. On one view advanced in the course of this debate, any linguistic element (a word, phrase, sentence, etc) embodied the formal specification of its meaning. Another view was that the meaning of any linguistic element was to be found in the conventional usage of that element. To be clear, this article is not presenting the argument that the dictum of Jordan CJ in *Scott* is directly or indirectly referring to this philosophical literature. The judgments of Jordan CJ do not expressly refer to this philosophical literature, and nor does biographical material expressly state that Jordan CJ was aware of this literature notwithstanding his keen interest in literature.<sup>20</sup> However, the reason for referring to this philosophical literature is that it expresses most clearly the different views regarding sources of linguistic meaning that are commonly referred to by us all when we examine the nature of linguistic meaning. When we discuss linguistic meaning we commonly refer to these different sources of meaning. We might say 'we use "income" to mean ...' and we might also say 'the semantic meaning is ...'. The semantic and pragmatic strands of linguistic philosophy are not distinctly 'philosophical' – they echo common understandings of competing foundations of linguistic meaning.

When viewed through this lens, it can be seen that Sir Frederick Jordan's statement gains rhetorical force from the apparent synthesis of the intellectual foundations that underpinned different strands of early twentieth century linguistic philosophy and also common understandings of the foundations of linguistic meaning. I argue that this rhetorical force should be tested by critically assessing whether Sir Frederick successfully threaded disparate strands into a durable fabric that underpins a stable and determinate meaning of 'income' or 'ordinary income'.<sup>21</sup> In undertaking this analysis, I argue that the elements of Sir Frederick's statement are ill-defined and quite possibly reflect fundamentally irreconcilable approaches to specifying the nature of the inquiry into income and also the nature of income itself. The significant practical and theoretical

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<sup>18</sup> French, above n 3, 30. See also Murray Gleeson, 'The Meaning of Legislation: Context, Purpose and Respect for Fundamental Rights' (2009) 20(1) *Public Law Review* 26, 27.

<sup>19</sup> For a useful critical overview of the development of linguistic philosophy over the latter part of the nineteenth century and the first half of the twentieth century see P M S Hacker, 'The Linguistic Turn in Analytic Philosophy' in Michael Beaney (ed), *The Oxford Handbook of the History of Analytic Philosophy* (Oxford University Press, 2013) 926.

<sup>20</sup> See J M Bennett, *Portraits of the Chief Justices of New South Wales 1824-1977* (John Ferguson, 1977); J M Bennett, *A History of the Supreme Court of New South Wales* (Law Book Co, 1974); Maurice Byers, 'Recollections of Sir Frederick Jordan' (1991)(Winter) *Bar News* 13. This material notes that Sir Frederick Jordan had a keen interest in literature, but does not directly refer to any awareness of the philosophy of language.

<sup>21</sup> Hacker, above n 19, noting that analytical school may still have several decades of life. With respect to tax jurisprudence, there is ongoing interest in Wittgenstein's work, which was a key legacy of the linguistic turn: Bret N Bogenschneider, 'Wittgenstein on Why Tax Law is Comprehensible' [2015] 2 *British Tax Review* 252.

consequences of these conclusions are noted briefly in the conclusion of this article and chart a future research program.

## 2. SIR FREDERICK JORDAN'S STATEMENT IN *SCOTT*

Sir Frederick Jordan's statement was made in relation to the former New South Wales income tax legislation.<sup>22</sup> That legislation imposed tax upon 'taxable income'<sup>23</sup> which was defined to be the amount of assessable income left after taking away allowable deductions.<sup>24</sup> Assessable income was defined to be the gross income after excluding amounts of income specifically exempted.<sup>25</sup> In effect, the concept of income was left undefined because 'income' was defined to mean 'income derived ... directly or indirectly ...'.<sup>26</sup> In *Scott* the taxpayer was appointed to a statutory Board and that Board was subsequently dissolved by the *Meat Industry (Amendment) Act 1932*. That Act also stated that members of the Board should be compensated in the amount that they would have received had their services been terminated otherwise than according to law. The taxpayer received a lump sum of £7,000 as compensation. By way of case stated, the New South Wales Court of Appeal was asked to determine whether the compensation received by Mr Scott was 'income'.

In this context, and in deciding that the lump sum was not 'income', Jordan CJ<sup>27</sup> observed that the assessment of 'income' appeared in the context of income tax legislation, and continued:

The word 'Income' is not a term of art and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to [be applied].<sup>28</sup>

This dictum addresses two fundamental matters: the subject of the inquiry into the ordinary meaning of a statutory term and also the process by which the ordinary meaning is extracted from examination of that subject matter. Different interpretations of the dictum identify differing specifications of the subject matter and the process.

On its face, the first part of the dictum describes a four-stage inquiry, the logical order<sup>29</sup> of which is:

1. determine whether the statutory language is a 'term of art';

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<sup>22</sup> *Income Tax (Management) Act 1928* (NSW).

<sup>23</sup> *Income Tax (Management) Act 1928* s 8(1).

<sup>24</sup> *Income Tax (Management) Act 1928* s 4.

<sup>25</sup> *Income Tax (Management) Act 1928* s 4.

<sup>26</sup> In relation to the definitions of 'income from personal exertion' and 'income from property', see comments at n 2, above.

<sup>27</sup> Stephen and Street JJ agreeing on this point. Stephen J decided that the amount was assessable as a 'retiring allowance'.

<sup>28</sup> *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215, 219.

<sup>29</sup> As opposed to the order in which the stages of the inquiry are identified in the dictum of Jordan CJ.

2. if the statutory language is not a 'term of art', such as the statutory reference to 'income', identify the set comprising 'ordinary concepts and usages';
3. review this broad set in order to identify receipts of a form that are comprehended as income under ordinary concepts and usages; and
4. consider the principles that are applied for determining how much of a receipt that fits a requisite form 'ought to be treated as income'.

Thus, for statutory terms that are not 'terms of art', the subject matter comprising 'ordinary concepts and usages' is analysed for the purpose of identifying the forms and principles governing inclusion in the relevant set. These forms and principles are then applied to identify members of the set identified by the statute (such as 'income'). This approach examines what might be described as the logical fabric of our language that may lie 'beneath' or be seen to underpin the meaning of terms according to ordinary concepts and usages.

However, on a different interpretation, the proviso in the latter part of Sir Frederick Jordan's statement suggests that different subject matter and a different process should be adopted. This proviso refers to identifying amounts that are income 'in ordinary parlance'. On one interpretation of this approach, a judge would examine 'ordinary parlance' to produce a list of receipts that have come to be labelled as 'income' 'in ordinary parlance'. On this interpretation, and in contrast to the analytical approach identified in the first part of the dictum, the second part of the statement focuses upon the 'surface meaning' that is presumably obvious to any observer of ordinary parlance prepared to compile a list of things referred to by each linguistic 'label'.<sup>30</sup> This interpretation appears to be supported by Sir Frederick Jordan's subsequent observations, arrived at without any preceding express analysis of 'income', that Mr Scott's compensation sum was not 'income' according to its 'ordinary'<sup>31</sup> and/or according to its 'natural'<sup>32</sup> meaning. An observer could reasonably interpret these observations to imply that 'income' is a label that need not be analysed in order to identify the set of rules governing inclusion in the set 'income' because the term 'income' may have come to be applied to all sorts of things by convention. On this reading of the judgment, we do not need to analyse the meaning of 'income' to arrive at the conclusion that 'income' does not refer to a compensation sum such as Mr Scott's, because we intuitively know that the label would never be applied to such a sum 'in ordinary parlance'.

A third interpretation of Sir Frederick's reference to 'ordinary parlance' could be that this is no more than a shorthand reference to the analytical extraction of forms/principles described in the first part of the statement. This approach would overcome the possibility of any inconsistency between the first and second parts of the statement, but only by adopting an interpretation of 'ordinary parlance' that appears to contradict the majority's decision in *Montgomery*, in which the majority appeared to treat the two elements as though they were not substitutable.

These tensions within Sir Frederick's statement will be examined more closely in section 5 of this article. However, for present purposes suffice it to say that Jordan CJ

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<sup>30</sup> See the discussion of the naming theory of meaning in section 4.2.

<sup>31</sup> *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215, 219.

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

might be taken to have contemplated two quite different approaches to identifying the meaning of 'income'. Before turning to further analysis of this statement, it is appropriate to review the adoption of the statement of Jordan CJ by the High Court of Australia in some decisions upon the meaning of 'ordinary income' over the past two decades.<sup>33</sup>

### 3. THE HIGH COURT'S ADOPTION OF THE JORDAN CJ DEFINITION OF 'INCOME' WHEN INTERPRETING SUBSECTION 6-5(1)

In the course of considering the definition of ordinary income in subsection 6-5(1), in some decisions the High Court has emphasised the significance of the statement of Jordan CJ. The purpose of this section of the article is to establish two propositions with respect to the adoption of Sir Frederick's statement in various High Court decisions. The first proposition is that the elements of Sir Frederick's statement have not been analysed by the High Court. Following from this first proposition, the second proposition is that this absence of analysis has allowed different judicial paraphrases of Sir Frederick's statement to be adopted without criticism. This confusion about the substantive content of Sir Frederick's statement is only compounded by the fact that some High Court decisions dealing with the meaning of ordinary income have not referred to Sir Frederick's statement at all, leaving open the possibility that Sir Frederick's statement may not be as significant as other High Court decisions suggest.<sup>34</sup>

In dealing with the application of the former section 25(1) of the *Income Tax Assessment Act 1936* (ITAA 1936), the majority's joint judgment in *Montgomery* observed that counsels' submissions had been framed upon analogies to decided cases, and continued:

That approach is often helpful, but resort to analogy should not be permitted to obscure the essential nature of the inquiry which is to determine whether 'in ordinary parlance' the receipt in question is to be treated as income. As Jordan CJ made plain, the references to 'ordinary parlance' and to the 'ordinary concepts and usages of mankind' are no mere matters of ritual incantation; they identify the essential nature of the inquiry.<sup>35</sup>

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<sup>33</sup> For a review of Australian decisions in which the dictum of Jordan CJ was directly referred to, see Mark Burton, 'A review of judicial references to the dictum of Jordan CJ, expressed in *Scott v Commissioner of Taxation*, in elaborating the meaning of "income" for the purposes of the Australian income tax' (2017) 9 *Journal of Australian Taxation* 297.

<sup>34</sup> This article clearly proceeds upon the basis that judicial words within a judgment have a meaning and that this meaning is important to the legitimacy of judgments. The legitimacy of judgments, according to the widely accepted understanding of law framed in terms of 'legal objectivity', exists because a judgment explains how the outcome of the case was arrived at 'according to law'. The law is an object which pre-exists any judgment and so the judge discovers the relevant law and applies that law to the facts of the particular case. Taking judicial words in judgments seriously, by analysing those words in pursuit of an understanding of the judicial discovery of the statutory meaning, is routine in legal analysis. Acknowledging this significance of judicial words in judgments is consistent with the principle that judicial words in a judgment do not supplant the meaning of statutory terms, but rather reveal how the meaning of statutory terms was discovered and how that meaning was applied in a particular case. In this section of the article, I discuss the different judicial descriptions of the meaning of the dictum of Jordan CJ that have been adopted in judgments of the High Court. In doing so, I identify differing verbal formulations that appear to describe the meaning of that dictum. I finish this section by noting that this proliferation of judicial formulations of the meaning of Sir Frederick Jordan's dictum is problematic if we accept the proposition that the statutory text in subsection 6-5(1) only has one meaning which, according to the widely accepted account of legal objectivity, pre-exists any case decision.

<sup>35</sup> *Federal Commissioner of Taxation v Montgomery* (1999) 198 CLR 639, 661 [64].

This statement of the majority in *Montgomery* indicates that Sir Frederick's statement should be the starting point for any consideration of whether a particular amount is 'income'. However, according to its terms, this statement differs from that of Jordan CJ in several important respects.

First, *Montgomery* does not expressly refer to the forms/principles analysis described by Jordan CJ.

Second, *Montgomery* appears to identify several quite different and incomparable 'essential natures of the inquiry' in the statement of Jordan CJ. The first such specification of the relevant inquiry is expressly identified as the identification of whether 'in ordinary parlance' a receipt is '*to be treated as income*'. However, this statement could be interpreted in different ways. This could be a reference to the forms/principles analysis of Jordan CJ outlined above. Alternatively, the statement could be a reference to the 'surface meaning' approach described by Jordan CJ in the second part of his Honour's statement, also outlined above. As a further possible alternative, could 'is to be treated as income' be taken to mean that the courts will determine whether a particular amount 'is to be treated as income' and that this *stipulation* of meaning thereafter will be adopted in ordinary parlance?

The second essential nature of the relevant inquiry identified in *Montgomery* requires reference to 'ordinary parlance' and to 'the ordinary concepts and usages of mankind'. However, although the majority in *Montgomery* stated that these phrases describe the nature of the inquiry, these phrases do not describe a process of inquiry but do potentially identify subjects of an inquiry. The phrases identify what is to be examined without specifying the process of examination. Moreover, the two phrases are not synonymous. 'Ordinary concepts and usages' could include written usages, for example, and 'parlance' generally would not refer to written usage.<sup>36</sup> Given this potential conflict, the relationship of these two elements should have been made clear in *Scott* and/or in *Montgomery*. In the absence of any judicial elaboration of these potentially inconsistent elements, the application of Sir Frederick's statement remains problematic after *Montgomery*.

In *Federal Commissioner of Taxation v Stone*<sup>37</sup> the High Court was called upon to determine whether receipts of a sportsperson were 'ordinary income' for the purposes of section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997). The 'plain language' definition of 'ordinary income' in subsection 6-5(1) was quoted at the beginning of this article. One question that arose was whether this definition incorporated a change to the law. The former legislation merely referred to 'income' while the new legislation defined the new statutory concept of 'ordinary income' to be 'income according to ordinary concepts'. There was no comparable 'old law' definition of income and the definition of 'ordinary income' clearly did not duplicate all of Sir Frederick's statement.

In the course of deciding that Stone's receipts were ordinary income, the joint judgment referred to ITAA 1997, section 1-3<sup>38</sup> and immediately concluded that subsection 6-5(1)

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<sup>36</sup> See the discussion of this matter in section 4.8 below.

<sup>37</sup> (2005) 222 CLR 289.

<sup>38</sup> The High Court did not analyse the text of section 1-3.

was an 'evident reference'<sup>39</sup> to the decision of Jordan CJ in *Scott*. Sir Frederick's statement in *Scott* was then extracted in full.

Later in the joint judgment in *Stone*, the plurality noted that the existence of a business activity 'perhaps very often' will carry with it the conclusion that the proceeds of that business activity are ordinary income.<sup>40</sup> However, the joint judgment appears to have adopted a definition of ordinary income that is not necessarily supported by the text of subsection 6-5(1) and nor by the statement of Sir Frederick Jordan:

Asking whether a person was carrying on a business may therefore be useful and necessary. But the inquiry about "business" must not be permitted to distract attention from the question presented by both the 1936 Act and the 1997 Act. That question seeks to identify whether a receipt is, or receipts are, "income". As s 6-5 of the 1997 Act makes plain, that requires consideration of whether the receipt in question is income *in accordance with "the ordinary concepts and usages of mankind"* (emphasis added).<sup>41</sup>

With respect, the adoption of Sir Frederick's statement in *Stone* is open to criticism. One cause for criticism is that the text of subsection 6-5(1) is substantially different to the text of Sir Frederick's statement. Given this difference, the conclusion that subsection 6-5(1) adopted all of Sir Frederick's statement does not necessarily follow from the premise that subsection 6-5(1) incorporates one phrase from Sir Frederick's statement. If anything, there is a good case for concluding that the more narrowly framed statutory text should prevail over the inquiry more fully expressed by Sir Frederick,<sup>42</sup> rather than taking the statutory text to have adopted the entire dictum of Jordan CJ.

Moreover, the joint judgment in *Stone* did not undertake any express textual analysis of ITAA 1997, section 1-3, but stated that '[b]ecause the 1997 Act contains provisions of the 1936 Act in a rewritten form, construing the word "income" in the 1997 Act requires reference to the definition in s 6(1) of the 1936 Act of "income from personal exertion"'.<sup>43</sup> This statement indicates that the majority accepted that the provisions of the ITAA 1997 necessarily had the same meaning as the comparable provisions found in the ITAA 1936. However, this conclusion is inconsistent with section 1-3 itself,<sup>44</sup> the statutory framework of the ITAA 1997<sup>45</sup> and the relevant statement in the Explanatory

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<sup>39</sup> *Commissioner of Taxation v Stone* (2005) 222 CLR 289, 294 [8].

<sup>40</sup> *Ibid* 296 [16].

<sup>41</sup> *Ibid*.

<sup>42</sup> See, for example, *FCT v Slater Holdings Limited* (1954) 15 CLR 447; Gageler J in *Baini v The Queen* [2012] HCA 59; 24 CLR 469 [43].

<sup>43</sup> *Commissioner of Taxation v Stone* (2005) 222 CLR 289, 296-297 [17]. This statement appears to be a reference to the earlier statement that 'section 1-3(1) of the 1997 Act provides that the 1997 Act contains provisions of the 1936 Act 'in a rewritten form': *ibid* [9].

<sup>44</sup> Beginning with the conditional conjunction 'if', subsection 1-3(2) requires consideration of whether it is true that the ITAA 1997 appears to have expressed the same idea as that which was expressed in the ITAA 1936. On the reading of subsection 1-3(1) adopted in *Stone*, the test set out in subsection 1-3(2) would necessarily be answered in the affirmative. In this case, why would the legislature have used the conditional 'if'?

<sup>45</sup> Section 15-2, for example, clearly recognises that it is subordinate to the general income rule in section 6-5(1). By contrast, the former comparable rule (ITAA 1936 s 26(e)) took priority over the former general assessing rule in ITAA 1936 s 25(1).

Memorandum accompanying the Bill for the ITAA 1997.<sup>46</sup> Deciding that section 1-3 applies without analysing its terms first is contrary to the description of orthodox interpretative practice set out in various High Court decisions.<sup>47</sup> This is particularly significant given the rebuttable presumptive rule of statutory interpretation that different statutory words are presumed to be intended to have a different meaning.<sup>48</sup>

The joint judgment in *Stone* refers to the decision in *Montgomery* in support of other propositions regarding the concept of ordinary income.<sup>49</sup> However, the joint judgment in *Stone* does not directly refer to the consideration of *Scott* in *Montgomery*. This oversight is extraordinary, given the observation in *Montgomery* that the decision in *Scott* specifies the essential nature of the relevant inquiry into the nature of income.

Finally, at different points the joint judgment appears to adopt different elements of Sir Frederick's statement. At paragraph 8 the joint judgment extracted Sir Frederick's statement in full, which suggests that the entire statement ought to be adopted for the purpose of identifying 'income'. At paragraph 16, extracted above, the joint judgment appears to adopt just one part of Sir Frederick's statement: 'income in accordance with "the ordinary concepts and usages of mankind"'.<sup>50</sup>

In *FCT v Anstis*<sup>51</sup> the joint judgment in the High Court also appears to have adopted an ambiguous position with respect to Sir Frederick Jordan's statement by referring to the decision in *Stone* with approval, by adopting the limited reference to elements of Sir Frederick's statement in *Montgomery*<sup>51</sup> and by paraphrasing that statement with full reference to the forms/principles inquiry:

As has been said [citing *Stone*], that is an evident reference to the statement by Jordan CJ that the forms of receipt falling within the term 'income', and the principles to be applied to ascertain how much of those receipts ought to be treated as income, 'must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income' [citing *Scott*]. The reference to 'ordinary parlance' and to the 'ordinary usages of mankind' are 'no mere matters of ritual incantation; they identify the essential nature of the inquiry' [citing *Montgomery*].<sup>52</sup>

In *Commissioner of Taxation v McNeil*<sup>53</sup> the joint judgment made no direct reference to Sir Frederick Jordan's statement or to the High Court decisions adopting that statement for the purposes of subsection 6-5(1). Rather, the decision in *McNeil* was grounded upon

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<sup>46</sup> The Explanatory Memorandum noted that 'most provisions are being rewritten without any intention of changing their effect': Explanatory Memorandum accompanying the Income Tax Assessment Bill 1996, 34.

<sup>47</sup> *Project Blue Sky Inc v Australia Broadcasting Authority* (1998) 194 CLR 355, 381-382 [69].

<sup>48</sup> D C Pearce and R A Geddes, *Statutory Interpretation in Australia* (LexisNexis Australia, 8th ed, 2014) 150-154 [4.6]-[4.7].

<sup>49</sup> See *Commissioner of Taxation v Stone* (2005) 222 CLR 289, 297 [18] and 306 [60].

<sup>50</sup> (2010) 241 CLR 443.

<sup>51</sup> *Federal Commissioner of Taxation v Montgomery* (1999) 198 CLR 639, 661 [64].

<sup>52</sup> *Federal Commissioner of Taxation v Anstis* (2010) 241 CLR 443, 450 [13].

<sup>53</sup> *Commissioner of Taxation v McNeil* (2007) 229 CLR 656.

acceptance of Justice Pitney's statement of principle in *Eisner v Macomber*,<sup>54</sup> as adopted by the High Court in *Montgomery*.<sup>55</sup>

In *Spriggs* the unanimous Full High Court decision observed:

It was not disputed that these payments were income according to the concept of 'ordinary income' under s 6-5 of the ITAA, that is, within 'the ordinary concepts and usages of mankind' [citing *Scott*].<sup>56</sup>

The endnote to this text referred to the decision of Jordan CJ in *Scott*, the decision in *Stone* and also to the Explanatory Memorandum accompanying the Income Tax Assessment Bill 1996.

In section 2 of this article I suggested that Sir Frederick Jordan's statement in *Scott* incorporated two apparently different approaches to identifying 'income' and, moreover, that his Honour did not elaborate upon the elements of these approaches in the course of his judgment. The review of High Court judgments dealing with Sir Frederick Jordan's statement in this section of the article demonstrates that those decisions have not incorporated express, close analysis of that statement. This absence of close analysis of Sir Frederick Jordan's definition is striking, given the reasons for the preparation of written judgments in the appellate courts.<sup>57</sup> Arguably, express analysis of Sir Frederick's judgment would have shone light upon the meaning and application of the elements of Sir Frederick's statement. This critical appraisal of *Scott* would have avoided the omissions and inconsistencies regarding this matter that can be seen in the decisions in *Montgomery*, *Stone*, *Anstis*, *McNeil* and *Spriggs*. Upon the basis of those decisions, there are at least five, and potentially six, different approaches to the relevance of Sir Frederick's statement for the purpose of identifying 'ordinary income':

1. the full statement of Jordan CJ in *Scott* (*Stone*, *Anstis*);
2. 'income according to the ordinary concepts and usages of mankind' (*Stone*, *Spriggs*);
3. 'ordinary parlance' (*Montgomery*);
4. 'ordinary concepts and usages of mankind' and 'ordinary parlance' (*Montgomery*);
5. the statement may not be relevant to the determination of some 'income' cases, given the adoption of a different approach in *McNeil* with respect to income from property without any reconciliation to Sir Frederick's statement; and
6. apply the terms of the statutory text – 'income according to ordinary concepts' – given that the general rules of statutory interpretation place considerable emphasis upon the statutory text, particularly in the absence of any clear

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<sup>54</sup> 252 US 189, 206-207 (1920).

<sup>55</sup> (1999) 198 CLR 639, 660-663. See critical discussion of these judgments in Neil Young QC, 'The Historical Significance of the High Court's Decision in *Federal Commissioner of Taxation v The Myer Emporium Ltd*' (2007) 31(1) *Melbourne University Law Review* 266, 285ff.

<sup>56</sup> *Spriggs v Federal Commissioner of Taxation* (2009) 239 CLR 1, 17.

<sup>57</sup> See the material referred to at n 15 above.



rationale for displacing the statutory text of subsection 6-5(1) with some other judicial words more or less drawn from the statement of Sir Frederick in *Scott*.

This proliferation of general statements of principle regarding the process for identifying the meaning of 'ordinary income', apparent within particular case decisions (eg, *Stone*) as well as across different decisions, should be of concern to any observer who considers that the law 'works itself pure' by progressively identifying the respective determinate meanings of statutory terms. These general statements are not tailored to the facts of particular cases because they describe the *process* for identifying the meaning of ordinary income, rather than the outcome of the process, the meaning of income. The process for identifying the meaning of ordinary income should be the same in any case, and this is reflected in the singular reference to 'the essential nature of the inquiry' in *Montgomery*.

#### 4. IDEAS OF 'MEANING' AROUND THE TIME OF SIR FREDERICK JORDAN'S STATEMENT

In the absence of judicial analysis of Sir Frederick's statement, different commentators could adopt different approaches to elaborating the meaning and significance of that statement. I have decided to examine the statement by locating it within its historical context, and in particular by critically analysing that statement through the lens of linguistic philosophy that so preoccupied early twentieth century Western philosophers. By doing so I am not implying that judges are or should be philosophers.<sup>58</sup> However, as will become apparent, analysis of the meaning of the elements of Sir Frederick Jordan's statement in *Scott* is enhanced by examining those elements in the context of the themes within the contemporaneous linguistic philosophy.

Two matters are central to identifying the meaning of legislation:

1. In general terms, how does language 'latch onto' ideas and things in our world so that we can use language to communicate about those ideas and things?

For example, when we use the word 'income' to describe a particular amount, what is it that we are referring to? Does the 'incomeness' of the amount inhere in the essential nature of the particular amount, in its DNA if you like? Or is the incomeness of the amount determined irrespective of the essential nature of the amount itself, and found rather in the semantic or conventional rules governing our use of the label 'income' when we perceive and understand our world? Or is 'income' whatever the legislature intended should be treated as income?

Our answers to these questions determine what we examine when identifying the meaning of statutory terms – the intrinsic nature of the things in the world to which we attach our linguistic labels, our linguistic conventions regarding the semantic meaning of linguistic symbols or the rules of usage regarding those symbols or the intention of the 'speaker' who uttered the linguistic symbols.

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<sup>58</sup> This matter has attracted opposition from legal positivists such as Joseph Raz, apparently upon the basis that philosopher judges would import metaphysics into the law - a proposition anathema to legal positivism: Joseph Raz, *Between Authority and Interpretation* (Oxford University Press, 2009) 53, 79ff. By contrast, Ronald Dworkin's natural law theory accommodated the concept of the philosopher judge who would grapple with metaphysical principles underpinning the law: Ronald Dworkin, *Law's Empire* (Belknap Press, 1986) 90.

This is the metaphysical aspect of statutory interpretation; and

2. Once the first question above is answered, what is the process by which we identify the meaning of the language unit and how do we specify the standard to be applied in determining that a claim to have found that meaning should be accepted as true?

This is the epistemological aspect of statutory interpretation.<sup>59</sup>

This brief reference to the interrelated metaphysical and epistemological questions is sufficient to indicate that a *meaningful* definition of ordinary income will explicitly and/or implicitly answer both questions by telling us what makes something 'income' and also by telling us how to go about verifying the truthfulness of a statement that a particular amount is/is not income. Some or even all of these matters might be addressed by expressly or implicitly adopting social norms, such as the norms of logic.<sup>60</sup>

#### 4.1 What is statutory language referring to? The concept of income and the problem of universals

The concepts of 'ordinary', 'usage', 'parlance', 'concept' and 'income' are all instances of universals, in that they name general categories of particular instances.<sup>61</sup> When we examine a particular monetary sum (say, 'the \$1,000 paid by Tom to Mary at 8:01am on 15 June 2016') to determine whether it falls within the set of monetary sums that we call 'income', we are confronting what philosophers refer to as the problem of universals. The problem of universals grapples with the basis upon which we determine that a particular instance is appropriately determined to fall within a universal category. Commentators have identified three broad categories of theories regarding the problem of universals: realism, conceptualism and nominalism.

##### 4.1.1 Realism

Realist approaches to this metaphysical question share the idea that things that we know of or perceive *exist* and also exist independently of our thoughts or beliefs about those objects of our thought. Some commentators appear to have adopted some form of realism when considering the basis upon which particular amounts are identified as income. Prebble, for example, suggests that a particular receipt has a substantive essence or nature that legal characterisations can only imperfectly identify.<sup>62</sup> Upon this basis, Prebble argues that the law of income taxation must always be incomprehensible because it can never hope to operate upon the 'real' natures of particular amounts.<sup>63</sup>

One strand of realism, developed by Plato, holds that a universal is an ideal form of a property that exists independently of any particular instance of the universal *and* is also manifest in each particular instance of that universal. The ideal Form exists independently of thought, time and space, being received by humans prior to birth and 'remembered' afterwards by an intellectual elite (philosophers). Reference to a

<sup>59</sup> Michael Moore, 'A Natural Law Theory of Interpretation' (1985) 58(1-2) *Southern California Law Review* 277, 291.

<sup>60</sup> Raz, above n 58; Ekins and Goldsworthy, above n 17, 67.

<sup>61</sup> Aristotle defined universals as being 'predicated of many': Aristotle, 'De Interpretatione', (17a38) in Aristotle, *Categories and De Interpretatione* (trans J L Ackrill, Clarendon, 1963) 37.

<sup>62</sup> John Prebble, 'Income Taxation: A Structure Built on Sand' (2002) 24(3) *Sydney Law Review* 301, 306.

<sup>63</sup> John Prebble, 'Why is Tax Law Incomprehensible?' [1994] 4 *British Tax Review* 380, 388.

universal such as 'income' therefore entails reference to a thing that exists, the Form of income. In Plato's metaphor of the cave, universals (Forms) exist behind observers and the shadows of the Forms are seen on a cave wall. Unable to see the Forms directly, the observers are consigned to only ever seeing shadows of those Forms. One reading of the Cave metaphor is that ordinary people live their respective lives without ever seeing the purity of Forms, which have to be rediscovered by philosophers who reveal this *a priori* knowledge by rational thought, rather than discovering knowledge by empirical investigation of the world.

Another form of realism is attributed to Aristotle. In broad terms, one reading of Aristotle<sup>64</sup> is that he accepted that universals exist, but unlike Plato, Aristotle considered that universals exist only in the particular forms of matter<sup>65</sup> where a universal is manifest. According to this view, the substance of things is their respective primary essences and there is a difference between these primary essences and accidental characteristics.<sup>66</sup> Tom's payment to Mary may be made by way of 10 x \$100 currency notes rather than 20 x \$50 currency notes. The mode of payment is 'accidental' in that it does not affect the essential nature of the payment.

After ruling out various contenders for identifying the essence of something upon grounds that need not detain us here, Aristotle proposed that the essence of something is its 'form' that inheres in the thing rather than the matter of which it is composed. The essence of a bronze statue is the form of the statue rather than the bronze (ie, the 'matter') of which the statue is made. Likewise, the essence of Tom's payment to Mary is the form of the payment rather than the (possibly 'nonsubstantial') 'matter' of it. According to one reading of Aristotle, the form of something is a universal or a compound of universals. Universals are capable of definition and definitions may incorporate universals which can be defined.<sup>67</sup> This process of definition continues until the simple, logical atoms of the definition have been identified.

So on this reading of Aristotle the substance of income is its essence, its essence consists of its form and its form consists of universals and there are definitions of universals in terms of necessary and sufficient conditions that must be found in any particular instance of 'income'. On this view, when our senses perceive an amount that is 'income', the image of income that we receive corresponds to the definition of 'income' because the form of the particular image of the amount corresponds to the definition of 'income'. For example, the manifestation of the form of a thing (comprising of universals) can be demonstrated by matching the necessary and sufficient criteria of the universal to the essence of the particular instance (where the essence will assume a particular form and a form will be or comprise definable universals).

It is important to note that 'form' typically differs from what lawyers refer to as the legal form of a transaction because the legal rules governing the nature of the legal form of a thing do not necessarily correspond to the universals that realist philosophers refer to.

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<sup>64</sup> For the contrary argument, that each form of a kind is unique to each particular instance of that kind, see Edwin Hartman, 'Aristotle on the Identity of Substance and Essence' (1976) 85(4) *Philosophical Review* 545; Charlotte Witt, 'Aristotelian Essentialism Revisited' (1989) 27(2) *Journal of the History of Philosophy* 285.

<sup>65</sup> Here, matter can be perceived (ie, the wood in a tree) and intelligible (such as a geometric figure).

<sup>66</sup> See, for example, Aristotle, *Metaphysics*, Book 5 ch 6, observing that a person being musical is taken to be an accidental characteristic of that person rather than essential to that person's being.

<sup>67</sup> Aristotle, *Metaphysics*, Book Z8, 1034a6-8.

Thus, as I have already noted, Prebble argued that the legal forms of 'income' do not capture the real form of income.<sup>68</sup>

#### 4.1.2 *Conceptualism*

The second and third approaches to the problem of universals reject the suggestion that universals exist independently of human thoughts and beliefs.

The second approach, referred to as conceptualism, maintains that concepts identify characteristics that are common across a range of particular instances. Thus, according to conceptualists, there is a concept of 'income' that picks out the characteristics that make a particular instance, such as Tom's payment to Mary, 'income'. By assessing the extent to which a particular amount satisfies those characteristics, we are able to classify some monetary amounts as particular instances of income. Concepts therefore exist independently of the particular instances that they describe, but concepts are not things that exist in the particular instances of the concepts in the way that realists envisage universals to be. If concepts are things that exist independently of the things in the world that they categorise, we need to identify the concept of a concept that we are applying when identifying these metaphysical things called concepts. The problematic concept of a concept is discussed further in section 5.9 of this article below.

#### 4.1.3 *Nominalism*

The third approach to the problem of universals, referred to as nominalism, rejects the existence of universals from particular instances and also rejects the idea that concepts mediate between the real world and our perception of the real world. A nominalist approach to words such as 'income' is that they merely describe characteristics that exist and that humans have identified as part of the reference of that linguistic unit – there is no need to incorporate metaphysical 'universals' or 'concepts' within a nominalist account. Nominalism therefore appears to resolve the problem of universals without reliance upon excess theoretical components (ie, Plato's forms, Aristotle's universals, or concepts). Rather than focusing upon things that are external to the linguistic unit, a nominalist can find the meaning of a linguistic unit within that linguistic unit itself by undertaking semantic analysis of that language unit and/or by considering the rules governing the use of the particular language unit and/or by finding the meaning intended by the 'speaker'.

### 4.2 **The philosophy of language – are ordinary usages sufficient to underpin propositions regarding truths about the world?**

At the time that Jordan CJ set out his definition of income, Western philosophy was working itself through 'the linguistic turn' – a reconsideration of the nature of philosophy which examined whether and how philosophical problems were linguistic problems.<sup>69</sup> In particular, the nature of any connection between the world and the truthfulness of statements made about that world was subjected to renewed scrutiny from the late nineteenth century.

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<sup>68</sup> See text accompanying nn 62-63 above.

<sup>69</sup> For a history and analysis of the concept of the linguistic turn see Hacker, above n 19.

Prior to this renewed interest in language as a philosophical problem,<sup>70</sup> it was widely accepted that language meant what it referred to, and the use of language to refer to something was learned by associating language 'names' with particular objects/ideas and/or with particular sense perceptions of those objects or ideas.<sup>71</sup>

Several aspects of language usage suggested that this referential theory of language did not provide a comprehensive account of language meaning. For example, we have words for things that do not exist (eg, unicorn, ghost) and use those words to make meaningful statements. This non-referring aspect even extends to names for people that do not exist ('Santa Claus'). We also can say meaningful things about things that do not exist ('It is true that Santa Claus does not exist'). Further, Frege observed that different modes of referring expression could refer to the same thing but have different meanings.<sup>72</sup> For example, 'The Morning Star' and 'The Evening Star' both refer to Venus but have a different meaning and therefore cannot necessarily be substituted. To illustrate this point, before hearing the statement I might not know that 'the morning star is Venus and that Venus is the evening star' and so that statement would add to my knowledge. Yet under a referential theory of language my knowledge should not be enhanced because the statement is merely saying 'Venus=Venus=Venus'. Frege also noted that this difference between sense and reference created circumstances in which the premises of a statement might be true but the conclusion is false. For example, what if Tom believes that the morning star is Venus but Tom does not know that the evening star is Venus? It would be true to state 'Tom believes that the morning star is Venus' and also true to state 'Venus is the evening star'. However, it would be false to state 'Tom believes that the morning star is the evening star'. All of this pointed to an important difference to our understanding of meaning – the difference between the 'sense' – the way that we convey information about a subject – and the subject itself (the 'reference').

This distinction between sense and reference therefore prompted a shift away from conceiving of language as a referential reflection of reality (a naming of reality) and precipitated various endeavours in search of a theory of linguistic meaning not grounded upon reference to objects in the world.<sup>73</sup> Two approaches emerged over the early decades of the twentieth century and were the subject of close discussion by the time Jordan CJ delivered his judgment in *Scott*. The first of these two approaches conceived of meaning in terms of truth claims derived by analysis of any particular statement. According to this account, to understand the logic of language would be to understand the logic of the world.<sup>74</sup> The second approach focused upon identifying the meaning of

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<sup>70</sup> This was not a new problem. In his *Cratylus* Plato observed the apparent arbitrariness of words as signs for what they signified, and suggested that there must be a connection between the sign and the signified.

<sup>71</sup> The proposition that language comprised mere names of ideas in the human mind can be seen in John Locke, *An Essay Concerning Human Understanding* (Oxford University Press, 1975 [1690]) 166; Jeremy Bentham, *Of Laws in General* (H L A Hart ed, Athlone Press, 1970 [1782]) 82.

<sup>72</sup> Gottlob Frege, 'On Sense and Reference' (1892) in Peter Geach and Max Black (eds and trs), *Translations from the Philosophical Writings of Gottlob Frege* (Blackwell, 2nd ed, 1960) 57, 62.

<sup>73</sup> Writing in his later *Philosophical Investigations*, Wittgenstein captured the general perception of this picture theory of language as being one too primitive to capture our description of natural language: Ludwig Wittgenstein, *Philosophical Investigations* (tr. G E M Anscombe, P M S Hacker and J Schulte, Wiley Blackwell, 2009 [1953]) 6 [2].

<sup>74</sup> See discussion of this in P M S Hacker, 'Wittgenstein's Anthropological and Ethnological Approach' in Jesús Padilla Gálvez (ed), *Philosophical Anthropology: Wittgenstein's Perspective* (Ontos Verlag, 2010) 15, 15.

a statement by examining the social conventions governing the making of that statement in the particular circumstances in which it was made.

Over this period Bertrand Russell proposed his theory of descriptions, by which he hoped to reveal the hidden logic of the complex compositions within singular statements made in natural language.<sup>75</sup> Russell's study of the internal logic of statements promised a comprehensive and objective treatment of meaning that focused upon the truthfulness of the propositions that could be 'unpacked' by close analysis of the statements. In this way, the meaning of a statement was severed from any necessary reference to something in the world. Thus, on this view, the meaning comprised the truth claims made in the statement whether or not those truth claims were in fact true in the sense of correspondence to the real world. For example, Russell illustrated his argument by showing how reference to the (non-existent) king of France could be analysed into a number of truth claims.<sup>76</sup> Meaning existed, he claimed, without any need to refer to an object in the world.

In the 1930's the loosely affiliated members of the Vienna Circle of logical positivists interpreted this quest for improving the objectivity of the language of science in various ways. However, they shared the view that meaningful statements can only be made upon 'objective' foundations – comprising empirically verifiable propositions and analytic truths (such as the logical truths of mathematics).<sup>77</sup> According to this view, meaning was found in the truth value of statements, and truths could be 'analytic truths' (because the truth is contained within the proposition) or 'synthetic truths proven empirically (*a posteriori* truths)'.<sup>78</sup> The title of Rudolf Carnap's influential paper 'The Elimination of Metaphysics through Logical Analysis of Language' captured this theme – the meaning of language could be analysed by reducing words to their ultimate 'observation sentences' which were truth evaluable – they could be at least theoretically open to empirical confirmation.<sup>79</sup> Ayer's influential work disseminated this logico-empiricist approach in Great Britain,<sup>80</sup> arguing that the meaning of a statement is that which is capable of derivation by analysing the statement or as its truth conditions which are capable of empirical verification.<sup>81</sup>

While logical positivists were pursuing several approaches to eliminating metaphysics from the language of science, inspired by the earlier work of Wittgenstein, from the beginning of the 1930s Wittgenstein came to reject key elements of his earlier philosophy.<sup>82</sup> In his later work, Wittgenstein maintained that the meaning of words was

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<sup>75</sup> Bertrand Russell, 'On Denoting' (1905) 14 *Mind* 479.

<sup>76</sup> Ibid.

<sup>77</sup> The manifesto signed by some members of the Vienna Circle declared that '[c]larification of the traditional philosophical problems leads us partly to unmask them as pseudo-problems and partly to transform them into empirical problems and thereby to subject them to the judgment of empirical science. The task of philosophical work lies in this clarification of problems and assertions, not in the propounding of special "philosophical" pronouncements'. *The Scientific Conception of the World: the Vienna Circle* (Reidel, 1973 [1929]) 8.

<sup>78</sup> Immanuel Kant, *Critique of Pure Reason* (tr N Kemp Smith, St Martin's Press, 1965 [1781]) 48.

<sup>79</sup> Rudolph Carnap, 'Überwindung der Metaphysik durch der Logische Analyse der Sprache' ('The Elimination of Metaphysics through the Logical Analysis of Language') (1932) *Erkenntnis II* (reprinted in A J Ayer, *Logical Positivism* (The Free Press, 1959)).

<sup>80</sup> A J Ayer, *Language, Truth and Logic* (Victor Gollancz, 1956 [1936]).

<sup>81</sup> Ayer, *Language, Truth and Logic*, above n 80, 35.

<sup>82</sup> For careful comparison see P M S Hacker, 'Wittgenstein on Grammar, Theses and Dogmatism' (2012) 35(1) *Philosophical Investigations* 1.

conventionally determined and that language was an autonomous system, the words of which bore no necessary relation to the things that they depict or name.<sup>83</sup> However, this does not mean that language use is arbitrary – language is a tool used to meet our pragmatic ends<sup>84</sup> and so we might develop conventions regarding the use of language that are arbitrary in the sense that we might have developed different conventions in pursuit of those pragmatic ends. But this does not make the rules of grammar arbitrary in the strong sense of being incomprehensible because there is no way of knowing what any of us have determined those rules to stand for. Nor are the rules of grammar answerable to some correspondence with the real world or some ultimate pragmatic end for which language is created. Thus, the study of the meaning of words requires the study of the rules governing the proper use of components of natural languages.<sup>85</sup> Wittgenstein suggested that the philosophical task was one of description, not analytical discovery. By description, philosophical problems would be solved 'through an insight into the workings of our language ... not by coming up with new discoveries, but by assembling what we have long been familiar with'.<sup>86</sup> Careful scrutiny of natural language usage would reveal the nuances of the deeper layers of grammar beneath the surface grammar of a particular text.<sup>87</sup>

### 4.3 The relevance of linguistic philosophy to analysis of Sir Frederick Jordan's statement

This brief overview of the philosophy of language over the first decades of the twentieth century indicates that different theories of meaning were being robustly assessed over the period leading up to the time when Jordan CJ set out his definition of income. A central theme of the literature of that period was the quest to refine the understanding of language so that language would not be a barrier to truthful communication about the world. This quest was grounded upon logical analysis or empirical verification of statements made in natural languages:

1. one strand approached this subject upon the basis that logical analysis of the semantic elements of truth claims would reveal the (possibly hidden) meaning of statements; and
2. an alternative strand considered that examination of the conventional use of language offered a therapeutic to philosophers who had turned their backs upon the rationality of human thought reflected in common language usage.

Both approaches encountered fundamental difficulties in specifying the foundations of truthful statements. A semantic theory of language confronted the challenge of identifying the threshold at which a description was sufficiently detailed so as to identify that which was signified. A conventional account of language meaning confronted the challenge of specifying the threshold at which a usage was a convention and the basis upon which that convention determined the statement's meaning. Moreover, a

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<sup>83</sup> Wittgenstein, above n 73, [355].

<sup>84</sup> Wittgenstein, above n 73, [5] 'clearly survey the purpose and functioning of the words'; see also [127], [132].

<sup>85</sup> Wittgenstein, above n 73, [28]-[33].

<sup>86</sup> Wittgenstein, above n 73, [109].

<sup>87</sup> Wittgenstein, above n 73, [664].

conventional account must accept that 'truth' can only ever be what is right for us, which is not consistent with the universality that we attribute to 'truth'.<sup>88</sup>

This philosophical examination of the foundations of linguistic meaning is relevant to the present examination of the dictum of Jordan CJ in several ways. First, linguistic philosophy highlights the fact that the foundations of the meaning of linguistic elements cannot be taken for granted. Second, the first proposition is reflected in the echoes of the semantic and pragmatic threads, of both common understandings of the foundation of linguistic meaning and also of linguistic philosophy, to be found in the dictum of Jordan CJ, a matter taken up in section 5 of this article. Third, the examination of the foundations of linguistic meaning, characteristic of linguistic philosophy, highlights the matters that one might expect to be considered if reference to the dictum of Jordan CJ is to reach beyond ritual incantation with judicial analysis of the elements of the dictum.

## 5. UNDERSTANDING SIR FREDERICK JORDAN'S STATEMENT THROUGH THE LENS OF LINGUISTIC PHILOSOPHY

### 5.1 Science, and the science of language

In this intellectual context it would have been extremely difficult for lawyers to ignore the underlying 'scientific' examination of language and its use.<sup>89</sup> According to this formalist<sup>90</sup> approach to statutory construction, the meaning of legislation is an objective fact revealed by appropriate methods of 'statutory construction'. This objective statutory meaning is then applied to transactions 'objectively' characterised according to their respective legal forms. Indeed, in the taxation context, the proposition that taxation could only be imposed by clear language had come to be adopted for more than a century.<sup>91</sup> If any reminder of this proposition were needed, decisions including *Scott v Cawsey*<sup>92</sup> and *IRC v Duke of Westminster*<sup>93</sup> no doubt served to emphasise this narrative of legal objectivism.

At the same time it would have been extremely difficult to ignore the fact that there was no universal methodology that could be applied in discovering the objective linguistic meaning in a manner that would sustain the legitimation of law upon the basis that law comprised objective, determinate rules that could be applied with certainty. Judges had accepted that the ordinary usage of words recorded in dictionaries did not comprehensively capture the 'natural or ordinary' meaning of words.<sup>94</sup> Further, by the time of Sir Frederick's decision in *Scott*, it had already come to be accepted that

<sup>88</sup> Moore, above n 59, 297.

<sup>89</sup> See, for example, Thomas C Grey, 'Langdell's Orthodoxy' (1983) 45(1) *University of Pittsburgh Law Review* 1.

<sup>90</sup> For discussion of the concept of legal formalism, see Frederick Schauer, 'Formalism' (1988) 97(4) *Yale Law Journal* 509; Judith Shklar, *Legalism: Law, Morals and Political Trials* (Harvard University Press, 2nd ed, 1986). For critical discussion of Shklar's work, see Robin West, 'Reconsidering Legalism' (2003) 88(1) *Minnesota Law Review* 119.

<sup>91</sup> For early expressions of the strict construction of penal legislation, including taxation law, see *Ramsden v Gibbs* (1823) 1 B & C 319; 107 ER 119; *Denn v Diamond* (1825) 4 B & C 243, 245; 107 ER 1049, 1050. <sup>92</sup> (1907) 5 CLR 132, 154 per Isaacs J.

<sup>93</sup> *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1, 24-25 per Lord Russell.

<sup>94</sup> *Girls' Day Public School Trust v Ereaud* [1931] AC 12, 34 per Lord MacMillan, observing that the editors of the *New Dictionary* stated that the varieties of the sense of 'public' are such that there are many meanings of the term. Also, it was accepted that the meaning of composite expressions could not be established by merely compiling dictionary definitions of each part: *Perpetual Trustee v FCT* (1931) 45 CLR 224, 240 per McTiernan J.



'income' had been ascribed different meanings in different contexts.<sup>95</sup> In the early twentieth century the 'trust' concept of income had been identified as a possible theory of income for the purposes of Australian income taxation.<sup>96</sup> Meanwhile, a commercial or business understanding of income, influenced by the developing discipline of accountancy, had been acknowledged to be an alternative theory of income that could be applied in the context of income taxation.<sup>97</sup> Just three years after the decision in *Scott*, and during the era when logical positivists pursued their anti-metaphysical agenda, Henry Simons contributed to stripping the economic concept of income of metaphysical elements by focusing upon the apparent objectivity of 'market value' for the purpose of identifying income as a tax base.<sup>98</sup> Awash with these conflicting currents of thought upon the nature of income, Greene MR captured the view of many with his suggestion that the income/capital distinction seemed to turn on the spin of a coin.<sup>99</sup>

By the time of the decision in *Scott* the general statutory references to 'income' presented a considerable challenge to judges because of the tension between the 'no taxation without clear words' maxim and the fact that 'income' did not clearly refer to one finite meaning comprising necessary and sufficient criteria for its application to particular circumstances.

In contexts other than the income tax this balancing of linguistic imprecision and, at least the appearance of, legal certainty could be resolved by reliance upon principles of interpretation that allowed reference to the statutory context<sup>100</sup> or to the legislative purpose.<sup>101</sup> These principles allowed judges to construct, and quite possibly genuinely believe in the truth of, a narrative of discovering the 'right' meaning out of a range of possible meanings, while claiming that this right meaning had been the purpose of the legislature all along (that only lawyers with superior skills, such as judges, could discover). However, the purpose of taxing income was not considered by judges to offer secure footing upon which to elaborate the meaning of income<sup>102</sup> and, as Jordan CJ noted,<sup>103</sup> the statutory context of the reference to 'income' offered little guidance in elaborating the meaning of income.

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<sup>95</sup> See the discussion of the different meanings of income in its general sense and for income taxation purposes in *Harding v Federal Commissioner of Taxation* (1917) 23 CLR 119, 130 per Isaacs J (Gavan Duffy and Rich JJ agreeing).

<sup>96</sup> W Strachan, 'The Differentiation of Capital and Income' (1902) 18 *Law Quarterly Review* 274; W Strachan, 'Economic and Legal Differentiation of Capital and Income' (1910) 26 *Law Quarterly Review* 40; W Strachan, 'Capital and Income (Lifeowner and Remainderman)' (1912) 28 *Law Quarterly Review* 175; W Strachan, 'Capital and Income under the Income Tax Acts' (1913) 29 *Law Quarterly Review* 163.

<sup>97</sup> *The Commissioner of Taxes (South Australia) v The Executor Trustee and Agency Company of South Australia Limited (Carden's Case)* (1938) 63 CLR 108, 152 per Dixon J.

<sup>98</sup> Henry Simons, *Personal Income Taxation* (University of Chicago Press, 1938) 42 and, more generally, ch 2.

<sup>99</sup> *Inland Revenue Commissioners v British Salomon Aero Engines Ltd* (1938) 22 TC 29, 43.

<sup>100</sup> *The Metropolitan Gas Co v The Federated Gas Employees' Industrial Union* (1924) 35 CLR 449, 452 (per Isaacs and Rich JJ).

<sup>101</sup> *Attorney General v Carlton Bank* [1899] 2 QB 158, 164 (Lord Russell).

<sup>102</sup> See, for example, the decision of Dixon J in *Carden's Case, The Commissioner of Taxes (South Australia) v The Executor Trustee and Agency Company of South Australia Limited (Carden's Case)* (1938) 63 CLR 108, 152.

<sup>103</sup> *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215, 220.

## 5.2 Analytical approaches to 'income' reflected in Sir Frederick Jordan's statement compared to orthodox interpretation of non-technical statutory language

In this context we can begin to understand Sir Frederick Jordan's reasoning behind adoption of his forms/principles framework. This framework for interpreting the definition of ordinary income is unusual when compared to the 'ordinary grammatical meaning',<sup>104</sup> 'literal meaning',<sup>105</sup> or 'grammatical meaning',<sup>106</sup> of the text commonly referred to by judges when considering the general principles of statutory construction.<sup>107</sup> When these textual formulae are adopted it seems to be implicitly assumed that the ordinary, natural or literal meaning is immediately apparent or readily accessed, for example by reference to dictionaries.<sup>108</sup>

The first part of Sir Frederick Jordan's statement appears to depart from this process of identifying the meaning of non-technical language. In the same way that linguistic philosophy accepted that rules governing the linguistic meaning could be revealed by analysis, Sir Frederick indicated that language usage and concepts need to be *analysed* in order to arrive at the meaning of natural language terms. Forms of receipt are 'comprehended within'<sup>109</sup> the word 'income', suggesting that forms of receipt will be revealed by examining the inner logic of 'income'. However, this inner logic can only be revealed by examining 'ordinary concepts and usages'. Sir Frederick seems to be stating that identification of the forms of receipt comprehended within 'income' entails both semantic analysis of the word and conventional analysis of the use of the word. The preceding overview of linguistic philosophy indicates that this part of Sir Frederick's statement embodies a potentially irresolvable conflict between competing semantic and pragmatic accounts of the foundation of linguistic meaning.

Sir Frederick's reference to identifying 'principles' also presents challenges. It is not clear whether the principles also are 'comprehended within' 'income' or whether they are to be found by examining the social practice of using 'income'. The phrase 'ought to be treated as income' does not assist in clarifying the nature of the process contemplated by Sir Frederick Jordan's statement, because it could be referring to norms evident on the surface of ordinary language usage or it could be referring to norms that lie hidden beneath surface usage in circumstances where the usage does not necessarily reflect those norms.<sup>110</sup>

Notwithstanding these difficulties, the first part of Sir Frederick's statement has been understood to offer a rigorous foundation for the elaboration of income by focusing attention upon extracting forms and principles from 'ordinary concepts and usages'.

<sup>104</sup> *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (NT)* (2009) 239 CLR 27, 46 [45].

<sup>105</sup> *Project Blue Sky Inc v Australia Broadcasting Authority* (1998) 194 CLR 355, 384 [78]; *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (NT)* (2009) 239 CLR 27, 46 [45].

<sup>106</sup> *Project Blue Sky Inc v Australia Broadcasting Authority* (1998) 194 CLR 355, 382 [72], 384 [78].

<sup>107</sup> While this 'ordinary or natural' etc meaning may not be adopted as the meaning of the legislative text in the context of resolving a matter by adjudication, decisions such as *Project Blue Sky* proceed upon the basis that such 'ordinary or natural' etc meaning should be adopted unless the context or purpose indicates that a 'legal' meaning ought to be adopted.

<sup>108</sup> This approach had long been adopted in Australia before the decision in *Scott: Sydney Municipal Council v Commonwealth* (1904) 1 CLR 208, 241 per O'Connor J. Around the time of *Scott*, see *Federal Commissioner of Taxation v Riley* (1935) 53 CLR 69, 80 per Starke J.

<sup>109</sup> *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215, 219 per Jordan CJ.

<sup>110</sup> Because, for example, the general population may misunderstand the proper meaning of a term, by reference to the 'deep' meaning of the term, and so misuse the term.

This interpretation appears to emphasise the analytical aspects of the statement while downplaying the unresolved tension between semantic/conventional analysis and also ignoring the vagueness of the source of the principles to be identified. By revealing the hidden logic of 'income', Jordan CJ appeared to accept that the rules governing classification as 'income' would be determinate at any particular point in time and that these rules could underpin the classification of an amount as 'income' in circumstances not previously encountered. Thus, the application of the concept 'income' could adjust to changing social circumstances while remaining constant in its internal logic. This balance between change and continuity therefore appeared to resolve the tension between the ideal of legal certainty embodied in immutable law, reflected in the maxim that taxation can only be imposed with certain words, and the apparent confusion of competing concepts of income reflected in the contemporaneous literature.

The second part of Sir Frederick Jordan's statement appears to be consistent with the ordinary principle of adopting dictionary definitions of non-technical statutory language. In the second sentence of the extract from *Scott* his Honour appears to paraphrase his forms/principles approach by suggesting that we can determine whether an amount is income simply by determining whether it is income 'in ordinary parlance'. Indeed, in the next paragraph in his judgment Sir Frederick observed that 'according to the ordinary meaning of "income," as an English word, there can be no doubt that such a receipt as that now in question is not income'.<sup>111</sup> His Honour did not expressly apply his forms/principles approach for the purpose of identifying what he took to be the ordinary meaning of 'income', although this may be because Sir Frederick considered such express analysis superfluous given his immediately preceding statement. However, references to 'ordinary parlance' and to 'the ordinary meaning of "income"' could be interpreted to contradict the analytical discovery of the deep meaning of income hidden beneath the superficial veneer of ordinary usage. After all, 'ordinary parlance' is not synonymous with 'ordinary concepts and usages' as, unlike the former, the latter is broad enough to include written usages as well as parlance.

There is, then, a tension between the first and second parts of Sir Frederick's statement. If that statement were interpreted so that 'income' meant its meaning in ordinary parlance as reflected in dictionary meanings, we would justifiably question why Sir Frederick would have expressed such an orthodox proposition in such a convoluted manner. Why refer to the forms/principles analysis at all? Likewise, the High Court decisions that have adopted Sir Frederick's statement might have more economically adopted the orthodox principle regarding reference to dictionaries. At least in a formal context such as a statute or a judicial decision, there is a conventional assumption that all words are intended to have some effect, unless nonsense would arise by doing so. Applying this interpretative assumption, *all* of the elements of Sir Frederick Jordan's statement should be recognised. However, in this case, it seems that a choice must be made between incomparable approaches to identifying the meaning of income.

### 5.3 Does the forms/principles framework apply to other expressions that are not terms of art?

The forms/principles analysis is expressed in the first part of Sir Frederick's statement in such a manner as to suggest that this analysis ought to apply to all statutory terms that are not terms of art and also to judicial terms that are not terms of art. Thus, 'income' is not a term of art and its meaning is determined according to the forms/principles analysis

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<sup>111</sup> *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215, 219 per Jordan CJ.

of ordinary concepts and usages and perhaps 'ordinary parlance'. Is it also the case that these expressions are not 'terms of art'? If so, should the same forms/principles analysis be undertaken in elaborating the meaning of these terms/phrases? Further, should the same analysis be applied to those meanings, and so on in infinite regress *unless* at some point this process will reveal ultimate, 'atomic' foundations that are true in virtue of themselves? If there is an infinite regression, the foundation of meaning cannot be found.<sup>112</sup> However, Sir Frederick Jordan's statement leaves this matter unresolved.

If it is possible for the meanings of components of Sir Frederick's statement to be identified without undertaking the same forms/principles analysis, upon what basis is this determination made?

#### 5.4 Why the forms *and* principles approach?

Elaboration and application of the two-stage forms/principles framework depends upon the meanings attributed to 'forms' and 'principles' and also upon specification of the source(s) from which those forms and principles are derived.

Sir Frederick's statement clearly accepts that 'income' describes receipts that meet particular formal descriptions. A lawyer reading the dictum, recorded in a legal judgment, could reasonably be expected to read this reference to 'forms of receipt' to be a reference to forms of receipt classified according to legal rules rather than amounts being classified according to rules derived from non-legal sources. However, this legal interpretation of 'forms' is undermined by two elements of the dictum of Jordan CJ. As the forms of receipt are derived by analysis of ordinary concepts and usages, in this context it would be reasonable to infer that his Honour did not have in mind the legal form of a receipt. Moreover, this 'non-legal' interpretation of the reference to 'forms' is also supported by Sir Frederick's observation that income is not a 'term of art'. If 'income' were a term of art then it is more likely that legal forms would be considered in characterising amounts, as distinct from applying non-legal rules when identifying forms of receipt that are 'income'.

In section 4.1 above it was noted that philosophers have refined different approaches to classifying things such as income and that legal classifications of things such as income are not necessarily consistent with these approaches. The reference to 'forms' might be a passing acknowledgment of philosophical realism which, as we have seen, would identify the essence of a particular amount by comparing it to the essence of a Platonic Form or by comparing the amount against the formal Aristotelian essence or even by assessing the amount against what Wittgenstein called a 'logico-pictorial' form.<sup>113</sup> On this view, 'income' might be equated to a genus that groups different species of receipt according to their respective forms. Each form would have its own essence and hence its own necessary and sufficient criteria. However, all forms would share the essence of income.

However, his Honour's reference to the secondary role of principles, also extracted from ordinary concepts and usages, complicates this realist interpretation because it is

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<sup>112</sup> The prospect of a parallel infinite regression was raised by Quine in his critique of logical positivism: W V O Quine, 'Truth by Convention' (1935) in W V O Quine, *The Ways of Paradox, and Other Essays* (Harvard University Press, 1976) 77 and W V O Quine, 'Two Dogmas of Empiricism' (1951) 60(1) *Philosophical Review* 20.

<sup>113</sup> Ludwig Wittgenstein, *Tractatus Logico-Philosophicus* (Kegan Paul, 1922) 2.2.

difficult to see how 'principles' can be accommodated within a realist framework in which things have an essence that is defined in terms of necessary and sufficient criteria. If a receipt has a form of a kind that warrants its inclusion under the category 'income' because its essence corresponds with the essence of income, a realist would reject the proposition that the particular amount cannot be income because 'principles' operate to override the essential nature of the receipt. This suggests that Sir Frederick cannot have meant to adopt some version of philosophical realism when referring to forms of receipt.

If Sir Frederick's reference to 'forms of receipt' does not refer to legal formalism and also does not refer to philosophical realism, what are the rules governing identification of the relevant forms? And how do 'principles' interact with those rules? For example, could principles affect the types of form comprehended within the concept of income? These aspects of Sir Frederick's statement remain unresolved.

Moreover, his Honour did not elaborate upon the reasons for adopting this dual forms/principles inquiry. However, adopting the convention of interpreting statements in their best possible light, it is reasonable to speculate that his Honour had in mind the benefit of undertaking a preliminary cull of forms of receipt that could never satisfy the concept of income described by the principles considered in the second stage of the inquiry. For example, the relatively blunt instrument of assessing forms of receipts could enable a judge to quickly dispose of many cases without recourse to the second stage identification and application of principles. If a gains concept of income were to be extracted from ordinary concepts and usages, benefiting from the public provision of infrastructure could be considered to be a gain.<sup>114</sup> However, exclusion of such benefits upon the basis of their form (such as 'absence of an 'earning activity'<sup>115</sup> or the absence of a 'receipt'<sup>116</sup>) could avoid the need for close consideration and application of the second stage principles.

This forms/principles approach therefore has intuitive cognitive appeal because it accords with two cognitive approaches that humans routinely adopt when categorising things – application of necessary and sufficient criteria and also consideration of concept theories when classifying more problematic cases.<sup>117</sup> However, the cognitive power of this two-stage analysis depends upon the specification of the forms and principles and also the specification of the rules that prevent conflict between those forms and principles. The absence of these definitional and operative rules in Sir Frederick's judgment and/or in judgments that have adopted Sir Frederick's statement means that it is not possible to take this analysis further here.

## 5.5 'Ordinary'

The references to 'ordinary parlance' and 'ordinary concepts and usages' maintain some degree of continuity with established principles of interpretation that recognised the 'ordinary or natural' meaning of words.<sup>118</sup> However, I have already noted that Jordan

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<sup>114</sup> See discussion of this point in Boris Bittker, 'A "Comprehensive Tax Base" as a Goal of Income Tax Reform' (1967) 80(5) *Harvard Law Review* 925, 935.

<sup>115</sup> *Hayes v FCT* (1956) 96 CLR 47, 54 per Fullagar J.

<sup>116</sup> *Payne v FCT* (1996) 56 FCR 299.

<sup>117</sup> These cognitive processes are discussed further below when dealing with concepts: see section 5.9 below.

<sup>118</sup> *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd* (1920) 28 CLR 129, 161-162 per Higgins J.

CJ departed from that simplistic account of natural language meaning by suggesting that analysis of ordinary concepts and usages and ordinary parlance would reveal the forms of income receipt and principles to be applied in characterising receipts as income.

Although 'income' was to be elaborated by analysis and judgment, according to Jordan CJ, the ordinariness of the language elements subjected to judicial analysis promoted a narrative that depicted one concept of income that was routinely adopted in the community and therefore was of the community and hence unremarkable. This narrative promotes the view that judicial decisions regarding the income concept reflect the univocal community's understanding of the term rather than being imposed from above by unrepresentative appointees to judicial office.<sup>119</sup>

The narrative of analysis of ordinary language usage also serves to explain why the characterisation of amounts as income is not necessarily a straightforward application of ordinary meaning and may require legal expertise to correctly characterise such amounts. The narrative of analysis therefore promotes the legitimacy of 'law as scientific analysis of observable phenomena' and also of the professional judgment necessary to the operation of law.<sup>120</sup> Judges, rather than ordinary folk, must be at the centre of pronouncements upon the meaning of an ordinary term such as 'income'.

Superficially, then, this narrative of linguistic analysis of ordinary language usage answered several imperatives by portraying judicial practice as objective examination of the community's 'ordinary' meaning of language. However, given the central importance of the concept of 'ordinary' to this narrative, surprisingly little attention has been devoted to what is 'ordinary'. Dictionary definitions reflect an ambivalence regarding what is ordinary. One sense of the word is that it refers to the unexceptional nature of the thing. Something may be rare but unexceptional – the last example of a particular model of utilitarian passenger car, for example. 'Ordinary' might also refer to the commonality of the occurrence and perhaps the distribution of the thing. William Shakespeare's poetry may be extraordinary by nature but so commonly available as to be ordinary in the sense of availability/usage.

Turning to 'ordinary concepts', an extraordinary (by nature) concept might be so frequently used that it is ordinary. Conversely, a concept that is unexceptional in terms of the structure of the concept could be extraordinary because it is rarely used. Jordan CJ did not elaborate upon the conditions governing what counts as 'ordinary', and the dictionary definitions leave considerable leeways of choice.

In the absence of any judicial analysis of the concept of ordinariness itself for the purposes of applying Sir Frederick's statement, it is impossible to assess the truthfulness of claims that a particular usage, concept or parlance is 'ordinary'. Parsons alluded to this epistemic problem when he suggested that members of the community might not accept the concept of income attributed to them,<sup>121</sup> as did Hill J in his first instance

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<sup>119</sup> See *Harding v Federal Commissioner of Taxation* (1917) 23 CLR 119, 130 per Isaacs J (Gavan Duffy and Rich JJ agreeing), noting that the relevant sense of 'income' was one with which the community had been familiar for over 100 years.

<sup>120</sup> Eliot Friedson, *Professionalism* (University of Chicago Press, 2001) ch 1; noting Friedson's caveats about 'ideal types': 8-10.

<sup>121</sup> Ross Parsons, 'Income Tax - An Institution in Decay' (1986) 3(3) *Australian Tax Forum* 233, 239.

decision in *Stone*.<sup>122</sup> This absence of precision appears to have allowed some judges to adopt a range of approaches to the concept of ordinariness which have underpinned different approaches to the meaning of 'income'. For example, a 'business' or 'commercial' concept of income could be adopted in characterising the nature of a particular receipt<sup>123</sup> while a gains concept of income can also be considered to be 'ordinary'.<sup>124</sup>

## 5.6 Ordinary concepts and usages: a composite expression or a single object?

It is not clear whether 'ordinary concepts and usages' is one composite expression or whether it refers to two sets of social phenomena: 'ordinary concepts' and 'ordinary usages'. An ordinary concept of 'income' could differ from an (ordinary?) usage of 'income', depending upon the meanings of 'concepts', 'usages', and 'ordinary'. Is there a difference between ordinary concepts and ordinary usage? If so, which one prevails in arriving at the proper meaning of income? If ordinary concepts and ordinary usage are different but lead us to the same meaning of income, why refer to them both?

## 5.7 Rules governing the identification of relevant 'ordinary concepts and usages'

With respect to the epistemological aspect of Sir Frederick Jordan's statement, his Honour did not set out the basis upon which we ought to derive the relevant forms/principles from the entire set of 'ordinary concepts and usages'.

Confronted with the entire set of ordinary concepts and usages (ie, 'star', 'fairy', 'apple' are all concepts), how do we go about extracting the forms/principles specific to 'income'? Without close specification of this inquiry, there is a risk that the forms/principles which I identify will merely reflect personal predispositions regarding the nature of income rather than having an objective logical or empirical foundation. To illustrate this point, it is fair to suppose that there are ordinary concepts and usages with respect to 'apples'. It is also fair to suppose that most would accept that ordinary concepts and usages with respect to apples have very little or nothing to do with ordinary concepts and usages regarding the forms/principles of 'income'. But upon what basis can I be sure that concepts and usages regarding apples have little or nothing to do with income other than because I have already formulated a concept of income that incorporates an element that allows me to exclude apples, or, a concept of apples that excludes income?

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<sup>122</sup> *Stone v FCT* [2002] FCA 1492, 2002 ATC 5085, 5094 [57], noting that some observers may be surprised that ordinary concepts are so complex, but continuing by noting the ambiguity commonly encountered in natural languages.

<sup>123</sup> *The Commissioner of Taxes (South Australia) v The Executor Trustee and Agency Company of South Australia Limited (Carden's Case)* (1938) 63 CLR 108, 152. The recognition of the ordinariness of the commercial and accounting concept of 'profits' in the context of the United Kingdom income tax legislation had been accepted in *Gresham Life Assurance Society v Styles* [1892] AC 309; 3 TC 185, 189 per Halsbury LC ('in a sense which no commercial man would misunderstand'); 3 TC 185, 191 per Lord Herschell ('as a matter of business').

<sup>124</sup> See, for example, *Commercial and General Acceptance Ltd v FCT* (1977) 137 CLR 373, 382 per Mason J. Note also the adoption as 'ordinary' of a gain concept of income by Pitney J in *Eisner v Macomber* 252 US 189, 206-207 (1920); see nn 54-55 above. For discussion of this aspect of the decision in *Montgomery* see Domenic Carbone, 'An Extraordinary Concept of Ordinary Income? The Significance of *FCT v Montgomery* on What is Income According to Ordinary Concepts' (2010) 20 *Revenue Law Journal* 1, 21-24.

## 5.8 'Parlance'

I have already noted that the reference to 'ordinary parlance' could restrict the scope of the survey of ordinary concepts and usages to those concepts and usages found in 'ordinary conversation'. This privileging of the spoken word, upon the basis that oral utterances offered an immediate reflection of the speaker's meaning that is lost when words are committed to writing, was subjected to critical analysis by Derrida.<sup>125</sup> Without revisiting that critique, for present purposes it is sufficient to note that the reference to 'parlance' indicates that the analytical narrative embodied in Sir Frederick's statement could be taken to suggest that judges focus upon analysing the one true meaning of income revealed in ordinary parlance, by contrast to analysis of 'degenerate' usages of 'income' such as those found in written form. If this interpretation is correct, there would be a contradiction in reflecting ordinary parlance in written judgments and also in analysing written usages of 'income' in documents such as written case decisions.

## 5.9 Theories of Concepts

Subsection 6-5(1) specifically refers to 'ordinary concepts' and therefore could be taken to adopt the same phrase from Sir Frederick Jordan's statement in *Scott*. Given the importance of the concept of a concept to identifying the statutory meaning of 'ordinary income', it is surprising that the concept of a concept has not been subjected to close analysis in the case law regarding the meaning of income.

The purpose of this section is to provide an overview of different concepts of concepts in order to take Australian tax jurisprudence some way down the path of addressing that lacuna. In elaborating upon different theories of concepts, I am not attempting to develop an argument for a preferred concept of a concept. Rather, the first purpose of this section is to establish the proposition that there is a multitude of concepts of concepts available and that these concepts are 'ordinary' in terms of their general recognition and/or in terms of their use.<sup>126</sup> If there are different ordinary concepts of concepts, and different ordinary concepts of concepts such as 'income' and 'capital', the difficulty of applying the statutory definition in subsection 6-5(1) is compounded. This difficulty is only exacerbated by the fact that the choice between concepts of concepts is not guided by statutory, judicial or non-legal rule.<sup>127</sup> If these premises are accepted, then the meaning of 'ordinary income' is inherently unstable. Therefore legal pluralism or legal scepticism could more accurately describe the operation of the statutory definition of 'ordinary income' than legal formalism.<sup>128</sup>

<sup>125</sup> Jacques Derrida, 'Signature Event Context' in *Limited Inc* (Northwestern University Press, 1988) ch 1.

<sup>126</sup> I hope that the accompanying references are useful for those wishing to engage with the literature upon concepts of concepts.

<sup>127</sup> Typically, judges accept that any statutory term has an ordinary, natural, literal or grammatical meaning. The basis upon which such a meaning is identified is not specified. It seems that it is simply assumed that one such meaning exists. One anonymous reviewer suggested that my approach to 'concepts' was misconceived, upon the basis that the statutory and judicial references to 'concepts' was to the ordinary or natural meaning of the word:

The author makes some interesting points in part 9, 'Theories of Concepts', but, if I interpret her correctly, in doing so seems to assume that Jordan CJ intended to use the term 'concepts' with one of a number of technical meanings, when, as explained, he appears more probably to have intended simply to expound the ordinary meaning rule of standard statutory interpretation.

The point of this section, as I say in this paragraph, is that there is no one ordinary meaning of 'concept'.

<sup>128</sup> Compare Evans' suggestion that a 'theory theory' of concepts can both recognise competing theories of constitutional meanings while simultaneously providing a stable foundation for constitutional



### 5.9.1 Dictionary definitions

The *Shorter Oxford English Dictionary* states that a 'concept' is an idea of a class. The *Shorter Oxford English Dictionary* also indicates two relevant senses in which 'ordinary' is commonly used: 'ordinary' according to the common usage of the thing and 'ordinary' according to the intrinsic nature of the thing. Putting these elements together, it is plausible that an 'ordinary concept' is any idea of a class of objects that is widely found or widely attested in language usage (rather than being a specialised, or what might be called an 'artificial' language, such as that of symbolic logic). I have also noted that the ITAA 1997 has not stipulated the meaning of the phrase 'ordinary concepts' and nor have relevant case decisions analysed the meaning of the phrase.

### 5.9.2 Concepts of concepts in the literature of philosophy and psychology

For those with even limited knowledge of the literature upon the subject of concepts, the propositions that there are multiple theories of concepts, and that to date there is no one 'universally right' concept of a concept has been identified, will be uncontroversial. However, the apparent judicial reluctance to undertake an analysis of concepts of concepts makes it necessary for me to sketch some of the main concepts of concepts. Laurence and Margolis<sup>129</sup> identify five broad categories of concepts of concepts, conceding that this taxonomy does not do justice to the many nuances identified in the literature upon this subject. Those categories are:

1. classical;
2. prototype;
3. exemplar;
4. 'theory theories'; and
5. various combinations of the preceding categories.

In the following paragraphs I will sketch these concepts and illustrate their respective relevance to inquiries into the meaning of 'income'.

### 5.9.3 Classical theories of concepts

Classical theories of concepts characterise concepts as definitions that denote the necessary and sufficient criteria for a concept to apply in a particular case. According to this view, an individual possesses a concept when they grasp the rules by which a member of a set is identified – when they know the necessary and sufficient conditions for membership of the relevant class.<sup>130</sup> This definitional account of concepts is not only

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interpretation. Evans does not explain how this stability can arise, given his apparent acceptance that there is no basis upon which the merits of competing theories can be assessed and the one stable meaning identified: Simon Evans, 'The Meaning of Constitutional Terms: Essential Features, Family Resemblance and Theory-Based Approaches' (2006) 29(3) *University of New South Wales Law Journal* 207.

<sup>129</sup> Stephen Laurence and Eric Margolis, 'Concepts and Cognitive Science' in Stephen Laurence and Eric Margolis (eds), *Concepts*, (MIT Press, 1999) ch 1.

<sup>130</sup> Joseph Raz adopts different definitions of concepts at different points in his work. However, at one point he appears to adopt a classical definition of concepts, stating that 'I will follow them in equating complete mastery of a concept with knowledge and understanding of all the necessary features of the objects to which it applies. Thus, complete mastery of the concept of a table consists in knowledge and understanding of all the essential properties of tables, and so on'. *Between Authority and Interpretation*, above n 58, 21.

applicable for those who subscribe to philosophical realism,<sup>131</sup> because the definition may identify the necessary and sufficient criteria that must exist in reality (the real essence of the thing) or they may identify the necessary and sufficient criteria that must be satisfied by convention.<sup>132</sup>

The classical theory of concepts resonates with legal rule formalism.<sup>133</sup> According to rule formalism, the meaning of a legal concept (such as income) is identified having regard to its set of definitional rules and this set of definitional rules is then 'laid on top' of the 'fact pattern' comprising our sensory perceptions of the particular instance under examination. One can then mechanically determine whether or not the 'fact pattern' corresponds to the definitional rules of the concept.

Although classical theories of concepts were the predominant paradigm for concepts until the latter half of the twentieth century,<sup>134</sup> they have been subjected to considerable criticism in contemporary philosophy and cognitive psychology upon several grounds.<sup>135</sup> One limitation is that it is extremely difficult to identify a concept that satisfies the classical focus upon definitional rules that comprehensively specify necessary and sufficient conditions for their application.<sup>136</sup> A second difficulty is that the classical theory implies that all members of a class would be identified with more or less equivalent speed because of the binary nature of determining whether each of the necessary and sufficient conditions were respectively satisfied. However, experimental data indicates that this is not the case because individuals exhibit 'typicality effects' in processing the application of a concept – 'simple' cases are more readily identified to fall within a concept than 'difficult' cases.<sup>137</sup>

One explanation for these typicality effects is that the definitional rules comprising concepts may be fuzzy. With respect to the concept of income, the High Court appears to have accepted that this is the case. In *Anstis*, the majority's joint judgment appeared to acknowledge that a criterial approach to identifying the concept of income was not discernible in the income tax case law:

There is a difficulty in making good absolute propositions in this field. In *Federal Commissioner of Taxation v Montgomery*, Gaudron, Gummow, Kirby and Hayne JJ recognised that 'income is often (but not always) a product of

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<sup>131</sup> See the discussion in section 4.1.1 above.

<sup>132</sup> A point noted, for example, by Edouard Machery, *Doing Without Concepts* (Oxford University Press, 2009) 78. Thus, the classical theory of concepts is not describing a universal thing of the kind of a Platonic Form.

<sup>133</sup> See, for example, the discussion of 'serious rules' in Larry Alexander, "'With me it's all er nuthin'": Formalism in Law and Morality' (1999) 66(3) *University of Chicago Law Review* 530, 539; Schauer, 'Legal Formality', above n 90.

<sup>134</sup> Chris Swoyer, 'Conceptualism' in P F Strawson and Arindam Chakrabarti (eds), *Universals, Concepts and Qualities: New Essays on the Meaning of Predicates* (Routledge, 2017) 127, 141; Machery, above n 132, 77-78.

<sup>135</sup> R Mark Sainsbury, 'Concepts without Boundaries' in Rosanna Keefe and Peter Smith (eds), *Vagueness: A Reader* (MIT Press, 1996) 186; J Fodor, M Garrett, E Walker and C Parkes, 'Against Definitions' (1980) 8(3) *Cognition* 263.

<sup>136</sup> Wittgenstein, for example, argued that the concept 'game' could not be defined in a manner that satisfied the classical idea of concepts: Wittgenstein, above n 73, [65]-[78].

<sup>137</sup> Laurence and Margolis, above n 129, 24-26. Margolis and Laurence critically assess the limitations of the classical account of concepts that have been identified in the literature.

exploitation of capital; income is often (but not always) recurrent or periodical; receipts from carrying on a business are mostly (but not always) income'.<sup>138</sup>

By contrast, the High Court in *Montgomery* appeared to adopt a criterial approach in identifying the concept of the class of all inquiries into the meaning of income by specifying the essential nature of such inquiries.<sup>139</sup> However, the vagaries of Sir Frederick's statement, already noted earlier in this article, indicate that the elements identified in his Honour's statement are insufficient to constitute necessary and sufficient conditions for identifying inquiries into the income concept which would satisfy the requirements of *Montgomery*.

#### 5.9.4 Prototype theories

Prototype theories of concepts emerged in the 1970s as research was undertaken indicating that individuals did not necessarily apply the classical theory of concepts in practice.<sup>140</sup> Prototype theories relax the strictness of necessary and sufficient conditions by suggesting that concepts include a body of knowledge regarding the statistical ordering of properties most likely to be found in members of a class.<sup>141</sup> This probabilistic understanding of concepts does not necessarily, and typically does not, maintain that concepts exclusively comprise this statistical information.<sup>142</sup> However, a prototype concept allows for quick classification of many cases which exhibit properties typically found in the relevant concept and therefore the prototype theory offers an explanation of cognitive studies which suggest that the classical concept of concepts is not always applied in practice.<sup>143</sup>

Machery notes that prototypical properties can be featural or dimensional.<sup>144</sup> A featural property is one that a member of a class either has or does not have. Income is not capital, for example. A dimensional property is one that a member of a class can have to varying degree. Parsons' seminal identification of indicia of income implicitly recognised a prototype concept of income by identifying the features of income commonly found in the set of income amounts without specifying that these indicia were necessary.<sup>145</sup> Regularity of receipt, for example, often exists when an amount is income but regularity of receipt is neither determinative<sup>146</sup> of the 'characterisation as income' question nor is it essential.<sup>147</sup>

<sup>138</sup> *Federal Commissioner of Taxation v Anstis* (2010) 241 CLR 443, 452 [19].

<sup>139</sup> *Federal Commissioner of Taxation v Montgomery* (1999) 198 CLR 639, 661 [64].

<sup>140</sup> Prototype theory grew out of Wittgenstein's reservations regarding the usefulness of a classical theory of concepts: Wittgenstein, above n 73, [65]-[78].

<sup>141</sup> This approach arose because of the difficulties encountered in framing comprehensive descriptions of the objects of language. To overcome this difficulty with respect to Russell's theory of descriptions, Searle anticipated the prototype model by suggesting that a proper name (ie, 'Aristotle') did not necessarily require a comprehensive description of all necessary elements that make up 'Aristotle': John Searle, 'Proper Names' (1958) 67 *Mind* 166.

<sup>142</sup> Machery, above n 132, 85.

<sup>143</sup> Laurence and Margolis, above n 129, 29-30.

<sup>144</sup> Machery, above n 132, 84.

<sup>145</sup> Ross Parsons, *Income Taxation in Australia* (Law Book Co, 1985) ch 2.

<sup>146</sup> *Federal Commissioner of Taxation v Anstis* (2010) 241 CLR 443, although query whether the import of this decision is that regularity may support an inference of dependence or reliance and that the two factors combined will be sufficient to characterise an amount as income.

<sup>147</sup> *Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199, 210.

One source of difficulty with concept prototypes is that they might include statistical information about dimensional features, such as the mean and standard deviation from the mean. But such information is fuzzy, as atypical members of a class exist. The extract from *Anstis* in the preceding section of this article<sup>148</sup> illustrates why this statistical ordering of dimensional features of the concept 'income' could be applied for Australian income tax purposes. However, such a statistical ordering of dimensional features is problematic, because no one property can have a high indexical rating owing to the fact that there are cases in which each property, respectively, did not exist. A one-off receipt was income,<sup>149</sup> a non-receipt was income because there was a profit<sup>150</sup> and an amount that did not fall within one of the three generally recognised categories of receipt was income,<sup>151</sup> and so on.

A second source of difficulty with concept prototypes is that the rules governing specification of the featural and dimensional properties are ill-defined. While there is evidence to suggest that individuals use a prototypical approach to concepts in day-to-day living,<sup>152</sup> as it seems the High Court did in *Anstis*,<sup>153</sup> a key difficulty confronting prototype theories is specifying the rules by which we identify the statistically relevant features.<sup>154</sup> Birds, for example, have many features that are either ignored or downplayed when applying the concept 'bird' (ie, digestive system, circulatory system, possession of a brain, eyes). Upon what basis do we focus upon just some of these features in specifying the prototypical properties?

#### 5.9.5 Exemplar theories

Exemplar theories conceive of concepts as a body of information regarding examples of a concept encountered in the past. Reasoning by analogy, this information regarding the properties of prior examples is compared to the thing under scrutiny and a classification decision is made. Exemplar theories of concepts account for the categorisation of a thing as being a member of a concept class upon the basis that the thing closely resembles a known member of the class. When crossing difficult epistemological terrain, reasoning by (dis)analogy to past cases makes sense and is commonly found in case law dealing with the meaning of income.

Consider the case of a thing that closely matches a known member of a class but is only 'moderately similar'<sup>155</sup> to other members of the class. This thing is more likely to be classified as a member of the class by comparison to another thing that is only moderately similar to most known members of the class. This aspect of exemplar theories derives from the fact that they typically recognise that the properties taken into account are dependent, in that application of a concept is a non-linear function of the properties of the subject that match the exemplar. Machery observes that the non-linearity of the exemplar function distinguishes exemplars from prototypes because prototypes typically apply a linear function.<sup>156</sup>

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<sup>148</sup> See text accompanying n 138 above.

<sup>149</sup> For example, *Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199.

<sup>150</sup> *Warner Music Pty Ltd v FCT* (1996) 70 FCR 197.

<sup>151</sup> *Federal Commissioner of Taxation v Anstis* (2010) 241 CLR 443.

<sup>152</sup> Laurence and Margolis, above n 129, 84.

<sup>153</sup> *Federal Commissioner of Taxation v Anstis* (2010) 241 CLR 443.

<sup>154</sup> Machery, above n 132.

<sup>155</sup> For discussion of this aspect of exemplar theories, see Machery, above n 132, 98.

<sup>156</sup> Machery, above n 132, 98.

So when considering whether an amount is 'ordinary income', an exemplar theory suggests that if the receipt matches my exemplars of income in several respects (beneficially received, etc) but does not match other properties of my exemplars (ie, the receipt is irregular) then I apply a function (multiplicative, for example) in weighing whether the receipt is income. In the absence of express consideration of this function, it is possible for different judges and others to apply different functions in resolving a particular case, a process loosely described as determining the weight to be given to particular facts.

The unspecified application of this function underpinned the reservations regarding analogical reasoning – application of an exemplar concept of concepts – expressed by the majority in *Montgomery*. There the majority observed that counsel in their submissions had argued upon the basis of what they considered to be analogous cases, an approach that the majority justices stated missed the import of the definition of income.<sup>157</sup>

#### 5.9.6 'Theory theories'

One of the key difficulties with both prototype theories and exemplar theories is that they do not currently specify the basis upon which prototypes or exemplars are identified. 'Theory theories' of concepts seek to address this shortcoming by suggesting that concepts are theories or else are part of a broader theoretical/conceptual framework. Reflecting this 'theory theory' of concepts, both Parsons<sup>158</sup> and Prebble<sup>159</sup> have criticised the concept of income adopted for income tax purposes upon the basis that it does not reflect any theory of the nature of income.

In broad terms, the proposition that concepts are theories is taken to mean that each concept comprises information that explains the membership of a category. Margolis and Laurence suggest that this idea of theories as explanations is tied to the idea that scientific theories explain phenomena and that this idea of theories is supported by the many instances of essentialist thinking that psychologists observe.<sup>160</sup> Essentialist conceptualisation entails identification of the essence of a thing – a three-legged dog may have lost its tail, no longer bark and suffer from a condition that means that it has lost its fur, but it will still be a dog because it satisfies the hidden essence that causes it to be a dog.<sup>161</sup> Thus, a 'theory theory' of concepts does not countenance the checklist of observable properties envisaged by classical theories. One key benefit of 'theory theory' is that it appears to explain the development of concepts as children mature into adulthood,<sup>162</sup> and so it is understandable that developmental psychologists have been most attracted to the 'theory theory' of concepts.

Under the second type of 'theory theory', concepts are parts of a broad theoretical framework within which the mind organises concepts into domains. Machery suggests that 'domains are sets of entities, including categories, properties, and processes, that

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<sup>157</sup> See extract accompanying n 35 above.

<sup>158</sup> Parsons, 'Income Tax - An Institution in Decay', above n 121.

<sup>159</sup> Prebble, above n 62 and Prebble, above n 63.

<sup>160</sup> Laurence and Margolis, above n 129, 45-6.

<sup>161</sup> S Gelman and H Wellman, 'Insides and essences: Early understandings of the non-obvious' (1991) 38 *Cognition* 213, cited by Machery, above n 132, 103.

<sup>162</sup> Laurence and Margolis, above n 129, 46-47.

are treated similarly by the mind'.<sup>163</sup> Thus, for example, artificial and natural domains may be separated upon the principle of differentiating those things that have been created intentionally from those that arose without deliberate action. Accidental inventions may pose a challenge for this neat categorisation, but the point is that the 'theory theory' envisages a metatheoretical structure within which concepts (possibly comprising mini-theories) will be organised.

In the context of the income tax, a 'theory theory' of income could be grounded upon some concept of justice. Benefit theory<sup>164</sup> and gains theory<sup>165</sup> are alternate options that might shape our thinking about what falls within the class of 'income', either generally or more specifically in the context of taxation. Alternatively, the subjective intention of the taxpayer (or objective/subjective intention) might offer a similar foundation for explaining categorisation of particular amounts as income.<sup>166</sup> If there is a change to a part of the underlying metatheoretical structure, it is reasonable to expect that this flapping of a butterfly's wings might generate ripples throughout the entire conceptual structure as theories of different concepts are adjusted to take account of the changes as they occur. Thus, if the class of things in the world that is grouped under a particular concept changes, then this could affect the scope of other concepts. For example, the concept of 'capital' might change, prompting a reconsideration of the concept of income. Likewise, the concept of 'business activity' might change, once again prompting a reconsideration of 'income' and 'capital'.<sup>167</sup> This approach clearly has implications for the durability of particular concept definitions, as they are liable to change at any moment as a result of change to any other conceptual definition.

#### 5.9.7 *Combinations of conceptual theories*

So far we have been examining individual theories of concepts upon the basis that a person applies the one theory of concepts with respect to all concepts and with respect to all aspects of those concepts. We have noted that depicting broad concepts of concepts in this way is undertaken with crude brushstrokes that obscure the nuances of individual theories and that individual theories may contemplate that concepts are a complex assemblage of different concepts of concepts. Some theories of concepts take this heterogeneity further in accepting that individuals apply combinations of concepts of concepts in higher level thought.

These hybrid theories suggest that individuals use different conceptual theories with respect to different aspects of a concept, but nevertheless arrive at a fixed concept comprising different conceptual approaches.<sup>168</sup> These heterogeneous theories also accept that individuals apply different concepts of concepts, but argue that individuals may have different concepts for the same thing and that the application of the most appropriate concept will be determined having regard to the context in which the conceptual thinking occurs.

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<sup>163</sup> Machery, above n 132, 103.

<sup>164</sup> Graeme Cooper, 'The Benefit Theory of Taxation' (1994) 11(4) *Australian Tax Forum* 397.

<sup>165</sup> Simons, above n 98.

<sup>166</sup> For discussion of intention of the artefact maker, see Paul Bloom, 'Intention, history, and artefact concepts' (1996) 60(1) *Cognition* 1, cited in Machery, above n 132, 103.

<sup>167</sup> See discussion of this point in *Commissioner of Taxation v Stone* (2005) 222 CLR 289, 295-297.

<sup>168</sup> Machery, above n 132, ch 3.

### 5.9.8 *Is there an ordinary concept of a concept?*

The preceding overview of different concepts of concepts indicates that there is considerable difficulty in identifying those concepts which are ordinary, in the sense of widely used or attested.

If 'widely used or attested' is understood to imply that something is preferred, then it is possible that the set identified by the label 'ordinary concept' is an empty set because no concept of a concept is preferred. Rather, it is possible that different ideas of concepts are applied by different people and in different contexts. However, I suggest that it is appropriate to adopt the interpretative presumption against meaningless statutory words by proceeding upon the basis that 'widely used' does not require that a particular concept of a concept is preferred. Rather, widely used can be understood to mean 'commonly found in usage'. Thus, given that at least some of the different concepts of concepts described here are commonly accepted to be found in common usage, the legislative reference to 'ordinary concepts' is not an empty set.

However, proceeding on this basis does not resolve the difficulty of identifying ordinary concepts because the ordinary concept of a concept could include all manner of theories of concepts. If so, a judge must extract a concept of income after considering a multitude of possibly incomparable, ordinary concepts of income, and that choice is not guided by any principle expressed in the legislation or the case law.

## 6. CONCLUSION

In *Montgomery* a majority of the High Court stated that at least some elements of the statement of Sir Frederick Jordan in *Scott* identified the essential nature of the inquiry into the meaning of income and that this statement was not a matter of ritual incantation. In doing so, the High Court juxtaposed ritual incantation with analysis, implying that statutory meaning is an object that can be discovered by analysis of the relevant statutory text in accordance with orthodox principles of statutory interpretation.

Despite this legalist depiction of the objective discovery of law, the meaning of the subsection 6-5(1) definition of 'ordinary income' remains shrouded in a Dickensian fog<sup>169</sup> that several authoritative High Court decisions upon the subject have not dispersed. Indeed, with respect, those High Court decisions appear to have thickened the fog by adopting various inconsistent statements of the elements of Sir Frederick Jordan's statement. Moreover, those decisions have not analysed the elements of that statement. Given this significant lacuna in the High Court's elaboration of the concept of ordinary income, this article analysed Sir Frederick Jordan's statement by locating it in the context of the vibrant linguistic philosophy of the early twentieth century. Viewed through the lens of this contemporaneous linguistic philosophy, analysis of Sir Frederick's statement suggests that the meaning and interaction of the elements of that statement are ill-defined. Further, it was noted that some of those elements may be contradictory, giving rise to the possibility that Sir Frederick Jordan's statement incorporates irresolvable contradictions.

These conclusions regarding the absence of analysis undertaken by the High Court and the difficulties that would arise were such analysis were to be undertaken, are significant for several reasons. They are significant for the doctrinal approach to the concept of

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<sup>169</sup> Charles Dickens, *Bleak House* (Penguin, 1971 [1853]) ch 1.

ordinary income, for our self-understanding as we reflect upon the nature of 'law'<sup>170</sup> and also to the sociology of law.

From the perspective of doctrinal elaboration of the concept of income, the analysis of Sir Frederick Jordan's statement indicates that the statement does not offer a secure foundation for identifying 'income'. This indicates that a different approach to the statutory definition of 'ordinary income' must be found. However, the plurality of concepts of concepts poses considerable challenges if the statutory definition of ordinary income is to be interpreted in line with orthodox principles of statutory construction.

If there is no uniformly adopted foundation upon which amounts are characterised under the income/capital dichotomy, there is the possibility that law is inherently pluralist as Davies suggests.<sup>171</sup> Taking this inherent heterogeneity of law to an extreme, it is possible that this instance of what is commonly described as 'black letter law' in fact is one in which philosophical scepticism might offer a more appropriate account<sup>172</sup> than theories of law framed upon determinate legal meaning<sup>173</sup> or limited 'judicial discretion'.<sup>174</sup> Moreover, as 'judicial activism'<sup>175</sup> is necessarily part of the practice of Australian taxation law because of the absence of analysis described in this article, and also because of the intrinsic pluralism that would be exposed if analysis were undertaken, sociological examination of law's legitimacy in this domain should be re-examined. If the legitimacy of judicial practice in this domain cannot plausibly be grounded upon the objective discovery of statutory meaning, then the existence and foundations of that legitimacy need to be reassessed.

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<sup>170</sup> Raz, *Between Authority and Interpretation*, above n 58, 31.

<sup>171</sup> Margaret Davies, 'The Ethos of Pluralism' (2005) 27(1) *Sydney Law Review* 87.

<sup>172</sup> Prebble, 'Why is Tax Law Incomprehensible?', above n 63.

<sup>173</sup> For example, Ronald Dworkin, above, n 58.

<sup>174</sup> H L A Hart, *The Concept of Law* (Oxford University Press, 2nd ed, 1994) ch 7.

<sup>175</sup> Dyson Heydon, 'Judicial Activism and the Death of the Rule of Law' (2003) *Quadrant*, January-February, 9; for critical review of this article, see Allan C Hutchinson, 'Heydon' Seek: Looking for Law in All the Wrong Places' (2003) 29(1) *Monash University Law Review* 85.



# Value-added tax effort

Marius van Oordt<sup>1</sup>

## ***Abstract***

The success of the value-added tax (VAT) towards revenue objectives is limited by the environment within which the VAT operates. Controlling for these environments allows for comparative estimates of countries' VAT efforts. This article provides such estimates for 129 countries with a VAT.

**Key words:** value-added tax, tax capacity, tax effort, VAT, GST

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<sup>1</sup> African Tax Institute, University of Pretoria, Pretoria, South Africa; marius.vanoordt@up.ac.za.

## 1. INTRODUCTION

Many countries require additional revenue from the VAT towards fiscal consolidation and sustained economic development. Cnossen (2015) confirms this argument for African countries, and de Mooij and Keen (2012) for European countries. To obtain such additional revenues, countries should increase their VAT performance.

Three measures of VAT performance are generally used: a VAT to gross domestic product (GDP) ratio, a VAT to total final consumption ratio, and a C-efficiency ratio, which is similar to a VAT to final consumption ratio, but controls for standard rate differences among countries. Although each of these measures is useful, none of them takes into account that the performance of any VAT is limited by the environment within which that VAT operates. This environment is mostly beyond the control of the policy-maker; policy-makers face VAT capacity constraints. One may therefore argue that taking the different VAT capacity constraints of countries into account will offer an improved comparable measure of VAT performance, namely VAT effort.<sup>2</sup> Following the traditional tax effort approach, I estimate a VAT effort index for 129 countries over a period of 11 years (2004-2014).

The literature on tax effort and VAT performance is relevant for this article. Prominent contributions in the tax effort literature include Lotz and Morss (1967), Bahl (1971), Leuthold (1991), Tanzi (1992), Strotsky and WoldeMariam (1997), Piancastelli (2001), Teera (2002), Alm, Martinez-Vazquez & Schneider (2004), Bahl (2005), and Clist and Morrissey (2011) who use variables representing the economic environment as tax capacity constraints. Following Bird, Martinez-Vazquez and Torgler (2004), demand-side factors such as the political institutional environment have also been included as tax capacity constraints by Gupta (2007), Bird and Martinez-Vazquez (2008), Mkandawire (2010), Pessino and Fenochietto (2010), Le, Moreno-Dodson and Bayraktar (2012), and Fenochietto and Pessino (2013). I also follow Bird, Martinez-Vazquez and Torgler (2004) and include both economic environment and political institutional environment factors as VAT capacity constraints. Similar to Davoodi and Grigorian (2007) I include country and year fixed effects in the analysis.<sup>3</sup>

In the VAT performance literature, simple cross-country measures of VAT performance – such as VAT to GDP and C-efficiency – are often provided, as for instance by Martinez-Vazquez and Bird (2011) and de Mooij and Keen (2012). Other empirical work considers the effect of having a VAT on total tax performance (Baunsgaard & Keen, 2010; Keen & Lockwood, 2010) and other economic factors such as trade (Feldstein & Krugman, 1990; Hines & Desai, 2005). The most relevant VAT literature for this article is the study by Aizenman and Jinjark (2008) who provide empirical evidence to explain the variation in C-efficiency among countries. However, the aim of this article is not to explain the country variation in VAT performance, but rather to provide an improved measure of comparable VAT performance.

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<sup>2</sup> In my view, C-efficiency remains a better measure of VAT performance for non-comparative purposes. Further, my understanding of the Keen (2013) article is that C-efficiency is not meant to be a comparative measure of VAT performance, although in practice it is often used as one.

<sup>3</sup> Year fixed effects will for instance be events that influenced all countries' VAT performance, such as the 2008 financial crisis. Country fixed effects will for instance be the location of the country and the historical background of the country.

This article contributes to the tax literature by providing the first VAT effort index. The regression results on VAT capacity factors, although informative, should be interpreted with caution. Endogeneity bias is not addressed for these results and consistent coefficients are beyond the aim of this article. For empirical results on VAT capacity factors, see Aizenman and Jinjark (2008). The estimated VAT effort index is useful in identifying the potential of countries to increase VAT revenues by either increasing the rate of the tax, broadening the base of the tax or increasing tax compliance.

In the remainder of the article, I first discuss the measurement of VAT performance used and provide *a priori* justifications for the VAT capacity variables included in the models estimated. The regression results used to predict VAT capacity, a VAT capacity index and a VAT effort index then follow.

## 2. VAT PERFORMANCE

### 2.1 VAT ratio

The terms VAT ratio, VAT capacity and VAT effort are used similarly to past tax effort studies. For tax effort studies, the tax ratio is almost exclusively calculated as:

$$Tax\ ratio = \frac{TR}{Y} \quad (1)$$

where  $TR$  is total tax revenue and  $Y$  is GDP. In this equation, GDP is used as an overall indicator of tax capacity (Lotz & Morss, 1967). In this sense, the tax ratio can also be viewed as a tax effort indicator since tax effort can be defined as the extent to which a government raises tax revenues, taking into account its capacity to do so (Advisory Commission of Intergovernmental Relations, 1962). Since the VAT is not intended to be a tax on production, but rather on consumption, there is little reason to consider GDP as an overall indicator of VAT capacity. More specifically, exported goods (included in GDP) are predominantly not taxed under a VAT, while imported goods (excluded from GDP) are taxed under a VAT. Total final consumption is therefore the preferred indicator of overall VAT capacity; the calculation thereof is more consistent with the potential amount of goods and services that can be taxed under a VAT.<sup>4</sup> For the regression results in this article (used to construct the VAT effort index) the dependent variable, being  $VATratio$  can be written:

$$VATratio = \frac{VR}{TCE} \quad (2)$$

where  $VR$  is VAT revenue and  $TCE$  is total consumption expenditure of households and government. Government consumption is specifically included since many experts argue that goods and services supplied by government entities, public sector bodies, non-profit organisations, charitable organisations and similar tax-exempt bodies can and should be taxed under a VAT.<sup>5</sup>

The other popular measure of VAT performance is C-efficiency ( $CEFF$ ), which can be written as:

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<sup>4</sup> The only exclusion to this statement is the treatment of residential consumption of non-investment goods and services in other jurisdictions. This consumption is included in total final consumption but cannot be taxed under the VAT.

<sup>5</sup> Refer to de la Feria (2009), Gendron (2010) and Henkow (2013) for further discussion on this.

$$CEFF = \frac{VR}{TCE \times SR} \quad (3)$$

where  $SR$  is the standard rate of VAT for each country in the dataset. It would not be sensible to use C-efficiency as the measure of VAT performance in this article since the standard rate of the VAT is not a capacity constraint; it is a tool used to raise VAT effort.<sup>6</sup> Another potential measure of VAT performance found in the representative tax system literature (Bahl, 1972) would be to use representative VAT as:

$$RepVAT = \frac{\sum_{j=1}^n \left( \frac{VR_{ij}}{TCE} \right)}{n} \quad (4)$$

where  $n$  is the sample size. The  $RepVAT$  measure therefore indicates the VAT performance of countries if all countries had the same VAT rate. This approach is not followed for purposes of this article since the objective of this article is to obtain the best potential measure of the true tax base in calculating the VAT effort index. In the representative tax system literature the focus is on the specific tax capacity measures and how the obtained coefficients of these measures relate to overall tax capacity (Bahl, 1972).

The data used to calculate the VAT ratio, summarised in Table 1, were obtained from the International Monetary Fund's International Financial Statistics dataset, Government Financial Statistics dataset and World Revenue Longitudinal dataset, the Organisation for Economic Co-operation and Development's National Accounts datasets and many countries' National Accounts and Public Finance Reports (or similar reports).

**Table 1: Summary Statistics of VAT Ratio**

Variable	N	Mean	Std Dev.	Min	Max
VAT ratio	1187 <sup>7</sup>	7.779	3.053	0.176	15.995

## 2.2 VAT capacity

In this section I identify and discuss VAT capacity factors that potentially have a significant influence on VAT performance. To identify VAT capacity factors, I rely on discussions in the theoretical VAT literature suggesting factors that may be expected to influence VAT performance, and also on the empirical VAT literature that considers the determinants of C-efficiency. This literature is discussed under the relevant headings in this section. I refer to tax-effort literature where the VAT literature does not provide adequate guidance.

<sup>6</sup> For decomposition of C-efficiency, see Keen (2013).

<sup>7</sup> Outliers were removed from the dataset taking into account their studentised residuals, leverage and Cook's distance. An outlier was only removed in the case where it was apparent that an outlier resulted from a data error.

It is not the intention that the list of capacity factors be exhaustive since many capacity factors will be highly collinear and I do not aim to make arguments of causality based on the results of the estimations performed.

### 2.2.1 *Political institutions*

[T]he tax level in any country does not just depend on the ability of its tax administration to collect taxes from the available ‘tax handles’. If taxpayers perceive that their interests are properly represented in political institutions and consider government not wasteful but helpful, their willingness to vote for higher levels of taxation and comply with their tax obligations will increase.

(Bird et al., p. 16.)

The performance of the VAT in any country is influenced by a country’s political institutions (Bird & Gendron, 2007). Political institutions are central in determining the structure of the VAT when adopted (Eccleston, 2007; James, 2015) and without political will this structure is unlikely to change (Ebrill et al., 2001; Crawford, Keen & Smith, 2010). These institutions most likely also influence compliance to the VAT; it seems reasonable to expect people to be more willing to pay taxes to governments that are less corrupt, more effective and fairly elected.

In a cross section of 42 countries, de Mello (2009) finds that government effectiveness, regulatory quality and rule of law are statistically significant determinants of C-efficiency. Aizenman and Jinjark (2008), with the use of a panel dataset of 44 countries over the period 1970-99, show that the durability of the political regime as well as regulation of political participation are statistically significant determinants of C-efficiency. Governments’ ability to control corruption was also shown to be correlated with C-efficiency by McCarten (2006).

I therefore consider political institutions as a potential VAT capacity factor and use data from the World Bank’s Worldwide Governance Indicators to construct an index named Institutions.<sup>8</sup> Six measures based on the perceptions of a large number of enterprises, citizens and expert survey respondents are included in the index and described in Table 2. Table 3 show the summary statistics of the index.

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<sup>8</sup> The variables in the index showed a high degree of multicollinearity and are therefore not individually included in the models estimated. The index was constructed by ranking countries for each variable in the index and taking the average rank over all variables for each country.

**Table 2: Institutions Index Variables**

Variable	Description
Political stability and absence of violence	Perceptions of the likelihood of political instability and/or politically motivated violence, including terrorism.
Control for corruption	Perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as 'capture' of the state by elites and private interests.
Regulatory quality	Perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
Government effectiveness	Perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
Rule of law	Perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
Voice and accountability	Perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

Source: Kaufmann, Kraay and Mastruzzi (2011)

**Table 3: Summary Statistics of Institutions**

Variable	N	Mean	Std Dev.	Min	Max
Institutions	1187	6.05	3.273	0.06	11.975

### 2.2.2 Development

Wagner's law is well known; the size of a government is expected to expand as a country becomes more developed. It can be expected that public expenditure on defence, law and order will increase and government will take on additional functions such as the provision of education and welfare services (Peacock & Scott, 2000). This means that as the level of development of a country rises, the demand for additional tax revenue would increase. It is not only in this sense that development could influence VAT performance. Development is associated with higher levels of education, literacy and technology, all of which can be expected to raise the capacity of a country to administer taxes.

I therefore consider the level of development as a VAT capacity factor, measured as GDP per capita. Data for this variable were obtained from the World Bank's World Development Indicators dataset and this variable is summarised in Table 4.

**Table 4: Summary Statistics of GDP per Capita**

Variable	N	Mean	Std Dev.	Min	Max
GDP per capita	1187	15006	19798.563	161.877	116612.9

### 2.2.3 Trade openness

It is standard policy advice following trade liberalisation to increase indirect taxes, especially the VAT, in order to replace lost trade revenues (Keen & Ligthart, 2002). Also, collecting VAT on imports is easier than through the self-assessment system tied to domestic VAT collections (Baunsgaard & Keen, 2010). Trade openness has also been shown to significantly influence development (Sachs et al., 1995; Dollar & Kraay, 2004) and government size (Alesina & Wacziarg, 1997). Both, as discussed above, can be expected to influence VAT performance.

I therefore include openness (summarised in Table 5) as a VAT capacity factor, using the standard measure of exports plus imports to GDP with data obtained from the World Bank's World Development Indicators dataset.

**Table 5: Summary Statistics of Openness**

Variable	N	Mean	Std Dev.	Min	Max
Openness	1187	.920	.524	.221	4.396

### 2.2.4 Hard-to-tax supplies

Traditionally tax effort studies have identified 'easy-to-tax' sectors as tax handles expected to increase tax capacity. In the VAT literature, the focus is predominantly not on easy-to-tax sectors, but rather on hard-to-tax supplies. The predominant hard-to-tax supplies that can be expected to influence VAT performance are financial services and agriculture. Although the supply of residential accommodation is hard to tax, the revenues received on the exempt supply of residential immovable property serve as a fairly accurate proxy for the total value of the accommodation service and should therefore not have a significant influence on VAT performance (Cnossen, 2011).<sup>9</sup> In this section I discuss the inclusion of financial services and agriculture as VAT capacity factors.

Financial services, which include deposits, lending, issuance of financial securities, long-term insurance, brokerage, advisory services and many other services are 'the major remaining frontier for the value added tax' (Gendron, 2008, p. 494). Some methods such as the addition method applied in Israel, France and Denmark or the subtraction method provide a fairly accurate proxy for the value of intermediation services, but cannot be applied on a transaction-by-transaction basis. This means that these methods are not conceptually correct, since the VAT is a transaction tax. Also, no

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<sup>9</sup> If the value of the property increases to levels above the interest rate, the margin is not taxed.

deduction of input VAT would be available to businesses to whom financial services are supplied under these methods, resulting in tax cascading.

The cash-flow approach proposed by Poddar and English (1997) allows for the correct calculation of value added by intermediation services and the taxation of this value on a transaction-by-transaction basis. There appear to be two main reasons for the non-adoption of this approach: (1) the administrative complexities of this approach are large, and (2) there is a concern of a loss in tax revenue as a result of implementing this approach (de la Feria & Lockwood, 2010).

The New Zealand approach of zero rating business-to-business core financial services<sup>10</sup> is not a method to tax financial intermediation, but is rather used to remove the negative effects of the exemption of these services. Although this method can be preferred to the exemption when only considering the efficiency of the VAT,<sup>11</sup> the potential loss in revenue when compared to the exemption decreases the attractiveness of this option.

Since identifying and separating the intermediation charge from the full margin of financial services efficiently and practically remains problematic, in most instances it is advised to exempt non-fee based financial services from the VAT (Ebrill et al., 2001). This exemption will influence VAT performance since the value added by intermediation services is not directly taxed. Also, the relative importance of financial services in the economy would be indicative of the sectoral composition of the economy; a general tax capacity factor. I therefore include Financial Credit to GDP (summarised in Table 6) in the models estimated as a proxy for the value of financial intermediation services supplied in the economy with use of data from the World Bank's World Development Indicators dataset.

**Table 6: Summary Statistics of Financial Credit to GDP**

Variable	N	Mean	Std Dev.	Min	Max
Financial credit to GDP	1187	129.14	68.341	15.4	430.33

Under best VAT practice, agriculture should not be taxed any differently to other standard rated supplies of goods and services (Cnossen, 2018). In countries where collection from and administration of rural farmers provide a challenge, efficiency concerns may provide an argument for non-standard treatment of agriculture. This argument is, however, unlikely to hold in most countries.

Political considerations, together with distributional concerns, have however led to a non-standard treatment in the form of exemptions, reduced rates or zero rates applied to agriculture inputs and outputs under most VATs. Although strong arguments have been made against this treatment of the agricultural sector,<sup>12</sup> this sector continues to avoid full taxation under the VAT. Agriculture is also often included in tax effort studies to proxy for the sectoral composition of the economy. I therefore include Agriculture to

<sup>10</sup> Supplies of financial services to consumers remain exempt under this approach.

<sup>11</sup> This approach relieves the obligation of financial institutions to apportion their input VAT and further decreases economic distortions by removing the cascading tax. It is of course required of financial institutions to differentiate between businesses and consumers.

<sup>12</sup> Refer to Cnossen (2018) for an in-depth discussion on these arguments.



GDP (summarised in Table 7) as a VAT capacity factor with the use of data from the World Bank's World Development Indicators dataset.

**Table 7: Summary Statistics of Agriculture to GDP**

Variable	N	Mean	Std Dev.	Min	Max
Agriculture to GDP	1187	10.712	10.695	0.28	55.867

### 2.2.5 Other capacity factors

In the estimations performed, other capacity factors are also included to test the robustness of the estimates, namely unemployment, population and foreign aid.<sup>13</sup> Although these variables are not used to predict VAT capacity for purposes of the VAT effort index, justification for the inclusion of these variables is important.

Unemployment is included as a VAT capacity factor since high levels of unemployment may constrain the government's ability to increase taxes, since such an increase could further increase unemployment (Blanchard & Katz, 1996). Population is included since smaller countries tend to have more international trade than larger countries. Similarly, larger countries tend to have more domestic trade than smaller countries (Alesina & Wacziarg, 1998). This is important since the burden of compliance and administration of the VAT is different for international trade compared to domestic trade. Lastly, foreign aid is included since this is likely to influence the need for countries to look towards domestic revenue mobilisation.

One potentially important VAT capacity factor not specifically included in the analysis due to data limitations is the size of the informal sector.<sup>14</sup> The informal sector can only be taxed indirectly under a VAT by taxing the production of informal businesses.<sup>15</sup> This means that the revenue from the value added by informal businesses that should be registered for VAT is forgone. It should, however, be noted that the level of development and the size of the agriculture sector can be viewed as 'broad indicators of informality' (Keen & Lockwood, 2010, p. 143).<sup>16</sup> Further, Friedman et al. (2000) show how political institutions have a statistically significant influence on the size of the informal sector. The influence of the informal sector on VAT performance should therefore be fairly well represented by the inclusion of the level of development, the size of the agricultural sector and political institutions in the models estimated.

## 3. ESTIMATION AND REGRESSION RESULTS

The VAT is imposed in 161 countries of which 129 are included in the panel dataset.<sup>17</sup> For the analysis I only consider recent VAT performance, from 2004 to 2014. All

<sup>13</sup> These variables are obtained from the World Bank's World Development Indicators dataset.

<sup>14</sup> For purposes of this article the informal sector can be taken to mean production activities that are not regulated by societal institutions (Castells & Portes, 1989).

<sup>15</sup> These businesses are not registered for VAT and can therefore not claim an input VAT deduction on their inputs.

<sup>16</sup> By using the measurements of informality in Schneider, Buehn and Montenegro (2010), I find a correlation of 0.575 between the size of the agriculture sector and the size of the informal sector.

<sup>17</sup> Refer to Schenk, Thuronyi and Cui (2015) for a list of countries with a VAT. It should also be noted that the number of countries with a VAT depends on what is considered a VAT; different sources therefore have more or fewer countries. A country was only excluded from the sample if sufficient data could not be obtained for the country. The panel is unbalanced.

models are estimated by the two-way fixed effects estimator<sup>18</sup> and I only show country clustered standard errors which are robust to arbitrary heteroscedasticity and autocorrelation. Further, to compare the relative influence of the VAT capacity factors on VAT performance, all variables are standardised. The model estimated, without variables included to test the robustness of the estimates, is written as:

$$VATratio = \beta_1 Inst_{it} + \beta_2 LogGDPpc_{it} + \beta_3 LogOpen_{it} + \beta_4 FcGDP_{it} + \beta_5 AgGDP_{it} + \mu_i + \lambda_t + v_{it} \quad (5)$$

where  $i = 1, \dots, N$ ;  $t = 1, \dots, T$ ;  $Inst$  = Institutions;  $GDPpc$  = GDP per capita;  $Open$  = Openness;  $FcGDP$  = Financial credit to GDP;  $AgGDP$  = Agriculture to GDP;  $\mu_i$  = unobservable country effects;  $\lambda_t$  = unobservable year effects and  $v_{it}$  = the remainder error term. Following the estimation of (3), I add unemployment, the natural log of population, and foreign aid to GDP interchangeably to give an indication of the robustness of the estimates of (3). The results of these estimations are provided in Table 8.

**Table 8: Regression of the VAT Ratio (Equation 2) on VAT Capacity Factors**

VAT ratio	(1)	(2)	(3)	(4)
Institutions	0.269** (0.106)	0.269** (0.116)	0.276** (0.110)	0.252** (0.111)
Log GDP per capita	0.582*** (0.199)	0.431* (0.222)	0.573*** (0.205)	0.596*** (0.203)
Log openness	0.332*** (0.0770)	0.341*** (0.0761)	0.333*** (0.0771)	0.351*** (0.0760)
Financial credit to GDP	0.0858* (0.0459)	0.0895* (0.0456)	0.0868* (0.0465)	0.0882* (0.0467)
Agriculture to GDP	0.0168 (0.0941)	-0.0345 (0.0959)	0.0147 (0.0951)	0.0189 (0.0958)
Unemployment		-0.0738* (0.0377)		
Log population		0.176 (0.937)	0.276 (0.929)	0.363 (0.927)
Aid to GDP				0.0317 (0.0329)
Observations	1,187	1,148	1,187	1,180
R-squared	0.944	0.946	0.944	0.945
Country FE	YES	YES	YES	YES
Year FE	YES	YES	YES	YES

Notes: Country clustered standard errors in parenthesis. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ . All variables have been standardised.

The results in Table 8 show that all statistically significant coefficients enter with the expected sign. As institutional quality, the level of development and openness increased,

<sup>18</sup> The null hypothesis of the Hausman test was rejected, meaning the random effects estimator would provide inconsistent estimates.

VAT performance also increased. The positive sign of financial credit to GDP supports de la Feria and Lockwood's (2010) hypothesis that VAT revenue could decline by removing the exemption applicable to financial services. The negative sign of unemployment is also consistent with the hypothesis that high unemployment limits the potential to increase VAT effort.<sup>19</sup>

It can also be seen, with reference to the magnitude of the coefficients, that the level of development is the most influential VAT capacity factor, followed by the level of international trade and the quality of institutions. A one standard deviation increase in the level of development, the level of international trade and the quality of institutions is associated with a 1.77%, 1.01% and 0.82% increase in the VAT ratio, respectively. These results should however be interpreted with care; all three of these coefficients most likely suffer from omitted variable bias and simultaneity or reverse causality bias.<sup>20</sup> No causal arguments can therefore be made and such arguments are also not the objective of this article.

To determine the extent to which VAT capacity factors explain the variance in the VAT ratio, the R-squared statistic is of importance. As is evident from Table 8, 94% of the variance in the VAT ratio can be explained by the inclusion of the VAT capacity factors as per model (3) above. This means that the model predicts the VAT capacity of a country well, which is important when calculating the VAT effort indexes.

#### 4. VAT EFFORT

VAT effort can be defined as the extent to which a government raises revenues from the VAT, taking into account its capacity to do so. This means that to calculate the VAT effort of a country, the VAT capacity of a country should first be determined. As previously indicated, the major capacity factor for any VAT is the level of consumption in the economy; the base of the VAT.<sup>21</sup> For this reason VAT performance is measured in this article as the amount of VAT revenue collected as a percentage of total final consumption, referred to as the VAT ratio.

Although consumption is the major capacity factor of the VAT, it is not the only capacity factor. This is perhaps the major weakness of other measures of VAT performance, such as C-efficiency, for cross-country comparative purposes. No two countries are the same. Besides having different levels of consumption, countries differ by institutional quality, their level of development and the advantages in tax administration associated with development. Countries' trade policies, population size, location and other factors that influence the level of international trade also differ. Countries further have hard-to-tax sectors that differ in size, such as the financial, agricultural and informal sectors.

Taking such VAT capacity constraints into account provides for an improved measure of VAT capacity. I report the average VAT capacity for 129 countries over 11 years in Table 9, as predicted by the regression of VAT ratio on a selection of VAT capacity

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<sup>19</sup> The results also appear robust to the inclusion and exclusion of additional variables.

<sup>20</sup> The structure and rate of the VAT can be expected to influence the level of development of a country since tax revenues are used towards development. Similarly, the compliance costs involved in exporting goods and the payment of refunds will most likely influence international trade. Moore (2007) also shows that taxation affects the quality of governance.

<sup>21</sup> In practice, VATs often tax production by exempting the supply of certain goods and services.

factors. The VAT capacity index is ranked from the country with the highest capacity to the country with the lowest capacity. The VAT capacity index indicates the percentage of total consumption expenditure that can be taxed, taking into account the economic and political institutional environments of each country. This measure does not take into account the current rate and base applied in each country. The capacity factors included are political institutions, the level of development, trade openness, the size of the financial services and agriculture sectors, population size, and country and year fixed effects (model (3) in Table 8).<sup>22</sup>

As expected, more developed countries with higher quality institutions and greater trade openness have a higher VAT capacity than lesser developed countries with poorer institutions and less international trade. Luxembourg, for instance, with the highest VAT capacity of 20 (meaning the VAT ratio at capacity is predicted at 20%), trades internationally nearly four times as much as it produces locally, ranks among the most developed countries, and has institutional quality that ranks very high.<sup>23</sup> Luxembourg also has a large financial services sector and a very small agricultural sector. In short, Luxembourg is probably close to the ideal environment for the VAT to operate in, when considering revenue performance.

At the bottom of the index is Burundi, an East African country with the second lowest level of development in the world. About 90% of the population are subsistent farmers (Agriculturist, 2017) whose self-supplies are not included within the scope of a VAT. With only about 5% of the population having access to electricity (USAID, 2017), VAT administration challenges are bound to be excessive. It is admittedly an extreme example, but it does not seem sensible to compare countries such as Luxembourg and Burundi by only referring to the amount of their consumption that is taxed.

**Table 9: Index of VAT Capacity (VC)**

Country	VC	Country	VC	Country	VC
Luxembourg	20	Croatia	13.2	Brazil	9.92
Singapore	18.69	Poland	13.19	Armenia	9.91
Ireland	17.75	Equatorial Guinea	13.14	China	9.9
Netherlands	17.28	Dominica	12.78	Argentina	9.87
Switzerland	17.23	Bulgaria	12.75	Peru	9.85
Denmark	16.87	St Vin. and Gren.	12.71	Philippines	9.8
Belgium	16.77	Botswana	12.68	Nicaragua	9.61
Iceland	16.45	Costa Rica	12.66	Colombia	9.59
Malta	16.36	Thailand	12.53	Ghana	9.55
Sweden	16.23	Grenada	12.45	Ecuador	9.53
Austria	16.21	Lebanon	12.32	Kyrgyzstan	9.53
Norway	16.16	Jordan	12.31	Guatemala	9.48
Cyprus	16.04	Namibia	12.12	Sri Lanka	9.48
Finland	15.91	Uruguay	12.12	Bolivia	9.38
Germany	15.48	South Africa	11.95	Cambodia	9.2

<sup>22</sup> I do not include the other capacity factors as per the second to fourth regression results since these factors did not substantially improve the explained variance in VAT ratio and also to keep the sample size as large as possible.

<sup>23</sup> The statements in this section are based on the data used for the estimations performed in this article, unless indicated otherwise.

Country	VC	Country	VC	Country	VC
Canada	15.43	Romania	11.9	Egypt	9.16
Slovenia	15.23	Fiji	11.88	Indonesia	9.09
Slovakia	15.06	Cape Verde	11.78	Senegal	8.93
United Kingdom	14.94	Jamaica	11.68	Cote d'Ivoire	8.78
Czech Rep.	14.93	Samoa	11.68	Mozambique	8.72
New Zealand	14.87	Tunisia	11.65	India	8.43
Hungary	14.81	Macedonia	11.58	Zambia	8.29
Estonia	14.76	Belarus	11.57	Togo	8.1
Seychelles	14.62	Serbia	11.51	Benin	7.93
France	14.52	Mexico	11.32	Kenya	7.86
Korea, Rep.	14.47	Turkey	11.31	Nigeria	7.86
Australia	14.4	Kazakhstan	11.3	Tajikistan	7.86
Barbados	14.36	Mongolia	11.13	Mali	7.82
Portugal	14.32	Albania	10.93	Sierra Leone	7.8
Lithuania	14.31	Georgia	10.86	Tanzania	7.74
Malaysia	14.28	Ukraine	10.71	Madagascar	7.72
Spain	14.22	Azerbaijan	10.67	Malawi	7.56
Israel	13.97	El Salvador	10.67	Cameroon	7.34
Japan	13.97	Vietnam	10.66	Burkina Faso	7.22
Latvia	13.87	Lesotho	10.53	Nepal	6.97
St Kitts and Nevis	13.82	Moldova	10.53	Uganda	6.82
Italy	13.81	Honduras	10.52	Bangladesh	6.54
Mauritius	13.71	Morocco	10.49	Pakistan	6.44
Panama	13.64	Paraguay	10.37	Ethiopia	6.37
Greece	13.4	Dominican Rep.	10.31	Niger	6.07
Trin. and Tobago	13.36	Russia	10.29	Congo, DR	5.76
Chile	13.35	Venezuela	9.95	Cen. African Rep.	5.61
St Lucia	13.33	Algeria	9.93	Burundi	5.49

Following the prediction of total VAT capacity, calculating countries' VAT effort is straightforward. The VAT effort is calculated as:

$$VATeffort = \frac{VATratio}{VATcapacity} \quad (6)$$

Equation 6 shows that VAT effort is equal to the current percentage of total consumption expenditure that is taxed, divided by the percentage of total consumption expenditure that can be taxed (based on the results in Table 9). I provide the VAT effort index, together with an effort rank, alphabetically for all countries in the sample in Table 10.

Continuing with the example of Luxembourg and Burundi, Table 10 shows that Luxembourg has a VAT effort of 0.65. In 2014 (the last year in the data period), Luxembourg had a standard VAT rate of 15% and reduced rates of 12% and 6%. Luxembourg also had the fifth highest VAT ratio in the dataset and a C-efficiency exceeding 1 in 2014.<sup>24</sup> Yet, Luxembourg had capacity to increase revenues from the

<sup>24</sup> The C-efficiency is based on my own calculations with data used to calculate the VAT ratio used in this study.

VAT, which partially explains the increase in the VAT rates to 17%, 14% and 8% on 1 January 2015.

On the other hand, the VAT effort of Burundi is 0.95, the 12th highest in the sample. Burundi has a VAT rate of 18% with a reduced rate of 10%. Although Burundi's VAT is not a modern VAT, it also does not suffer from excessive exemptions, with a shorter list of exemptions than most European countries.<sup>25</sup> Although Burundi had a VAT ratio of about 5% and a C-efficiency of 0.28 in 2014, when considering its VAT effort, Burundi is not doing as poorly as these two figures suggest. The high VAT effort in Burundi also means that there is likely limited capacity to obtain further revenues from the VAT.

It can further be seen from the VAT effort index that some countries have a VAT effort exceeding 1. This may indicate an overreliance on revenues from the VAT. For instance, Belarus has a VAT effort of 1.13 and a VAT rate of 20%. With a personal income tax rate of only 13%, a corporate tax rate of 18% and no capital gains tax (World Bank, 2017a), it may be challenging for Belarus to ensure equity in the tax system.

As a final point, it should be understood that the VAT effort index is not useful in comparing policy or compliance gaps; this requires an alternative method by decomposing C-efficiency (refer to Keen, 2013). The main purpose of the index is to compare VAT performance among countries based on a comparable measure of VAT capacity and identify the potential of a country to increase their VAT effort.

**Table 10: Index of VAT Effort (VE)**

Country	Rank	VE	Country	Rank	VE
Albania	17	0.9	Latvia	69	0.64
Algeria	48	0.73	Lebanon	112	0.41
Argentina	30	0.8	Lesotho	99	0.53
Armenia	25	0.84	Lithuania	63	0.65
Australia	115	0.34	Luxembourg	64	0.65
Austria	66	0.64	Macedonia	35	0.79
Azerbaijan	11	0.95	Madagascar	124	0.23
Bangladesh	97	0.54	Malawi	91	0.56
Barbados	53	0.7	Malaysia	128	0.13
Belarus	3	1.13	Mali	40	0.77
Belgium	92	0.55	Malta	86	0.58
Benin	15	0.91	Mauritius	87	0.58
Bolivia	9	0.97	Mexico	113	0.4
Botswana	90	0.56	Moldova	4	1.06
Brazil	6	1	Mongolia	23	0.87
Bulgaria	19	0.89	Morocco	13	0.95
Burkina Faso	20	0.89	Mozambique	21	0.88
Burundi	12	0.95	Namibia	78	0.6
Cambodia	107	0.45	Nepal	45	0.75
Cameroon	31	0.8	Netherlands	95	0.55
Canada	119	0.29	New Zealand	36	0.79
Cape Verde	44	0.75	Nicaragua	70	0.63

<sup>25</sup> According to the Burundi VAT Act, financial services, residential accommodation, medical goods and services, education, agricultural inputs and postage stamps are exempted.

Country	Rank	VE	Country	Rank	VE
Central African Rep.	108	0.44	Niger	114	0.39
Chile	32	0.8	Nigeria	129	0.03
China	1	1.27	Norway	41	0.77
Colombia	54	0.7	Pakistan	61	0.66
Congo, DR.	123	0.23	Panama	117	0.31
Costa Rica	103	0.5	Paraguay	55	0.7
Cote d'Ivoire	127	0.2	Peru	22	0.88
Croatia	2	1.14	Philippines	122	0.24
Cyprus	67	0.64	Poland	51	0.71
Czech Rep.	68	0.64	Portugal	65	0.65
Denmark	37	0.77	Romania	29	0.81
Dominica	57	0.69	Russia	34	0.8
Dominican Rep.	106	0.48	Samoa	75	0.61
Ecuador	50	0.71	Senegal	18	0.9
Egypt	110	0.43	Serbia	10	0.96
El Salvador	71	0.62	Seychelles	16	0.91
Equatorial Guinea	126	0.21	Sierra Leone	116	0.34
Estonia	33	0.8	Singapore	120	0.26
Ethiopia	125	0.22	Slovakia	79	0.6
Fiji	26	0.84	Slovenia	47	0.74
Finland	49	0.72	South Africa	56	0.7
France	74	0.61	Spain	102	0.52
Georgia	5	1.02	Sri Lanka	100	0.53
Germany	82	0.58	St Kitts and Nevis	80	0.59
Ghana	93	0.55	St Lucia	42	0.77
Greece	83	0.58	St Vinc. and Gren.	101	0.53
Grenada	94	0.55	Sweden	43	0.76
Guatemala	84	0.58	Switzerland	118	0.31
Honduras	88	0.57	Tajikistan	24	0.85
Hungary	38	0.77	Tanzania	96	0.55
Iceland	58	0.69	Thailand	109	0.44
India	62	0.65	Togo	27	0.84
Indonesia	77	0.6	Trin. and Tobago	105	0.49
Ireland	85	0.58	Tunisia	60	0.68
Israel	59	0.68	Turkey	81	0.59
Italy	98	0.53	Uganda	76	0.61
Jamaica	72	0.62	Ukraine	7	1
Japan	121	0.25	United Kingdom	104	0.5
Jordan	28	0.82	Uruguay	8	0.99
Kazakhstan	89	0.57	Venezuela	14	0.93
Kenya	73	0.62	Vietnam	46	0.75
Korea, Rep.	111	0.43	Zambia	52	0.71
Kyrgyzstan	39	0.77			

## 5. CONCLUSION

The VAT is a major source of tax revenue in nearly all of the countries where it is applied.<sup>26</sup> Due to the relative ease of shifting production and incomes to low-tax jurisdictions, obtaining revenue from consumption taxes may become of even greater importance. Once established that additional revenue from a VAT is required, it should be considered whether a country has the necessary capacity to increase the VAT rate or broaden the base of its VAT. The VAT effort index provided in this article indicates the extent to which countries can look towards the VAT as a source of additional revenues.

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<sup>26</sup> Based on data from the World Bank (2017b), Afghanistan, Angola, and Nigeria are countries where VAT revenues would likely not be regarded as a major source of tax revenues.



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# A dispute systems design evaluation of the tax dispute resolution system in the United States and possible recommendations from Australia

Melinda Jone\*

## ***Abstract***

A number of studies have been conducted which utilise dispute systems design (DSD) principles to evaluate the Australian tax dispute resolution system. Notwithstanding that the United States is regarded as a relatively mature jurisdiction in terms of the use of alternative dispute resolution (ADR) in resolving tax disputes, to date few studies have been conducted utilising DSD principles to evaluate the US tax dispute resolution system. Accordingly, this article evaluates the tax dispute resolution system in the US using DSD principles and consequently makes possible recommendations for improvements to the system drawing from certain DSD features of the Australian tax dispute resolution system.

**Key words:** Dispute systems design, tax dispute resolution, alternative dispute resolution, United States, Australia

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\* Dr Melinda Jone, Research Assistant, Department of Accounting and Information Systems, University of Canterbury, melinda.jone@canterbury.ac.nz.

## 1. INTRODUCTION

There are a variety of factors that influence taxpayers' attitudes towards the tax system and voluntary compliance. One critical factor is the experience that taxpayers have when dealing with revenue authorities.<sup>1</sup> The way in which tax disputes are managed and resolved can have a significant impact on the overall experience that taxpayers may have in interacting with revenue authorities and thus affect voluntary compliance.<sup>2</sup> To help achieve the goal of fostering willing participation, revenue authorities have recognised the need to manage and resolve disputes early, quickly and in a cost effective way.<sup>3</sup> Thus, in order to reduce conflict escalation and improve their relationships with taxpayers, there has been a trend by revenue authorities internationally in employing different initiatives such as alternative dispute resolution (ADR) processes, to resolve tax disputes without litigation.<sup>4</sup> For the purpose of this article, ADR can be defined as 'an umbrella term for processes, other than judicial determination, in which an impartial person assists those in a dispute to resolve the issues between them'.<sup>5</sup> In the context of tax dispute resolution, common ADR processes utilised by revenue authorities to resolve or otherwise help limit a dispute, include various forms of mediation<sup>6</sup> and facilitation.<sup>7</sup>

The underlying essence of ADR processes is that they may allow more tax disputes to be resolved earlier, or avoided altogether, thereby giving both parties greater certainty and the ability to channel scarce resources into more productive activities.<sup>8</sup> Moreover, the movement towards ADR processes in tax dispute resolution generally accords with revenue authorities 'moving away from a "command and control" culture to one designed to build trust, support and respect in the community' which in turn encourages voluntary compliance.<sup>9</sup>

In addition, the adoption of ADR processes by revenue authorities also aligns with the concept of dispute systems design (DSD), which refers to a deliberate effort to identify and improve the way an organisation addresses conflict by decisively and strategically arranging its dispute resolution processes.<sup>10</sup> Thus, the use of ADR to improve the

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<sup>1</sup> Debbie Hastings, 'ATO Reinvention and Managing Disputes Post Independent Review' (Paper presented at the Tax Institute of Australia Financial Services Taxation Conference, Surfers Paradise, 18-20 February 2015) 4.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> EY, *Tax Dispute Resolution: A New Chapter Emerges – Tax Administration Without Borders* (2010) 4.

<sup>5</sup> National Alternative Dispute Resolution Advisory Council, *Dispute Resolution Terms: The Use of Terms in (Alternative) Dispute Resolution* (2003) 4.

<sup>6</sup> Mediation is a process in which the parties to a dispute, with the assistance of a dispute resolution practitioner (the mediator), identify the disputed issues, develop options, consider alternatives and endeavour to reach an agreement. National Alternative Dispute Resolution Advisory Council, above n 5, 9.

<sup>7</sup> Facilitation is a process in which the parties, with the assistance of a dispute resolution practitioner (the facilitator), identify problems to be solved, tasks to be accomplished or disputed issues to be resolved. Depending on the form of facilitation utilised, the facilitation process may conclude there, or it may further be used to assist the parties to develop options, consider alternatives and endeavour to reach an agreement. National Alternative Dispute Resolution Advisory Council, above n 5, 7.

<sup>8</sup> EY, above n 4, 4.

<sup>9</sup> Duncan Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law, 2007) 166.

<sup>10</sup> William L Ury, Jeanne M Brett and Stephen B Goldberg, *Getting Disputes Resolved: Designing Systems to Cut the Costs of Conflict* (Program on Negotiation at Harvard Law School, first published 1988, 1993

efficiency and effectiveness of tax administration as well as to provide ‘flow-on improvements to taxpayer compliance by making it easier to resolve disputes with revenue authorities or even to allay concerns’,<sup>11</sup> is consistent with the underlying aim of DSD in reducing the cost of handling disputes and producing more satisfying and durable resolutions.

The Internal Revenue Service (IRS) in the United States and the Australian Taxation Office (ATO) in Australia are two revenue authorities which have incorporated various ADR processes within their tax dispute resolution systems.<sup>12</sup> The US is regarded as a relatively mature jurisdiction in terms of the use of ADR in tax dispute resolution.<sup>13</sup> In 1990, Congress passed the *Administrative Dispute Resolution Act of 1990*<sup>14</sup> which mandated that all federal government agencies begin to implement ADR into their administrative dispute processes in order to reduce the time and cost associated with resolving disputes. In 1998, the *Internal Revenue Service Restructuring and Reform Act of 1998*<sup>15</sup> enacted Internal Revenue Code §7123. This section directed the IRS to implement procedures to allow a broader use of early appeals programs and to establish procedures that allow for ADR processes such as mediation and arbitration. Pursuant to these mandates the IRS created five main post-filing ADR programs: Fast Track Settlement (FTS); Fast Track Mediation (FTM); Early Referral; Post Appeals Mediation (PAM); and Arbitration. Since then the range and scope of ADR programs offered by the IRS has changed and developed over time. Some of the current IRS ADR programs are discussed further in section 3.2 of this article.

In Australia, a number of obligations on the part of the ATO underpin its comparatively more recent use of ADR as part of its dispute resolution approach. The ATO’s model litigant obligations under Appendix B to the Attorney-General’s Legal Services Directions 2005 (Cth) require the ATO to avoid, prevent and limit the scope of legal proceedings, including by giving consideration to ADR before initiating legal proceedings.<sup>16</sup> The *Civil Disputes Resolution Act 2011* (Cth) also requires the ATO, as a party to a dispute, to take ‘genuine steps’ to resolve a dispute before commencing proceedings in the Federal Court of Australia, including considering ADR.<sup>17</sup> In addition, under the ATO’s Code of Settlement, resolution of disputes by ADR may be appropriate as a matter of good management of the tax system, overall fairness and best use of ATO resources.<sup>18</sup>

Nevertheless, in recent times, there have been a number of further drivers behind the ATO’s use of ADR. One of which was the Inspector-General of Taxation’s (IGT’s)

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ed); Cathy A Costantino and Christina S Merchant, *Designing Conflict Management Systems: A Guide to Creating Productive and Healthy Organizations* (Jossey-Bass, 1996).

<sup>11</sup> Bentley, above n 9, 172.

<sup>12</sup> Examples of other jurisdictions around the world which utilise ADR in their tax dispute resolution systems include, but are not limited to: Belgium, China, Germany, India, Italy, Mexico, New Zealand, South Africa, the Netherlands, Turkey and the United Kingdom. See EY above, n 4, 9.

<sup>13</sup> Ibid 52.

<sup>14</sup> The *Administrative Dispute Resolution Act of 1990*, Pub. L. No. 101-552, 104 Stat. 2736 (1990) was re-enacted as the *Administrative Dispute Resolution Act of 1996*, Pub. L. No. 104-320, 110 Stat. 3870 (1996).

<sup>15</sup> *Internal Revenue Service Restructuring and Reform Act of 1998*, Pub. L. No. 105-206, 112 Stat. 685 (1998).

<sup>16</sup> *Legal Services Directions 2005* (Cth) Appendix B, sections 5.1 and 2(e)(iii).

<sup>17</sup> *Civil Disputes Resolution Act 2011* (Cth) ss 6-7.

<sup>18</sup> Australian Taxation Office, Practice Statement Law Administration 2015/1: Code of settlement (2015) [3].

*Review into the Australian Taxation Office's use of early and Alternative Dispute Resolution*<sup>19</sup> in 2012, which made a number of recommendations including piloting the use of in-house facilitators to assist in resolution of disputes involving less complex indirect tax disputes.<sup>20</sup> Subsequently, the ATO has rolled out an in-house facilitation service with effect from 1 April 2014.<sup>21</sup> Another recent driver behind ATO ADR has been the 'significant change agenda' of the current Australian Commissioner of Taxation, Mr Chris Jordan AO.<sup>22</sup> Since 2013 the ATO has embarked on a transformation project, 'Reinventing the ATO', in which it aims to 'transform how it goes about its core business, and make it a contemporary and service-oriented organisation'.<sup>23</sup> Managing and resolving tax disputes in a way that is 'efficient, respectful and fair', including through the use of ADR, has formed part of the transformation project.<sup>24</sup>

A number of studies have been conducted with respect to the utilisation of DSD principles in evaluating the tax dispute resolution system in Australia.<sup>25</sup> However, notwithstanding its relatively mature use of ADR in tax dispute resolution, to date, only one study has been conducted to evaluate the US tax dispute resolution system from a DSD perspective.<sup>26</sup> Against this background, this article seeks to evaluate the tax dispute resolution system of the US utilising DSD principles. Based on the DSD evaluation made, the article then makes suggestions for improvements to the system from the DSD perspective of the Australian tax dispute resolution system. In addition to having already been evaluated a number of times from a DSD perspective, it is fitting that this article draws from the context of the Australian tax dispute resolution system given that, anecdotally, the ATO is perceived as one of the leading tax agencies in the world.<sup>27</sup> While it is acknowledged that the Australian tax dispute resolution system has a number of structural design deficiencies when evaluated from a DSD perspective, it is not the

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<sup>19</sup> Inspector-General of Taxation, *Review into the Australian Taxation Office's Use of Early and Alternative Dispute Resolution: A report to the Assistant Treasurer* (2012).

<sup>20</sup> Ibid 44 [3.99].

<sup>21</sup> See Australian Taxation Office, 'In-house facilitation' (29 September 2017), <https://www.ato.gov.au/General/Dispute-or-object-to-an-ATO-decision/Options-for-resolving-disputes/In-House-Facilitation/?=redirected>.

<sup>22</sup> Hastings, above n 1, 3.

<sup>23</sup> See Australian Taxation Office, 'Reinventing the ATO' (30 June 2017), <https://www.ato.gov.au/About-ATO/About-us/Reinventing-the-ATO/>.

<sup>24</sup> Hastings, above n 1, 3.

<sup>25</sup> See Duncan Bentley, 'Problem resolution: Does the ATO approach really work?' (1996) 6(1) *Revenue Law Journal* 17, updated in Bentley, *Taxpayers' Rights: Theory, Origin and Implementation*, above n 9, ch 5; Sheena Mookhey, 'Tax disputes systems design' (2013) 11(1) *eJournal of Tax Research* 79; Melinda Jone, 'Evaluating Australia's tax dispute resolution system: A dispute systems design perspective' (2015) 13(2) *eJournal of Tax Research* 552; Melinda Jone, 'What can the United Kingdom's Tax Dispute Resolution System Learn from Australia? – An Evaluation and Recommendations from a Dispute Systems Design Perspective' (2017) 32(1) *Australian Tax Forum* 59; Melinda Jone, 'Lessons New Zealand Can Learn from the Tax Dispute Resolution System in Australia' (2018) 24(1) *New Zealand Journal of Taxation Law and Policy* 13.

<sup>26</sup> See Melinda Jone, 'The Internal Revenue Service's Future State initiative and its impact on the tax dispute resolution system of the United States: A dispute systems design perspective' (Paper presented to the Australasian Tax Teachers Association Conference 2018, Melbourne, 17-19 January 2018), which utilises DSD principles to evaluate the US tax dispute resolution in the particular context of the IRS's Future State initiative and its associated digital advances.

<sup>27</sup> John Hasseldine, 'Consultancy Report for the National Audit Office of the United Kingdom' (15 October 2007). For example, the ATO has been a global innovator in adopting the Compliance Model, which differentiates between the economic, psychological, and social circumstances of taxpayers. See Michael D'Ascenzo, 'Modernising the Australian Taxation Office: Vision, people, systems and values' (2015) 13(1) *eJournal of Tax Research* 361, 375.

purpose of this article to provide a complete DSD evaluation of the Australian tax dispute resolution system.<sup>28</sup> Instead, as stated above, this article draws from certain design strengths of the Australian system in order to make possible recommendations for the US.

Henceforth, the remainder of this article is organised as follows. Section 2 provides a background to the DSD principles utilised in this study. Section 3 outlines the US tax dispute resolution procedures. Section 4 then evaluates the tax dispute resolution procedures using the DSD principles outlined in section 2. Section 5 provides a discussion of the findings from the DSD evaluation and makes recommendations for improvements to the system from an Australian perspective. Lastly, conclusions and limitations are provided in section 6.

## 2. BACKGROUND TO DISPUTE SYSTEMS DESIGN PRINCIPLES

Dispute systems design (DSD) began in the context of workplace disputes and can be traced to the publication of *Getting Disputes Resolved: Designing Systems to Cut the Costs of Conflict* by Ury, Brett and Goldberg in 1988.<sup>29</sup> DSD is based on three interrelated theoretical propositions. The first is that dispute resolution procedures can be categorised according to whether they are primarily interests-based, rights-based or power-based in approach.<sup>30</sup> Interests-based approaches focus on the underlying interests or needs of the parties with the aim of producing solutions that satisfy as many of those interests as possible. Rights-based approaches involve a determination of which party is correct according to some independent and objective standard. Power-based approaches are characterised by the use of power, that is, the ability to coerce a party to do something he or she would not otherwise do. The second DSD proposition is that interests-based procedures have the potential to be more cost effective than rights-based procedures, which in turn may be more cost effective than power-based procedures.<sup>31</sup> The third proposition is that the costs of disputing may be reduced by creating systems that are ‘interests-oriented’, that is, systems which emphasise interests-based procedures, but also recognise that rights-based and power-based procedures are necessary and desirable components.<sup>32</sup>

Tax dispute resolution systems internationally generally have not been evaluated extensively from a DSD perspective.<sup>33</sup> One reason for this may be because tax disputes

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<sup>28</sup> The structural DSD deficiencies of the Australian tax dispute resolution system are outlined in Jone, ‘Evaluating Australia’s tax dispute resolution system: A dispute systems design perspective’, above n 25, which provides a full DSD evaluation of the Australian tax dispute resolution system.

<sup>29</sup> Ury, Brett and Goldberg, above n 10.

<sup>30</sup> Ibid 4-9.

<sup>31</sup> Ibid 4, 10-15.

<sup>32</sup> Ibid 18.

<sup>33</sup> To the author’s knowledge, to date, tax DSD evaluations have been conducted in four jurisdictions: Australia (see Bentley, ‘Problem resolution: Does the ATO approach really work?’, above n 25, updated in Bentley, *Taxpayers’ Rights: Theory, Origin and Implementation*, above n 9, ch 5; Mookhey, above n 25; Jone, ‘Evaluating Australia’s tax dispute resolution system: A dispute systems design perspective’, above n 25); New Zealand (see Jone, ‘Evaluating New Zealand’s tax dispute resolution system: A dispute systems design perspective’ (2016) 22 *New Zealand Journal of Taxation Law and Policy* 228; Jone, ‘Lessons New Zealand can Learn from the Tax Dispute Resolution System in Australia’, above n 25); the UK (see Jone, ‘What can the United Kingdom’s Tax Dispute Resolution System Learn from Australia? – An evaluation and Recommendations from a Dispute Systems Design Perspective’, above n 25); and the US (see Jone, ‘The Internal Revenue Service’s Future State initiative and its impact on the tax dispute resolution system of the United States: A dispute systems design perspective’, above n 26).



have traditionally not been regarded as interests-based disputes.<sup>34</sup> McDonough states that: ‘Tax disputes ... are more typically focused on obtaining a result, such as “what dollar amount to pay”’ as opposed to considering the needs and interests of each party.<sup>35</sup> In a tax dispute the individual interests of parties tend to be subsumed in the argument over legal rights. It is usually only when the parties enter into a form of ‘problem-solving’ in an effort to resolve the conflict that interests are taken into account.<sup>36</sup> It thus follows that the movement by revenue authorities towards the use of interests-based ADR processes such as facilitation and mediation is consistent with the concept of the creation of interests-orientated systems underpinning DSD.

A number of principles have been put forward by various practitioners for best practice in DSD.<sup>37</sup> Systems that follow these general design principles are generally thought to be more likely to produce positive dispute outcomes and improve the organisation’s overall capacity for effective conflict management.<sup>38</sup> The earlier tax DSD studies conducted in Australia by Bentley<sup>39</sup> and Mookhey<sup>40</sup> utilised a set of six DSD principles originally proposed by Ury, Brett and Goldberg. These principles were as follows:<sup>41</sup>

1. Create ways for reconciling the interests of those in dispute.
2. Build in ‘loop-backs’ that encourage disputants to return to negotiation.
3. Provide low-cost rights and power ‘back-ups’.
4. Prevent unnecessary conflict through notification, consultation and feedback.
5. Arrange procedures in a low to high cost sequence.
6. Provide the necessary motivation, skills and resources to allow the system to work.

However, consistent with the more recent tax DSD evaluations conducted by the author,<sup>42</sup> this study utilises a more comprehensive set of 14 DSD principles synthesised

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<sup>34</sup> Bentley, *Taxpayers’ Rights: Theory, Origin and Implementation*, above n 9, 183.

<sup>35</sup> Kirsten J McDonough, ‘Resolving Federal Tax Disputes Through ADR’, (1993) 48(2) *Arbitration Journal* 38, 41.

<sup>36</sup> Bentley, *Taxpayers’ Rights: Theory, Origin and Implementation*, above n 9, 181.

<sup>37</sup> See Ury, Brett and Goldberg, above n 10; Costantino and Merchant, above n 10; Mary P Rowe, ‘Dispute Resolution in the Non-Union Environment: An Evolution Toward Integrated Systems for Conflict Management?’ in Sandra Gleason (ed), *Frontiers in Dispute Resolution in Labor Relations and Human Resources* (Michigan State University Press, 1997) 79; Jennifer Lynch, *CCRA: Contemporary Conflict Resolution Approaches* (Canada Customs and Revenue Agency, 1998); Karl A Slaikeu and Ralph H Hasson, *Controlling the Costs of Conflict: How to Design a System for Your Organization* (Jossey-Bass, 1998); Society for Professionals in Dispute Resolution, *Designing Integrated Conflict Management Systems: Guidelines for the Design of Integrated Conflict Management Systems within Organizations* (2001). For a synthesis of the DSD principles proposed by the above authors, see John P Conbere, ‘Theory Building for Conflict Management System Design’ (2001) 19(2) *Conflict Resolution Quarterly* 215.

<sup>38</sup> Tina Nabatchi and Lisa B Bingham, ‘From Postal to Peaceful: Dispute Systems Design in the USPS REDRESS® Program’ (2010) 30(2) *Review of Public Personnel Administration* 211, 215.

<sup>39</sup> Bentley, ‘Problem resolution: Does the ATO approach really work?’, above n 25, updated in Bentley, *Taxpayers’ Rights: Theory, Origin and Implementation*, above n 9, ch 5.

<sup>40</sup> Mookhey, above n 25.

<sup>41</sup> Ury, Brett and Goldberg, above n 10, 42.

<sup>42</sup> Jone, ‘Evaluating Australia’s tax dispute resolution system: A dispute systems design perspective’, above n 25; Jone, ‘Evaluating New Zealand’s tax dispute resolution system: A dispute systems design perspective’, above n 33; Jone, ‘What can the United Kingdom’s Tax Dispute Resolution System Learn

from the DSD literature. As indicated in Table 1 below, this set of DSD principles reflects the development of DSD principles over time from Ury, Brett and Goldberg's six fundamental principles. That is, the work by authors in the DSD field has been cumulative in the respect that 'each author or group of authors has built on the concepts contained in the earlier [DSD] models'.<sup>43</sup>

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from Australia? – An evaluation and Recommendations from a Dispute Systems Design Perspective', above n 25; Jone, 'The Internal Revenue Service's Future State initiative and its impact on the tax dispute resolution system of the United States: A dispute systems design perspective', above n 26.

<sup>43</sup> Conbere, above n 37, 217.

**Table 1: The 14 Dispute Systems Design Principles Used in this Study**

(1)	<b>Stakeholders are included in the design process.</b> Stakeholders should have an active and integral role in creating and renewing the systems they use.
(2)	<b>The system has multiple options for addressing conflict including interests, rights and power-based processes.</b> The system should include interests-based processes and low-cost rights and power-based processes should be offered should interests-based processes fail to resolve a dispute.
(3)	<b>The system provides for loops backward and forward.</b> The system should include loop-back mechanisms which allow disputants to return from rights or power-based options back to interests-based options and also loop-forward mechanisms which allow disputants to move directly to a rights or power-based option without first going through all of the earlier interests-based options.
(4)	<b>There is notification and consultation before and feedback after the resolution process.</b> Notification and consultation in advance of taking a proposed action affecting others can prevent disputes that arise through misunderstanding or miscommunication and can identify points of difference early on so that they may be negotiated. Post-dispute analysis and feedback can help parties to learn from disputes in order to prevent similar disputes in the future.
(5)	<b>The system has a person or persons who function as internal independent confidential neutral(s).</b> Disputants should have access to an independent confidential neutral to whom they can go to for coaching, referring and problem-solving.
(6)	<b>Procedures are ordered from low to high cost.</b> In order to reduce the costs of handling disputes, the procedures in the system should be arranged in graduated steps in a low to high cost sequence.
(7)	<b>The system has multiple access points.</b> The system should allow disputants to enter the system through many access points and offer a choice of persons whom system users may approach in the first instance.
(8)	<b>The system includes training and education.</b> Training of stakeholders in conflict management as well as education about the dispute system and how to access it are necessary.
(9)	<b>Assistance is offered for choosing the best process.</b> This includes the use of guidelines and/or coordinators and process advisers to ensure the appropriate use of processes.
(10)	<b>Disputants have the right to choose a preferred process.</b> The best systems are multi-option with disputants selecting the process.
(11)	<b>The system is fair and perceived as fair.</b> The system should be fair to parties and foster a culture that welcomes good faith dissent.
(12)	<b>The system is supported by top managers.</b> There should be sincere and visible championship by senior management.
(13)	<b>The system is aligned with the mission, vision and values of the organisation.</b> The system should be integrated into the organisation and reflect the organisational mission, vision and values.
(14)	<b>There is evaluation of the system.</b> This acts to identify strengths and weaknesses of design and foster continuous improvement.

Nevertheless, it should be noted that the DSD principles in Table 1 are expressed in the context of organisational disputes in which they were originally formulated. Thus, as acknowledged in the prior tax DSD studies conducted by the author,<sup>44</sup> there are certain discrepancies which emerge with the direct application of the DSD principles in the context of tax dispute resolution. These discrepancies are highlighted in the DSD evaluation of the US tax disputes resolution procedures conducted in section 4. Despite these discrepancies, the prior tax DSD studies indicated above nevertheless provide support for the application of DSD principles in the context of tax dispute resolution. Section 3 now outlines the US tax dispute resolution system before using the 14 DSD principles in Table 1 to evaluate the effectiveness of their design in section 4.

### 3. THE TAX DISPUTE RESOLUTION SYSTEM IN THE UNITED STATES

This section provides an outline of the US tax dispute resolution procedures (section 3.1) as well as IRS ADR (section 3.2) and other IRS dispute resolution initiatives (section 3.3).<sup>45</sup>

#### 3.1 The tax dispute resolution procedures

The IRS is the principal national revenue authority in the US.<sup>46</sup> Tax disputes in the US generally arise through the IRS's examination (or audit) process.<sup>47</sup> When the taxpayer does not agree with any or all of the IRS findings in an examination procedure, the taxpayer may request a meeting or a telephone conference with the IRS examiner and/or the examiner's supervisor. If no agreement is reached at the meeting, the US tax dispute resolution procedures generally involve the following steps:

- A 30-day letter (Preliminary Notice of Deficiency) is issued by the IRS notifying the taxpayer of their rights to appeal to the IRS Appeals Office within 30 days.
- If the taxpayer makes an appeal, the IRS Appeals Office will review the issues of the case and schedule a conference (the Appeals conference) between the parties so that they can attempt to settle the differences between them.
- If the taxpayer and the IRS do not agree on some or all of the issues after the Appeals conference, or if the taxpayer does not respond to the 30-day letter (that

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<sup>44</sup> Jone, 'Evaluating Australia's tax dispute resolution system: A dispute systems design perspective', above n 25, 558; Jone, 'Evaluating New Zealand's tax dispute resolution system: A dispute systems design perspective', above n 33, 234; Jone, 'What can the United Kingdom's Tax Dispute Resolution System Learn from Australia? – An evaluation and Recommendations from a Dispute Systems Design Perspective', above n 25, 67.

<sup>45</sup> The description of the US tax dispute resolution system in this section and the DSD evaluation which follows in section 5 of this article, are in respect of the tax dispute resolution system in place as at June 2018.

<sup>46</sup> The IRS is organised into four operating divisions serving groups of taxpayers with similar needs. These operating divisions are: (1) Wage and Investment (W&I); (2) Small Business/ Self-Employed (SB/SE); (3) Large Business and International (LB&I); and (4) Tax-Exempt and Government Entities (TE/GE): CCH *US Master Tax Guide 2015* (CCH, Chicago, 98th ed, 2014) [¶2701].

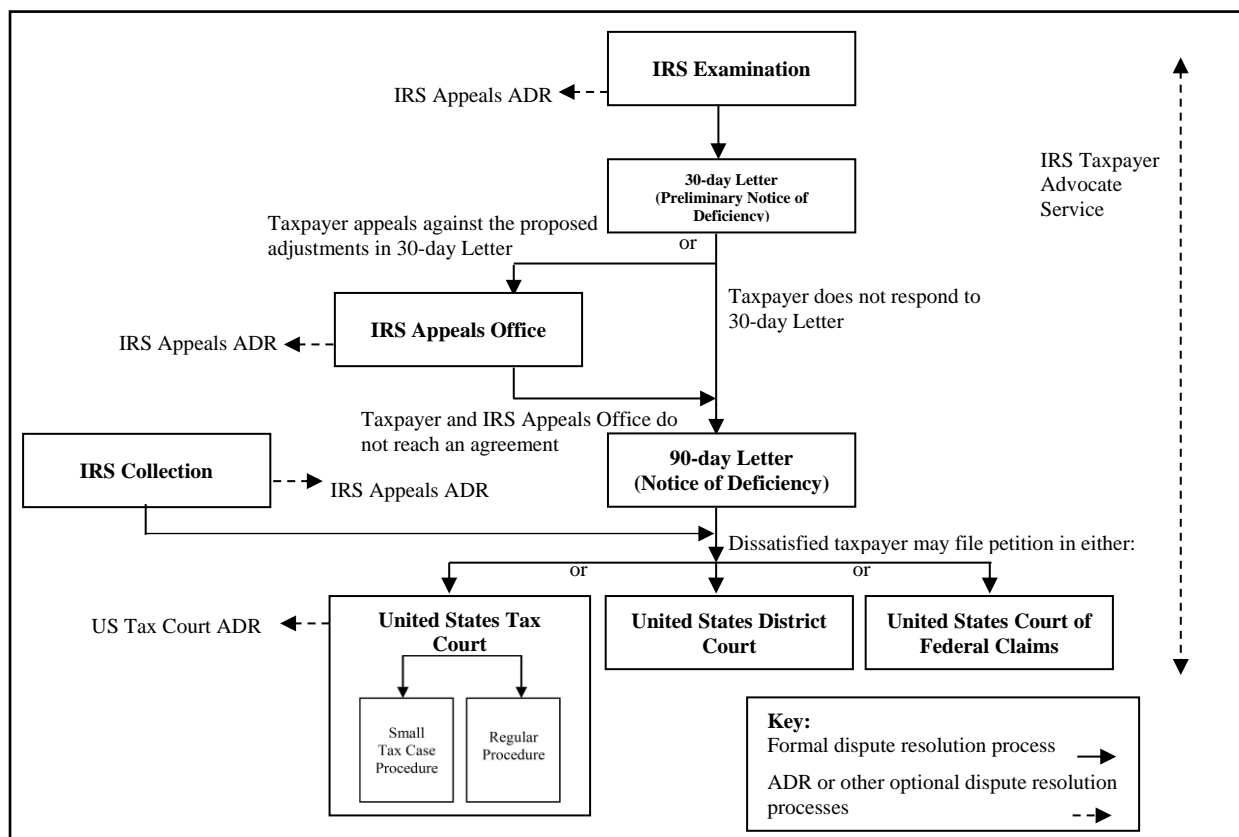
<sup>47</sup> Tax disputes can also arise when a taxpayer disagrees with a proposed or taken IRS collection action. The formal tax dispute resolution procedures for disputes arising from IRS examination and IRS collection differ. Tax disputes initiated through the IRS collection process are beyond the scope of this article as this article focuses on tax disputes concerning disagreements over taxpayers' tax liabilities or entitlements rather than disputes over the collection efforts of the revenue authority.

is, chooses to bypass the IRS Appeals system), a 90-day letter (Notice of Deficiency) is issued by the IRS.

- The taxpayer has 90 days (150 days if it is addressed to a taxpayer outside the US) from the date of the 90-day letter to file a petition with the US Tax Court, the US District Court or the US Court of Federal Claims.

In addition, as indicated in Figure 1, the IRS Appeals Office offers a number of ADR programs for certain types of taxpayers to resolve tax disputes during the examination, appeals and collection stages of the dispute resolution process (see section 3.2 below for further details on the IRS Appeals Office's ADR programs). For disputes reaching the US Tax Court, ADR processes (arbitration or mediation) are also potentially available.<sup>48</sup> The Taxpayer Advocate Service (TAS) provides an additional avenue for taxpayers to resolve problems with the IRS which they have been unable to resolve themselves.<sup>49</sup> As indicated in Figure 1, the TAS is available alongside the traditional dispute resolution process.

**Fig. 1: The United States' Tax Dispute Resolution Procedures**



<sup>48</sup> See Internal Revenue Manuals (IRM) 35.5.5.

<sup>49</sup> See Taxpayer Advocate Service, <https://taxpayeradvocate.irs.gov/>.

### 3.2 Internal Revenue Service Alternative Dispute Resolution

As stated in section 3.1 above, the IRS Appeals Office offers a number of optional post-filing ADR programs for certain qualifying taxpayers to resolve disputes during the examination, appeals and collection stages of the dispute resolution procedures. These programs currently include: Fast Track Settlement (FTS)<sup>50</sup> (available at the examination stage); Fast Track Mediation – Collection (FTMC)<sup>51</sup> (available at the collection stage); and Post-Appeals Mediation<sup>52</sup> and the Rapid Appeals Process (RAP)<sup>53</sup> (available at the Appeals stage). These ADR processes are designed to help taxpayers resolve disputes at the earliest possible stage generally through utilising mediation services provided by IRS Appeals employees.<sup>54</sup>

The IRS describes mediation as ‘an informal, confidential, and flexible dispute resolution process in which an Appeals Officer [‘Appeals mediator’] trained in mediation techniques serves as an impartial third party facilitating negotiations between the disputing parties’.<sup>55</sup> The Appeals mediators help resolve disputes by identifying the core issues and possible obstacles to settlement, and working with the parties to develop resolution strategies. The Appeals mediator has no power to render a decision or to force either party to accept a settlement.<sup>56</sup> However, it should be noted that in the FTS program, the Appeals mediator may suggest settlement proposals to the parties.<sup>57</sup>

The Appeals mediator is specifically trained in mediation techniques and is independent of the IRS employee with whom the taxpayer has been dealing. The expenses associated with the Appeals mediator are met by the IRS. Generally, parties do not have the option of using a non-Appeals employee as a mediator. However, in PAM, taxpayers have the option to additionally elect to use a non-IRS co-mediator (alongside the Appeals mediator) at their own expense.<sup>58</sup>

If a dispute is unable to be resolved using one of the IRS ADR programs occurring at the pre-Appeals (examination) stage of the disputes process (for example, FTS), taxpayers still retain their otherwise applicable appeal rights to request consideration of any unresolved issue(s) by the IRS Appeals Office or alternatively, pursue their claim in court.

### 3.3 Other Internal Revenue Service dispute resolution initiatives

The IRS also offers a number of other post-filing dispute resolution initiatives or programs which do not fall within the definition of ADR (defined in section 1 as ‘an umbrella term for processes, other than judicial determination, in which an impartial person assists those in a dispute to resolve the issues between them’).<sup>59</sup> These include,

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<sup>50</sup> See Internal Revenue Service, Rev. Proc. 2003-40, 2003-25 IRB 1044 (‘Rev. Proc. 2003-40’); IRM 8.26.1; IRM 8.26.2; IRM 8.26.7.

<sup>51</sup> See Internal Revenue Service, Rev. Proc. 2016-57, 2016-49 IRB 786 (‘Rev. Proc. 2016-57’); IRM 8.26.3.

<sup>52</sup> See Internal Revenue Service, Rev. Proc. 2014-63, 2014-53 IRB 1014 (‘Rev. Proc. 2014-63’); IRM 8.26.5; IRM 8.26.9.

<sup>53</sup> See IRM 8.26.11.

<sup>54</sup> See Internal Revenue Service, ‘Appeals Mediation Programs -Alternative Dispute Resolution (ADR)’ (22 May 2018), <https://www.irs.gov/compliance/appeals/appeals-mediation-programs>.

<sup>55</sup> Ibid.

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

<sup>58</sup> Internal Revenue Service, Rev. Proc. 2014-63, above n 52, [9.01].

<sup>59</sup> National Alternative Dispute Resolution Advisory Council, above n 5, 4.

but are not limited to, the Accelerated Issue Resolution (AIR) program,<sup>60</sup> Delegation Order 4-24<sup>61</sup> and Delegation Order 4-25.<sup>62</sup> These IRS dispute resolution initiatives do not fall within the definition of ADR primarily because they do not specifically involve an impartial third party assisting those in dispute to resolve the issues between them.<sup>63</sup> For example, the AIR program involves an agreement between the IRS and certain qualifying taxpayers to advance the resolution of issues arising from an audit of the taxpayer from one or more tax periods, to other tax periods ending prior to the date of that agreement.<sup>64</sup>

#### **4. DISPUTE SYSTEMS DESIGN EVALUATION OF THE SYSTEM**

This section evaluates the US tax dispute resolution procedures utilising the 14 DSD principles outlined in Table 1 in section 2 of this article.

##### **4.1 DSD Principle 1: stakeholders are included in the design process**

The IRS involves taxpayers and other stakeholders in the design process through its pilot programs of IRS ADR processes and its requests for stakeholder submissions on proposed or revised versions of IRS revenue procedures and other forms of IRS guidance. The Taxpayer Advocacy Panel (TAP),<sup>65</sup> a Federal Advisory Committee to the IRS which listens to taxpayers, identifies taxpayers' issues and makes suggestions for improving IRS service and customer satisfaction, may also provide a means for taxpayers to submit suggestions to the IRS in relation to the disputes process and its design. In addition, the IRS Oversight Board engages with a wide variety of stakeholders to understand their views on tax administration and its impact on taxpayers.<sup>66</sup> It interacts regularly with external groups which include tax professionals, taxpayer advocacy groups, representatives of state tax departments, IRS advisory committees, IRS employees, the National Treasury Employees Union, and other groups that have an interest in tax administration. Thus, these groups can provide input in the design process of the system through these interactions.

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<sup>60</sup> See Internal Revenue Service, Rev. Proc. 94-67, 1994-2 CB 800 ('Rev. Proc. 94-67').

<sup>61</sup> See IRM 1.2.43.22.

<sup>62</sup> See IRM 1.2.43.23.

<sup>63</sup> Although, for the purposes of this article, these IRS dispute resolution initiatives may be viewed as 'loop-forward mechanisms' (as defined under DSD Principle 3 in section 2, Table 1 of this article).

<sup>64</sup> Internal Revenue Service, 'Rev. Proc. 94-67', above n 68. Delegation Order 4-24 provides IRS Examination case managers settlement authority on recurring issues for a taxpayer, provided that the issues were settled in IRS Appeals for the same taxpayer or another taxpayer directly involved in the same transaction in a prior or later period: IRM 1.2.43.22. Delegation Order 4-25 provides IRS Examination case managers settlement authority for issues that are the subject of Appeals Coordinated Issue Settlement Guidelines in accordance with the guidelines, provided there is review and concurrence by an IRS Appeals Technical Coordinator: IRM 1.2.43.23.

<sup>65</sup> See Internal Revenue Service, 'Taxpayer Advocacy Panel (TAP)' (19 April 2018), <https://www.irs.gov/Advocate/Taxpayer-Advocacy-Panel>.

<sup>66</sup> See IRS Oversight Board, 'IRS Oversight Board', <https://www.treasury.gov/IRSOB/Pages/default.aspx>. Effective from 1 January 2015, there are six open seats on the Oversight Board. Hence, the Oversight Board currently does not have enough members confirmed by the US Senate to make up a quorum and as a result has suspended operations.

#### **4.2 DSD Principle 2: the system has multiple options for addressing conflict including interests, rights and power-based processes**

As indicated in section 3, the US tax dispute resolution system has multiple options for addressing conflict. The procedures provide for initial negotiations between the taxpayer and the IRS examiner and/or the examiner's supervisor at the conclusion of an IRS examination. If the dispute remains unresolved, the taxpayer may appeal their case to the IRS Appeals Office (the IRS's internal review forum) where a conference is scheduled so that the taxpayer and the IRS can attempt to negotiate a mutually acceptable settlement. If the dispute cannot be resolved at the IRS Appeals Office level (or the taxpayer chooses to bypass the IRS Appeals Office), taxpayers may pursue rights-based litigation processes by filing a petition in either the US Tax Court, US District Court or the US Court of Federal Claims.

In addition to the formal disputes process, the IRS Appeals Office offers a number of post-filing ADR programs which may be utilised by different types of taxpayers to manage or resolve disputes during the examination and appeals stages. The main post-filing ADR programs currently available at these stages include FTS; PAM and RAP,<sup>67</sup> and as indicated in section 3.2, constitute primarily interests-based processes. Mediation and arbitration procedures are also potentially available where a dispute reaches the US Tax Court.

The TAS provides an additional option for taxpayers for resolving problems with the IRS which they have been unable to resolve themselves through normal IRS channels. The TAS may be able to help a taxpayer if: (i) the taxpayer's problem is causing financial difficulties for the taxpayer, their family, or their business; (ii) the taxpayer faces (or their business is facing) an immediate threat of adverse action, or (iii) the taxpayer has tried repeatedly to contact the IRS but no one has responded, or the IRS has not responded by the date promised.<sup>68</sup> The TAS is not a substitute for the established administrative or judicial review procedures. Rather it is a possible mechanism that can be used to supplement existing procedures generally if a taxpayer is about to suffer or is suffering a significant hardship.

#### **4.3 DSD Principle 3: the system provides for loops backward and forward**

The US tax dispute resolution system features both loops backward and loops forward. The potential availability of ADR processes, such as mediation, before a trial in the US Tax Court can provide a loop-back mechanism in the system from a rights-based option back to interests-based processes. The US system provides for loops forward in the respect that a taxpayer may choose to bypass the IRS Appeals process and file a court petition upon the receipt of a 90-day letter. As noted in section 3.3, loops forward in the system are also potentially provided for through various additional IRS dispute resolution programs such as the AIR program, Delegation Order 4-24 and Delegation Order 4-25.

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<sup>67</sup> As noted in section 3.2, the FTMC ADR program is available during the collection stage. However, as stated in section 3.1, the dispute resolution process pertaining to collection disputes is beyond the scope of this article.

<sup>68</sup> Internal Revenue Service, 'Topic Number 104 - Taxpayer Advocate Service - Your Voice at the IRS' (9 May 2018), <https://www.irs.gov/taxtopics/tc104>.



#### 4.4 DSD Principle 4: there is notification before and feedback after the resolution process

The US tax dispute resolution system provides certain forms of notification before and feedback after the resolution process. Notification is built into the dispute resolution process through the IRS's Taxpayer Bill of Rights which provides that taxpayers have 'the right to be informed about IRS decisions about their tax accounts and to receive clear explanations of the outcomes'.<sup>69</sup> Taxpayers also have the right to know the maximum amount of time they have to challenge the IRS's position.<sup>70</sup> In addition, notification may be provided through the IRS's webpage *Compliance & Enforcement News* which contains a collection of recent news releases, statements and other items related to IRS compliance and enforcement efforts.<sup>71</sup> This information may highlight potential areas where disputes may arise.

A limited form of systemic feedback occurs through certain Appeals statistics provided on the IRS's website.<sup>72</sup> However, these statistics are very general in nature. Feedback is also provided through the NTA's annual reports to Congress which, among other things, include a summary of the 20 most serious problems encountered by taxpayers and an examination of the year's ten most frequently litigated tax issues.<sup>73</sup> The dispute system provides for micro-level feedback from taxpayers in the respect that at the conclusion of certain IRS ADR programs IRS Appeals officials are directed 'to provide a Customer Satisfaction Survey to the taxpayer along with a return envelope'.<sup>74</sup> Notwithstanding this procedure for collecting feedback, it has been observed that the IRS does not routinely make public statistics regarding its ADR programs.<sup>75</sup>

#### 4.5 DSD Principle 5: the system has a person or persons who function as internal independent confidential neutral(s)

With respect to an internal independent confidential neutral within the system that employees can go to for coaching, referring and problem-solving, in cases worked in IRS Appeals, an Appeals Team Case Leader (ATCL) in each region leads a team of Appeals officers, technicians, and other support personnel. Part of the role of the ATCL is to 'provide feedback to team members and his/her immediate manager, and serve as a mentor and coach to team members to enhance their performance and settlement skills'.<sup>76</sup> Thus, for certain IRS Appeals employees, ATCLs may be viewed as the closest equivalent to internal independent confidential neutrals in the system for IRS staff.

As noted earlier, the TAS is an independent organisation within the IRS which provides free help to qualifying taxpayers where they have been unable to resolve a problem with the IRS themselves or believe that an IRS system or procedure is not working as it should. The TAS can give taxpayers advice on how to approach IRS disputes at a very high level, including discussing options for resolution, pointing taxpayers to the

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<sup>69</sup> Internal Revenue Service, *Your Rights as a Taxpayer* (2017) 1.

<sup>70</sup> Ibid.

<sup>71</sup> Internal Revenue Service, *Compliance & Enforcement News*, <https://www.irs.gov/newsroom/compliance-enforcement-news>.

<sup>72</sup> Internal Revenue Service, *Tax Statistics*, <http://www.irs.gov/uac/Tax-Stats-2>.

<sup>73</sup> The NTA's annual reports to Congress are available at: Internal Revenue Service, *Reports to Congress*, <http://www.taxpayeradvocate.irs.gov/reports>.

<sup>74</sup> IRM 8.26.3.10; IRM 8.26.7.11.

<sup>75</sup> Ken Jones, 'Appeals Arbitration: Not a Compelling Litigation Alternative' (2 June 2014) 143 *Tax Notes* 1059, 1062, 1064.

<sup>76</sup> IRM 8.1.3.5.

Taxpayer Bill of Rights provisions, providing fact sheets and FAQ's on their website and referring taxpayers to Low Income Taxpayer Clinics (LITCs).<sup>77</sup> Thus, in the context of the US tax dispute resolution process, the TAS may be viewed as the taxpayers' equivalent of an independent confidential neutral in the system.

It should be noted that the existence of the TAS within the US tax dispute resolution system prevents a particular discrepancy occurring in relation to DSD Principle 5 which has been observed in the prior DSD evaluations conducted by this author in Australia, New Zealand and the UK.<sup>78</sup> In the tax dispute resolution systems of these three jurisdictions there is no equivalent of the IRS's TAS. Thus, while there are internal independent confidential neutrals for revenue authority staff involved in disputes in the tax dispute resolution systems of Australia, New Zealand and the UK, there are no equivalent internal independent confidential neutrals provided in the system for taxpayers involved in disputes. Taxpayers in these jurisdictions generally only have the option of seeking advice and assistance on dispute resolution matters externally from professional advisors, at their own expense.

#### **4.6 DSD Principle 6: procedures are ordered from low to high cost**

The formal disputes procedures can be viewed as being ordered in a low to high cost sequence in the respect that there is the opportunity for negotiation with the IRS examiner and/or the examiner's supervisor in the first instance, followed by the IRS's administrative Appeals process and then potential proceedings in court. This sequence generally implies an increase in costs at each level. However, there is also the option for taxpayers to utilise the IRS's Appeals ADR programs during the examination and appeals stages of the disputes process. These programs potentially create additional costs at the stage of the disputes procedures at which they are utilised, although the expenses associated with each of the IRS Appeals ADR programs vary. For example, in FTS, PAM and RAP, the expense of the IRS Appeals mediator is met by the IRS.<sup>79</sup> However, in PAM, if a taxpayer elects to additionally utilise a non-IRS co-mediator, they must cover all the expenses associated with the co-mediator.<sup>80</sup> Thus, the additional costs incurred by the taxpayer may vary according to the number and type of additional processes pursued in the disputes procedures.

Furthermore, it should also be noted that the tax dispute resolution process in the US can require substantial upfront costs (for example, the time spent by the taxpayer in preparing for, and participating in negotiations as well as the cost of professional advisers) from the taxpayer. This suggests that an exception to the apparent low to high cost sequence of the formal disputes procedures identified above is that taxpayers in tax disputes generally incur high initial upfront costs irrespective of the stage of the disputes process at which the dispute is ultimately resolved. However, this exception is not necessarily unique to the US tax dispute resolution system. Rather, as indicated by the

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<sup>77</sup> LITC's are discussed further under DSD Principle 8 in section 4.8 of this article.

<sup>78</sup> See Jone, 'Evaluating Australia's tax dispute resolution system: A dispute systems design perspective', above n 25; Jone, 'Evaluating New Zealand's tax dispute resolution system: A dispute systems design perspective', above n 33; Jone, 'What can the United Kingdom's Tax Dispute Resolution System Learn from Australia? – An Evaluation and Recommendations from a Dispute Systems Design Perspective', above n 25.

<sup>79</sup> Internal Revenue Service 'Rev. Proc. 2003-40', above n 50, [5.01]; Internal Revenue Service 'Rev. Proc. 2014-63', above n 52, [9.01].

<sup>80</sup> Internal Revenue Service 'Rev. Proc. 2014-63', above n 52, [9.01].

prior DSD evaluations conducted by the author, it may be a common feature of tax disputes resolution systems in general.<sup>81</sup> This is because, given the arguably complex nature of many tax disputes, taxpayers are required to work out their positions from the outset and, as a consequence, may require professional advice and assistance (which involves incurring related costs) in order to do so.<sup>82</sup>

#### 4.7 DSD Principle 7: the system has multiple access points

The disputes process has two structural access points at which taxpayers can enter – either at the IRS Appeals Office level or at the level of the US Tax Court. If the taxpayer cannot reach an agreement at the meeting with the IRS examiner and/or their supervisor at the end of an IRS examination, in most instances they will enter the formal disputes process through appealing the decision to the IRS Appeals Office (following the receipt of a 30-day letter). However, in some instances a taxpayer may choose not to respond to the 30-day letter. In this case they will receive a 90-day letter whereby they may instead choose to enter the disputes process at the stage where they file a petition in the US Tax Court.

In addition, if certain criteria are met, there may be multiple access points to the system available for small cases. Generally, to appeal an IRS decision, a taxpayer must send a formal written protest to their local IRS Appeals Office. However, if the total amount of the dispute is not more than USD 25,000 for each tax period, the taxpayer has the option of making a small case request by sending a letter instead of filing a formal written protest. Also, if a case is petitioned to the US Tax Court and the amount is USD 50,000 or less for any one tax year or period (albeit that the same petition form is used), the taxpayer has the option to request in their petition form that their case be handled under the small tax case procedures rather than through the regular procedures.

The system offers a choice of access persons whom certain system users can approach in the first instance, namely limited English proficient (LEP) persons<sup>83</sup> and also the deaf and hard of hearing.<sup>84</sup> While these options offer certain taxpayers a choice of persons in contacting the IRS generally, they arguably may also act to provide a choice of access persons for certain taxpayers to approach to acquire information about the dispute resolution system in the first instance.

#### 4.8 DSD Principle 8: the system includes training and education for stakeholders

The US tax dispute resolution system provides various forms of education and training for stakeholders. The IRS's webpage *Appeals – About the Office of Appeals* contains information on the IRS Appeals Office and on how to prepare an IRS Appeals request.<sup>85</sup>

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<sup>81</sup> For example, this exception has been identified in the tax dispute resolution systems of Australia, New Zealand and the UK. See Jone, 'Evaluating Australia's tax dispute resolution system: A dispute systems design perspective', above n 25; Jone, 'Evaluating New Zealand's tax dispute resolution system: A dispute systems design perspective', above n 33; Jone, 'What can the United Kingdom's Tax Dispute Resolution System Learn from Australia? – An evaluation and Recommendations from a Dispute Systems Design Perspective', above n 25.

<sup>82</sup> Jone, 'Evaluating Australia's tax dispute resolution system: A dispute systems design perspective', above n 25, 568.

<sup>83</sup> IRM 22.31.1.2.1.

<sup>84</sup> Internal Revenue Service, 'Topic 102 - Tax Assistance for Individuals with Disabilities' (18 January 2018), <https://www.irs.gov/taxtopics/tc102.html>.

<sup>85</sup> Internal Revenue Service, 'Appeals - About the Office of Appeals' (20 April 2018), <https://www.irs.gov/compliance/appeals>.

Forms and publications on taxpayers' Appeal rights are also available online.<sup>86</sup> The IRS further has a webpage, *Appeals Mediation Programs: Alternative Dispute Resolution (ADR)*, which provides education and guidance for taxpayers and other stakeholders on the Appeals mediation programs.<sup>87</sup> In addition, the TAS has a separate dedicated website providing information for individuals, businesses and tax professionals on its services and programs, and on the Taxpayer Bill of Rights.<sup>88</sup>

The IRS Internal Revenue Manual (IRM),<sup>89</sup> revenue procedures,<sup>90</sup> notices<sup>91</sup> and announcements,<sup>92</sup> which are publicly available on the IRS's website, provide official guidance and public pronouncements for IRS employees, taxpayers and other stakeholders on aspects of the US dispute resolution system, including the IRS Appeals Office and the IRS Appeals ADR programs.

LITCs administered by the TAS can represent low income individuals in disputes with the IRS.<sup>93</sup> In addition to providing taxpayer representation, they can also provide education for low income taxpayers and taxpayers who speak English as a second language about their taxpayer rights and responsibilities.

IRS Appeals employees are generally trained in-house by IRS Appeals instructors. Special courses may also be provided by contract instructors. IRS Appeals employees which act as mediators in the IRS's ADR programs are trained in mediation. While the actual training is conducted in-house by IRS Appeals, the training regime is designed by an independent (non-governmental) contractor, currently the National Mediators Association.<sup>94</sup>

#### 4.9 DSD Principle 9: assistance is offered for choosing the best process

There are process advisers for the IRS Appeals process available for taxpayers. This is indicated on the IRS website which outlines that taxpayers can contact the IRS employee that they have been dealing with or call the Taxpayer Service number for assistance in identifying whether their case meets the requirements for entering into the IRS Appeals system.<sup>95</sup> The IRS also provides a number of self-help tools to assist

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<sup>86</sup> See Internal Revenue Service, 'Forms and Publications About Your Appeal Rights' (2 May 2018), <https://www.irs.gov/individuals/forms-and-publications-about-your-appeal-rights>.

<sup>87</sup> Internal Revenue Service, above n 54.

<sup>88</sup> See Taxpayer Advocate Service, above n 49.

<sup>89</sup> The IRM is the primary, official source of 'instructions to staff' that relate to the administration and operation of the IRS. IRM 1.11.2.2.

<sup>90</sup> A revenue procedure is an official statement of a procedure that affects the rights or duties of taxpayers or other members of the public under the IRC, related statutes, tax treaties and regulations and that should be a matter of public knowledge. Revenue Procedures are also published in the IRB. Internal Revenue Service, 'Understanding IRS Guidance - A Brief Primer' (9 May 2018), <http://www.irs.gov/uac/Understanding-IRS-Guidance-A-Brief-Primer>.

<sup>91</sup> A notice is a public pronouncement that may contain guidance that involves substantive interpretations of the IRC or other provisions of the law. For example, notices can be used to relate what regulations will say in situations where the regulations may not be published in the immediate future. Internal Revenue Service, above n 90.

<sup>92</sup> An announcement is a public pronouncement that has only immediate or short-term value. For example, announcements can be used to summarise the law or regulations without making any substantive interpretation. Internal Revenue Service, above n 90.

<sup>93</sup> Internal Revenue Service, 'Low Income Taxpayer Clinics' (25 June 2018), <https://www.irs.gov/Advocate/Low-Income-Taxpayer-Clinics>.

<sup>94</sup> Email from a Principal and Co-leader of an accounting firm, Washington, DC to the author, 7 June 2014.

<sup>95</sup> Internal Revenue Service, 'Is Appeals the Place for You?' (2 May 2018),

taxpayers in choosing the best process.<sup>96</sup> The Appeals Online Self-Help Tools can be used by taxpayers to determine whether they would benefit from filing an appeal and the Appeals Mediation Online Self-Help Tool can be used to determine whether there is an appropriate IRS ADR program that may be utilised to help resolve disputes.

IRS revenue procedures on the IRS ADR programs and the IRM provide guidance for IRS officers and taxpayers on, *inter alia*, case eligibility and case exclusions from the ADR programs.<sup>97</sup> The IRS's ADR programs may be requested by either the taxpayer or the IRS after consulting with the other party. However, IRS Appeals Managers generally act as process advisers to ensure the appropriate use of the ADR programs.<sup>98</sup>

#### 4.10 DSD Principle 10: disputants have the right to choose a preferred process

As indicated under DSD Principle 7 in section 4.7, taxpayers have the right to choose a preferred process in the respect that they can choose to enter the disputes process at either the IRS Appeals Office level or at the level of the US Tax Court. Also, for taxpayers with small tax cases there are further opportunities to choose a preferred process in the respect that if certain criteria are met, qualifying taxpayers may choose to file a small case request (thus, following simplified filing requirements) instead of filing a formal protest with the IRS Appeals Office. In addition, at the level of the US Tax Court, taxpayers with qualifying small tax cases may request that their case be handled by the simpler, less formal small case procedures instead of the regular US Tax Court procedures.

Taxpayers also have the right to choose a preferred process in the respect that they are able to select between the formal disputes process and various IRS ADR programs available at the examination and appeals stages of the disputes process. As outlined in section 3.2, for certain ADR programs utilised at the examination (pre-Appeals) stage of the formal disputes process (for example, FTS), if an agreement (in whole or in part) is unable to be reached through ADR, the taxpayer retains all of their otherwise applicable appeal rights to request traditional IRS Appeals consideration of unresolved issues.<sup>99</sup>

At the level of the US Tax Court taxpayers can choose a preferred process in the respect that before commencing any formal court proceedings, parties may choose to utilise US Tax Court arbitration or mediation where appropriate. If arbitration is entered into, the arbitrator's decision is binding on the parties. However, if the parties are unable to reach an agreement through mediation, the parties may prepare for trial as normal.

In addition, provided that the taxpayer meets the criteria for assistance, the option of the TAS may technically be used in parallel with the formal tax dispute resolution process. This is because, as stated under DSD Principle 2 in section 4.2, the TAS is not intended to be a substitute disputes process for the formal disputes process, but rather it is

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<https://www.irs.gov/compliance/appeals/is-appeals-the-place-for-you>.

<sup>96</sup> The online self-help tools are available at: Internal Revenue Service, 'Appeals Online Self-Help Tools' (22 May 2018), <http://www.irs.gov/Individuals/Appeals-Online-Self-Help-Tools>.

<sup>97</sup> See, eg, Internal Revenue Service 'Rev. Proc. 2003-40', above n 50, [3.02]-[3.03]; Internal Revenue Service 'Rev. Proc. 2014-63', above n 52, [4.03]-[4.04].

<sup>98</sup> Internal Revenue Service 'Rev. Proc. 2003-40', above n 50, [4.01].

<sup>99</sup> Internal Revenue Service 'Rev. Proc. 2003-40', above n 50, [2.02].

intended to supplement the existing process if a taxpayer is about to suffer or is suffering significant hardship and have not been able to solve their problems on their own.

#### 4.11 DSD Principle 11: the system is fair and perceived as fair

The mission of the IRS Appeals Office is to ‘resolve tax controversies, without litigation on a basis which is fair and impartial to both the government and the taxpayer’.<sup>100</sup> Independence from other IRS offices is critical for the IRS Appeals Office to accomplish this mission. A key indication of the perceived independence and fairness of the IRS Appeals Office is provided by the Appeals Customer Satisfaction Survey. While these surveys have been conducted annually since 1997, the results of the surveys are not routinely made publicly available. Arguably, this makes changes in the perceived independence and fairness of the IRS Appeals Office difficult to monitor.

Notwithstanding the above, in February 2012, IRS Appeals initiated the Appeals Judicial Approach and Culture (AJAC) project in response to concerns by internal and external stakeholders, including IRS Appeals employees, that its determinations did not appear to be independent and impartial. The project was aimed at ‘reinforcing Appeals’ quasi-judicial approach to the way it handles cases, with the goal of enhancing internal and external customer perceptions of a fair, impartial and independent Office of Appeals’.<sup>101</sup> As a consequence of the AJAC project, IRS procedures have been modified to emphasise the following features of the Appeals system:

- IRS Appeals will not raise new issues nor reopen any issues on which the taxpayer and IRS are in agreement.<sup>102</sup>
- The IRS Appeals process is not a continuation or an extension of the examination process.<sup>103</sup>
- IRS Appeals should receive cases from the examination function that are fully developed and documented, such that IRS Appeals will not refer the case back to the examination function for further development, but will attempt to settle the case as submitted taking into account factual hazards.<sup>104</sup>
- Where the taxpayer raises new issues, information, or evidence, IRS Appeals will forward these to the examination function for their consideration.<sup>105</sup>

However, concerns have been raised that in practice AJAC is being used ‘to limit taxpayer’s access to Appeals, causing cases to be bounced back and forth between Appeals and Compliance, and resulting in curtailed review by Hearing Officers’.<sup>106</sup> This outcome of AJAC implementation ‘is diminishing the timeliness, quality and fairness of case reviews’.<sup>107</sup>

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<sup>100</sup> IRM 1.1.7.1.

<sup>101</sup> Internal Revenue Service, AP-08-0714-0004 (2 July 2014).

<sup>102</sup> IRM 8.6.1.6.2.

<sup>103</sup> IRM 8.6.1.6.2.

<sup>104</sup> IRM 8.2.1.4.3.

<sup>105</sup> IRM 8.2.1.5.2.

<sup>106</sup> Nina E Olson, *National Taxpayer Advocate 2015 Annual Report to Congress – Volume 1* (2015) 82.

<sup>107</sup> Nina E Olson, *National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress – Volume 2* (2016) 48.

Nevertheless, personal correspondence by the author with a number of US practitioners indicates the existence of generally positive perceptions of the IRS Appeals Office in effectively resolving disputes.<sup>108</sup> Historically IRS Appeals have settled 90 to 95 per cent of all cases coming to the Appeals Office in all of their dispute resolution processes.<sup>109</sup> Furthermore, a former IRS First Commissioner claims that:<sup>110</sup>

Appeals officials take a great deal of pride regarding their independence. Rarely have there been complaints about their independence. In general, Appeals officers are recruited from experienced IRS agents, and they have an intense training program in ADR tools and independence.

#### **4.12 DSD Principle 12: the system is supported by top managers**

There appears to be limited visible evidence of the championship of the IRS Appeals Office and/or of the IRS Appeals ADR programs by the IRS Commissioner in the form of published speeches or other media releases.<sup>111</sup> However, there appears to be some degree of evidence of the support and championship of the IRS Appeals process and of the IRS Appeals ADR programs in presentations given by the current Chief of IRS Appeals (who reports directly to the IRS Commissioner).<sup>112</sup> In addition, personal correspondence by the author with a US tax practitioner suggests that IRS officials do regularly speak at various conferences on the IRS Appeals process and ADR.<sup>113</sup>

#### **4.13 DSD Principle 13: the system is aligned with the mission, vision and values of the organisation**

The dispute resolution system is structurally integrated into the organisation through the IRS Appeals Office. Organisationally located in the Office of the Commissioner, the IRS Appeals Office operates independently from IRS functions such as the examination division, which performs audits to determine the correct tax liability, and the Office of Chief Counsel, which litigates US Tax Court cases for the IRS. As stated under DSD Principle 11 in section 4.11, since its establishment in 1927, the mission of the IRS Appeals Office has been to:<sup>114</sup>

[R]esolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.

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<sup>108</sup> Email from a Tax Partner of an accounting firm, California to the author, 9 May 2015; telephone correspondence from a Principal and Co-leader of an accounting firm, Washington, DC to the author, 7 May 2015.

<sup>109</sup> Telephone correspondence from a Principal and Co-leader of an accounting firm, Washington, DC to the author, 7 May 2015.

<sup>110</sup> Email from a Tax Partner of an accounting firm, California to the author, 9 May 2015.

<sup>111</sup> See the published speeches and statements made by the IRS Commissioner, available at: Internal Revenue Service, 'Commissioner's Comments, Statements and Remarks', <https://www.irs.gov/newsroom/commissioners-comments-statements-and-remarks>.

<sup>112</sup> See, eg, Donna C Hansberry 'Recent Developments in Appeals' (Presentation at the 41st Annual Tax Law Conference, Washington, DC, 3 March 2017); Donna C Hansberry 'A Conversation with Donna Hansberry, IRS Chief of Appeals' (Presentation at the Tax Executives Institute 67th Midyear Conference, Washington, DC, 19-22 March 2017).

<sup>113</sup> Email from a Managing Director of an accounting firm, Houston to the author, 5 August 2014.

<sup>114</sup> IRM 1.1.7.1.

The overall Mission, Vision and Values of the IRS are as outlined in Figure 2.<sup>115</sup>

**Fig. 2: Internal Revenue Service's Mission, Vision and Values**

<p><b>Mission:</b> Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.</p> <p><b>Vision:</b> We will uphold the integrity of our nation's tax system and preserve the public trust through our talented workforce, innovative technology and collaborative partnerships.</p> <p><b>Values:</b> Honesty and Integrity Respect Continuous Improvement Inclusion Openness and Collaboration Personal Accountability</p>
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It follows that the mission of the IRS Appeals Office of enhancing voluntary compliance and overall confidence in the fairness of the tax system through providing an efficient and independent administrative appeals system for taxpayers generally aligns with the overall mission of the IRS to 'provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all'.<sup>116</sup> The disputes process provided by the IRS Appeals Office also serves to fulfil the right in the IRS's Taxpayer Bill of Rights which states that 'taxpayers are entitled to a fair and impartial administrative appeal of most IRS decisions'.<sup>117</sup>

In providing the central direction for the attainment of the overall mission of the IRS, the current IRS *Strategic Plan FY 2018-2022* (which sets out the IRS's primary goals and objectives for the next four years) outlines that one of the strategic goals of the IRS is to 'protect the integrity of the tax system by encouraging compliance through administering and enforcing the Tax Code'.<sup>118</sup> Notwithstanding this goal, the IRS Appeals Office currently does not appear to feature in the IRS's planned initiatives for achieving the strategic priorities outlined in the Strategic Plan.

Furthermore, there is an apparent lack of integration of the dispute resolution system in the 'IRS Future State' initiative, a comprehensive plan developed by the IRS since 2014 which envisions how it will operate in five years and beyond.<sup>119</sup> The plan includes a stated goal of creating online taxpayer accounts through which taxpayers will be able to

<sup>115</sup> Internal Revenue Service, *Strategic Plan FY 2018-2022* (2018) 8.

<sup>116</sup> Ibid.

<sup>117</sup> Internal Revenue Service, above n 69, 1.

<sup>118</sup> Internal Revenue Service, above n 115, 13-14.

<sup>119</sup> See Internal Revenue Service, 'Future State Initiative' (12 January 2018), <https://www.irs.gov/uac/Newsroom/Future-State-Initiative>.



obtain information and interact with the IRS.<sup>120</sup> Further, implicit in the plan is an intention on the part of the IRS to substantially reduce telephone and face-to-face interaction with taxpayers.<sup>121</sup> Consequently, a reduced ability for taxpayers to personally contact the IRS may have an adverse impact on the ability afforded to resolve issues underlying those contacts.<sup>122</sup> A reduced opportunity to receive personal assistance and resolve conflicts with the IRS may in turn erode taxpayers' confidence in and perceptions of fairness of the system and, consequently, potentially lower the rate of voluntary compliance.<sup>123</sup>

With respect to the integration of ADR within the system, in order to achieve its mission, the IRS Appeals Office provides taxpayers with 'a variety of alternative dispute resolution forums to resolve taxpayer disputes without litigation'.<sup>124</sup> However, IRS efforts to incorporate ADR within the disputes system were primarily driven by the *Internal Revenue Service Restructuring and Reform Act of 1998* (enacting Internal Revenue Code §7123), which directed the IRS to implement procedures to allow a broader use of early appeals programs and to establish procedures that allow for ADR processes such as mediation and arbitration. Moreover, whether ADR has in fact been sufficiently integrated into the disputes system in practice can arguably be questioned given the observation that the IRS has been reluctant to fully embrace ADR due to, *inter alia*, the 'well-established' negotiation procedures of the IRS Appeals Office.<sup>125</sup> The extant literature suggests that the IRS has designed its ADR programs 'with a purposely narrow scope and application so that they can supplement, rather than replace, the existing negotiation process'.<sup>126</sup> Furthermore, the limited available statistics on the IRS's ADR programs suggest that the ADR programs 'are not being fully used and must be improved to help Appeals achieve its mission'.<sup>127</sup>

#### 4.14 DSD Principle 14: there is evaluation of the system

Various forms of evaluation of the US tax dispute resolution system exist. As highlighted under DSD Principle 11 in section 4.11, ongoing evaluation of the system occurs through the IRS Appeals Customer Satisfaction Survey. However, as stated earlier, it appears that the results of the IRS Appeals Customer Satisfaction Survey are generally not made publicly available. As noted under DSD Principle 4 in section 4.4, there is also provision for the specific evaluation of certain IRS Appeals ADR programs in the respect that taxpayers are requested to participate in a Customer Satisfaction Survey at the conclusion of the ADR program so that information can be gathered for evaluating and improving the relevant ADR process. However, similar to the IRS Appeals Customer Satisfaction Survey, the IRS Appeals Office does not routinely publish the results of these surveys.<sup>128</sup> Also, in 2012, the IRS Appeals Office engaged the Harvard Negotiation and Mediation Clinical Program (HMNCP) to evaluate the

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<sup>120</sup> Ibid.

<sup>121</sup> Olson, above n 106, 3.

<sup>122</sup> Ibid vii.

<sup>123</sup> Ibid 4.

<sup>124</sup> IRM 1.1.7.1.

<sup>125</sup> Stephen Folan, 'Even ADR Must Pay Its Dues: An Analysis of the Evolution of the Internal Revenue Service's ADR Programs and Where They Still Need to Grow' (2013) 13(2) *Pepperdine Dispute Resolution Law Journal* 281, 299.

<sup>126</sup> Ibid 289.

<sup>127</sup> Jones, above n 75, 1064.

<sup>128</sup> Email from a Practice Administrator of an accounting firm, New York to the author, 30 July 2014.

IRS's existing ADR tools. This was a one-off evaluation conducted on the IRS Appeals Office's ADR programs to identify potential opportunities for improvement.<sup>129</sup>

The Taxpayer Advocacy Panel may also provide a means through which evaluation of the dispute resolution system can occur as it conducts outreach to solicit suggestions or ideas from citizens, and serves on project committees working with IRS program owners on topics important to taxpayers and the IRS. The NTA's annual reports to Congress may provide a form of evaluation of the system to the extent that problems relating to the IRS Appeals Office and its processes are identified and consequent legislative and/or administrative changes may be recommended. The IRS Oversight Board may further provide an evaluation of aspects of the dispute resolution system through its annual reports to Congress and other special reports issued. Federal oversight organisations such as the US Government Accountability Office (GAO) and the Treasury Inspector-General for Tax Administration (TIGTA) have also provided reports on the IRS Appeals Office and its processes.

## 5. DISCUSSION AND RECOMMENDATIONS FROM AUSTRALIA

The dispute systems design evaluation conducted above in section 4 indicates that the US tax dispute resolution system follows many of the DSD principles of best practice derived from the DSD literature, including: (i) involving stakeholders in the design process; (ii) providing multiple options for addressing conflict; (iii) the provision of loop-back and loop-forward mechanisms; (iv) allowing for notification before and feedback after the dispute resolution process; (v) the inclusion of internal independent confidential neutrals in the system; (vi) the ordering of the procedures from low to high cost (notwithstanding the high upfront costs generally incurred by taxpayers in tax disputes); (vii) provision of multiple access points to the system; (viii) the provision of forms of training and education for stakeholders; (ix) assistance for choosing the best process; (x) offering disputants the right to choose a preferred process, and (xi) the presence of evaluation of the system.

Nevertheless, the US tax dispute resolution system also has some DSD deficiencies. There appears to be limited visible evidence of the support and championship of the dispute resolution system by certain members of IRS top management, namely the Commissioner of the IRS. Moreover, with respect to the support and championship of ADR in the system, it appears that the IRS has been reluctant to fully embrace ADR, in part due to the relative success of the well-established procedures of the IRS Appeals Office. There is also an apparent absence of the dispute resolution system and ADR from the IRS's current *Strategic Plan* and the IRS Future State initiative.

There has also been some evidence of negative perceptions of fairness of the tax dispute resolution system. These have largely related to concerns by internal and external stakeholders on the independence and impartiality of determinations made by the IRS Appeals Office. In addition, notwithstanding that there are mechanisms present in the system for the collection of feedback from taxpayers on the processes in the dispute resolution procedures that they have been involved in, namely various IRS customer

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<sup>129</sup> However, the majority of the HNMCP report (including the findings and recommendations) is exempt from disclosure as privileged information. Email from an Internal Revenue Service representative to the author, 7 February 2015.

satisfaction surveys, a further deficiency in the system appears to be the limited publication of the feedback collected.

It thus follows that the DSD evaluation conducted indicates that the strengths of the US tax dispute resolution system lie in various structural aspects of the system design such as providing multiple options for addressing conflict, multiple entry points to the system and loops backwards and forwards in the procedures. Furthermore, a notable feature of the system is the availability of the independent TAS within the IRS, which provides an avenue for taxpayers supplementing the traditional dispute resolution process. Notwithstanding these structural strengths, the US dispute resolution system is deficient in certain aspects pertaining to the support and championship of the system, the integration of the dispute resolution system within the wider tax administration and the reporting of feedback on the system. In seeking to improve the tax dispute resolution procedures in these particular areas, there are a number of design features which the US could potentially consider drawing upon from the Australian tax dispute resolution system.

As noted in section 1, Australia is widely regarded as one of the leaders in best practice tax administration.<sup>130</sup> Moreover, given that the Australian tax dispute resolution system has previously been evaluated in the DSD context, it arguably provides suitable guidance on the DSD strengths and weaknesses which may exist in the context of tax dispute resolution. The mission of the ATO is to 'contribute to the economic and social wellbeing of Australians by fostering willing participation in our tax and superannuation systems'.<sup>131</sup> To help achieve the goal of fostering willing participation in the tax system, the ATO recognises the need to manage and resolve disputes early, quickly and in a cost effective way.<sup>132</sup> Accordingly, the ATO's Practice Statement Law Administration 2013/3 (PS LA 2013/3) on *Alternative Dispute Resolution in ATO Disputes* states that '[w]hen disputes cannot be resolved by early engagement and direct negotiation, the ATO is committed to using ADR where appropriate to resolve disputes'.<sup>133</sup>

Championship of a dispute resolution culture and of ADR are recurrent themes in the speeches<sup>134</sup> of various senior ATO members including the Australian Commissioner of Taxation (Australian Commissioner), Second Commissioner Law Design and Practice and First Assistant Commissioner Review and Dispute Resolution (RDR).<sup>135</sup> This practice of the ATO aligns with the DSD literature which provides that:<sup>136</sup>

At least one senior person must be a visionary who champions the cause of creating a conflict-competent culture ... The champion's passion inspires

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<sup>130</sup> Bentley, *Taxpayers' Rights: Theory, Origin and Implementation*, n 9, 9; Michael D'Ascenzo, above n 27, 362.

<sup>131</sup> Hastings, above n 1, 4.

<sup>132</sup> Ibid.

<sup>133</sup> Australian Taxation Office, 'Practice Statement Law Administration 2013/3: Alternative Dispute Resolution in ATO Disputes' (2013) [5].

<sup>134</sup> Published ATO speeches are available on the ATO website at: Australian Taxation Office, 'Media centre', <https://www.ato.gov.au/Media-centre/?sorttype=SortByType>.

<sup>135</sup> RDR is an ATO business line established to oversee and manage disputes. RDR is part of the Law Design and Practice group and is independent of the Client Engagement group (formerly known as the Compliance group) of the ATO.

<sup>136</sup> Society of Professionals in Dispute Resolution, above n 37, 14.

others to act. It is this ability to connect others to a vision that often drives the success of a program.

Moreover, since his appointment in 2013, the current Australian Commissioner has embarked on a project of 'Reinventing the ATO' which aims to transform the ATO into a contemporary and service-orientated organisation.<sup>137</sup> The reinvention project has three main streams – transforming the client experience, transforming the staff experience and changing the ATO culture.<sup>138</sup> It follows that the tax dispute resolution system is integrated within the wider tax administration system in the respect that managing disputes fairly and effectively is an important part of the reinvention program. Hence, a number of processes have been implemented by the ATO to resolve disputes as early as possible. These include: (i) encouraging early engagement with taxpayers at both the audit and objection stages; (ii) the introduction of an independent review process for large business taxpayers, and (iii) the increased use of ADR, including the introduction of in-house facilitation.<sup>139</sup>

Furthermore, as part of the transformation of the organisation, various ATO staff have undergone training on how to better communicate with taxpayers during disputes.<sup>140</sup> The ATO have also established a Case and Technical Leadership group within RDR to provide mentoring and leadership to RDR staff in objections, ADR and litigation.<sup>141</sup> With respect to in-house facilitation, various frontline staff within the ATO have undergone training/awareness sessions on the benefits of in-house facilitation as a suitable approach to resolve less complex disputes.<sup>142</sup> Externally, the ATO has worked to raise awareness of its in-house facilitation service through interaction and consultation with professional associations and the legal profession.<sup>143</sup> For example, RDR have had various interactions with the Dispute Resolution Working Group<sup>144</sup> and the Legal Practitioner Roundtable.<sup>145</sup>

In addition, the ATO has indicated a continuing commitment towards incorporating dispute resolution within the organisation in the respect that, among other things, 'resolving disputes' was first included as a dedicated focus area of the ATO's *Corporate Plan* for 2014-18<sup>146</sup> and there has been further inclusion of the topic in subsequent ATO

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<sup>137</sup> See *Australian Taxation Office*, above n 23.

<sup>138</sup> Hastings, above n 1, 3.

<sup>139</sup> Ibid 4-5.

<sup>140</sup> Nassim Khadem, 'ATO seeks to make tax disputes resolution more cordial', *Sydney Morning Herald* (online), 20 July 2015, <http://www.smh.com.au/business/the-economy/ato-seeks-to-make-tax-disputes-resolution-more-cordial-20150717-giesm7.html>.

<sup>141</sup> Hastings, above n 1, 10.

<sup>142</sup> Ibid 8.

<sup>143</sup> Ibid 11.

<sup>144</sup> The Dispute Resolution Working Group is the ATO's key external working group for dispute resolution comprising representatives from tax professional associations, the Federal Court of Australia, the Administrative Appeals Tribunal (AAT), academics, industry, the Commonwealth Attorney-General's Department and senior ATO officers.

<sup>145</sup> The Legal Practitioner Roundtable comprises membership from the Law Council of Australia, all State and Territory law societies and bar associations, law firms and the Corporate Lawyers Association.

<sup>146</sup> Australian Taxation Office, *Corporate plan 2014-18* (2014) 37-40.

corporate plans.<sup>147</sup> The ATO's annual reports also include a separate section which reports on 'resolving disputes'.<sup>148</sup>

With respect to the reporting of feedback from tax disputes, the ATO has had its ADR processes independently evaluated to help build community confidence in the use of ADR in tax disputes. The ATO engaged the Australian Centre for Justice and Innovation (ACJI) at Monash University to conduct a feedback survey involving all participants in ADR processes with the ATO. The findings were outlined in a final report published in 2015.<sup>149</sup> The survey findings provided insight into the quality and effectiveness of the ATO's use of ADR and identified areas for improvement. In addition, the ATO has reviewed its Key Performance Indicators (KPIs), as reported in its annual report, to include a measure pertaining to 'taxpayer perceptions of fairness in tax disputes'.<sup>150</sup>

Against this background, the US could possibly draw from certain practices demonstrated by the Australian system in the respects outlined below. As highlighted in section 4.13, in a similar vein to the ATO's 'Reinventing the ATO' project, the IRS has developed a 'Future State' initiative which seeks to transform the way the IRS interacts with taxpayers.<sup>151</sup> Managing disputes fairly and effectively is an integral part of the ATO's reinvention program. Hence, following the DSD practice of the ATO, the author suggests that as part of the IRS's Future State plan, the use of ADR as an efficient and effective means of resolving tax disputes should be encouraged. The encouragement of the use of ADR processes as a less adversarial way of resolving disputes may in turn produce more positive perceptions of the IRS and thereby enhance voluntary compliance. An emphasis on the use of interests-based ADR methods such as facilitation and mediation as a means of resolving disputes is supported not only in practice by revenue authorities such as the ATO,<sup>152</sup> but also in the literature. Prior tax mediation research has indicated that affording taxpayers involved in tax disputes 'the opportunity to put their cases forward and feel as if they have been heard' may potentially have resulting positive impacts on taxpayers' perceptions of fairness and on voluntary compliance.<sup>153</sup>

Thus, the tax dispute resolution system could potentially be integrated in the IRS's Future State initiative through efforts made by the IRS to promote the use of ADR as a fair and efficient way of resolving disputes. Given the noted apparent under-utilisation

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<sup>147</sup> See, eg, Australian Taxation Office, *Corporate plan 2015-19* (2015) 5; Australian Taxation Office, *Corporate plan 2016-17* (2016) 5; Australian Taxation Office, *Corporate plan 2017-18* (2017) 5.

<sup>148</sup> See the ATO's annual reports, available at: Australian Taxation Office, 'Annual report' (30 October 2017), <https://www.ato.gov.au/About-ATO/Access,-accountability-and-reporting/Reporting-to-parliament/Annual-report/>.

<sup>149</sup> Tania Sourdin and Alan Shanks, *Evaluating Alternative Dispute Resolution in Taxation Disputes* (2015).

<sup>150</sup> See, eg, Australian Taxation Office, *Commissioner of Taxation Annual Report 2016-17* (2017) 96.

<sup>151</sup> Other jurisdictions around the world, such as New Zealand and the UK, are also currently undertaking various forms of transformation and modernisation programmes. See Inland Revenue, 'Transforming Inland Revenue' (19 February 2018), <http://www.ird.govt.nz/transformation/?id=footer> and HM Revenue and Customs, 'HMRC announces next step in its ten-year modernisation programme to become a tax authority fit for the future' (12 November 2015), <https://www.gov.uk/government/news/hmrc-announces-next-step-in-its-ten-year-modernisation-programme-to-become-a-tax-authority-fit-for-the-future>.

<sup>152</sup> Hastings, above n 1, 4.

<sup>153</sup> Melinda Jone and Andrew J Maples, 'Mediation as an Alternative Option in New Zealand's Tax Disputes Resolution Procedures: Refining a Proposed Regime' (2013) 19 *New Zealand Journal of Taxation Law and Policy* 301, 318.

of the IRS ADR programs as well as the seeming reluctance of IRS staff to depart from the established procedures of the Appeals Office, training/awareness sessions on the benefits of ADR could be provided to various frontline IRS staff in order to raise the internal profile of ADR. Notwithstanding that there is evidence of some external promotion of ADR by the IRS Chief of Appeals, in order to raise greater external awareness of its ADR programs, the IRS could undertake to further promote its ADR programs to key external stakeholders including the legal and accountancy professions and large and smaller accountancy firms.

The IRS could also follow the ATO by demonstrating a continuing commitment towards dispute resolution through including its plans with respect to dispute resolution in the IRS's *Strategic Plan*. Moreover, as suggested by the ATO experience (and the DSD literature), there must be support and championship of a dispute resolution culture which emanates from the top level of the revenue authority. This envisages an enhanced role for senior revenue authority members such as the Commissioner of the IRS and the Chief of Appeals in sincerely championing a dispute resolution culture and ADR in their speeches, presentations and other interactions with profession associations and other key stakeholders.

In addition, the IRS could improve its reporting of feedback on the dispute resolution system through publicly reporting the findings from its customer satisfaction surveys conducted. Greater transparency with respect to the survey findings may increase public confidence in the procedures and thereby potentially enhance voluntary compliance. Furthermore, the publication of feedback may improve the accountability of the IRS as well as help to identify areas for improvements to the IRS's ADR programs in particular, so that they can be more fully utilised.

Budget constraints have been a significant driver behind the IRS's Future State plan and its push toward online taxpayer accounts.<sup>154</sup> The NTA notes that:

... the fact that the agency's budget has been reduced by some 19 percent in inflation-adjusted terms since FY 2010 continues to require it to cut corners in providing a full range of taxpayer services.<sup>155</sup>

Thus, distinct from the situation in Australia, the integration of the use of ADR as part of the IRS's Future State initiative may be hampered by the fact that implicit in the Future State plan is an intention on the part of the IRS to substantially reduce telephone and face-to-face service in favour of online and 'self-service' options.<sup>156</sup> Taxpayer service historically has been labour-intensive.<sup>157</sup> Therefore, there is an inherent tension between providing high-quality taxpayer service and reducing costs.

The NTA has submitted that if the IRS substantially reduces the opportunity for taxpayers to personally interact with IRS employees, many taxpayers will find it much

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<sup>154</sup> With respect to the Australian tax dispute resolution system, while productivity benefits and operational savings were expected from the Reinventing the ATO program, they were not a key driver for its implementation. Australian National Audit Office, *Costs and Benefits of the Reinventing the ATO program* (ANAO Report No. 15 2017-18, 2017) 14.

<sup>155</sup> Nina E Olson, *National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress— Volume I* (2016) 79.

<sup>156</sup> Olson, above n 106, 7.

<sup>157</sup> Olson, above n 107, 3.

harder to resolve their problems with the IRS.<sup>158</sup> As a consequence, confidence in the fairness of the tax system may erode, and taxpayer frustration and alienation may lead over time to a lower rate of voluntary compliance.<sup>159</sup> These concerns have been discussed extensively in a series of public forums held by the NTA on the Future State initiative.<sup>160</sup> It is not realistic to expect that taxpayers who are told they owe more tax or whose refunds have been significantly delayed are going to be satisfied resolving their problems with the IRS exclusively through an online account.<sup>161</sup> A high percentage of taxpayers in this situation will want to speak with an IRS employee so they can be certain they understand the source of the problem and what more they need to do — and try to obtain reassurance about when they can expect a final resolution.<sup>162</sup>

Ultimately, the IRS must work within whatever budget it is given. Nevertheless, the IRS should be clear in communicating to Congress about the difficult choices it is facing. If the IRS implies that the adoption of online accounts will enable it to do a better job of meeting taxpayer needs at lower cost (through reduced personal interaction), Congress will have no reason to give the agency more funding. If the IRS can warn that online accounts, while desirable in many ways, will not be sufficient to address most taxpayer needs, Congress will be better informed about the tradeoffs that must be made.

The encouragement and promotion of ADR by the IRS may also be made more complex due to existing stakeholder perceptions of the IRS. In recent times IRS officials have faced scrutiny by the media, Congress and the public for several alleged lapses in judgment.<sup>163</sup> During 2013, national news media reported that the IRS had targeted certain organisations that had applied for tax-exempt status. The claim was that IRS personnel had been more closely scrutinising applications submitted by conservative groups. In particular, the IRS began creating lookout lists that contained names of organisations they believed needed further review.<sup>164</sup> Organisations that included the words ‘tea party’ or ‘patriot’ in their applications for tax-exempt status were included in the list.<sup>165</sup> As a result, several investigations of the IRS were triggered, including a Federal Bureau of Investigation criminal probe ordered by US Attorney General Eric Holder. In October 2017, following a multi-year legal battle, the US Justice Department settled with the conservative groups. In April 2018, a federal judge gave preliminary

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<sup>158</sup> Ibid 4.

<sup>159</sup> Ibid.

<sup>160</sup> See Taxpayer Advocate Service, ‘National Taxpayer Advocate Public Forums’, <http://www.taxpayeradvocate.irs.gov/public-forums>. See also Olson, above n 155, 4-49, for extended excerpts from the NTA’s public forums.

<sup>161</sup> Olson, above n 106, 10.

<sup>162</sup> Ibid.

<sup>163</sup> Along similar lines, recently the ATO has faced allegations of bullying tactics being used by the ATO on small businesses and individuals in order to meet revenue goals. See, eg, Katharine Murphy, ‘Tax Commissioner blasts Four Corners’ report on ATO’, *The Guardian* (online), 30 May 2018, <https://www.theguardian.com/australia-news/2018/may/30/tax-commissioner-blasts-four-corners-report-on-at>.

<sup>164</sup> Thomas L Davies, Angeline M Lavin and David H Moen, ‘The Effect of Recent Internal Revenue Missteps on Taxpayer Perceptions’ (2015) 8 *Journal of Business and Accounting* 102, 104.

<sup>165</sup> Peter Overby, ‘IRS Apologizes for Excessive Scrutiny of Conservative Groups’ (27 October 2017), NPR, <https://www.npr.org/2017/10/27/560308997/irs-apologizes-for-aggressive-scrutiny-of-conservative-groups>.

approval to a USD 3.5 million settlement between the department and a class-action lawsuit against the government launched on behalf of more than 400 groups.<sup>166</sup>

The role of the IRS in collecting taxes and enforcing federal tax laws is vitally important to the US. However, ‘the IRS generally does not have a positive reputation in the eyes of many taxpayers’ and a recent study suggests that the events of 2013 tarnished the IRS’s image and taxpayers’ confidence in it.<sup>167</sup> Because of the alleged questionable practices of the IRS, there is concern in general that some taxpayers will be less willing to voluntarily comply with the tax law, and also more willing to evade the law. Research further shows that taxpayers may be less willing to seek help from the IRS on tax matters.<sup>168</sup> Thus, the negative perceptions harboured by US taxpayers may not only potentially impact on the ability of the IRS to fulfil its duty of collecting taxes, but also its ability to manage and resolve tax disputes. ADR offers the prospect of resolving tax disputes in a less confrontational manner.<sup>169</sup> However, it requires the active engagement and willingness of both parties. This indicates that in order for ADR to take place effectively, the IRS must firstly seek to (re)build its reputation in the eyes of taxpayers and improvements to taxpayer service in general are a key part of this. Yet, as noted above, the IRS faces an inherent tension between improving taxpayer service and reducing costs.

The foregoing discussion suggests that the US tax dispute resolution system could potentially draw from certain DSD aspects of the Australian tax dispute resolution system, in particular with respect to the integration of ADR in the IRS’s Future State plan. However, in practice the integration of the use of ADR by the IRS may be somewhat constrained by budgetary constraints as well as existing negative stakeholder perceptions of the IRS. As noted in the recent series of public forums hosted by the NTA, over time continued poor service has the potential to undermine respect and confidence in the tax administration.<sup>170</sup> Moreover, once the public loses trust in an agency charged with administering the tax system, it is difficult to recapture.<sup>171</sup> However, implicit in the public forums is that in order to recapture trust and confidence in the agency, a change in the culture within the IRS is needed.<sup>172</sup> Setting aside the budgetary constraints of the agency, the author sees no reason why the greater integration of ADR cannot follow on from the said culture change.

## 6. CONCLUSIONS AND LIMITATIONS

This article has been set against the background of the use of ADR by both the IRS and the ATO as a means of managing and resolving tax disputes earlier without resorting to litigation. Accordingly, this article has evaluated the tax dispute resolution system in the US using DSD principles and has subsequently made possible recommendations for

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<sup>166</sup> Jeff Stein, ‘Tea Party groups targeted by the IRS are now eligible for government payouts’, *The Washington Post* (online), 20 April 2018, [https://www.washingtonpost.com/news/wonk/wp/2018/04/20/tea-party-groups-targeted-by-the-irs-are-now-eligible-for-government-payouts/?utm\\_term=.1e2c2f3a6b91](https://www.washingtonpost.com/news/wonk/wp/2018/04/20/tea-party-groups-targeted-by-the-irs-are-now-eligible-for-government-payouts/?utm_term=.1e2c2f3a6b91).

<sup>167</sup> Davies, Lavin and Moen, above n 164, 115.

<sup>168</sup> David H Moen, Thomas L Davies and Angeline M Lavin, ‘Taxpayer Perceptions of the Internal Revenue Service’ (2014) 7 *Journal of Business and Accounting* 64, 74

<sup>169</sup> EY, above n 4, 4.

<sup>170</sup> Olson, above n 155, 5.

<sup>171</sup> Ibid.

<sup>172</sup> Ibid 12-13.



improvements to the system drawing upon DSD features of the tax dispute resolution system in Australia and its 'Reinventing the ATO' transformation project.

The DSD evaluation conducted indicates that the US tax dispute resolution system meets many of the DSD principles of best practice. Its particular strengths lie in the structural aspects of design, including providing multiple options for dispute resolution, multiple entry points to the system and loops backwards and forwards in the procedures. However, it is deficient in a number of areas which largely relate to the support and championship of the dispute resolution system and ADR by certain members of the IRS, the integration of the system and ADR within the wider tax administration and the reporting of feedback collected on the system.

Accordingly, drawing from certain practices and experiences of the Australian tax dispute resolution system, this article recommends that the US tax dispute resolution system and ADR could be integrated within the IRS's Future State initiative. Consistent with the various initiatives of the ATO's reinvention program, this would involve measures taken by the IRS to raise awareness, both internally and externally, of its ADR programs as an efficient and effective means of resolving tax disputes. Greater awareness of the IRS's ADR programs could potentially contribute towards more positive perceptions of fairness of the tax administration with respect to affording taxpayers the opportunity to personally interact with the IRS in order to resolve any disputes that may arise (in particular, in a less adversarial manner). In turn, this may consequently enhance voluntary compliance.

It is further suggested that IRS could continue to demonstrate the integration of the dispute resolution system and ADR in the wider tax administration system through the inclusion of its dispute resolution plans in its *Strategic Plan*. Moreover, the adoption of an enhanced role in the support and championship of the US tax dispute resolution system and of ADR by senior revenue authority staff, including the Commissioner of the IRS and Chief of Appeals, is suggested. The Australian experience indicates that the support and championship of a fair and efficient tax dispute resolution system can contribute towards enhancing the client experience and fostering voluntary compliance. Improvements to the publication of feedback collected on the dispute resolution system by the IRS may also increase taxpayers' confidence in the system.

Nevertheless, the above recommendations are subject to a number of limitations, some of which are specific to the tax dispute resolution environment in the US. Most significantly, the recommendations are limited in the light of the current reductions to the IRS budget. From this it follows that implicit in the IRS's Future State plan are reductions in the level of face-to-face interaction with taxpayers. This in turn potentially limits the IRS's service delivery with respect to both dispute resolution generally and ADR. A further major limitation to the greater integration of ADR in the system lies in the prevailing negative stakeholder perceptions of the IRS. The IRS needs to rebuild its reputation in the eyes of taxpayers in order to be able to integrate ADR effectively within the system. However, a change in taxpayers' perceptions will take time to emerge and take effect.

The suggestions put forward in this article would also be dependent on the support and championship of the dispute resolution system by IRS staff at all levels of the organisation. In theory, an increased level of support and championship should follow from a culture change within the IRS. Nevertheless, even if ADR is well supported by IRS staff (and setting aside any budgetary constraints), in order to be effective, interests-

based ADR processes such as mediation generally require the willingness and consent of both parties (that is, both the taxpayer and the IRS).

It should also be noted that the DSD recommendations put forward for the US system have primarily been drawn from the Australian tax dispute resolution system and the ATO's transformation project. Notwithstanding that the use of ADR by the ATO is relatively recent in comparison to the use of ADR by the IRS (and even though there are certain structural DSD deficiencies to the Australian system which have not been the subject of this article), it is nevertheless appropriate that this article draws from the Australian system given that it has previously been evaluated using DSD principles and, furthermore, that the ATO is widely recognised as one of the leaders in best practice in tax administration. Thus, as outlined in this article, there are a number of (non-structural) design aspects that the US can potentially draw from with respect to the Australian tax dispute resolution system, in particular so that the IRS's ADR programs may be more fully utilised. Nevertheless, potential future research opportunities lie in providing recommendations for further improving the US tax dispute resolution system, including its ADR processes, by drawing additional DSD strengths, if any, from the tax dispute resolution systems in other jurisdictions.

# The effect of professional standards on confirmation bias in tax decision-making

Darius Fatemi,<sup>1</sup> John Hasseldine<sup>2</sup> and Peggy Hite<sup>3\*</sup>

## ***Abstract***

This study first examines whether confirmation bias in a tax decision context is greater when the quantity of information describing the tax issue is substantially increased. The study reviews international accounting bodies' professional codes and then focuses on de-biasing by testing the use of principles-based ethical standards to mitigate pro-client confirmation bias. Specifically, we examine the effect of AICPA Code of Conduct Section 54 for integrity and Rule 102-6 for advocacy. We use novice participants who would not yet have preconceived notions developed from their workplace environment regarding the standards or the case facts. Our results show that pro-client recommendations are a function of the presence of a professional standard and the level of contextual detail. Confirmation bias exists in the detailed context without professional standards. However, when professional standards are present, this type of confirmation bias is mitigated.

**Key words:** client advocacy; confirmation bias; principles-based standards; professional ethics

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<sup>1</sup> Associate Professor of Accounting, Haile/US Bank College of Business, Northern Kentucky University.

<sup>2</sup> Professor of Accounting, Peter T. Paul College of Business and Economics, University of New Hampshire.

<sup>3</sup> Emeritus Professor of Accounting, Kelley School of Business, Indiana University-Bloomington.

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## 1. INTRODUCTION

Throughout the world, tax practitioners offer planning and compliance services to business clients and their executives (Frecknall-Hughes & Moizer, 2015; Gupta, 2015). In the US, the regulatory environment has been strengthened in recent years to improve compliance and prevent abuse from overly aggressive client-favourable reporting (Financial Accounting Standards Board (FASB), 2006; Internal Revenue Service (IRS), 2009; IRS, 2011). The tax and auditing literature has documented the propensity of professional accountants to exhibit confirmation bias, a psychological tendency to seek out, attend to, and remember information that is in line with an outcome the accountant prefers, either because it agrees with a client's preference or because it follows the accountant's preconceptions (Kunda, 1990; Oswald & Grosjean, 2004). For example, Cloyd and Spilker (1999) demonstrated that practitioners tend to seek out more favourable cases, rulings and standards than unfavourable ones. The penchant toward pro-client outcomes has been documented in the interpretation and weighting of evidence for moderate-risk clients (Johnson, 1993; Cuccia, Hackenbrack & Nelson, 1995), while Kadous, Magro and Spilker (2008) found that confirmation bias evidenced with moderate-risk clients is not observed for clients with a high practice risk. Assuming most clients are moderate risk and that ambiguous issues abound, the results imply that the impact of confirmation bias is non-trivial.

Notwithstanding the pervasiveness of the literature supporting confirmation bias, Nelson (2003) asserts that practitioners ultimately make decisions that are consistent with their incentives. These incentives include motivating factors such as likelihood of litigation, potential for client loss, loss of reputation, possible penalties, and client importance. He argues, however, that the incentives could be designed to favour accuracy. For example, in an auditing environment he applauds the Financial Accounting Standards Board (FASB) consideration of a 'true and fair' override that would require transactions to reflect the underlying economic substance.

Similar to the proposed FASB override, guidance for accurate, objective reporting is provided in the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct (2014).<sup>4</sup> The 2014 version of the Code replaced an earlier version effective from 2010. In the 2014 Preface, Section 0.300.040 requires members to demonstrate the highest sense of integrity, and adds that integrity requires honest and candid reporting and that integrity does not permit deceit or subordination of principle (previously ET Section 54 in the 2010 Code). Another AICPA rule, Section 1.140 of the 2014 Code, (previously rule 102-6 in the 2010 version) implicitly acknowledges that accuracy can become subjective in the presence of ambiguous technical guidance.<sup>5</sup> This

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<sup>4</sup> The rule for independent, unbiased judgments is not the same as the term for independence that is used in the auditing literature. Auditors are forbidden to opine unless the independence requirements are satisfied. In this situation, independence regarding the client-auditor relationship is regulated by a specific set of regulations.

<sup>5</sup> The Section's first paragraph states: 'An advocacy threat to compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist when a member or the member's firm is engaged to perform non-attest services, such as tax and consulting services, that involve acting as an advocate for the client or to support a client's position on accounting or financial reporting issues either within the firm or outside the firm with standard setters, regulators, or others'. Also, paragraph 3 states: 'Some professional services involving client advocacy may stretch the bounds of performance standards, go beyond sound and reasonable professional practice, or compromise credibility, thereby creating threats to the member's compliance with the rules and damaging the reputation of the member and the member's firm. If such circumstances exist,

is consistent with Nelson (2003) who suggests that aggressive reporting decisions tend to increase with more imprecise reporting standards. Section 1.140 (formerly Rule 102-6) of the AICPA Code condones justifiable client advocacy in tax and financial decision-making. To date, research has not examined the impact of AICPA standards for advocacy and integrity on the propensity toward pro-client decision-making, yet Libby and Luft (1993) argue that the purpose of professional standards is to influence professional judgments. The issue is whether professional standards required by the Code act as incentives that influence decision-making. The current article contributes to the literature by examining the effects of the advocacy standard and integrity standard as contained in the 2010 version of the AICPA Code on tax decision-making that involves ambiguous technical guidance. We purposely use student participants to provide a homogenous group for this baseline study and to reduce possible rival effects from work experience and/or organisational climate.

Confirmation bias is often exacerbated by supplemental material, as the additional judicial and legislative rulings can be misinterpreted or over-weighted as support for a pro-client position (Johnson, 1993; Cuccia et al., 1995). Klayman (1995) admits that much is unknown about why confirmation bias exists, but he adds that a potential theme for future research is to examine the role of motivation as a moderator of the cognitive processes that result in confirmation bias. Prior research, however, has not examined the potential impact of professional standards as motivating factors (e.g., such as Integrity and Advocacy in a tax context). If the presence of these standards is included, would the additional evidence still result in more pro-client outcomes as prior literature suggests?

When analysing how to apply a subjective rule, irresolute information regarding the facts and circumstances of a tax issue can contribute to the ambiguity, as it is difficult to evaluate how the subjective rule fits an indeterminate case. Clearly, recommendations and reporting decisions should not be driven by additional, irresolute information, but rather by authoritative tax guidance, yet prior studies have documented a confirmation bias arising from a conscious or unconscious supportive interpretation of the regulatory and judicial rulings. The AICPA standard for integrity requires its members to be honest and candid in their judgments. Therefore, if this type of AICPA professional standard is applied, it should mitigate the propensity toward pro-client decision-making related to the added details.

Client advocacy has also been sanctioned by the AICPA, perhaps as acknowledgment that conservatism does not always result in an accurate decision. If the technical guidance is ambiguous, a professional standard such as Rule 102-6 could either increase the likelihood of a pro-client reporting decision if it is justifiable, or the standard itself could be over-valued as motivation for pro-client decisions that are not justified. The concern is that confirmation bias could affect how the added detail would be weighted, possibly leading to an increase in the likelihood of a pro-client outcome. That said, the advocacy rule is not intended to condone this type of confirmation bias. Its status as a professional standard as well as the discussion included in Rule 102-6 reinforces its purpose of helping the client determine an objective, appropriate interpretation of the relevant technical guidance.

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the member and member's firm should determine whether it is appropriate to perform the professional service'. See n 9, below, for the equivalent paragraph in the 2010 version of the Code.

Our results show that in the absence of professional standards for integrity and advocacy, confirmation bias derived from additional inconclusive information leads to a more pro-client tax outcome than does the same tax issue without that additional information. In contrast, when either AICPA Section 54 or Rule 102-6 is explicitly presented to the participants, the final tax reporting decision does not significantly differ between the contexts with and without the additional information. The implication is that the professional standards tend to mitigate the confirmation bias that is associated with a propensity to misinterpret additional information as support. In addition, we find that the presence of AICPA Section 54 for integrity decreases the likelihood of a pro-client recommendation in the context with additional inconclusive details, which is a more realistic case.

Prior literature, e.g., Johnson (1993), has documented confirmation bias in a tax setting involving the deductibility of reasonable compensation, and correlated advocacy attitudes with client advocacy judgments, and Pinsker, Pennington and Schafer (2009) also use a reasonable compensation case scenario and contrast the different roles of audit vs. tax professional to examine whether switching roles influences client advocacy and professional scepticism. As no prior studies have considered the influence of professional standards, we document the potential impact of AICPA professional standards on judgments involving ambiguous tax reporting decisions. The present study shows that professional standards are important factors in compliance contexts. Furthermore, most prior research related to professional codes of ethics in accounting has involved an audit setting, and none of those studies involved the overarching principles-based standards for integrity and advocacy.

Our study further contributes to the literature by comparing the effects of advocacy and integrity standards in two contexts. Both contexts involve the same ambiguous tax issue (classification of compensation to the owner as a salary or as a dividend). One case, however, has scant evidence to support or deny its tax deductibility. The other case contains a considerable amount of additional but inconclusive detail. Consistent with Bonner (1994), the quantity of components that must be considered creates additional ambiguity for the task context, and this can lead to an increased likelihood of confirmation bias given the tendency to interpret the evidence as pro-client (Johnson, 1993; Cuccia et al., 1995). Our study confirms this finding in the absence of professional standards. However, confirmation bias attributable to the added detail does not exist in the presence of the professional standards. The implication is that increased exposure to overriding standards, especially Section 54 for integrity, may be able to reduce some of the confirmation bias that has been demonstrated in the information searches, data evaluation, and reporting decisions.

The results of this study have important implications for: 1) accounting standard setters who develop professional codes and rules; 2) tax, audit, financial and managerial accountants who have varying sets of ethical standards meant to guide their professional judgments; 3) regulatory tax authorities, such as the Internal Revenue Service (IRS), who monitor professional accountants' behaviour, and 4) academics who wish to engage students in applied ethical decision-making.

The remainder of this article proceeds as follows. The next section provides background information and develops our hypotheses. Sections 3 and 4 outline our method and results respectively, with concluding remarks in section 5.

## **2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

### **2.1 Professional Codes of Ethics**

This study explores the influence of professional standards as contained in the AICPA Code of Professional Conduct (2010; 2014); specifically the effects of integrity and client advocacy on confirmation bias. Apart from the US, at the suggestion of a reviewer, we examined the codes of several English speaking countries, specifically for chartered accountants in Australia, New Zealand, Ireland, South Africa and the UK, who must all comply with a code based on the Code of Ethics for Professional Accountants of the International Ethics Standards Board for Accountants (IESBA) published by the International Federation of Accountants.<sup>6</sup>

The IESBA Code has adopted a principles-based (rather than rules-based) approach and does not apply directly to members of a particular professional body, but rather the main accountancy bodies throughout the world are required to comply with a code no less stringent than the principles included in the IESBA Code of Ethics. This Code states: 'The principle of integrity imposes an obligation on all members to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness', and is an element of the traditional accountant stereotype (Carnegie & Napier, 2010).

### **2.2 Confirmation bias**

Confirmation bias is a tendency to seek out, attend to, and remember information that is in line with a preferred outcome. Essentially, individuals are hard-wired to exhibit a confirmation bias (seeking confirmation of one's prior beliefs) and a selective information processing bias (seeing only what one wants to see) when evaluating evidence (Kunda, 1990; Oswald & Grosjean, 2004). The bias is clearly of interest to accounting firms, as it may affect audit and tax professionals' weighting of evidence and their professional judgments and decisions.

Confirmation bias can be distinguished from the separate construct of client advocacy which Mason and Levy (2001, p. 127) define in a tax setting as '.... a state of mind in which one feels one's primary loyalty belongs to the taxpayer. It is exhibited by a desire to represent the taxpayer zealously within the bounds of the law, and by a desire to be a fighter on behalf of the taxpayer'. The IESBA Code defines an 'Advocacy threat' as 'the threat that a Member will promote a client's or employer's position to the point that the Member's objectivity is compromised', but unlike the AICPA or Ontario, the IESBA does not specifically condone client advocacy; rather, the IESBA assumes professional accountants will be client advocates.

The significant influence of advocacy was a frequent result in early behavioural studies on tax practitioners' recommendations to clients (Ayres, Jackson & Hite, 1989; Jackson & Milliron, 1989), and the positive correlation between client advocacy and favourable recommendations on tax decision-making continues today (Johnson, 1993; Levy, 1996; Mason & Levy, 2001; Pinsker et al., 2009; Bobek, Hageman & Hatfield, 2010). Although several studies have documented the significant effects of advocacy, most of these results have not had large explanatory effects. For example, the correlation

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<sup>6</sup> Interestingly, CPAs in Ontario (and possibly other Canadian provinces), like the AICPA, do not utilise the 'standard' definition of Integrity as per the IESBA Code.

between advocacy attitude and recommended tax position in Johnson (1993) was 0.17, it was only 0.13 in Pinsker et al. (2009), and it was not significant at all in Barrick, Cloyd and Spilker (2004).

Bobek et al. (2010) note that most prior research does not use a scale to measure individual advocacy attitude. Instead, a treatment effect is induced for advocacy by indicating the client-favourable position (Cloyd & Spilker, 1999). In Cuccia et al. (1995), aggressive reporting decisions were significantly higher for the scenarios that described the client as having a preference for aggressive (but legitimate) tax reporting positions rather than clients described as having conservative preferences. In contrast, the Ayres et al. (1989) study did not manipulate client preference, but the underlying premise of the decision variable was to capture practitioners' propensity to prefer decisions that are favourable for the client (i.e., reduce taxable income) rather than report conservatively on ambiguous reporting issues. This is consistent with research finding that most practitioners assume their clients prefer tax saving strategies, even when not explicitly requested (Christensen, 1992; Stephenson, 2007).

In a review of tax practitioners' decision-making, Roberts (1998) reiterated the effects of advocacy in practice. As indicated by the studies he reviewed, advocacy attitudes produce confirmation bias when practitioners evaluate case law, weigh evidence, and decide how much effort to expend to find support for pro-client positions. Kadous et al. (2008) demonstrated the complexities of client preference by explicitly manipulating the client's level of tax practice risk. They found that the extent to which information search is confirmatory is influenced by a balance of incentives including client risk and the regulatory environment. Specifically, confirmation bias was not exhibited when their high-risk clients had a history of aggressive reporting and litigation. In contrast, confirmation bias was documented for the moderate-risk clients. Bobek et al. (2010) found that advocacy attitude is specific to the client's characteristics. That is, when told that the client has previously proposed questionable tax-saving strategies and has been audited by the IRS, resulting in sizable adjustments and penalties, tax practitioners are less likely to be an advocate for the client. This is consistent with research finding that when the client engagement is described as high-risk, auditors are less likely to permit an aggressive reporting decision (Hackenbrack & Nelson, 1996). Furthermore, Cuccia et al. (1995) reported that when a client is described as risk-averse, practitioners are not as likely to recommend an aggressive pro-client tax position. In sum, the studies have shown that auditors and tax practitioners are more likely to permit aggressive reporting when the engagement risk is moderate.

The distribution of tax clients who are highly risk-seeking or highly risk-averse is not known, but utility theory assumes that most taxpayers prefer to pay less tax than more. Hence, consistent with prior studies, the current study examines confirmation bias for moderate-risk clients with the assumption that saving taxes by reducing taxable income is a favourable outcome for the typical client (i.e., not excessively risk-seeking or risk-averse).

Whether measured as advocacy attitude or confirmation bias, the tax literature is replete with studies acknowledging practitioners' tendency to favour pro-client judgments (Ayres et al., 1989; Johnson, 1993; Cloyd and Spilker, 1999), and the same is true for the auditing literature in which auditors often demonstrate a bias toward a position that is favourable for their client (Hackenbrack & Nelson, 1996; Kadous, Kennedy & Peecher, 2003; Moore et al., 2006).



Relevant to the present study, Cuccia et al. (1995) found that tax practitioners attempted to conform to client preferences by interpreting vague verbal standards as support for their aggressive decisions. In addition, when the threshold standards were described in numerical terms (e.g., 60% required level of support), practitioners interpreted the evidential support as being more favourable in order to justify an aggressive position. Similar work by Johnson (1993) found that tax judgments were influenced by confirmation bias. Her study labelled prior court cases as either favourable or unfavourable evidence for a client's preferred position on an ambiguous tax issue. Half of the practitioner sample was told cases A and C (B and D) constituted favourable (unfavourable) evidence, but the others were told that the same cases, A and C (B and D) were unfavourable (favourable). Participants perceived the cases that were labelled as favourable to be more applicable to their client's situation, and they interpreted those cases as supportive regardless of the unsupportive details and facts specified within each case. The study documented the propensity to overweight additional facts and evidence as favourable to a client-preferred position, even when the underlying facts were not supportive.

Bonner (1994) explains that technically correct solutions can be confused by uncertain information as well as the number of criteria on which to evaluate a decision. The implication is that practitioners are prone to confirmation bias when given a myriad of facts to consider, as the cognitive effort needed to process a large quantity of information is likely to be reduced by substituting a less effortful heuristic such as confirmation bias.

To avoid preparer penalties on aggressive reporting positions, US tax law standards typically require a 'more likely than not' weighting of the judicial evidence and legislative guidance. In both the Cuccia et al. (1995) and Johnson (1993) studies, the amount of information given to all participants was substantially equal, and most responded that the presented information met the 'more likely than not' tax criterion. The current study extends the test of confirmation bias to tax decisions in which a case with an ambiguous outcome involves additional but inconclusive details about the facts of the client's transaction. It is posited that the decision-maker will interpret the case scenario with detailed information as more supportive of the client-preferred outcome, relative to the same scenario that is stripped of most of the irresolute information. If the case is presented without the detail, then there is less information to interpret as supporting evidence (i.e., there is less evidence to 'confirm'). Consequently, confirmation bias should be weaker in the less detailed context. This leads to our first hypothesis:

**HYPOTHESIS 1.** *In the absence of motivating professional standards, a case with additional, inconclusive, information is more likely to result in confirmation bias (a more pro-client decision) than a case with substantially less information.*

### **2.3 Effect of integrity on confirmation bias**

Under the AICPA Code of Conduct (2010), Section 54 reinforces integrity as an ethical guideline for CPAs. The rules of the Code are intended to help CPAs interpret the entire body of principles- and rules-based guidance. In fact, one of the initiatives associated with the Sarbanes-Oxley Act of 2002 is the proposed adoption of principles-based technical accounting standards, which is expected to dampen aggressive financial reporting related to undue reliance on form over substance (Agoglia, Douppnik & Tsakumis, 2011). To date, however, there is scant evidence on the effects of integrity, a

principles-based ethical standard required by the Code. Given the complexity of current tax laws, expertise in interpreting government rules and regulations is a valued service. Even though integrity is sanctioned by the profession, its effectiveness remains a question for empirical research. As noted by Jones, Massey and Thorne (2003), the AICPA's professional code could either enhance or limit auditors' ethical sensitivities, and they call for research to identify ways in which the Code can enhance ethical awareness and behaviour. Herron and Gilbertson (2004) compared the effects of principles-based and rules-based ethical guidelines, as student participants were given either excerpts from AICPA Section 50 with a principles-based focus or from the rules-based AICPA Section 101, each pertaining to independence in the auditor-client relationship. This treatment did not significantly affect the participants' decisions regarding a specific transaction: whether an auditor's independence would be violated if the hypothetical audit engagement were accepted when the client was already a tax and consulting client. They did find, however, that participants with high-level moral reasoning (based on DIT scores) were influenced only by the principles-based excerpts and those with low-level moral reasoning were influenced only by the rules-based excerpts. Applying this result to practice is difficult as each practitioner's level of moral reasoning is not known. The implication is that in the presence of rules-based guidance only, even very ethical decision-makers lose focus on the primary objective. The trend toward principles-based accounting reinforces the need for decision-makers to stay focused on the primary objective. Hence, the current study examines the effect of exposure to principles-based standards on tax decision making.<sup>7</sup>

Sunder (2010) discusses the balance between uniform, written rules-based standards and principles-based social norms, arguing that the latter should be given a stronger role in restoring personal and professional responsibility in accounting. Both Sunder (2010) and Jones et al. (2003) assert that more research is needed to identify ways in which the Code can enhance ethical awareness and behaviour. Both the 2010 and 2014 versions of the Code require members to make professional reporting decisions that are accurate, honest, and candid, which is consistent with Nelson's (2003) call for principles-based technical standards that require a 'true and fair' override to incentivise more accurate reporting. Libby and Luft (1993) argue that the professional code was created with the goal of influencing professional judgments, and they argue that even minimal exposure to professional guidelines could influence ethical judgments. The present study tests the effectiveness of Section 54 as a principles-based standard that could diminish confirmation bias by providing an explicit prime for this professional code.

Klayman (1995) asserts that little is known about the connection between motivation and the cognitive processes that result in confirmation bias. By including professional ethical standards in our model, the desire to see a client-favourable solution must be weighed against the desire to satisfy a professional ethics standard. Hence, the question is whether the confirmation bias from the detailed case will persist when participants

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<sup>7</sup> The Defining Issues Test (DIT), developed by Rest (1979), is widely used to measure one's current ethical stage of development. The test incorporates more personal dilemmas than business dilemmas, and this has led numerous researchers to question its application in business settings (Weber, 1990; Trevino, 1992; Fisher, 1997; Doyle, Frecknall-Hughes & Glaister, 2009; Bailey, Scott & Thoma, 2010). Shawver and Sennetti (2009) created eight business scenarios and asked a total of 24 questions regarding intended behaviour. Subject responses on the DIT were significantly correlated with only three of the 24 items. The researchers concluded that the DIT may be appropriate for measuring absolute levels of cognitive, ethical development, but applied business dilemmas are more appropriate for measuring relative effects on professionals' business decision-making.

are exposed to the integrity standard. If exposure to the integrity standard is a robust effect, then it should negate any increased tendency, conscious or unconscious, to recommend the deduction when additional but inconclusive details are added. Thus, the standard calling for candid and honest judgments may lead participants to interpret the additional information with more scepticism. On the other hand, if the effect of confirmation bias related to the added details is dominant (per H1), then the pro-client tendency should persist. Hence, the presence of a confirmation bias driven by additional detail is examined to test whether the confirmation bias expected in the absence of a professional standard (H1) is mitigated in the presence of a professional standard for integrity, which leads to our second hypothesis:

*HYPOTHESIS 2. The increased propensity for confirmation bias (a pro-client decision) in a detailed context is less likely in the presence of a professional standard for integrity than in its absence.*

## **2.4 Effect of advocacy on confirmation bias**

The AICPA has repeatedly confirmed the right of CPAs to be advocates for their tax clients, and Rule 102-6, originally drafted in 1995, of the 2010 AICPA Code sanctioned the need for taxpayer advocacy. Traditionally, client advocacy has been associated with tax services, although Rule 102-6 condones advocacy for accounting, financial reporting, and tax. It is important to note that when acting as a client advocate, the 2010 and 2014 versions of the Code, both require members to maintain objectivity and integrity, with the narrative for Rule 102-6 thus implying that advocacy is justifiable only when the technical guidance is unclear. Several behavioural studies have shown that attitude toward advocacy correlates with preferences for client-favourable outcomes (e.g., Johnson, 1993, Levy, 1996, Davis & Mason, 2003), but Barrick et al. (2004) did not. When advocacy has been tested by manipulating client preference, research tends to show a positive association as practitioners strive to help their clients, provided the hypothetical client is not too risk-seeking or too risk-averse (Hackenbrack & Nelson, 1996; Cuccia et al., 1995; Kadous et al., 2008). This suggests that the presence of a professional standard sanctioning advocacy might reinforce the pro-client tendency.

Both confirmation bias and an advocacy standard could lead to a more pro-client outcome when there is scant or substantial information that is inconclusive. Kunda (1990), however, asserts that motivated reasoning toward preferred outcomes has boundaries, caused by internal or external constraints, which result from certain thresholds or limits. For example, personal norms, societal norms, professional standards, and/or sanction threats could restrict the amount of risk-seeking or risk-taking behaviour that is acceptable to the decision-maker. If by definition the issues are truly ambiguous (lack sufficient support), then confirmation bias can move the decision to a favourable position when it is allegedly not supportable. At some point, this bias crosses the line and becomes unjustifiable.

This raises the issue that advocacy, as a standard allowed by the AICPA, could infer a professional ceiling for the extent of advocacy that would be consistent with the professional standard. In essence, although the standard permits advocacy, the standard itself cautions against exceeding certain boundaries.<sup>8</sup> Moreover, merely being labelled

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<sup>8</sup> See n 5, above.

as a professional standard in the AICPA Code of Conduct conjures up behaviour that is fitting for a professional.

In sum, prior studies have documented the role of advocacy in confirmation bias, treating advocacy either as an internalised belief (i.e., using the Mason & Levy (2001) scale) and/or as an outcome arising from an explicit manipulation of client preference. The current study, however, presents advocacy as delineated by professional guidelines. It should be noted that the wording in Rule 102-6 is guarded (e.g., ‘...*may be requested by a client*...’). The purpose of the present study is not to induce aggressive, pro-client decisions. If Rule 102-6 acts as a boundary because of its recognised position as a part of the AICPA Code of Conduct, then its presence would mitigate the expected confirmation bias coming from the added context. Thus, the following hypothesis is tested:

**HYPOTHESIS 3.** *The increased propensity for confirmation bias (a pro-client decision) in a detailed context is less likely in the presence of a professional standard for advocacy than in its absence.*

### 3. RESEARCH DESIGN AND METHOD

We test our hypotheses in a mixed between- and within-subjects design, varying between participants the primed professional standard at three levels (none, integrity, and advocacy standard). The level of contextual information presented in a case scenario is varied within subjects at two levels (low vs. high).

#### 3.1 Participants

On the first day of their introductory tax class, undergraduate students (mostly seniors) from a large, public, Midwestern US university were asked to participate in the present study. Given the lack of research on the effectiveness of current wording in the AICPA standards for advocacy and integrity, the use of students allows for a more homogenous group to test for any differential impact of the treatment variables, and it reduces the likelihood of rival effects such as prior work experience and/or organisational climate.

The use of student participants as surrogates has been a controversial area in behavioural tax and accounting research. For instance, Marriott (2014) challenges the wisdom of using student subjects as a proxy for adult taxpayers, and she suggests studies should justify their sample choices, per the preceding paragraph, and note the inherent limitations, especially if tax policy research questions are being examined. In terms of whether student participants are appropriate surrogates for practising accountants, there is encouraging evidence from Liyanarachchi and Milne (2005) and Mortensen, Fisher and Wines (2012) who find advanced level accounting students to be useful surrogates for accounting practitioners in decision-making tasks.

Interestingly, a prior study by Pflugrath, Martinov-Bennie and Chen (2007) found that codes of ethics did impact experienced auditors but did not affect student participants. The researchers asserted that the amount of content from a professional code may have been too much material for students to grasp in an abbreviated experiment. The present study merely provides brief excerpts from the AICPA Code of Conduct. This increases the likelihood that the treatment effects will be sufficiently understood by the homogenous student groups. Experienced professionals will likely have pre-conceived notions and/or workplace norms regarding the interpretation of these standards and/or how the classification between owner compensation and return of capital should be

distinguished. Consequently, research involving professionals may require a different treatment effect than a mere presentation of the stated standard. In contrast, for student participants, a brief exposure to the principles-based standards is expected to be sufficient (Pinsker et al., 2009). Although external validity for professional decision-making will be limited, the cost of using student participants for this baseline study is much less than using experienced professionals.

### 3.2 Case scenarios and dependent variable

In the present study we test the impact of exposure to professional standards for advocacy and integrity on two hypothetical cases involving the same ambiguous tax guidance, one with scant details and the other with substantially more information. The order was not randomised because if the second case was presented first, participants would likely assume, consciously or unconsciously, that the low-context case has similar facts as the first case. Thus, the low-context case with few details was presented first, followed by the high-context case. After responding about deductibility on each of the two cases, additional information was solicited regarding tendency to be an advocate, as well as background questions including items such as gender, age, work experience, and beliefs about the AICPA standards.

The first case, shown in Appendix 1, is a substantially-condensed version of the second case. The second case, in Appendix 2, was adopted from prior research (Pinsker et al., 2009). These researchers used the case because of the inconclusive facts and ambiguous regulatory guidance, and they indicated that the facts given were insufficient to support either deductible compensation or return of capital. The authors did not report the mean responses, but they did report that the outcomes significantly differed by one's professional role (e.g., tax professionals were more likely to recommend a tax deduction than were the auditors).

The decision context concerns a payment of \$600,000 to the corporation's president and whether it should be deducted as compensation for services rendered or not deducted because the excessive payment is a return of capital to a shareholder. The case includes favourable and unfavourable, relevant and irrelevant information that could be perceived as support for the deduction. The present study operationalises context specificity, in that the high-context case contains more irresolute details that give the decision-maker an opportunity to interpret them in their preferred direction. Johnson (1993) using the same tax issue as the present study and Pinsker et al. (2009), but with different facts, reported that professionals found the high-context case to be ambiguous, and on average, the professionals indicated a 56% likelihood that the deduction would be allowed in a court of law.

The primary dependent variable in the present study is the change toward a pro-client judgment when a variety of potentially pro and con information is added to the case. The debatable item involves the deductibility of a capital expenditure. Both cases use a seven-point scale, ranging from -3 for 'definitely no deduction' to 3 for 'definitely a deduction', following Pinsker et al. (2009) who used the same case and response scale. Klayman (1995) explained confirmation bias as the extent to which the confirming tendency exceeds an appropriate amount, yet he acknowledges that appropriateness is a vague measure. For the purpose of the current study, we operationalise it as a judgment that significantly differs from a neutral response (that neither favours nor disfavours the related tax deduction). It should also be noted that the dependent variable represents an intended behaviour. Our study assumes that the manipulation for ethical standards will

affect moral reasoning, and that moral reasoning correlates with intended and actual behavior (Fishbein & Ajzen, 1975; Trevino, 1992).

### 3.3 Independent variables

Each participant was randomly assigned to a treatment group – either the advocacy group (Advocacy), integrity group (Integrity), or a control group. Participants first received their respective treatment scenarios prior to reading the two cases and making separate reporting recommendations about deducting the payments to the company president/shareholder. Participants in the control group (without a manipulation) began by responding to the low-context case. After indicating their decision, they were told to proceed to the next case. Before responding to both cases, participants in the respective advocacy and integrity groups first read a targeted standard: AICPA Rule 102-6 for the advocacy group and Section 54-Article III.02 for the integrity group. The primed conditions were extracted directly from the AICPA Code of Conduct (2010):<sup>9</sup>

‘Integrity requires a member to be, among other things, honest, and candid ... Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.’ [Integrity]

‘A member or a member’s firm may be requested by a client ... to act as an advocate in support of the client’s position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.’ [Advocacy]

## 4. ANALYSIS AND RESULTS

A total of 73 students attending the first day of tax class completed the questionnaires in January 2011 on a voluntary and anonymous basis. The average age of the participants was 21.58 ( $SD = 1.98$ ) with a range from 19 to 35. The majority, 56.9%, was 21, and most were seniors. In addition, most were males, 67.1%, similar to the overall male to female population in the university’s business school. In the Advocacy group, one-third of participants had heard of the AICPA Code of Conduct, but none indicated any familiarity with Rule 102-6. The mean score was 1.96 ( $SD = 0.98$ ) on a scale from 1-7 in which 1 indicates ‘very unfamiliar’. In the Integrity group, 39% had heard of the Code, but only 11% indicated any familiarity with Section 54 (scores of 5-7), and the mean score was 2.43 ( $SD = 1.57$ ). These responses indicate that the respondents were quite unfamiliar with the targeted professional standards, and, therefore, were unlikely to have strong, preconceived notions about the standards. This suggests that student participants are appropriate participants as the goal of this study is to examine how the current language in the professional standards differentially affects judgments associated with the confirmation bias coming from additional, but

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<sup>9</sup> Note that in presenting the Advocacy prime, we did not present to participants the final paragraph of Rule 102-6 which states: ‘Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member’s firm should consider whether it is appropriate to perform the service’. It is possible that if this had been presented to participants, it may have changed their perception of whether integrity was more important than advocacy.

inconclusive, details. Seasoned professionals are likely to have more varied exposure to and strong *a priori* beliefs regarding these standards as well as stronger positions regarding the technical rules for classification of compensation to shareholders and dividend payments. If confirmation bias varies in the presence or absence of professional standards for the novice group, then future research should pursue this line of research on experienced professionals to investigate whether the hypothesised effects of the standards persist when respondents have strong internalised beliefs regarding the professional standards and/or the nature of the ambiguous technical issues.

To ensure that the randomised treatments were effective, we tested for group differences on advocacy scale, interpretation of the advocacy standard, interpretation of the integrity standard, and relative importance of the two standards for tax decision-making. Regarding the advocacy scale, responses to all five questions (with anchors of 1 for disagreement to the statement favouring advocacy and 7 for agreement) were averaged for an overall advocacy attitude. Cronbach's alpha for reliability among the five questions is 0.881 as presented in Table 1. The scaled average has a mean of 4.49 ( $SD = 1.36$ ). It should be noted that a midpoint of 4 (for lack of agreement or disagreement) would represent the lack of a strong tendency in either direction. Thus, overall, most had a very slight tendency toward being an advocate. This average response is slightly less aggressive than prior research using professionals (Pinsker et al., 2009 reporting a mean of 4.35: 3.90 for auditors and 4.90 for tax professionals; Bobek et al., 2010 reporting an overall mean score of 4.95 by tax professionals). When comparing the control group responses to the advocacy and integrity groups, the respective means ( $SD$ ) on the advocacy scale were 4.81 ( $SD = 1.51$ ), 4.36 ( $SD = 1.14$ ), and 4.41 ( $SD = 1.49$ ). These means did not significantly differ ( $F(2,65) = 0.669$ ,  $p = 0.516$ ). The implication is that our participants have similar attitudes regarding their own inclination toward advocacy; thus, the randomisation to groups is successful on this attitude.

Similarly, we tested for mean differences among the randomised groups on belief about the advocacy standard (see Panel B in Table 1). The respective means ( $SD$ ) for the control, advocacy, and integrity groups were 5.00 ( $SD = 1.46$ ), 5.04 ( $SD = 1.13$ ), and 5.14 ( $SD = 1.21$ ). These means did not significantly differ from each other ( $F(2,70) = 0.086$ ,  $p = 0.918$ ). Thus, the overall mean of 5.07 ( $SD = 1.23$ ) illustrates that most believed the advocacy standard only slightly favoured agreement with a pro-client position. The respective means ( $SD$ ) on attitude toward the integrity standard were, respectively, 3.94 ( $SD = 1.55$ ), 3.78 ( $SD = 1.16$ ), and 3.36 ( $SD = 1.42$ ), which were not significantly different ( $F(2,70) = 1.184$ ,  $p = 0.312$ ). Lastly, the respective means ( $SD$ ) on which standard is more important in tax decision-making were 4.39 ( $SD = 1.82$ ), 4.15 ( $SD = 1.73$ ), and 4.54 ( $SD = 1.73$ ) indicating no significant differences ( $F(2,70) = 0.341$ ,  $p = 0.712$ ). The implication of these results is that most subjects agreed, 71.2%, that the advocacy standard slightly favours a pro-client position; that integrity tends to result in a less favourable client position (53.4% agreed), and that a slight majority, 50.7%, agreed that integrity is a more important standard than advocacy for tax decision-making (35.6% responded that advocacy is a more important standard than integrity). Table 1 presents demographics, advocacy attitude scale and attitudes toward the professional standards.<sup>10</sup>

<sup>10</sup> Prior literature suggests that these variables might influence tax decision-making. Although gender has frequently been identified as a significant factor in explaining non-compliance tendencies, prior research is mixed (Conroy, Emerson & Pons, 2010; Mayhew & Murphy, 2009; Shaub, 1994; Eynon, Hill & Stevens,

**TABLE 1: Demographics and Attitudes for Advocacy and Integrity**

Panel A: Demographics (n = 73)			
Age	Mean (SD) = 21.58 (1.98)		
Gender	Percent Male/Female = 67.1/32.9		
Panel B: Attitude			
ADVOCACY/INTEGRITY	Mean (SD)	Less Favorable to Client (%)	More Favorable to Client (%)
“Do you believe this AICPA guideline requires you to be more favorable (pro client) or less favorable (less pro client) in your interpretation of the tax reporting standards?” <sup>a</sup>			
AICPA Code, Rule 102-6(2) [Advocacy]	5.07 (1.23)	13.7	71.2
AICPA Code, Section 54-Article III(2) [Integrity]	3.66 (1.37)	53.4	21.9
RELATIVE INFLUENCE	Mean (SD)	Rule 102-6 (%)	Section 54 (%)
“Based on the above two standards, which one would be more influential, to you, in most tax decisions?” <sup>b</sup>	4.36 (1.74)	35.6	50.7
ADVOCACY SCALE	Mean (SD)	% Disagree	% Agree
Average Response to Five Statements <sup>c</sup>	4.49 (1.36)	33.8	60.3

Notes:

<sup>a</sup>Responses ranged from +1 (much less favorable) to +7 (much more favorable). Responses of 1-3 (5-7) were coded as Less (More) Favorable to Client.

<sup>b</sup>Responses ranged from +1 (Rule 102-6) to +7 (Section 54). Responses of 1-3 (5-7) indicate the view that Rule 102-6 (Section 54) would be more influential.

<sup>c</sup>The five statements (e.g., “I feel I should apply ambiguous professional guidelines to the client’s benefit”) were adopted from Mason and Levy (2001) and Pinsker et al. (2009). Responses ranged from +1 (Strongly Disagree) to +7 (Strongly Agree). Average responses of under (over) +4.0 were coded as Disagree (Agree).

1997; Radtke, 2000). Similarly, age has been found to correlate with compliance. Conroy et al. (2010) found that age is a significant factor in explaining compliance, suggesting that levels of compliance increase with age. Pflugrath et al. (2007) found that experience rather than age could affect compliance levels. However, Emerson et al. (2007) reported that ethical attitudes did not differ with age or experience. Lastly, based on research previously presented in our literature review, advocacy has been identified as a strong predictor variable for tax reporting decisions. Consequently, we used the condensed five-question advocacy scale used by Pinsker et al. (2009) to measure a participant’s agreement/disagreement with whether the client is entitled to favourable treatment when tax laws are unclear or ambiguous. A longer version of the advocacy scale was originally developed by Mason and Levy (2001).



Prior to testing our hypotheses, we examined the relationship between the dependent variables for pro-client decision-making and the background information for gender, advocacy scale, age, and attitude toward the standards for advocacy and integrity. These variables were not significantly correlated with the dependent variables, nor did they affect the results presented in this article. Therefore, the background variables are not included as control variables in the models presented below.

The dependent variables range from -3 for 'no deduction' to 3 for 'definitely taking the deduction'. Descriptive statistics for the recommended reporting decisions and their statistical tests are presented in Table 2. On the first scenario with scant detail, the average response across all three groups is 0.26 ( $SD = 1.63$ ). Those responding less than zero, indicating it is not deductible, comprised 35.6% of the participants, whereas 50.7% of the participants tended to recommend the expenditure as deductible (scores greater than zero). For the second scenario, which contained substantially more detail, the average response across all three groups is 0.42 ( $SD = 1.86$ ). Most, 56.2%, indicated that the expenditure should be deductible, and 39.7% indicated that it should not be deductible.

**Table 2: Reporting Decisions and Gain Scores**

<b>Panel A: Reporting Decisions<sup>a</sup></b>			
Treatment <sup>b</sup>	Case <sup>c</sup>	Mean (SD)	N
Control	Low Context	-.22 (1.80)	18
	High Context	1.11 (1.91)	18
	Total	.44 (1.95)	18
Integrity	Low Context	.46 (1.60)	28
	High Context	-.07 (1.88)	28
	Total	.20 (1.75)	28
Advocacy	Low Context	.37 (1.52)	27
	High Context	.48 (1.72)	27
	Total	.43 (1.61)	27
Total	Low Context	.26 (1.63)	73
	High Context	.42 (1.86)	73
	Total	.34 (1.74)	73
<b>Panel B: Gain Scores<sup>d</sup></b>			
Treatment	Mean (SD)		
Control	1.33 (2.68)		
Integrity	-.54 (2.17)		
Advocacy	.11 (2.29)		

Notes:

<sup>a</sup>Reporting Decision: The dependent variable measures whether the participant believed the ambiguous item should be deducted on the tax return. For both cases a seven-point scale was used, anchored at “-3” for definitely not deducting and “3” for definitely deducting.

<sup>b</sup>Treatment: Before reading the two hypothetical tax cases and making tax reporting recommendations, participants first responded either to questions about the advocacy or integrity professional standards (the control group did not receive either of these primes).

Advocacy – AICPA Rule 102-6.

Integrity-- AICPA Section 54-III.02

<sup>c</sup>Case:

Low Context – A condensed version of the below High-Context case. See Appendix A.

High Context - Adopted from a case used by Johnson (1993) and Pinsker et al. (2009), Appendix B.

<sup>d</sup>Gain Score: Response to Low-Context case subtracted from response to High-Context case

In order to examine the overall difference between the two cases, the responses were collapsed across all treatment groups. A paired t-test was then computed for a within-subject analysis for responses to the low and high-context cases. The t-test is not significant (means of 0.26 for the low-context case and 0.42 for the high context,  $t(72) = 0.58$ ,  $p = 0.565$ ) for the combined groups of participants, suggesting that the added

context does not increase the likelihood of a confirmation bias. However, as discussed below, the paired t-test results are dependent on the randomly assigned manipulations.

The principal test for each hypothesis is shown in Table 3. Hypothesis 1 predicts that, in the absence of a professional standard, participants are more likely to exhibit confirmation bias in a high context case. This is operationalised in the present study as a higher propensity toward pro-client decisions when the context has substantial data relative to a context with scant details. To test this hypothesis, only the participants in the control group were analysed. A paired t-test is appropriate for this situation, as each participant responded to both cases. Table 2 shows the mean response for the context with scant detail as -0.22 ( $SD = 1.80$ ), but the mean response on the detailed case is 1.11 ( $SD = 1.91$ ). The result from the t-test, shown in Table 3, is significant ( $t(17) = 2.11$ ,  $p = 0.025$ ), which supports our primary hypothesis (H1) for confirmation bias related to the detailed context.<sup>11</sup>

**Table 3: Hypothesis Tests**

H1: In the absence of motivating professional standards, a case with additional, inconclusive information is more likely to result in confirmation bias (a more pro-client decision) than a case with substantially less information.

Test: Paired t-test comparing reporting decisions on the Low- and High-Context cases in the Control group

Low Context	High Context	t (df)	p	H1
-0.22	1.11	2.11 (17)	.025	Supported

H2: The increased propensity for confirmation bias (a pro-client decision) in a detailed context is less likely in the presence of a professional standard for integrity than in its absence.

Test: Independent-samples t-test comparing the gain score in the Control group to the Integrity group

Control	Integrity	t (df)	p	H2
1.33	-.54	2.60 (44)	.007	Supported

H3: The increased propensity for confirmation bias (a pro-client decision) in a detailed context is less likely in the presence of a professional standard for advocacy than in its absence.

Test: Independent-samples t-test comparing the gain score in the Control group to the Advocacy group

Control	Advocacy	t (df)	p	H3
1.33	.11	1.64 (43)	.055*	Supported

\* $p = .035$  using a Mann-Whitney U Test ( $U = 165.5$ ).  
Variables are defined in Table 2.

To test the second hypothesis, we repeat the paired t-test that was used on our control group to measure the first hypothesis regarding this type of confirmation bias. Although

<sup>11</sup> One-tailed (two-tailed) tests are used for directional (nondirectional) predicted effects.

the first hypothesis indicated that the added detail leads to a higher pro-client preference for the control group, this result does not hold in the presence of AICPA professional standard for integrity. The means for the integrity group of 0.46 ( $SD = 1.60$ ) for the low context and -0.07 ( $SD = 1.88$ ) for the high context, presented in Table 2, do not significantly differ ( $t(27) = 1.307$ ,  $p = 0.202$ ). This result suggests that the added detail does not result in increased confirmation bias for the high-context case in the presence of the integrity standard.

Rather than rely only on a comparison of separate t-tests, we also calculate the gain scores for each participant's response to the high-context case reduced by his/her response to the low-context case. The gain score represents one's incremental tendency to make a pro-client decision on the high-context case (decreased tendency would be a negative score). The outcome variable is then compared between the control group and the group exposed to the professional standard for integrity.

The results are presented in Table 3 and show that the incremental pro-client effect (confirmation bias related to the added detail) significantly differs among the groups. The control group is significantly more likely to demonstrate this bias (mean gain score of 1.33,  $SD = 2.68$ ) than those in the integrity group (mean gain score of -0.54,  $SD = 2.17$ ;  $t(44) = 2.60$ ,  $p = 0.007$ ). This result supports our second hypothesis that confirmation bias driven by a high-context will be mitigated in the presence of the professional standard for integrity.

#### 4.1 Additional analysis on Integrity

Although the main purpose of this study is to examine whether professional standards can mitigate the confirmation bias associated with additional but inconclusive details, we also test whether there is a direct effect of the standards on each reporting decision, both the low and high-context cases. If the current language of the AICPA standard is sufficiently clear and the strength of message is adequate, then it is likely that exposure to the standard will impact subsequent decision-making. The current study tests whether exposure to AICPA Section 54 for integrity results in less pro-client decisions relative to a control group without exposure to this professional standard. The means in Table 2 show that in the low-context case the Integrity group approximated a neutral position with slight leaning toward a deduction 0.46 ( $SD = 1.60$ ), and the mean for the control group was -0.22 ( $SD = 1.80$ ), which approximates a neutral position more than an aggressive one. The difference is not statistically significant for the low-context case. When the integrity standard is tested on the high-context (detailed) case, the respective means are -0.07 ( $SD = 1.88$ ) in the presence of an integrity standard, indicating a neutral position, and 1.11 ( $SD = 1.91$ ) in the absence of this standard, indicating a leaning toward the pro-client position for the control group. The result is significant at  $p = 0.023$  ( $t(44) = 2.068$ ). This suggests that exposure to Section 54 for integrity may be effective in lessening the likelihood of a pro-client position in a high context case. Unanswered is the reason for a stronger effect on the detailed case than the case with scant detail. Based on the premise of the first hypothesis, additional information, relevant or not, is expected to be interpreted as additional support. Under the presence of an integrity standard that requires 'honest' and 'candid' reporting, the extra information may have been viewed more sceptically, which led to a lack of perceived support for the pro-client position. Conversely, those in the control group had no exposure to the standards, and the implication is that the lack of professional constraints allowed the participants to overvalue the added detail as support for the deduction.

The third hypothesis examines whether the AICPA standard for advocacy has a similar effect on confirmation bias as the integrity standard did. Although Rule 102-6 sanctions advocacy, it is a subset of the professional Code and it allows for justifiable pro-client positions. We use a paired t-test to see if participants were significantly more likely to make pro-client judgments in the high-context case. The respective means of 0.37 ( $SD = 1.52$ ) and 0.48 ( $SD = 1.72$ ) on the low-context and high-context cases for the advocacy group do not significantly differ ( $t(26) = 0.252$ ,  $p = 0.803$ ). This suggests that in the presence of the AICPA's professional advocacy standard, the added detail does not increase the inclination toward confirmation bias (similar to the insignificant result reported earlier for the integrity standard).

To examine the relative effect of a more pro-client response related to the high-context case, we compare the gain score for more pro-client responses between the control group and the advocacy group. As seen in Table 3, the difference is marginally significant ( $t(43) = 1.638$ ,  $p = 0.055$ ) as the advocacy group has a mean gain score of 0.11 ( $SD = 2.29$ ) compared to the control group mean of 1.33 ( $SD = 2.68$ ). Using a Mann-Whitney U Test, which is a more robust test for ordinal data (Howell, 2013) such as Likert scales (also used for comparison with the integrity group), the p-value is 0.035 ( $U = 165.5$ ). These results provide support for the third hypothesis. The effect for advocacy is weaker than the integrity results, perhaps because the standard implicitly calls for caution merely because it is identified as an AICPA rule. To measure an overall effect for any 'standard', we combine the responses of the advocacy and integrity groups and then compare them to the control group. There is a significant overall effect ( $t(71) = 2.434$ ,  $p = 0.009$ ), which indicates that when professional standards are not explicitly communicated, confirmation bias is more likely on a high-context case than one with scant detail. The implication is that when professional standards are adequately communicated, they could mitigate some of the confirmation bias associated with the conscious or unconscious over-reliance on the additional information.

## 4.2 Additional analysis on Advocacy

Similar to the direct effects of exposure to the integrity standard presented above, we test the direct effect of exposure to the AICPA advocacy standard on the low and high context cases. Based on the previously presented results in which the standard led to a reduced propensity toward confirmation bias when the additional, inconclusive evidence was included, we examine whether the advocacy standard led to a more pro-client decision in each context. This would be expected if the wording of the standard is sufficiently strong in its sanctioning of pro-client positions. If the standard is perceived as weak support or cautious regarding when it is appropriate to be an advocate, then the level of pro-client judgments may reflect a status quo similar to the control group. Table 2 indicates that the mean for the control group on the low-context case was -0.22 ( $SD = 1.80$ ), and the mean for the Advocacy group was 0.37 ( $SD = 1.523$ ), which is not a statistically significant difference ( $t(43) = 1.189$ ,  $p = 0.241$ ). Similarly, when the advocacy standard is tested on the high-context case, with respective means of 1.11 ( $SD = 1.91$ ) and 0.48 ( $SD = 1.72$ ), the result is not statistically significant ( $t(43) = 1.153$ ,  $p = 0.255$ ). The lack of a significant effect could be a function of a weak manipulation or a threshold for the amount of aggressive reporting that the control group and advocacy group are willing to exhibit. Actually, Rule 102-6 states that a client 'may' request a member to be his/her advocate. This passive verb is not a strong manipulation for the encouragement of advocacy; merely allowing it when the guidance is ambiguous. We chose to use the exact wording of the current professional standards, as any change

in the wording would not be testing the current standards. Future studies may want to test how different wording or frames could alter the impact of an advocacy standard. In addition, the mere presentation of advocacy as a sanctioned professional standard may infer a higher threshold of professional conduct.

## 5. SUMMARY AND CONCLUSIONS

Although calls exist for more emphasis on accounting professionalism (e.g., Wyatt, 2004), studies such as Johnson (1993) and Cuccia et al. (1995) find that professionals, who are given access to supporting and non-supporting evidence, demonstrate a systematic confirmation bias by overweighting the positive evidence as support for the preferred outcome. Our study differs from prior research on confirmation bias primarily because: 1) it examines confirmation bias in the presence and absence of standards of professional conduct issued by the AICPA, and 2) it examines the effect of supporting and non-supporting evidence in the early stage evaluation of client-specific facts. The current study examines the relative effect of the absence or presence of additional but irresolute information rather than favourable and unfavourable judicial precedents. This allows us to test whether confirmation bias is exacerbated by the quantity of irresolute information. If confirmation bias is demonstrated in the early stage of synthesising the client's facts, this would suggest the possibility of a biased judgment (by the client and by the practitioner) that precedes the next level of potential bias at the legislative and judicial research stage. Our results show that in the absence of professional standards for integrity and advocacy, confirmation bias derived from additional inconclusive information leads to a more pro-client tax outcome than does the same tax issue without that additional information. In contrast, when either the advocacy or integrity standard is explicitly presented to the participants, the outcome does not significantly differ between the contexts with and without the additional information. The implication is that the professional standards tend to mitigate the confirmation bias that is associated with a propensity to misinterpret additional information as support.

The current study also investigates whether the explicit presence of AICPA standards for integrity and advocacy results in simple, direct effects on the tax judgment for recommending an uncertain deduction. Consistent with Nelson's (2003) assertion that a principles-based technical standard could be used to incentivise accurate reporting, we find significant effects for a principles-based code of conduct (integrity standard). As posited, less pro-client tax judgments are reported when this standard is explicitly presented, relative to the absence of the integrity standard for a control group. This holds true, however, only in the high-context case, which represents a more realistic tax case than does the low-context case. Recall that it is the high-context case in which the added detail is expected to exacerbate confirmation bias in the absence of this professional standard.

Prior literature finds that advocacy is correlated with pro-client tax reporting, suggesting that encouraging advocacy could lead to intentionally aggressive reporting behaviour. When advocacy is reinforced as a standard, it raises a concern that some might interpret the standard too liberally. On the other hand, the narrative surrounding Rule 102-6 suggests that advocacy can be justified but only when the technical guidance is unclear.

This study finds that the advocacy standard is not associated with significantly more favourable client decisions. The lack of an aggressive effect could be driven by the passive language in the written standard (i.e., '...may be requested by a client...') or by the fact that any standard sanctioned by the AICPA is assumed to embody professional

constraints. Future research will need to examine how stronger language would impact decision-making when the context is ambiguous.

In the long term, the effect of advocacy and integrity standards may be more affected by organisational culture than sporadic or serendipitous primes of the disparate signals. On the other hand, if new entrants to the profession have had educational training on these counterbalancing objectives and current professionals participate in continuing education on the profession's interpretation of these guidelines, then professionals may be better equipped to apply the standards in practice.

As mentioned in section 3, using students as participants in behavioural tax and accounting research is controversial and this study is limited in its generalisability as students were used as participants. The trade-off is that the study's internal validity is strengthened. Bryant, Stone and Wier (2011) observed no difference in ethical position between accounting students and practising accountants, although the graduate students in their analysis may have had more accounting education than the advanced undergraduates used in the current study. In addition, student participants may not be familiar with the difference between principles and rules as they relate to the structure of the AICPA Code, which may have contributed to the results found in this study. Accordingly, while a similar investigation should be created and administered to experienced tax professionals, the current study serves as a building block and benchmark for future work. This type of study has additional benefits in that the results can influence how new entrants to the profession as well as current accounting students could be educated about the effects of acting in accordance with professional standards.

Another limitation of this study is the use of context-specific tax issues to evaluate what the appropriate response or judgment should be, and it is possible that the results of this study (and prior studies as well) are dependent on the specific cases used. We examine one ambiguous tax issue, but we vary the level of detail in that case that could be misconstrued as positive or negative support.

Aside from implications for standard-setters in the tax profession, accounting firms, and educators, our study also has implications for tax administrations such as the IRS and other agencies. Confirmation bias can result in tax positions being recommended and taken that are not warranted, or perhaps even desired by client taxpayers, with Bobek et al. (2010) noting client advocacy should be 'within the bounds of the law'. While regulation of the tax profession has received attention recently (e.g., Soled & Thomas, 2017; Walpole & Salter, 2014), tax administrations should be aware of research literature on client advocacy, confirmation bias, and the effect of codes of professional conduct on the judgments and decisions of tax practitioners. Future research should continue to examine the balancing effects of professional standards for advocacy and for professional integrity on a variety of tax issues. Furthermore, such research should address how differing principles- and rules-based standards for integrity/objectivity and advocacy affect tax and financial compliance and planning decisions. Future research should also examine whether the effect of the standards holds when incentives for client preferences, sanctions, risk, and client importance are explicitly manipulated. Lastly, research should address how the tax profession can best ensure that its members will readily recall and apply such standards.

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## 7. APPENDICES

### Low-Context Ambiguous Case

Your client's corporate tax return has not yet been finalized. An expenditure of \$600,000 has created a controversy as to whether this payment, which was to the president of the corporation, should be deducted as compensation. The concern is whether it is reasonable compensation for services to a major shareholder (requiring its deduction) or a non-deductible payment for return of capital to a shareholder. If it is deducted on your client's tax return, the tax liability will be much lower as the net taxable income will be significantly reduced.

In this situation, you need to make a recommendation. How strongly do you think that the \$600,000 paid to an owner of Smith and Brown, Incorporated should be deducted on the tax return (reducing the company's net taxable income)?

-3	-2	-1	0	1	2	3
Definitely Do Not Deduct			Neutral			Definitely Deduct

### High-Context Ambiguous Case

#### *Background*

Your new client, Johnson and Sons, Inc., is a family-owned corporation engaged in the waste pickup and disposal business that performs trash-hauling services pursuant to contracts with various municipalities. The business was incorporated in 1970 by Mr. and Mrs. Johnson. In 1990,

after the death of Mr. Johnson, the board of directors (composed of Mrs. Johnson and her four sons) elected Mrs. Johnson president of the company. Each son is an officer with the title “vice president” and one son also holds the title of “secretary and treasurer.” During the past five years, the stock of Johnson and Sons, Inc. has been owned by Mrs. Johnson (46 percent) and her sons (13.5 percent each).

### ***Duties***

Mrs. Johnson works 40 or more hours per week, and her duties consist of (1) keeping the financial books, (2) reviewing bills and signing checks, (3) attending board meetings and voting on major proposals put forward by her sons, who are responsible for the day-to-day operations of the business, (4) engaging in extensive public relations activities, and (5) acting as co-guarantor (together with her sons) of bank loans to the company for major capital expenditures.

### ***Financial Information***

Some financial information for Johnson and Sons, Inc. for the current taxable year is provided:

Gross Sales	\$25,400,000
Net Income	\$ 155,000
Officer Compensation*:	
Mrs. Johnson	\$ 600,000
Son 1-4	\$ 375,000 (each)

\*Payments for salaries have been relatively consistent for several years.

### ***Relevant Tax Law***

Under Section 162(a)(1) of the Internal Revenue Code, there is a two-pronged test for the deductibility of amounts purportedly paid as salaries or other compensation for services: The payments must be (1) “reasonable,” and (2) in fact payments purely for services.

Courts have sometimes applied a five-factor test in considering the reasonableness of compensation, including (1) the employee’s role in the company, (2) a comparison of the compensation paid to similarly situated employees in similar companies, (3) the character and condition of the company, (4) whether a conflict of interest exists that might permit the company to disguise a dividend payment as deductible compensation, and (5) whether the compensation was paid pursuant to a structured, formal, and consistently applied program.

**Please answer the following question by circling a number on the scale:**

How strongly do you feel that the \$600,000 paid to Mrs. Johnson should be deducted on the tax return (reducing the company’s net taxable income)?

-3	-2	-1	0	1	2	3
Definitely Do Not Deduct			Neutral			Definitely Deduct

# Tax and human rights – much ado about nothing<sup>1</sup>

Kalmen Datt<sup>2</sup>

## ***Abstract***

There are claims that large Australian and other multinational corporations that pay no or little tax because of taking abusive tax positions breach their human rights obligations as they deprive governments of the means to provide services. These services include poverty alleviation, health, education, housing and access to water. This article critically examines the legal validity of this claim and seeks to determine if such a link exists. The article concludes that a breach by such corporations of their tax obligations, no matter how egregious, does not constitute a breach of human rights.

**Key words:** tax, human rights, tax avoidance, public services

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<sup>1</sup> Apologies to William Shakespeare. The author is grateful to anonymous reviewers whose constructive comments were useful in finalising this article.

<sup>2</sup> Dr Kalmen Datt BCom, LLB (Rand), MTax (1st Hons) (Auckland), GradCert ULT (UNSW), PhD (UNSW), senior lecturer in the School of Taxation and Business Law at the UNSW Sydney, Australia. Kalmen was previously a barrister in South Africa and a solicitor/barrister in New Zealand and has been admitted as a solicitor in Australia. Kalmen has successfully completed the Common Professional exams in the UK.

## 1. INTRODUCTION

There are many organisations and individuals, such as Carmona,<sup>3</sup> the German Tax Justice Network (GTJN),<sup>4</sup> the Australian Tax Justice Network,<sup>5</sup> Pogge,<sup>6</sup> de Zayas,<sup>7</sup> Scheffer,<sup>8</sup> Darcy,<sup>9</sup> the Centre for Economic and Social Rights,<sup>10</sup> Avi-Yonah and Mazzoni<sup>11</sup> and Lipsett,<sup>12</sup> who contend that large Australian and other multinational corporations (collectively referred to as MNCs) pay no or little tax because of taking abusive tax positions. In doing this they deprive governments of the means to alleviate poverty and to provide basic services such as health, education, housing and access to water (the rest of this article will only refer to the alleviation of poverty as a collective phrase for all of the foregoing).<sup>13</sup> Those who contend for a link between human rights and tax state that an abusive tax position includes criminal conduct, tax evasion, avoidance, and embarking on schemes that appear to be in compliance with the tax laws but do not result in the MNC paying what is referred to as a fair share of taxes.<sup>14</sup> This article examines whether there is any legal basis for such claims.

There are a few limitations to this article. The article does not seek to determine whether human rights can impact on the decision of the regulator or legislature in seeking to enforce or legislate the tax laws. Nor does it consider the issues that arise if a taxpayer's human rights are infringed by the tax law-maker or regulator. It is for this reason that there is little discussion on such human rights as privacy or the right to fair trial. Only limited reference is made to human rights cases both in Australia and overseas to illustrate that to the extent that human rights are raised in tax cases they are limited to allegations by taxpayers of a breach of their rights. The author has been unable to find any cases that suggest a breach of the tax laws constitutes a breach of human rights. The enquiry is focused on whether a link can be found between a breach of the tax laws and

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<sup>3</sup> Magdalena Sepúlveda Carmona, Promotion and protection of all human rights, civil, political, economic, social and cultural rights, including the right to development, Report of the Special Rapporteur on extreme poverty and human rights, Human Rights Council, Twenty-sixth session, Agenda item 3, A/HRC/26/28 (2014) [60].

<sup>4</sup> Policy brief of the Tax Justice Network Germany, 'Taxes and human rights', Info Steuergerechtigkeit No. 8, February 2013 <[http://www.l4bb.org/reports/taxes\\_human\\_rights.pdf](http://www.l4bb.org/reports/taxes_human_rights.pdf)>.

<sup>5</sup> Australian Tax Justice Network, <<http://www.taxjustice.org.au/>>.

<sup>6</sup> Thomas Pogge, 'Are we violating the human rights of the world's poor?' (2011) 14(2) *Yale Human Rights and Development Journal* 1.

<sup>7</sup> Alfred de Zayas, 'Human rights expert calls for a new UN body to address tax evasion and harmful tax competition around the world', media release (20 October 2016),

<<http://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=20721&LangID=E>>.

De Zayas was appointed as the first Independent Expert on the promotion of a democratic and equitable international order by the Human Rights Council, effective May 2012.

<sup>8</sup> David Scheffer, 'The ethical imperative of curbing corporate tax avoidance' (2013) 27(4) *Ethics and International Affairs* 361.

<sup>9</sup> Shane Darcy, "'The elephant in the room': Corporate tax avoidance and business and human rights' (2017) 2(1) *Business and Human Rights Journal* 1.

<sup>10</sup> Centre for Economic and Social Rights, <<http://cesr.org/article.php?id=1834>>.

<sup>11</sup> Reuven S Avi-Yonah and Gianluca Mazzoni, 'Taxation and human rights: A delicate balance' (University of Michigan Public Law Research Paper No. 520, September 2016).

<sup>12</sup> Lloyd Lipsett, 'Tax abuse as a business and human rights issue', Shift, October 2013, <<http://www.shiftproject.org/resources/viewpoints/tax-abuse-business-human-rights/>>.

<sup>13</sup> See for example International Bar Association, *Tax abuses, poverty and human rights* (2013) 94-96; Mauricio Lazala, Deputy Director, Business & Human Rights Resource Centre, 'Tax avoidance: the missing link in business & human rights?', <<https://business-humanrights.org/en/tax-avoidance-the-missing-link-in-business-human-rights>>.

<sup>14</sup> See for example International Bar Association, above n 13, 7.

a breach of human rights. Finally, the article does not consider the means that can be employed to enforce tax or human rights obligations in the event of a breach.

The scheme of this article is the following. Section 2 considers some preliminary issues and then considers the component parts of the phrase ‘abusive tax position’ mentioned above. Section 3 first briefly evaluates the human rights obligations of states and MNCs. It then determines whether any person in Australia can found a claim based on human rights that an abusive tax position taken by any MNC is a breach of such rights. The author concludes no such claim can succeed but, on the alternative assumption that this conclusion is mistaken, section 4 evaluates the proposition from a tax point of view. The article concludes that irrespective of whether the analysis is from a human rights or tax perspective the contention that there is a legal nexus between tax and human rights is mistaken.

The article now turns to the preliminary issues alluded to above.

## 2. PRELIMINARY ISSUES AND DEFINITIONS

### 2.1 Preliminary issues

First all human rights and tax laws should not be breached.

Second, taxes paid by MNCs do contribute towards the resources available to governments. Presumably this is done by the creation of wealth and jobs in the communities in which they operate and by the MNC paying income and other taxes. Wettstein and Waddock accept that governments depend on taxes to fund their programs but say:

[W]ith their narrow focus on profit-maximization, corporations did not only not contribute adequately to the realization of human rights, but often also perpetuated the massive and ongoing violation of them; through their uncompromising striving for profit, they are holding up and accelerating the very economic system that is largely responsible for the undermining of a vast array of human rights.<sup>15</sup>

An MNC’s emphasis on profit is not demonstrative of either a breach of human rights or of the tax laws. It is irrelevant if an MNC has the means to pay more tax than the law requires.<sup>16</sup> That MNCs or any other taxpayer may have a different view of the law to the regulator does not mean they have no sense of morality or business ethics or that their views of the law are incorrect.<sup>17</sup>

Third many of those that contend that abusive tax positions are breaches of human rights accept that this is not the sole cause of governments’ inability to alleviate poverty. For example, Carmona says:

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<sup>15</sup> Florian Wettstein and Sandra Waddock, ‘Voluntary or mandatory: That is (not) the question; Linking corporate citizenship to human rights obligations for business’ (2005) 6(3) *Zeitschrift für Wirtschafts- und Unternehmensethik* 304.

<sup>16</sup> Kalmen Datt, ‘Paying a fair share of tax and aggressive tax planning-A tale of two myths’ (2014) 12(2) *eJournal of Tax Research* 410.

<sup>17</sup> David F Williams, ‘The concept of tax governance’ (Paper presented at the KPMG Tax Business School, UK, 2007).

Evidence shows that, even in developing countries, widening tax bases and improving tax collection efficiency could raise considerable additional revenue... Tax collection efficiency can also be increased by improvements in tax administration. Tax administrations with appropriate financial, personal and technical resources are critical to increase levels of revenue collection and to avoid abuse.<sup>18</sup>

At the third International Conference on Financing for Development (July 2015) the participant countries agreed that domestic resource mobilisation was central and required measures that widened the revenue base, improved tax collection and combated both tax evasion and illicit financial flows.<sup>19</sup>

Alston (United Nations Special Rapporteur on Extreme Poverty and Human Rights) considered the link between tax and human rights and suggested the problem was primarily based on policy issues rather than the obligation to pay any taxes imposed. He said:

First, there is the most obvious link which is that of resource availability. Refusing to levy taxes, or failing to collect them, both of which are commonplace in many countries, results in the availability of inadequate revenue to fund human rights related expenditures.<sup>20</sup>

The problem alluded to by Alston is not limited to human rights expenditures. Tax policies that allow MNCs to pay little or no tax should be discouraged.

Next the European Court of Human Rights (ECtHR) in tax cases where breaches of the European Convention on Human Rights (ECHR) are raised, refers only to rights of taxpayers. For example, the inalienable right to property is not a human right that requires the state or anyone else to transfer property to others. This right ensures that you are not deprived of any property that you may hold without due compensation.<sup>21</sup> The ECtHR in *NKM* held that a tax at the rate of 98 per cent on the top slice of a severance payment (resulting in an average tax rate of 52 per cent) violated the right to enjoyment of possessions.<sup>22</sup> Attard, referring to the decision in *Ferrazzini v. Italy*,<sup>23</sup> notes that the ECtHR in a majority decision held that:

<sup>18</sup> Carmona, above n 3 [56]-[57]. The Tax Justice Network Germany, above n 4, have a similar view.

<sup>19</sup> United Nations, 'Secretary-General hails launch of "new era" for global partnership as General Assembly endorses framework for development financing, press release (27 July 2015), <<https://www.un.org/press/en/2015/ga11663.doc.htm>>.

<sup>20</sup> Philip Alston, 'Tax policy is human rights policy: The Irish debate' (Keynote Address at Christian Aid conference on The Human Rights Impact of Tax and Fiscal Policy, Dublin, 12 February 2015). The Scottish HR Commission has a similar view to that of Alston: Scottish Human Rights Commission, 'A Scottish Approach to Taxation', Submission to the Finance Committee - Call for evidence, Scottish Parliament, September 2016.

<sup>21</sup> See for example *Commonwealth of Australia Constitution Act* s 51(xxxi). See also Christophe Golay and Ioana Cismas, 'The right to property from a human rights perspective', Legal Opinion, International Centre for Human Rights and Democratic Development (2010), [http://storre.stir.ac.uk/bitstream/1893/21703/1/Golay%20and%20Cismas\\_Working%20Paper\\_2010.pdf](http://storre.stir.ac.uk/bitstream/1893/21703/1/Golay%20and%20Cismas_Working%20Paper_2010.pdf).

<sup>22</sup> *NKM v Hungary*, 14 May 2013, Application No. 66529/11.

<sup>23</sup> Application No. 44759/98, 12 July 2001, cited by Robert Attard, 'The classification of tax disputes, human rights implications' in Georg Kofler, Miguel Poiars Maduro and Pasquale Pistone (eds), *Human Rights and Taxation in Europe and the World* (IBFD Publications, 2011) 397, 397.



The ECHR does not apply to tax disputes because tax disputes are not civil rights and obligations to which Art. 6 applies. The decision of the ECtHR in *Ferrazzini* implies that in a tax dispute a litigant does not have a right to a fair hearing under Art. 6 of the ECHR.<sup>24</sup>

The effect of this judgment has subsequently been limited by the ECtHR by it holding that a case which involves a tax penalty of 25 per cent or higher is punitive in nature and changes the nature of the dispute from being a tax dispute subject to the restrictive *Ferrazzini* doctrine to a criminal law dispute subject to Article 6.<sup>25</sup>

The ECtHR has held that a taxpayer who had overpaid tax and was entitled to tax rebates but had not received them over a period of years suffered an interference with his possessions.<sup>26</sup> This was a breach of article 1 of Protocol No. 1 to the ECHR.<sup>27</sup> Other cases in the ECtHR have held that:

- tax laws may not breach Article 14 of the ECHR that protects individuals placed in similar situations from discrimination in their enjoyment of their rights under the Convention and its Protocols;<sup>28</sup>
- in the *Building Society* case there were alleged breaches of article 14 and article 6.1 that provides that in the determination of a person's civil rights and obligations 'everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law'. The facts briefly were that certain regulations imposing taxation were invalid. A building society challenged the imposition of this tax and was successful and obtained a refund of tax overpaid. In the interim the Government passed new legislation retrospectively validating the previously unenforceable law. The applicants although supporting the actions of the former took no formal steps themselves to challenge the validity of the assessments levied on them. The applicants then unsuccessfully sought to contend that the validating legislation breached their human rights. The court *inter alia* held that article 6 cannot be interpreted as preventing any interference by the authorities with pending legal proceedings to which they are a party by passing retrospective legislation.<sup>29</sup>

Sixth MNCs argue that they comply with the tax laws of countries in which they do business. For example, a news report in *BBC News Technology* of 17 June 2013 stated:

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<sup>24</sup> This article *inter alia* requires a fair trial and raises the presumption of innocence in criminal proceedings.  
<sup>25</sup> Attard, above n 23. See *Paykar Yev Haghtanak Ltd v Armenia*, European Court of Human Rights, Application No. 21638/03, 20 December 2007.

<sup>26</sup> *Buffalo Srl in liquidation v Italy* (no. 38746/97) (3 July 2003), Factsheet – Taxation and the ECHR (May 2017).

<sup>27</sup> This guarantees the 'peaceful enjoyment' of one's possessions.

<sup>28</sup> *Darby v Sweden* (Application no. 11581/85, 9 May 1989). *Van Raalte v The Netherlands* (Application no. 20060/92, 21 February 1997) also considered article 14 but the issue here was discrimination based on gender.

<sup>29</sup> *The National Provincial Building Society, The Leeds Permanent Building Society and The Yorkshire Building Society v The United Kingdom* (117/1996/736/933-935, 23 October 1997).

Scott Rubin, Communications Director, Google has been asked about Google's tax arrangements and said that his company pays what is 'required by law'.<sup>30</sup>

This seems to have been accepted by the chair of the UK Parliament's Public Accounts Committee, Margaret Hodge, who, in a question to Matt Brittin, vice-president for Alphabet Incorporated (Google) in northern and central Europe, said that '[w]e are not accusing you of being illegal; we are accusing you of being immoral'.<sup>31</sup> What Hodge appears to be saying is that the UK would like Google to pay more tax than it did and presumably in an amount greater than mandated by law. If this view of Hodge's statement is correct it is an indictment of the laws then in force in the UK or their administration or both.

Gelski, referring to a similar Senate enquiry in Australia, notes:

Most representatives of MNEs appearing before Senator Dastyari and his colleagues also pointed out that, not only were they legal, but many of their arrangements and structures had been blessed by the ATO in Advance Pricing Arrangements. These exchanges did not reach the eyes or ears of many a 'man and woman in the street'.<sup>32</sup>

Next even if MNCs paid all the taxes demanded by those who seek to draw a link between tax and human rights it does not mean such monies will be used to alleviate poverty. It is in the absolute discretion of governments to allocate resources as they deem appropriate unless required by legislation. The tax laws do not allocate revenue to any resource other than the Consolidated Revenue Fund.<sup>33</sup> These monies can be allocated to whatever project the government of the day determines including those which may breach their human rights obligations.

Penultimately, in Australia and other common law countries taxes can only be imposed by legislation. There is no common law of taxation.<sup>34</sup> The High Court has developed detailed and comprehensive criteria that must be met before determining whether an exaction is a tax or something else. A tax is defined in the following terms: '[i]t is a compulsory exaction of money by a public authority for public purposes, enforceable by law, and is not a payment for services rendered'.<sup>35</sup> A charge for the acquisition or use of property, a fee for a privilege and a fine or penalty imposed for criminal conduct or breach of statutory obligation are not taxes.<sup>36</sup> There are two further important factors the courts consider when determining if an exaction is a tax. The first is that the tax must

<sup>30</sup> BBC, 'Google: "We pay tax required by law"', *BBC News Technology* online (17 June 2013), <<http://www.bbc.co.uk/news/technology-22932794>>.

<sup>31</sup> UK Parliament, Evidence to Parliament's Public Accounts Committee (2 November 2012) (Margaret Hodge).

<sup>32</sup> Richard Gelski, 'Law, morality and multinationals' (Paper presented to the Taxation Institute of Australia, 32nd National Convention, Adelaide, 15 March 2017). Gelski refers to the Australian Senate inquiry into tax avoidance by multinationals which was chaired by Senator S Dastyari.

<sup>33</sup> *Commonwealth of Australia Constitution Act* s 81.

<sup>34</sup> *Liedig v Commissioner of Taxation* [1994] FCA 1058 [34]. Griffiths J noted in *Webb v Syme* (1910) 10 CLR 482 that: 'The scheme of the Acts can only be ascertained from their express provisions, for there is no common law of income tax'. See also *W T Ramsay Ltd v Inland Revenue Commissioners*, *Eilbeck (Inspector of Taxes) v Rawling* [1981] 1 All ER 865; Tony Honoré, 'The dependence of morality on law' (1993) 13(1) *Oxford Journal of Legal Studies* 1.

<sup>35</sup> *Matthews v The Chicory Marketing Board (Vic)* (1938) 60 CLR 263, 276 per Latham CJ (reference omitted).

<sup>36</sup> *Air Caledonie International v Commonwealth* (1988) 165 CLR 462.

not be arbitrary and second it must be contestable.<sup>37</sup> For a tax not to be arbitrary the legislation must determine the identity of the entity to be held liable and set out how that liability is to be calculated by reference to objective ascertainable facts. A tax that is arbitrary or not contestable is unconstitutional and unenforceable. These prerequisites are attempts to protect individual and other taxpayer rights and the rule of law.

The Crown is not entitled to retain any tax recovered by a lack of statutory power.<sup>38</sup> Just as the ATO and other tax regulators may hold audits or reviews to ensure a taxpayer has not underpaid tax, if the regulator determines too much tax had been paid it must refund the excess.<sup>39</sup>

Finally, Forstater looks at the claims of the immense share of wealth that is apparently available if governments crack down on what she calls ‘questionable tax practices’. She reviews the sources of these claims and concludes that many are overstated. She explains that estimates of illicit financial flows through trade mis-invoicing issued annually by the NGO Global Financial Integrity are often misunderstood as an estimate of tax loss whereas tax is always at best, a fraction of income. She then gives an example of what appears to be double counting of tax. The NGO Citizen’s for Tax Justice in the US views the low tax rates paid by companies such as Apple, Google, Nike, PepsiCo as taxes lost to the US treasury while those in Europe view them as taxes lost to the source countries. A third example given is that some of the most widely quoted evidence for massive transfer pricing abuses are estimates based on analysis of bilateral trade data which do not isolate trades involving subsidiaries from trades between unrelated companies. This mismatch suggests that the taxes at stake are several times greater than is in fact the case.<sup>40</sup>

Forstater suggests:

Unrealistic expectations cloud the perhaps obvious reality that while businesses should pay tax on the profits they make, the potential for countries to raise more from taxing international business is limited by actual level of activity by foreign companies within each country, and that changes to the effective tax burden may also have impacts on investment.

Forstater concedes the monies that are contended to be lost due to ‘abusive tax positions’ are not insignificant ‘but suggests this is a statistical observation and should not be interpreted as an estimate of the actual amount of money that could be collected in practice’.<sup>41</sup>

Significantly the Australian Commissioner of Taxation (CoT) in an address to the National Press Club is reported as stating that the tax gap from large corporations was much less than that arising from claims for deductions by individuals based on workplace expenditure.<sup>42</sup> It has never been contended that these persons are breaching their human rights.

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<sup>37</sup> *Deputy Federal Commissioner of Taxation v Brown* (1958) 100 CLR 32, 40-42 [7].

<sup>38</sup> *Woolwich Equitable Building Society v Inland Revenue Commissioners* [1992] 3 All ER 820.

<sup>39</sup> See for example *Taxation (Interest on Overpayments and Early Payments) Act 1983* (Cth).

<sup>40</sup> Maya Forstater, ‘Can stopping ‘tax dodging’ by multinational enterprises close the gap in development finance?’ (CGD Policy Paper 069, Center for Global Development, Washington, DC, October 2015).

<sup>41</sup> *Ibid.*

<sup>42</sup> Joanna Mather, ‘ATO Targets Work Expense Rorts’, *Australian Financial Review* (6 July 2017).

The article now considers the meaning attributed to the component parts of what is an 'abusive tax position' cited in section 1 above. This is necessary as these phrases are used in contexts that are not reflective of their accepted legal meanings by those who contend for a link between tax and human rights.

## 2.2 What is an abusive tax position?

Non-reporting of income from criminal activity does impact on a government's resources to meet its human rights and other obligations. Although there is no empirical evidence available, it is suggested that few criminals pay tax on their illicit gains. It is partly for this reason that the Serious Financial Crime Taskforce<sup>43</sup> in Australia commenced its activities in July 2015 and up to 30 September 2016 raised tax liabilities totalling AUD 146.79 million.<sup>44</sup> The author suggests that most, if not all, MNCs do not consciously embark on any criminal activity. MNCs would have well-developed risk management systems in place to identify and avoid any illegal conduct.<sup>45</sup> However, if they did, human rights would play no role in prosecuting these entities. The tax and criminal laws would deal comprehensively with these issues.

Tax planning or tax mitigation is the means used by MNCs (and other corporate taxpayers) to limit their tax liability, having regard to the interests of the corporation,<sup>46</sup> to what MNCs believe is the lowest amount of tax payable that the law requires. There is nothing illegal or immoral in acting in this manner. The Australian Taxation Office (ATO) has stated: 'You have the right to arrange your financial affairs to keep your tax to a minimum – this is often referred to as tax planning or tax-effective investing'.<sup>47</sup> The International Bar Association notes that: 'Stakeholders from civil society and government were careful not to suggest that anyone should pay more taxes than strictly required by law'.<sup>48</sup> The Organisation for Economic Co-operation and Development (OECD) in its Guidelines for Multinational Enterprises accepts this when it records:

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<sup>43</sup> The Serious Financial Crime Taskforce includes the AFP, ATO, Australian Crime Commission, Attorney-General's Department, AUSTRAC, Australian Securities and Investments Commission, Commonwealth director of public prosecutions and Australian customs and border protection services: ATO, 'Government expands serious financial crime focus' (last modified 3 July 2015), <<https://www.ato.gov.au/general/the-fight-against-tax-crime/in-detail/targeting-tax-crime-magazine/2015/targeting-tax-crime--wickenby,-a-lasting-legacy/?page=2>>.

<sup>44</sup> ATO, 'Tax crime prosecution results' (last modified 21 December 2016), <<https://www.ato.gov.au/General/the-fight-against-tax-crime/news-and-results/tax-crime-prosecution-results/>>.

<sup>45</sup> See for example HMRC, 'Exploring large business tax strategy behaviour', HMRC Research Report 363, July 2015; Catriona Lavermicocca, 'Tax risk management practices and their impact on tax compliance behaviour—The views of tax executives from large Australian companies' (2011) 9(1) *eJournal of Tax Research* 89; Emer Mulligan and Lynne Oats, 'Tax risk management: evidence from the United States' [2009] 6 *British Tax Review* 680; ATO, 'Seven principles of effective tax governance' (last modified 31 May 2016), <<https://www.ato.gov.au/business/privately-owned-and-wealthy-groups/tax-governance/corporate-governance-and-tax-governance/seven-principles-of-effective-tax-governance/>>.

<sup>46</sup> See for example *Corporations Act 2001* (Cth) s 181, which requires a director or other officer of a corporation to exercise their powers and discharge their duties in good faith in the best interests of the corporation.

<sup>47</sup> ATO, 'Tax Planning' (last modified 13 September 2016), <<https://www.ato.gov.au/general/tax-planning/>>. See also Michael Carmody, 'Managing Compliance' (Speech delivered at the Tasmanian Chamber of Commerce and Industry, 3 September 2003).

<sup>48</sup> International Bar Association, above n 13. See also OECD, *Addressing Base Erosion and Profit Shifting* (2013).

Enterprises should comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate. Complying with the spirit of the law means discerning and following the intention of the legislature. It does not require an enterprise to make payment in excess of the amount legally required pursuant to such an interpretation.<sup>49</sup>

Avi-Yonah, discussing Corporate Social Responsibility, refers to three theories about tax and the corporation and states that corporations should not embark on tax minimisation schemes under any theory because:

Under the artificial entity view, it undermines the constitutive relationship between the corporation and the state. Under the real view, it runs contrary to the normal obligation of citizens to comply with the law even in the absence of effective enforcement. And under the aggregate view, it is different from other forms of shareholder profit maximisation in that it weakens the ability of the state to carry out those functions that the corporation is barred from pursuing.<sup>50</sup>

Two of the matters mentioned by Avi-Yonah raise some difficulties. First, even if the company is a creation of the legislature, this does not mean its tax obligations should be other than as the law provides. If this were not the case, how would one determine how much tax must be paid and by whom this determination is to be made? Second, the fact that a corporation cannot perform certain functions that are the exclusive preserve of the state is not a basis for requiring corporate taxpayers to pay an indeterminate amount of tax to the revenue. If this argument had any validity, all taxpayers would be required to pay more tax than provided by law in some indeterminate amount. The real view as described by Avi-Yonah accords with the tax obligations of all corporations. Taxpayers must pay those taxes required by law. Avi-Yonah does not suggest they must pay more.

Evasion is intentional criminal conduct designed to limit or not pay taxes.

Tax avoidance is neither criminal nor compliance with the tax laws; it is somewhere in between the two. It can often be very difficult to define avoidance.<sup>51</sup> In Australia, there are objective factors to be met before a corporation falls foul of the anti-avoidance rules and particularly the general anti-avoidance rule contained in Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). For the purposes of this article tax avoidance in Australia means a breach of the specific or general anti-avoidance rules contained in the tax laws. This definition is supported by reference to legislation and case law. The proponents for a link between tax and human rights tend towards a subjective meaning for avoidance that has no relationship as to how the tax laws or the courts or the ATO construe avoidance.

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<sup>49</sup> OECD, 'Guidelines for Multinational Enterprises', <<http://www.oecd.org/daf/inv/mne/48004323.pdf>>.

<sup>50</sup> Reuven S Avi-Yonah, 'Corporate social responsibility and strategic tax behavior', in Wolfgang Schön (ed), *Tax and Corporate Governance* (Springer, 2008) 183.

<sup>51</sup> Freedman discusses some of the difficulties in defining 'tax avoidance': Judith Freedman, 'The tax avoidance culture: Who is responsible? Governmental influences and corporate social responsibility' (2006) 59(1) *Current Legal Problems* 359.

Even though Australia has anti-avoidance rules not all countries have such rules in their tax legislation. In some jurisdictions, the courts may resort to statutory interpretation or other tools to protect the revenue from tax avoidance schemes. In the UK, for example, the Commissioner can rely either on an anti-avoidance rule enacted in 2013<sup>52</sup> or the *Ramsay* principle as a means of challenging what HMRC contend to be an avoidance scheme.<sup>53</sup> The *Ramsay* principle requires a court to interpret legislation purposively and then to apply that finding to the facts found as a composite whole and viewed realistically.

In keeping with the views of the OECD,<sup>54</sup> the CoT and regulators in other jurisdictions at times refer to avoidance as following the letter, but not the spirit of the law;<sup>55</sup> or not following the policy of the law; or as being a scheme that undermines the integrity of the tax system. According to Hasseldine and Morris, references to the ‘spirit of the law’ imply ‘the existence of some form of shadowy parallel tax code to which only a privileged few have access while everyone else has to make do with the “letter” of the law’.<sup>56</sup> Freedman argues that proper consideration has to be given to the actual legal position, rather than focusing on vague and unenforceable notions such as the ‘spirit of the law’.<sup>57</sup>

References to concepts such as the ‘spirit’ or ‘policy’ of the law do not add much to the enquiry about the distinction between tax planning and tax avoidance, although the ‘spirit’ or ‘policy’ of the law may be relevant when a court seeks to interpret a statutory provision. For example, when interpreting the general anti-avoidance rule, a court may have regard to the policy behind the law or the ‘spirit of the law’. However, once the meaning and purpose of the legislation has been determined, these concepts play no further role in assessing whether a transaction is affected by these rules.<sup>58</sup>

Notwithstanding the foregoing, judicial officers have views on morality which may play a role in the ultimate determination of a tax or other dispute. If a scheme infringes that view the officer may insofar as the law permits seek to set aside the transaction. This has the inevitable consequence that if a taxpayer believes or is advised that a scheme is at or close to the boundary of breaching the anti-avoidance rules such schemes should be avoided. Notwithstanding this, as Bloom states:

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<sup>52</sup> This legislation refers to an ‘anti-abuse rule’ contained in Part 5 of the *Finance Act 2013*.

<sup>53</sup> *W T Ramsay Ltd v Inland Revenue Commissioners, Eilbeck (Inspector of Taxes) v Rawling* [1982] AC 300, [1981] 1 All ER 865.

<sup>54</sup> OECD, above n 49.

<sup>55</sup> In *Bropho v Human Rights and Equal Opportunity Commission* [2004] FCAFC 16 [93], Justice French describes the ‘spirit of the law’ in these terms:

In a statutory setting a requirement to act in good faith...will require honest action and fidelity to whatever norm, or rule or obligation the statute prescribes as attracting the requirement of good faith observance. That fidelity may extend beyond compliance with the black letter of the law absent the good faith requirement. In ordinary parlance, it may require adherence to the ‘spirit’ of the law.

<sup>56</sup> John Hasseldine and Gregory Morris, ‘Corporate social responsibility and tax avoidance: A comment and reflection’ (2013) 37(1) *Accounting Forum* 1, 11.

<sup>57</sup> Judith Freedman, ‘Responsive regulation, risk, and rules: Applying the theory to tax practice’ (2011) 44(3) *UBC Law Review* 627, 648-651.

<sup>58</sup> Kalmen Datt, *A Critical Evaluation of How Aspects of the Tax System in Australia Are Administered and Their Impact on Corporations and Directors* (Australian Research Foundation, Research Study 49, 2015).

It is worth noting, while we are on the tricky subject of morality, that not everyone shares the government's fervent zeal for taxation and its collection. Whether the Parliament likes it or not, income tax is, in every sense, an imposition. Thus, by the *Income Tax Act 1986* (Cth) s 5(1) 'income tax is imposed' upon taxable incomes, not anything else...<sup>59</sup>

The words of the late Justice Hill bear repeating here. He said:

First, there is a real danger in judges deciding cases by reference to their own morality or sense of justice. This is so for no other reason than that views of morality differ from person to person. Second, to adapt a metaphor from another area of law and another time, the outcome of each case would depend upon the size of the Chancellor's foot, rather than the application of some predictable principle.<sup>60</sup>

Finally, on the issue of morality Lord Wilberforce is recorded as saying: 'A subject is only to be taxed on clear words, not on "intendment" or on the "equity" of an Act'.<sup>61</sup>

Morality has no role to play in determining a taxpayer's liability for tax. Either the law imposes a tax on certain income or it does not. As stated earlier all taxpayers must comply with the tax laws but there is no obligation moral or otherwise to pay more taxes than the law provides. The author suggests that the cases such as the 'naming and shaming' of Starbucks and the subsequent overpayment of tax by this corporation should never have happened. As stated by the author on another occasion:

The obligation to pay tax should be based on a liability created by legislation and not be an ex gratia payment or attempt to appease what may be unjustified, uninformed and vociferous criticism. For corporations to act in the way required by the media may require directors to breach their common law and legislative obligations to the corporation and its stakeholders. This in fact occurred in the UK, when a spokesperson of Starbucks was reported as stating:

We listened to our customers in December and so decided to forgo certain deductions which would make us liable to pay £10m in corporation tax this year and a further £10m in 2014. We have now paid £5m and will pay the remaining £5m later this year.<sup>[62]</sup>

Conduct such as that set out above demeans the rule of law.<sup>63</sup>

The following can be reasonably inferred from the above extract from Starbucks:

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<sup>59</sup> David Bloom QC, 'Tax avoidance: A view from the dark side' (2016) 39(3) *Melbourne University Law Review* 950, 954.

<sup>60</sup> Justice Graham Hill, 'The judiciary and its role in the tax reform process' (1999) 2(2) *Journal of Australian Taxation* 66, 77.

<sup>61</sup> *W T Ramsay Ltd v Inland Revenue Commissioners, Eilbeck (Inspector of Taxes) v Rawling* [1981] 1 All ER 865, 870.

<sup>62</sup> Terry Macallister, 'Starbucks pays corporation tax in UK for first time in five years', *The Guardian* online (24 June 2013), <<http://www.theguardian.com/business/2013/jun/23/starbucks-pays-corporation-tax>>.

<sup>63</sup> Kalmen Datt, 'To shame or not to shame: That is the question' (2016) 14(2) *eJournal of Tax Research* 486.

- Starbucks would not apply the law of the land and claim a deduction to which it was entitled to appease a demand by customers;
- the law is of secondary importance when a corporation is named and shamed; and
- whether the corporation was blameless or not is irrelevant to the campaign of naming and shaming by the media.

In protecting a corporation's goodwill directors may be acting in the interests of the corporation. However, if they are fully compliant, the attacks on the corporation's reputation should not occur. Unfortunately, these attacks are commonplace.

Either a scheme is a lawful tax planning exercise, or it is avoidance or evasion. There is no *via media*. If the state wishes to collect more revenue (assuming no breach of the tax laws):

A change in the law is the only way to ensure these transactions are subject to tax. The House of Lords notes that it is primarily for the UK government to correct flaws in the (corporations) tax regime. If there is manipulation, the best way to counter this is to tighten the regulatory framework. There is no substitute for improving the tax code to reduce tax avoidance.<sup>64</sup>

The concept of a 'fair share of taxes' is incapable of definition.<sup>65</sup> For example, the question has been asked elsewhere by the author whether

[a] 'fair share' of tax means that corporate taxpayers must pay the headline rate, or is this an allusion to some other percentage? If the latter, how and who determines this liability? Must a taxpayer not claim deductions that the law allows? To suggest that, because some corporate taxpayers have a lower effective tax rate than the headline rate of 30 per cent, they are not paying their fair share is meaningless unless one knows how the tax is calculated and whether this is in accordance with the law. The question of what is a 'fair share' of tax is incapable of a rational answer by reference to the laws imposing tax.<sup>66</sup>

As Vodafone has noted in its Tax Risk Management Strategy document:

Vodafone believes its obligation is to pay the amount of tax legally due in any territory, in accordance with rules set by governments. In so doing it is not able to determine the 'fair' amount of tax to pay.<sup>67</sup>

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<sup>64</sup> Datt, 'Paying a fair share of tax and aggressive tax planning-A tale of two myths, above n 16 (references omitted).

<sup>65</sup> According to Slemrod, '[t]here is an active controversy about what exactly fairness means': Joel Slemrod, 'Old George Orwell got it backward: Some thoughts on behavioral tax economics' (CESifo Working Paper No. 2777, September 2009) 5.

<sup>66</sup> Datt, 'Paying a fair share of tax and aggressive tax planning-A tale of two myths, above n 16.

<sup>67</sup> Vodafone Group plc, 'Tax risk management strategy', <[https://www.vodafone.com/content/dam/sustainability/pdfs/vodafone\\_tax\\_risk\\_management\\_strategy.pdf](https://www.vodafone.com/content/dam/sustainability/pdfs/vodafone_tax_risk_management_strategy.pdf)>.



The CoT's responsibility is the administration of the tax laws, not some nebulous concept of 'fairness'.<sup>68</sup>

This article now turns to a consideration of the human rights obligations of states and MNCs.

### 3. HUMAN RIGHTS, STATES AND MNCs

#### 3.1 The human rights obligations of states

The starting point is the *Universal Declaration of Human Rights* by the United Nations in 1948 which *inter alia* provides that human rights are universal, inalienable and indivisible.

Donnelly notes:

Human rights are also inalienable rights, because being or not being human is an inalterable fact of nature, not something that either is earned or can be lost. Human rights are thus 'universal' rights in the sense that all human beings hold them 'universally'. Conceptual universality is in effect just another way of saying that human rights are, by definition, equal and inalienable.<sup>69</sup>

Shaw et al. in similar vein suggest human rights have four characteristics. These are that they are universal, equal, not transferable and are not dependent on human institutions.<sup>70</sup>

Any person that introduces a bill before the Australian Parliament must cause a statement of compatibility to be prepared that shows the bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.<sup>71</sup> A failure to comply with this Act does not affect the validity, operation or enforcement of the Act or any other provision of a law of the Commonwealth.<sup>72</sup> Each of these instruments imposes obligations only on states to ensure that they take adequate steps to ensure these

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<sup>68</sup> Datt, *A Critical Evaluation of How Aspects of the Tax System in Australia Are Administered*, above n 58.

<sup>69</sup> Jack Donnelly, *Universal human rights in theory and practice* (Cornell University Press, 3rd ed, 2013) 10.

<sup>70</sup> William H Shaw, Vincent Barry, Theodora Issa, Bevan Cately and Donata Muntean, *Moral issues in business* (Cengage, 3rd Asia Pacific ed, 2015) 89.

<sup>71</sup> The following international instruments are cited in section 3:

- (a) the *International Convention on the Elimination of all Forms of Racial Discrimination* done at New York on 21 December 1965 ([1975] ATS 40);
- (b) the *International Covenant on Economic, Social and Cultural Rights* done at New York on 16 December 1966 ([1976] ATS 5);
- (c) the *International Covenant on Civil and Political Rights* done at New York on 16 December 1966 ([1980] ATS 23);
- (d) the *Convention on the Elimination of All Forms of Discrimination Against Women* done at New York on 18 December 1979 ([1983] ATS 9);
- (e) the *Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment* done at New York on 10 December 1984 ([1989] ATS 21);
- (f) the *Convention on the Rights of the Child* done at New York on 20 November 1989 ([1991] ATS 4);
- (g) the *Convention on the Rights of Persons with Disabilities* done at New York on 13 December 2006 ([2008] ATS 12).

<sup>72</sup> *Human Rights (Parliamentary Scrutiny) Act 2011* (Cth) s 8(5).

rights are achieved. They do not impose obligations on those entities that do business in these states. As noted by O'Neill:

Declarations and Covenants are not the corollaries of the human rights that the documents proclaim. The Covenants do not assign states straight-forward obligations to respect liberty rights (after all, liberty rights have to be respected by all, not only by states), but rather second-order obligations to secure respect for them.<sup>73</sup>

The article now turns to the human rights obligations of MNCs.

### 3.2 The obligations of MNCs

This section commences with an extract from an article by Wilkinson, a Circuit Judge, United States Court of Appeals, for the Fourth Circuit in discussing the approach courts in the US take to the enforcement of what at times appear to be absolute human rights. He states:

More fundamentally, rights impose obligations on others, and in many cases, those obligations are more than society can absorb. Competing social needs and goals, not to mention limitations of time and money, necessitate various qualifications on rights that we think of as absolute. The implementation of individual rights should not take its cues from rhetoric alone, without any concern for the dictates of prudence.<sup>74</sup>

This statement reflects that courts, when enforcing human rights, must consider various competing interests when reaching a decision. This would appear to be an implicit limitation on the obligations of MNCs in relation to human rights.

The UN Global Compact's Ten Principles require corporations to operate in ways that meet fundamental responsibilities in the areas of human rights, labour, environment and anti-corruption.<sup>75</sup> In 2005, Ruggie drafted the United Nations Framework for Business and Human Rights 'Protect, Respect and Remedy'.<sup>76</sup> The concept of protect encompasses states promoting corporate respect for human rights and to prevent corporate-related abuse. Respect means corporations acting with due diligence to ensure they avoid infringing on the rights of others and addressing harms that do occur. This includes having policies, strategies and processes in place to ensure it does not breach any person's human rights. The requirement for a remedy means states must provide remedies for those whose human rights have been breached. The obligations of corporations extend not only to their activities but to the activities of those with whom they do business or interact but impliedly, there is no inter-jurisdictional obligation.<sup>77</sup> Leisinger records:

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<sup>73</sup> Onora O'Neill, 'The dark side of human rights' (2005) 81(2) *International Affairs* 427.

<sup>74</sup> J Harvie Wilkinson III, 'The dual lives of rights: The rhetoric and practice of rights in America' (2010) 98(2) *California Law Review* 277, 278.

<sup>75</sup> These can be found at <<http://www.unglobalcompact.org/aboutthegc/thetenprinciples/index.html>>.

<sup>76</sup> United Nations, 'The UN "Protect, Respect and Remedy" Framework for business and human rights' (September 2010), <<https://business-humanrights.org/sites/default/files/reports-and-materials/Ruggie-protect-respect-remedy-framework.pdf>>.

<sup>77</sup> Ibid.

For most of the companies that have signed on to the UN Global Compact, the sphere of influence extends beyond the factory site and includes immediate business partners and suppliers—it usually does not cover ‘government and the wider society’. John Ruggie’s Interim Report sees an emerging consensus view among leading companies that there is a gradually declining direct corporate responsibility outward from employees to suppliers, contractors, distributors, and others in their value chain but also including communities.<sup>78</sup>

Kinley and Tadaki say:

However, it can be argued that TNCs [MNCs] do have duties to prevent human rights abuses in certain circumstances where they maintain close connections with potential victims or potential perpetrators, and where TNCs are in a position to influence the level of enjoyment of human rights.<sup>79</sup>

It seems that an MNC’s human rights obligations are merely a reflection of the obligations of the state and are enforceable by the laws of the state in which the MNC does business. Cohen appears to accept this when he states that:

Although there is no explicit language restricting the obligations to a state’s own territory, one has the sense in reading the Covenant that extraterritorial obligations were not considered or intended.<sup>80</sup>

Cohen does note that:

[A]t least one committee of legal experts, convened by Maastricht University and the International Commission of Jurists, interprets the Covenant to impose extraterritorial obligations.<sup>81</sup>

The preamble to the United Nations *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights* appears to go further contending for an extra-territorial operation of human rights. It states:

Within their respective spheres of activity and influence, transnational corporations and other business enterprises have the obligation to promote, secure the fulfilment of, respect, ensure respect of and protect human rights recognized in international as well as national law, including the rights and interests of indigenous peoples and other vulnerable groups.<sup>82</sup>

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<sup>78</sup> Klaus M Leisinger, Special Advisor to the Secretary General on the Global Compact, ‘On corporate responsibility for human rights’, Basel, April 2006, <[http://www.commdev.org/userfiles/files/958\\_file\\_corpresforhr\\_kl.pdf](http://www.commdev.org/userfiles/files/958_file_corpresforhr_kl.pdf)>.

<sup>79</sup> David Kinley and Junko Tadaki, ‘From talk to walk: The emergence of human rights responsibilities for corporations at international law’ (2004) 44(4) *Virginia Journal of International Law* 931, 964.

<sup>80</sup> Stephen B Cohen, ‘Does Swiss bank secrecy violate international human rights?’ (2013) 140 *Tax Notes* 355, 356, referring to the *International Covenant on Civil and Political Rights*.

<sup>81</sup> Cohen, above n 80. See also United Nations, *Norms on the responsibilities of transnational corporations and other business enterprises with regard to human rights* art 1, <<https://documents-dds-ny.un.org/doc/UNDOC/GEN/G03/160/08/PDF/G0316008.pdf?OpenElement>>.

<sup>82</sup> United Nations, *Norms on the responsibilities of transnational corporations and other business enterprises with regard to human rights*, above n 81.

Even with this extended meaning the obligation is that of the state to enforce these rights.

Brenkert<sup>83</sup> suggests there are divergent views as to whether businesses need only comply with some or all human rights, other than those enshrined in law. He refers to a variety of approaches on how businesses should go about determining their specific human rights responsibilities. The first is what he refers to as a good reasons approach. Here the MNC must take a decision where the strongest weight of reason lies. This involves evaluating the extent to which it can make a difference, on what others can be expected to do, and the appropriateness of how the required supportive actions may be shared. On this basis and depending on the facts there may be no obligation to take any action. This approach is dependent on the view one takes of the corporation. Is it a private body or one with political power? If the latter the obligations may be greater and may be synonymous with those of the state. Next is the fair-share theory that determines which responsibilities a business has based upon three factors: relationship, effectiveness and capacity.<sup>84</sup> The reference to 'relationship' means the nature, duration and physical proximity of the business to the rights holder. On this basis, the cost of acting is a factor that may legitimately be considered. Effectiveness refers to the ability of different entities to carry out their human rights obligations whilst capacity refers to their ability to bear the costs involved in the enforcement and promotion of human rights. The use of risk management techniques in determining specific responsibilities are also issues to be considered.<sup>85</sup> This tool is more than just a cost benefit analysis of cause and effect.<sup>86</sup> Brenkert continues:

A third approach to determining specific responsibilities is exemplified by Ruggie's defence of risk management as a tool for businesses determining '... the human rights risks that the proposed business activity presents and [to] make practical recommendations to address those risks'. This involves determining which risks of adverse human rights impacts are the most significant where this involves determining not only the probability of such impacts occurring but also their severity and the vulnerability of those who might be impacted.<sup>87</sup>

The OECD Guidelines for Multinational Enterprises<sup>88</sup> also prescribe certain human rights obligations for MNCs although they appear not to have an extraterritorial operation. These Guidelines draw on the Ruggie Framework. The commentary to these Guidelines *inter alia* provides that:

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<sup>83</sup> George G Brenkert, 'Business ethics and human rights: An overview' (2016) 1(2) *Business and Human Rights Journal* 277.

<sup>84</sup> Brenkert cites Michael A Santoro, 'Engagement with integrity: What we should expect multinational firms to do about human rights in China' (1998) 10(1) *Business & the Contemporary World* 25, 34; Michael A Santoro, *Profits and principles: Global capitalism and human rights in China* (Cornell University Press, 2000) in support of this theory.

<sup>85</sup> See for example Bridget M Hutter and Clive J Jones, 'From government to governance: external influences on business risk management' (2007) 1(1) *Regulation and Governance* 27.

<sup>86</sup> Brenkert cites John Ruggie, *The corporate responsibility to respect human rights: An interpretative guide*, HR/PUB (2012) /12/02 42.

<sup>87</sup> Brenkert, above n 83, 297 (references omitted).

<sup>88</sup> OECD, *OECD Guidelines for Multinational Enterprises* (OECD, 2011), <<http://www.oecd.org/daf/inv/mne/48004323.pdf>>.

- MNCs should strive to honour human rights provided it does not cause them to breach the laws of the land in which they do business;
- where an enterprise causes or may cause an adverse human rights impact, it should take the necessary steps to cease or prevent the impact or if possible, use whatever influence it may have to effect change in the practices of an entity that cause adverse human rights impacts.

The Corporations Act itself imposes a limitation on the human rights obligations of corporations when it requires directors to take decisions that are in the interests of the corporation.<sup>89</sup> The ‘interests of the corporation’ is not some abstract concept. For example, Redmond discussing human rights and the interests of the corporation said:

Directors may have regard for non-shareholder stakeholder interests within some uncertain limits, but not independently of consequential corporate benefit... This formulary comprises three distinct but related duties: a subjective duty of good faith, that is, to act honestly in the company's interests as the directors perceive them; a duty to exercise powers for a proper purpose; and a duty to consult and act by reference to interests that the law recognises as the ‘interests of the company’.<sup>90</sup>

Kennedy discusses various problems that, in his opinion, arise when non-government organisations and other activist entities make claims about breaches of human rights issues by MNCs in taking abusive tax positions. He accepts that some have greater validity than others but, he says, one should not close one's eyes to them as the answers to each requires a pragmatic reassessment of humanitarian commitments, tactics and tools. Based on the views of Kennedy, various potential issues arise from the claim that abusive tax positions are a breach of human rights. These include:

- generalisations that MNCs are violating their human rights obligations by taking ‘abusive tax positions’ ignore the clear majority of MNCs that pay all taxes the law requires;
- those who contend for a link between tax and human rights are unable to enact laws that prescribe how taxes are to be calculated and paid or how to enforce such laws. The claim about abusive tax positions and human rights is rhetorical even though they may bring abuses of some MNCs into the public domain. As Gelski notes:

It was this change in taxpayer stakeholder expectations that has caught the government, and I suspect, the ATO off guard. I am not alone in pointing out that arrangements that the ATO not only knew about but in many cases officially approved, are now being revisited and challenged;<sup>91</sup>

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<sup>89</sup> *Corporations Act 2001* (Cth) s 181(1).

<sup>90</sup> Paul Redmond, ‘Directors’ Duties and Corporate Social Responsiveness’ (2012) 35(1) *University of New South Wales Law Journal* 317, 324-325.

<sup>91</sup> Gelski, above n 32.

- there may be a mistaken impression that there is a larger pool of monies available than may be the case. This is reminiscent of the views of Forstater considered in section 2.1 above.

The foregoing suggests the link between tax and human rights is at best tenuous and appears to be based on some (possibly intentional) misconceptions. These include:

- whatever additional tax is recovered by governments will be utilised in the alleviation of poverty;
- not paying more tax than the law requires is in some way a breach of an MNC's human rights or tax obligations (this suggests that complying with the law is something to be despised); and
- the obligation to pay tax is based on some subjective indeterminate criteria which are incapable of creating any enforceable legal liability. Examples of this are the use of phrases such as 'tax practices that may be legal, strictly speaking, but are currently under scrutiny because they avoid a "fair share" of the tax burden'.

Before concluding on the issue of the human rights obligations of MNCs, it is appropriate to cite the words of former High Court Chief Justice Robert French when delivering a speech on the Courts and Parliament. He said:

The common law principle of legality has a significant role to play in the protection of rights and freedoms in contemporary society while operating consistently with the principle of parliamentary supremacy. It does not, however, authorise the courts to rewrite statutes in order to accord with fundamental human rights and freedoms.<sup>92</sup>

Finally, if the legislature does not impose a human rights obligation on MNCs then there is nothing to be enforced. An essential element of the Ruggie framework would be missing. The comments of O'Neill are apposite here. She said:

If we take rights seriously and see them as normative rather than aspirational, we must take obligations seriously. If on the other hand we opt for a merely aspirational view, the costs are high. For then we would also have to accept that where human rights are unmet there is no breach of obligation, nobody at fault, nobody who can be held to account, nobody to blame and nobody who owes redress. We would in effect have to accept that human rights claims are not real claims.<sup>93</sup>

The foregoing suggests an MNC's human rights obligations are limited to those with whom the corporation has a direct connection or those for whom it voluntarily assumes liability. As the connection becomes more distant so the obligation becomes smaller until eventually it may become non-existent. If the state does not legislate enforcement mechanisms, claims for breaches of human rights are mere rhetoric.

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<sup>92</sup> Chief Justice Robert French AC, 'The courts and the Parliament' (2013) 87(12) *Australian Law Journal* 820, 827.

<sup>93</sup> O'Neill, above n 73, 430.

There is no legislation that draws a link between tax and human rights.<sup>94</sup> This does not mean claims cannot be made under international instruments such as the *International Covenant on Civil and Political Rights* where there has been a breach of human rights. An example where such a claim was made to a Committee created under the above instrument was that of one Charif Kazal who lodged a complaint to the UN about the operations of and findings of misconduct against him by a statutory body created in New South Wales known as the Independent Commission Against Corruption. No legal avenues were available to Kazal to challenge the findings of the Commission resulting in a claim of a breach of human rights under the above instrument.<sup>95</sup> No decision has to date been handed down on this complaint. This action by Kazal does not detract from the fact that it is a long row to hoe to find any actionable link between tax and human rights.

The foregoing indicates the obligations of MNCs are limited and not in the absolute terms suggested by those who contend for a link between tax and human rights. There is no direct link between the two. The article now considers whether in Australia MNCs owe some duty of care to persons other than the state (regulator) not to take an abusive tax position. This would appear to be the only basis for founding a claim based on a breach of human rights. In so far as the author can determine no country has legislatively sought to draw a link between a breach of the tax laws and a breach of human rights. Even the OECD in its action points designed *inter alia* to ensure that MNCs pay such taxes as they may be obliged to do on income generated in specific jurisdictions does not draw such a link.<sup>96</sup>

### 3.3 Do MNCs owe a duty of care?

As the Australian law currently stands, it seems an MNC does not owe a duty of care to any specific individual or group of individuals to ensure it does not take an abusive tax position. The courts can, however, extend the grounds under which a duty of care may be owed. As Brennan J noted:

When the existence of a duty in a new category of case is under consideration, the question for the court is whether there is some factor in addition to reasonable foreseeability of loss which is essential to the existence of the duty...where a novel category of duty is proposed...the court may have regard to a variety of considerations: the nature of the activity which causes the loss, the nature of the loss, the relationship between the parties and contemporary community standards (especially where liability for breach of the proposed duty would be disproportionate to the risk which a person might reasonably be expected to bear as an incident of engaging in the particular activity if no limiting factor were identified).<sup>97</sup>

Deane J in the same case noted that:

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<sup>94</sup> See for example Cohen, above n 82, 356.

<sup>95</sup> See for example Chris Merritt, 'Kazal sues state for "malicious ICAC inquiry"', *The Australian* (26 January 2018) 23; Chris Merritt, 'ICAC case ignites UN Human Rights Row', *The Australian* (26 January 2018) 4.

<sup>96</sup> See for example OECD, 'BEPS Actions', <<http://www.oecd.org/ctp/beps-actions.htm>>.

<sup>97</sup> *Hawkins v Clayton* [1988] HCA 15, 164 CLR 539, 556 [15].

The content of the duty of care... may, in some special categories of case, extend to require the taking of positive steps to avoid physical damage or economic loss being sustained by the person or persons to whom the duty is owed. Apart from cases...where the person under the duty has created the risk, the categories of case in which a relationship of proximity gives rise to a duty of care which may, according to circumstances, so extend are, like those in which there is a duty of care to avoid pure economic loss, commonly those involving the related elements of an assumption of responsibility and reliance.<sup>98</sup>

Based on the above dicta it seems unlikely that a new duty would be found to link human rights and tax. Even if this view is incorrect the courts will not extend the duty to cases where the duty is owed to the world at large. A relationship between a claimant and the MNC must be established to justify the allegation of a duty owed. An allegation of negligence *simpliciter* will not suffice. Thus, in *Chester*, a young child fell into a hole dug by the Council and drowned. The child's mother sued for mental anguish submitting the council owed her a duty of care not to injure her child so as to cause her a nervous shock when she saw, not the happening of the injury, but the dead body of the child. A majority in the High Court dismissed her appeal. Rich J handing down a concurring majority judgment said:

The train of events which flow from the injury to A almost always includes consequential suffering on the part of others...But the law must fix a point where its remedies stop short of complete reparation for the world at large, which might appear just to a logician who neglected all the social consequences which ought to be weighed on the other side.<sup>99</sup>

Starke J in the same case said:

Some relationship of duty on the part of the municipality towards the appellant must be established. Negligence in the abstract or in the air, as has often been said, is not enough.<sup>100</sup>

In *Heyman* the issue was whether a local authority which gave approval to the erection of a dwelling owed a duty to persons who subsequently became the owners and occupiers of the house, to take reasonable care to ensure that the building was constructed in conformity with the plans and specifications which it approved. Each member of the Court handed down separate concurring judgments dismissing the appeal. Deane J said (in a lengthy extract):

*The common law imposes no prima facie general duty to rescue, safeguard or warn another from or of reasonably foreseeable loss or injury or to take reasonable care to ensure that another does not sustain such loss or injury...reasonable foreseeability of a likelihood that such loss or injury will be sustained in the absence of any positive action to avoid it does not of itself suffice to establish such proximity of relationship as will give rise to a prima facie duty on one party to take reasonable care to secure avoidance of a reasonably foreseeable but independently created risk of injury to the other... Apart from those cases where the circumstances disclose an assumption of a*

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<sup>98</sup> Ibid 579 [27].

<sup>99</sup> *Chester v Waverley Municipal Council* (1939) 62 CLR 1, 11.

<sup>100</sup> Ibid 12.



particular obligation to take such action or of a particular relationship in which such an obligation is implicit, [special categories] are largely confined to cases involving reliance by one party upon care being taken by the other in the discharge or performance of statutory powers, duties or functions....<sup>101</sup>

*Chester* and *Heyman* reflect the case that MNCs do not owe a duty of care to all the inhabitants of a state or even an unknown and potentially unlimited number of claimants. The necessary relationship with the MNC or an assumption of liability by it is missing. This too would appear to be destructive of any contention for a link between human rights and tax.

It seems no individual would be able to contend that any one or more MNCs owed that individual a duty of care not to take an abusive tax position so as to found a claim in human rights. There is no special relationship between any MNC and the community at large or any individual where it can be contended the MNC assumed an obligation to eradicate poverty. On this basis 'there is no breach of obligation, nobody at fault, nobody who can be held to account, nobody to blame and nobody who owes redress'.<sup>102</sup>

A further hurdle for those who contend that 'abusive tax practices' are a breach of human rights is that for such a claim to succeed the claimant would have to show some breach by the MNC of both its tax and human rights obligations. The ability of such an entity doing so is remote especially in view of the secrecy provisions contained in Division 355 of the *Taxation Administration Act 1953* (Cth). The claimant/s would presumably be incapable of proving a breach of the tax laws. It seems all they can do is argue in generalities which may reflect an intentional but mistaken view of the operation of the tax and human rights law by those who contend for a link between the two.

There is no theory of the corporation that suggests it must pay more taxes than those required by the law. In the event of a breach by an MNC of its tax obligations there would presumably be an amended assessment issued by the tax regulator to ensure the correct amount of tax was paid. There is no need to suggest that human rights has any role to play in the enforcement of the tax laws. To do so would be pointless. Further to suggest that there is a moral obligation not to take an abusive tax position (which includes tax mitigation which is lawful) as this gives rise to a breach of human rights has the inevitable consequence that every act on the part of every person or corporation, whether lawful or otherwise, which results in a reduction of the revenue available to a government to alleviate poverty is a breach of human rights. Such a proposition would strain the credulity of even the most gullible of minds.

All of the foregoing suggests there is little, if any, merit in the claim that taking 'abusive tax positions' constitutes a breach of human rights. On the assumption, however, that the author is mistaken, the article now considers the same issues from a tax perspective.

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<sup>101</sup> *Council of the Shire of Sutherland v Heyman* (1985) 157 CLR 424, 502 (emphasis added and references omitted).

<sup>102</sup> See O'Neill, above n 73.

## 4. TAXES

### 4.1 The obligations of MNCs in relation to tax

Australia follows a self-assessment regime when dealing with the tax affairs of MNCs. Interestingly some MNCs are under permanent audit or review by the ATO depending on the ATO's views of their perceived risk to the revenue. The basic principle behind a self-assessment system is that any tax is capable of precise determination in an amount fixed by law.<sup>103</sup> According to Freedman, 'companies cannot be expected to pay voluntary tax over and above the amounts imposed by law'.<sup>104</sup> Such voluntary payments would not be the payment of taxes. An MNC is not obliged to put aside its own interests to pursue a tax policy that is the most beneficial to the state.<sup>105</sup> The Commissioner is 'obliged to collect tax in accordance with a correct assessment, that is to say, to collect the correct amount of tax, no more and no less'.<sup>106</sup>

When considering the tax obligations of MNCs and human rights there are cases in Australia where taxpayers sought to raise a defence to the payment of taxes that some taxes or conduct on the part of the ATO may be an abuse of human rights. The basis on which the courts found against these taxpayers is suggestive of an approach that might be followed if a claim were made that a breach of the tax laws was a breach of human rights.

### 4.2 Tax cases and human rights

In *Re Burrowes* the taxpayer *inter alia* argued he was not bound by the tax laws of Australia as it involved a violation of his right to conscientiously object to paying tax which was used by the Australian Government to finance military activities and the nuclear arms race. He relied on Article 18 of the *Universal Declaration of Human Rights* and the *International Covenant on Civil and Political Rights*. The Court held that neither document provides a legal basis which allows Australian taxpayers at their individual option to withhold any part of the tax which is otherwise payable.<sup>107</sup>

In *Ellenbogen* the taxpayer, a recent immigrant to Australia, claimed certain deductions which were disallowed by the Commissioner. The taxpayer then made a complaint of racial discrimination against the Commissioner contending Australian tax laws were discriminatory against newly arrived immigrants as they did not accord with the *Universal Declaration of Human Rights* because they discriminated on the basis of national origin. The taxpayer then lodged a claim before the Human Rights and Equal Opportunity Commission, but the claim was dismissed. The Court found the decision

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<sup>103</sup> For an article discussing the US tax system, see Bryan T Camp, 'Tax administration as inquisitorial process and the partial paradigm shift in the IRS Restructuring and Reform Act of 1998' (2004) 56(1) *Florida Law Review* 1. See also *IRC v Holmden* [1968] AC 685 where Lord Wilberforce said: 'A man is not to be taxed by a dilemma: he must be taxed by positive provision under which the Crown can satisfactorily show that he is fairly and squarely taxed. An entity is not obliged to put aside its own interests to pursue a tax policy that is the most beneficial to the government'.

<sup>104</sup> Judith Freedman, 'Tax and corporate responsibility: In my opinion' (2003) 695 *Tax Journal* 2, 6.

<sup>105</sup> Richard Happe, 'Multinationals, enforcement covenants, and fair share' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford University Centre for Business Taxation, 2008) 157.

<sup>106</sup> *Brown v Commissioner of Taxation* [1999] FCA 563 [51].

<sup>107</sup> *Re Burrowes; Ex parte DFCT* (1991) 22 ATR 885.

by the Commissioner did not deprive a person of any particular race, colour or national or ethnic origin of a right, or limit their enjoyment of a right.<sup>108</sup>

*Taylor*<sup>109</sup> involved bankruptcy proceedings which went on appeal. The taxpayer appellant sought to raise the *Human Rights and Equal Opportunity Commission Act 1986* (Cth) as a basis for prosecuting the appeal. The Court dismissed this submission on the basis the legislation did not afford the taxpayer any right.

Possibly of more relevance is a case examined by Aharony and Geva where an individual was charged with tax evasion in Israel.<sup>110</sup> The case was initially determined in favour of the revenue by the District Court but subsequently overturned by the Israeli Court of Appeal. As a basis for its determination the District Court found it necessary to consider the social and national purposes of taxation. Aharony and Geva report the learned judge in the District Court as stating:

Tax is a social instrument. With it, society fights phenomena perceived as negative. It encourages activities that are viewed favorably and deters undesirable activities. It develops natural and human resources. It encourages industry, research and science. It leads to redistribution of the means of production. Income tax constitutes a major part of the national income and it has fiscal, economic and social repercussions. Given that the main purposes of the income tax are to enrich the treasury and to realize various social goals, it is only too clear that the tax policy will aim to impose tax on any activity producing an income generated in Israel.<sup>111</sup>

The District Court in Israel appeared to take a broad view of the uses to which taxes may be put as a tool in determining the meaning and purpose of the statute being considered by it. The Court was of the view that the corporation has not only economic and legal obligations, but also certain responsibilities to society, which extend beyond these obligations.<sup>112</sup> This judgment did not seek to suggest that a breach of the tax laws in Israel was a breach of human rights.

The approach adopted by the District Court in Israel is analogous to the arguments put by those who contend that MNCs must not adopt 'abusive tax positions' to ensure states have sufficient resources to alleviate poverty. In setting aside this finding the Israeli Court of Appeal adopted an approach to the interpretation of the tax laws that precluded the use of external factors (unrelated to the mischief the statute was seeking to counter) to facilitate an interpretation of the law. The function of the court is to give effect to the will of Parliament as expressed in the law.<sup>113</sup>

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<sup>108</sup> *Ellenbogen v Federal Commissioner of Taxation* (1988) 19 ATR 736.

<sup>109</sup> *Taylor & Anor v DFC of T* [1999] FCA 195.

<sup>110</sup> Joseph Aharony and Aviva Geva, 'Moral implications of law in business: a case of tax loopholes' (2003) 12(4) *Business Ethics: A European Review* 378.

<sup>111</sup> *Ibid* 383-384 (references omitted).

<sup>112</sup> *Ibid* 383.

<sup>113</sup> *Saeed v Minister for Immigration and Citizenship* [2010] HCA 23, 241 CLR 252, 265 [32] per French CJ, Gummow, Hayne, Crennan and Kiefel JJ, citing Mason CJ, Wilson and Dawson JJ in *Re Bolton; Ex parte Beane* (1987) 162 CLR 514, 518. Heydon J was to the same effect: 241 CLR 252, 277-278 [74].

The Australian High Court in *Alcan*<sup>114</sup> is to the same effect when it referred to a judgment of Gleeson CJ<sup>115</sup> who stated:

[I]t may be said that the underlying purpose of an Income Tax Assessment Act is to raise revenue for government. No one would seriously suggest that s 15AA of the *Acts Interpretation Act* has the result that all federal income tax legislation is to be construed so as to advance that purpose.

The Honourable Murray Gleeson describes the approach of Australian courts in interpreting tax statutes as follows:

Liability to tax is not determined by judicial discretion. The rule of law applies both to revenue authorities and to taxpayers, regardless of whether in a particular case it comes down on one side or the other.<sup>116</sup>

A purposive approach is adopted to determine what the law is trying to achieve from a tax perspective.<sup>117</sup> That it may raise revenue for the state is not such a purpose. All statutes imposing tax raise revenue for the state. As early as 1907 Isaacs J noted:

Where Parliament has in the public interest thought fit... to exact from individuals certain contributions to the general revenue, a Court should be specially careful, in the view of the consequences on both sides, to ascertain and enforce the actual commands of the legislature, not weakening them in favour of private persons to the detriment of the public welfare, nor enlarging them as against the individuals towards whom they are directed.<sup>118</sup>

It seems Australian courts will adopt a similar approach to that used by the Israeli Court of Appeal in overturning the District Court judgment. It is the author's view that the question of the uses to which taxes may be utilised, unless specifically stated to be the case in the legislation, is not something of which a court will take account in interpreting tax legislation. Even if this were the case a court would still be faced with the issue of determining whether the contended liability was provided for in the legislation and if there were objective factors present capable of determining a precise liability. The fact that monies may be directed to human rights purposes does not mean that a transaction or income is targeted by the legislation. The purpose for which monies are used is not a basis for determining liability.

The tax laws in Australia permit the government of the day in its sole discretion to determine the uses to which all or part of any revenue received may be put. Courts do not interpret tax laws by way of conjecture as to possible uses to which revenue derived from a tax may be put.

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<sup>114</sup> *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* [2009] HCA 41, 239 CLR 27, 47 [51] per Hayne, Heydon, Crennan and Kiefel JJ. French CJ delivered a separate concurring judgment.

<sup>115</sup> *Carr v The State of Western Australia* [2007] HCA 47, 232 CLR 138, 143 [6].

<sup>116</sup> The Honourable Murray Gleeson, 'Justice Hill Memorial Lecture – statutory interpretation' (2009) 44(1) *Taxation in Australia* 25, 27.

<sup>117</sup> *Acts Interpretation Act 1901* (Cth), ss 15A-15AD.

<sup>118</sup> *Scott v Cawsey* (1907) 5 CLR 132, 154-155.

If the law does not impose tax on an entity no liability exists. If an MNC pays the lowest amount of tax required by law, no claim can legally be made for payment of additional amounts no matter what adjectives are used to describe this conduct.

Often it is the inability (unwillingness?) of Parliament to enact legislation that targets the income sought to be taxed that enable MNCs to pay less tax than anticipated. Pascal Saint-Amans (Director of the Centre for Tax Policy and Administration, OECD) is reported to have said:

Policy makers cannot blame businesses for using the rules that governments themselves have put in place. It is their responsibility to revise the rules or introduce new rules to address existing concerns.<sup>119</sup>

Demands by third parties or even governments for MNCs to pay taxes calculated on some unlegislated and subjective basis in an indeterminate amount are not taxes and no government can enforce such claims.

The Australian legislature, aware of these problems, has recently enacted legislation to capture a greater percentage of the revenue derived by MNCs and generated in Australia by amending the general anti avoidance rule in Part IVA of the ITAA 1936. These amendments are affected by the introduction of what is known as the multinational anti-avoidance law (MAAL)<sup>120</sup> and the diverted profits tax (DPT).<sup>121</sup>

The MAAL is designed to counter the erosion of the Australian tax base by multinational entities using artificial and contrived arrangements to avoid the attribution of profits to a permanent establishment in Australia.<sup>122</sup> Portas and Slater describe the primary purpose of the DPT as:

- ensuring significant global entities' (SGEs, ie, MNCs with turnover in excess of AUD 1 billion) Australian tax payable reflects the economic substance of Australian activities; and
- preventing SGEs from reducing Australian tax by diverting profits offshore.<sup>123</sup>

The CoT has already commenced recovery proceedings against some MNCs contending for liability based on an alleged breach of the MAAL. In this regard Andrew White reports that:

Seven companies are preparing to face claims from the office totalling \$2 billion by June in a crackdown on multinational tax avoidance.<sup>124</sup>

That an allegation of liability is made does not mean that the courts will necessarily agree with the views of the CoT. However, it does indicate that the new law has the

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<sup>119</sup> Greg Wiebe, 'Interview with Pascal Saint-Amans' cited in KPMG, *What should governments tax—A question of morality or policy?*, <<http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/future-focus-tax-asia-pacific/Pages/oecd-report.aspx>>.

<sup>120</sup> *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*.

<sup>121</sup> *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017*.

<sup>122</sup> How the MAAL and DPT operate is beyond the scope of this article.

<sup>123</sup> Anthony Portas and Daniel Slater, 'DPT and MAAL – How and when they apply and managing disputes' (Paper presented to the Tax Institute, 2017 Queensland Tax Forum, Brisbane 24-25 August 2017).

<sup>124</sup> Andrew White, 'ATO circles firms in \$2bn avoidance hit', *The Australian* (10 June 2016) 23.

prospect of raising significant revenue. Whatever additional revenue is raised may, subject to the priorities of the government of the day, be deployed in the alleviation of poverty.

## 5. CONCLUSION

There are claims by a range of stakeholders, academics, multinational organisations and non-government organisations that large Australian and other multinational corporations that pay no or little tax because of taking abusive tax positions breach their human rights obligations as they deprive governments of the means to *inter alia* alleviate poverty. This article has examined the legal basis for these claims and concluded there is no basis for this contention.

Any tax obligation is dependent on legislation specifying objective criteria as to how the tax is to be computed and who is liable. Provided the tax paid by the MNC complies with the law it is irrelevant how much tax an MNC pays. If no successful challenge can be made it is legally valid. Just as the ATO may adjust a taxpayer's liability upwards if it finds too much tax has been paid it must refund any overpayment of tax.

MNCs cannot be held responsible for a breach of human rights based on their tax affairs. MNCs do not owe a duty of care to the entire world nor to all the inhabitants of the state or any unspecified part thereof to ensure that poverty in that state is alleviated. There is no relationship between the MNC and these persons. There is also no assumption of liability by the MNC that would found a claim in human rights based on a contention that it has an obligation to alleviate poverty.

If a claim for a breach of human rights were lodged it seems no individual claimant would be able to discharge the onus on that individual needed to be successful. If the state were the claimant, it would not need to make any allegations of human rights abuses in its claim against the MNC. It would presumably rely exclusively on the tax and possibly criminal laws to justify its claim.

The essential problem in the past appears to be in part the ineptness (and/or possibly an unwillingness) of governments to legislate tax laws that capture the income sought to be taxed and in part the inability of the regulator to properly enforce those laws that have been enacted. The Australian government has recently enacted legislation that is intended to resolve this difficulty in the form of the MAAL and DPT. Time will tell if these will have their desired effect.

Seeking to draw a link between human rights and tax would appear to be much ado about nothing.

# Confirming the fundamental principles of taxation using Interactive Qualitative Analysis

Hanneke du Preez<sup>1</sup> and Madeleine Stiglingh<sup>2</sup>

## ***Abstract***

Are the existing guiding principles of taxation scientifically grounded and sufficient to support the growing economic pressures on the global community? This article attempts to base the formulation of the principles of taxation on scientifically defensible research. Keeping the various nuances of taxation in mind, together with their possible roots, and their relevance in practice and in education and research, this article postulates the following question: what are the principles of taxation that are essential to taxation internationally, both in the present and as taxation evolves into the future? This research applies a qualitative research method called Interactive Qualitative Analysis in order to address the specific research question: what are the fundamental principles of taxation? Ten guiding principles were formulated through this qualitative research. The findings were then compared to the history of the principles of taxation that emerged between 1776 and 2015. Eight of these principles were confirmed by the history of the principles between 1776 and 2015 and the remaining two principles were supported by history before 1776.

**Key words:** Taxation, Interactive Qualitative Analysis, fundamental principles, history, focus group

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<sup>1</sup> Senior lecturer in the Department of Taxation, University of Pretoria, South Africa, hanneke.dupreez@up.ac.za.

<sup>2</sup> Professor in the Department of Taxation, University of Pretoria, South Africa, madeleine.stiglingh@up.ac.za. The authors are grateful to three anonymous reviewers for valuable comments. The usual disclaimer applies.

*One only knows a thing completely when we know its causes and first principles – only wisdom (sophia) can give this knowledge. This highest level of knowledge must tell what things are and why they are – they must demonstrate these things on the basis of their principles (Aristotle, cited in Mariás, 1967, p. 63).*

## 1. INTRODUCTION

The Interactive Qualitative Analysis (IQA) research method was developed by Northcutt and McCoy in 2004 (Northcutt & McCoy, 2004) as a qualitative research design. Research commences with a focus group from which the affinities emerge through deductive and inductive reasoning (for this article, the affinities are the principles of taxation). The focus group constructs the principles and each participant completes the Affinity Relationship Table (ART). Thereafter, the individual ARTs are combined and the Pareto principle is applied. The Pareto principle declares that 20% of a population will be responsible for 80% of the variations in a population. The application of the Pareto principle leads to the compilation of the Interrelationship Diagram (IRD) which provides the data needed to draw the Systems Influence Diagram (SID). The SID is the final outcome of IQA and, for this study, delivers a visual presentation of the principles of taxation and the relationship between these principles, as formulated by the focus group.

The research question for this article is: *what are the principles in taxation that are essential to taxation internationally, both in the present and as taxation evolves into the future?*

The article applies IQA as a research method to the field of taxation, as well as to compare the findings from the IQA process to identified historical taxation principles. Taxation experts from various countries were consulted through the use of IQA to construct a set of fundamental principles of taxation that is scientifically grounded.

A distinction must be made between the concepts of operational/tax administration matters, overarching tax principles, and fundamental tax principles. Operational/tax administration matters deal with everyday decisions such as whether an amount is taxable or not and whether or not a taxpayer is compliant. Overarching tax principles can be defined as ‘broad tax policy considerations that have traditionally guided the development of taxation systems’ (OECD, 2014). The working definition, formulated for this article, of a fundamental (tax) principle is: a general truth – constructed through a chain of reasoning – that forms the most important part of the foundation of a unique field of study, from which theories<sup>3</sup> and applied practices can be derived and verified in accordance with the current knowledge available to humanity.<sup>4</sup> This was the definition of a fundamental principle that was given to the focus group participants. A fundamental tax principle thus encompasses practical, as well as tax policy, considerations.

An extract was made from the history of the guiding principles of taxation. For the compilation of the extract, 19 individuals/reviews/committees were consulted. One could very well wonder why it is necessary to revisit these principles if so many in

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<sup>3</sup> ‘Theories’ can be described as ideas that form the basis of something (e.g., a field of study).

<sup>4</sup> Drawn from the Collins Dictionary, Merriam-Webster Encyclopaedia, Oxford Dictionaries and Stanford Encyclopaedia of Philosophy.



high-level roles across the generations have already contributed to the formulation of the principles of taxation. Alley and Bentley, however, emphasise the importance of revisiting the principles of taxation when they note that, although Adam Smith's maxims are seminal, 'in the light of modern business practices ... it is suggested that Smith's principles need modernising' (Alley & Bentley, 2005, p. 624).

Attempts to 'craft' or reform the principles of taxation are thus not a new idea, as there have been intensive debates over what the principles should be for at least the last 200 years. In light of this observation, Kabinga (2015, p. 6) remarks that the 'interesting point that can be underscored is that at all times there [has been] a discussion about the "correct" taxation principles and/or the "just" taxation system and that at no time [have] there [been] any unanimously agreed sets of principles'.

The contribution of this research can thus be found in its attempt to align and scientifically ground the fundamental principles of taxation through the use of IQA, synthesised with an analysis of taxation history. This article attempts to base the formulation of the principles of taxation on scientifically defensible research, keeping the various nuances of taxation in mind, together with the possible roots of such nuances and their relevance in practice, as well as in education and research.

This article is structured to commence with an extract from the history of the formulation of the fundamental principles of taxation (1776-2015). The discussion and application of IQA as a research method follows, and concludes with the formulation of the findings of the IQA. The findings from the IQA were then integrated with the history in order to confirm the relevance of the findings of the IQA.

Two principles formulated through the IQA method were not confirmed through the integration with taxation history between 1776 and 2015, although these principles were observed in history before 1776 (Adams, 2001). These two principles are: obligation (taxpayers have a duty to contribute towards the cost of a country), and value system (there should be a general belief in an ideal tax system).

The findings of the research ultimately yielded eight proposed fundamental principles of taxation and were confirmed with the integration of history between 1776 and 2015, namely: certainty, coherence, fairness, practicability, public benefit, raising revenue, tax compliance, and tax understanding.

## **2. HISTORICAL EXTRACT OF THE GUIDING PRINCIPLES OF TAXATION FROM 1776 TO 2015**

In 1776, Adam Smith provided four maxims for taxation that were grounded in his own experience and observation of the world around him. The four maxims of taxation formulated by Smith were (Smith, 1784, p. 888):

- The subject of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities. (Equity and fairness).
- The tax which each individual is bound to pay ought to be certain, and not arbitrary. (Certainty).
- Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. (Convenience of payment).

- Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. (Economy in collection).

Over the past 200 years, many contributors have added to, criticised, or reformulated the above principles of taxation. However, in various countries, there seems to be an array of different ideas about what the principles of taxation should actually be. The non-consensus of taxation principles in various countries is confirmed by Frecknall Hughes (2014). Evidence of this non-consensus can be found in the variety of different tax reviews and committees that have existed over the past 60 years, each formulating its own list of taxation principles.

An extract from the history of contributors who have participated in the quest to formulate the principles of taxation is provided in Table 1. A limitation of this summary may be that only one Third World country tax review (South Africa) is included in Table 1. The inclusion of reviews from several Third World countries would have provided a more in-depth understanding of the demands for taxation of Third World economies. This limitation is, however, due to the restricted availability of such Third World reviews as a result of language differences and access issues.

**Table 1: An Extract of the History of Formulating the Guiding Principles of Taxation**

Author/s	Principles	Title of publication
Adam Smith England, 1776	-Equity -Certainty -Convenience of payment -Economy in collection (fairness, government revenue, efficiency)	<i>An inquiry into the nature and causes of the wealth of nations</i>
Newmarch England, 1861	-Tax according to ability -Savings and contribution to capital not taxed -Taxpayer not his own assessor	<i>The Newmarch lectures of 1919</i>
Carter Report Canada, 1966	-Equity -Certainty -Simplicity -Neutrality -Transparency and accountability -Flexibility	<i>Report of the Royal commission on taxation: the use of the Tax system to achieve economic and social objectives</i>
Asprey Report Australia, 1975	-Fairness -Efficiency -Simplicity -Growth -Stabilisation	<i>Criteria for tax systems</i>
Meade Report UK, 1978	-Incentives and economic efficiency -Simplicity and cost of administration and compliance -Flexibility and stability -Distributional effect	<i>The structure and reform of direct taxation: characteristics of a good tax structure</i>

Author/s	Principles	Title of publication
	-International aspects -Transitional problems	
Her Majesty's Stationery Office (HMSO) Green Paper report UK, 1981	-Fairness -Cost of administration -Accountability -Fiscal dimensions -Financial control -Practicality	<i>Requirement of a local tax system</i>
O'Brien Report Ireland, 1982	-Equity -Efficiency -Simplicity -Low administration and compliance cost	<i>Criteria for a tax system</i>
Ridge and Smith: Institute of Fiscal Studies (IFS) Report UK, 1991	-Equity and accountability -Economic efficiency -Administrative feasibility	<i>Criteria for local tax</i>
Jackson: Chartered Institute of Public Finance and Accounting (CIPFA) UK, 1994	-Equity or fairness -Certainty -Convenience of payment -Economy in collection and compliance -Transparency	<i>Characteristics of an effective tax system</i>
James and Nobes UK, 1997	-Equity -Efficiency -Incentives -Macroeconomic considerations	<i>The economics of taxation: principles, policy and practice</i>
Organisation for Economic Co-operation and Development (OECD) Ottawa, 1998	-Certainty and simplicity -Effectiveness and fairness -Efficiency -Neutrality -Flexibility	<i>Taxation framework conditions (for electronic commerce)</i>
Institute of Chartered Accountants in England and Wales (ICAEW) Tax faculty UK, 1999	-Certainty -Fair and reasonable -Simplicity -Easy to collect and calculate -Properly targeted -Constant, consultation -Regular review -Statutory -Competitive	<i>Towards a better tax system</i>
American Institute of Certified Public Accountants (AICPA) USA, 2001	-Equity and fairness -Certainty -Convenience of payment -Economy in collection -Simplicity -Neutrality -Economic growth and efficiency -Transparency and visibility	<i>Guiding principles of good tax policy</i>

Author/s	Principles	Title of publication
	-Minimum tax gap -Appropriate government revenues	
Alley and Bentley Australia, 2005	-Equity and fairness -Certainty and simplicity -Efficiency -Effectiveness -Neutrality	<i>A remodelling of Adam Smith's tax design principles</i>
President's Advisory Panel on Federal Tax Reform USA, 2005	-Simplicity -Fairness -Economic growth	<i>Report of the President's Advisory Panel on Federal Tax Reform</i>
Henry Review Australia, 2010	-Equity -Efficiency -Simplicity -Sustainability -Policy consistency	<i>Australia's future tax system</i>
The President's Economic Recovery Advisory Board USA, 2010	-Simplicity -Compliance	<i>The President's Economic Recovery Advisory Board</i>
Mirrlees Review UK, 2011	-Equity -Certainty -Convenience of payment -Economy in collection -Minimize negative effect on welfare and economic efficiency -Minimize administration and compliance cost -Fairness in more than a distributional sense -Transparency	<i>Tax by design</i>
Davis Tax Committee South Africa, 2015	-Equity -Simplicity -Efficiency -Transparency and certainty -Tax buoyancy	<i>First interim report on macro analysis</i>
American Institute of Certified Public Accountants (AICPA) USA, 2017	<i>Two additional principles were included:</i> -Information security -Accountability to taxpayers	<i>Update of the 2001 document</i>

Compiled from multiple sources: AICPA (2001); AICPA (2017); Alley & Bentley (2005); Asprey Review (1975); Davis Tax Committee (2015); Evans et al. (2010); Meade (1978); Mirrlees et al. (2011); OECD (1998); President's Advisory Panel on Federal Tax Reform (2005); Smith (2000 [1776]); Stamp (1921); The President's Economic Recovery Advisory Board (2010).

When Smith (cited in Stamp, 1921; Kennedy, 1913; Sabine, 2006 [1966]) expounded on the economic point of departure for a good tax structure, he used the following terms: equity (ability), certainty (time, amount, manner of payment), convenience (time, manner), and economy (take as little as possible). The reiteration of Smith's terms (2000 [1776]) can still be found in the tax reviews of Meade (1978) and Mirrlees (2011). In the eighteenth century, Verri (cited in Seligman, 1921) declared that every tax should bring about equilibrium, since it should affect each person according to his or her consumption. In 1830, Paley sought to simplify the concept of what should be taxed by stating: 'We should tax what can be spared' (cited in Stamp, 1921). Thus Paley reiterated the argument made by Turgot in 1764 that tax should fall on disposable wealth, in other words, income that is not needed for production in the following year (Seligman, 1921). In 1861, Newmarch expanded on the principles of Adam Smith by adding that savings and capital contributions should not be taxed.<sup>5</sup> He further declared that a taxpayer cannot be his or her own assessor (cited in Stamp, 1921).

The Carter Report in Canada (1966) formulated additional principles by adding simplicity, neutrality, transparency, accountability, and flexibility to the existing principles of taxation at that time (Alley & Bentley, 2005).

The Asprey Review stated that alternative methods should be explored in assessing an individual for tax purposes, suggesting the two alternatives of economic wellbeing (lifetime income) and consumption (Asprey Review, 1975).

In the Meade Report, written in the late 1970s in England (Meade, 1978), Smith's concepts (2000 [1776]) were refined and reformulated to form an extended list which proclaimed that tax should be just, efficient, and effective, should redistribute wealth, and should be equitable, coherent, straightforward, flexible, stable, and compatible with the country's international position.

A continuation of the development of taxation principles can be found in the OECD Report of 1998, which identified conditions for a taxation framework. These conditions were:

- certainty and simplicity,
- effectiveness and fairness,
- efficiency,
- neutrality, and
- flexibility.

The guiding principles of good tax policy, according to the AICPA (2001), focused on economic growth, minimising the tax gap, and collecting appropriate government revenue (Alley & Bentley, 2005; AICPA, 2001). In 2017, AICPA updated the 2001 document and included two more principles, namely: Information security and Accountability to taxpayers (AICPA, 2017).

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<sup>5</sup> Newmarch included this principle based on his understanding that investments should not be taxed as one would need such funds for future growth.

In Australia, the Henry Review (discussed in Evans et al., 2010) was an extension of the Asprey Review. The importance of the stability of a tax system was confirmed by the Henry Review (Evans et al., 2010). The guiding principles identified previously by the Asprey Review (1975) and the Meade Review (1978) were thus extended to include sustainability, and policy consistency as tax policy objectives.

In the UK, the Meade Review was followed by the Mirrlees Review (Mirrlees et al., 2011). Mirrlees (2011, p. 21) states that ‘the challenge of a tax design is to achieve social and economic objectives while limiting welfare-reducing side-effects’. In other words, it is necessary to consider how taxes can be designed to maximise their objectives as well as to minimise their negative effect on welfare.

The Davis Tax Committee in South Africa (2015, p. 7) observes that ‘attitudes towards the tax system have varied markedly’, and that taxation can be seen as a ‘market distortion’ as well as a method that can be used for the correction of market failures. Adding to these extreme attitudes is the further observation made by the Davis Tax Committee that ‘there is no universally recognised theoretical framework or conclusive empirical literature on how to craft a [tax] system’ (2015, p. 4). This may indicate that the place of taxation is blurred in the process of its application.

Taxation has existed for thousands of years. Many attempts have been made to find common ground in designing a tax structure. The above overview of different guiding principles mentioned by those in various roles suggests the need for careful reflection in order to achieve a synthesis of the principles which should form the foundation for taxation as a field of study.

### **3. THE INTERACTIVE QUALITATIVE ANALYSIS (IQA)**

The qualitative method used for this research, namely the IQA, is discussed by commencing with a description of the focus group: including its participants, and the entire process of identifying and formulating the resulting principles of taxation. The data collected is then used to draw a Systems Influence Diagram (SID), which is the final outcome of the IQA.

#### **3.1 Focus group**

The IQA research method commences with a focus group. A focus group is a group interview with the fundamental purpose of listening to and learning from the group members. The goal is to improve the overall understanding of a construct, issue, or phenomenon. The researcher listens to participants and learns from them, but the group also generates new possible lines of communication and idea-construction between the researcher and the participants, and between the participants themselves (De Vos et al., 2005; Mangioni & McKerchar, 2013). Although each participant may have his or her own ideas, a completely new set of data may emerge when participants interact (Babbie & Mouton, 2004; Cohen et al., 2002).

Interaction is both an element and a function of a focus group because it encourages individuals to bring their personal points of view together (Leedy & Ormrod, 2015; Salkind, 2012). Other functions and possible outcomes of a focus group can be summarised as: generating insight, gathering information, and further refining how participants reach their decisions (Salkind, 2012).

From the researcher's point of view, the ability to understand the thinking processes used by the individuals to arrive at specific conclusions is important. The facilitator<sup>6</sup> of a focus group is actively involved in the focus group, mostly to facilitate the clarification and elaboration of comments made during the session. Therefore, the facilitator has to create a protective and encouraging environment in which participants feel sufficiently secure to voice an experience, opinion, or perception (De Vos, et al., 2005; Salkind, 2012).

A strong limitation in using a focus group is the possibility that there may be participants in the group who feel insecure about voicing their opinions on the research problem (Welman et al., 2005). This feeling can arise if individuals are biased about either the research problem or other members of the group. If the facilitator is unskilled, it could result in one or more participants' taking part more actively than others, or even dominating the activity, while the remaining group members become passive or simply accepting of the view(s) expressed by the dominant participants. The outcome may thus be that the voices of some participants remain unheard, or that their opinions are suppressed. Some group members might also refrain from participating because they accede to what they consider to be polite social behaviour (Berg, 2007; De Vos et al., 2005). However, research methods such as IQA, which make use of focus group techniques, build in procedures which allow the voice of each member of the group to be heard without the possibility that the researcher, facilitator, or other participants can influence the views of each participant (Du Preez & Du Preez, 2012; Northcutt & McCoy, 2004).

The IQA focus group for this article was held at the Tax Research Network (TRN) conference in Roehampton, London in 2014. The researchers selected the participants for the focus group by means of the non-probability convenience-type sampling technique (Cooper & Schindler, 2003). The researchers' judgment was used to select the participants on the basis of their perceived ability to answer the research question and meet the objectives of the focus group activity, as recommended by Saunders, Lewis and Thornhill (2016). The specific sampling technique used was a convenience sampling technique, also known as the availability sampling technique. The selection took into account the country of origin of each possible attendee, as well as his/her contribution to the field of taxation. In total, 54 people registered for the TRN 2014 conference, including the doctoral colloquium. Of the 54 attendees, 38 were invited to participate in the proposed focus group. Of the invitees, 11 confirmed their attendance, but only nine actually participated in the focus group, resulting in a 24% positive reaction to the original invitation. A focus group should consist of between 8 and 12 participants (Babbie & Mouton, 2004; De Vos et al., 2005; Mangioni & McKerchar, 2013; Welman et al., 2005): therefore, the number of participants was adequate.

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<sup>6</sup> The facilitator can be the researcher or an independent person acting as the facilitator.

The nine participants of the focus group originated from eight different countries, including three First World countries,<sup>7</sup> one Second World country,<sup>8</sup> and four Third World countries,<sup>9</sup> thus giving the focus group a truly international flavour and providing a multi-level frame of reference in terms of policies and systems of taxation. A summary of the country of origin, gender, background, and field of interest of each of the nine participants is provided in Table 2.

**Table 2: Summary of Focus Group Participants**

Country	Gender	Background								Interest
		Economics	Law	Accountancy	Philosophy	Auditing	Marketing	Public Admin	Tax Admin	
Ghana	Male			X			X			Compliance, tax administration
Bangladesh	Female		X					X		Public policy
Jamaica	Female			X					X	Property tax, morale, fiscal studies
Ireland	Male			X						Morale, compliance behaviour
Australia	Male	X								Tax, fiscal federalism
Australia	Male	X	X	X						Comparative tax, capital gains tax
South Africa	Male			X		X				Tax burden, individuals
Wales	Male			X						Role of power in tax policy
Poland	Female		X		X					Tax law, tax avoidance and procedures

<sup>7</sup> 'First World' refers to developed, capitalist, industrial countries; roughly, a bloc of countries aligned with the US after World War II, with more or less common political and economic interests. See One World, Nations Online Project, 'First, Second and Third World', [http://www.nationsonline.org/oneworld/third\\_world\\_countries.htm](http://www.nationsonline.org/oneworld/third_world_countries.htm). In this study, the countries or subnational jurisdictions represented are Ireland, Wales and Australia.

<sup>8</sup> 'Second World' refers to the former communist-socialist countries, which are industrial states today (formerly the Eastern bloc: the territory and sphere of influence of the Union of Soviet Socialist Republic): *ibid.* In this study, the country represented is Poland.

<sup>9</sup> 'Third World' refers to all other countries and is often used today to roughly describe the developing countries of Africa, Asia and Latin America: *ibid.* In this study, the countries represented are South Africa, Jamaica, Bangladesh and Ghana.



Table 2 shows that the theoretical and experiential backgrounds of the participants included economics, law, accountancy, philosophy, auditing, marketing, public administration, and tax administration. Five of the participants were tax academics, three were tax advisors/practitioners and one was involved with policy-making. The participants' fields of interest (Table 2) spanned tax compliance and avoidance, tax administration and procedure, public policy, tax morale and behaviour, fiscal federalism, comparative taxes, capital gains taxes and property taxes, tax burden, and tax law. As taxation can be seen as intertwined with several disciplines, the interdisciplinary nature of the selected participants was vital for the reliability of the results.

### 3.1.1 Focus group activity

The independent facilitator began the focus group activity with some warm-up exercises, consisting of relaxation exercises, which then gave the participants time for quiet reflection. During this period of quiet reflection, the independent facilitator posed the research question: 'what are the fundamental principles of taxation?' Moving on to the next stage of the focus group activity, the participants were requested to write their thoughts down on flashcards. Each card reflected only one thought, expressed in words, phrases, or pictures; for example: 'confidentiality', or 'property redistribution'. The flashcards were then attached to a whiteboard. This stage took place in complete silence.

The next stage also took place in silence as the participants were asked to sort the cards into sets defined by notions that they perceived to be related or similar (*deductive coding*). The participants could use any criteria for sorting as long as they ultimately reached the agreement that the sets represented the group's thoughts on the fundamental principles of taxation.

After the sorting, the independent facilitator began a process of clarifying the sets with the participants. The independent facilitator requested clarification on each of the sets that the participants had constructed (*axial coding*). Finally, each set was given a name by the group members themselves (*inductive coding*) (Northcutt & McCoy, 2004); for example: 'public benefit', or 'compliance'. This step concluded the focus group activity.

The data were thus generated through inductive reasoning (the process of naming) and deductive reasoning (the process of reorganising), which are described together by John Dewey as the 'double movement of reflective thought' (Cooper & Schindler, 2003; Du Preez & Du Preez, 2012; Northcutt & McCoy, 2004). In the IQA focus group activity, the data collection and analysis become part of the same process, where members participate fully in drawing out themes and creating theories associated with the phenomenon that is being researched.

### 3.1.2 Formulating the principles

After the focus group activity, the researchers listened to the recording of the focus group activity several times. They also consulted the recording whenever clarification was needed. The researchers used the flashcards to construct a definition for each of the sets (principles of taxation) identified.

The researchers then compiled a document reflecting the gleaned principles of taxation in alphabetical order, as well as the participants' description of each principle as

constructed during the focus group activity and formulated by the researchers. The principle descriptions which follow were accepted as having emerged specifically from the focus group activity in response to the question: ‘what are the fundamental principles of taxation?’ The principle descriptions are listed alphabetically; the order of listing does not reflect their relative importance.

*Certainty (Principle 1): The tax system must be non-arbitrary.*<sup>10</sup>

With this proposed fundamental principle, the focus group described the importance of legal certainty, as well as administrative discretion in the tax system. Although discretion is an important aspect of taxation, tax administrators should be consistent.

*Coherence (Principle 2): A set of guiding principles and rules should be used as a yardstick to move from chaos to order in the tax environment.*

With this proposed fundamental principle, the focus group emphasised the importance of tax administration in developing procedures in order to apply the guiding principles and rules set out in tax legislation. Procedures in the tax system and in the courtroom should support existing policies in creating an efficient administrative system. The neutrality of the tax system should be protected by legislation.

*Fairness (Principle 3): Taxpayers with equal ability will contribute equally.*

The focus group described this proposed fundamental principle as the vital importance of tax ethics. The tax system should ensure the accountability and participation of all to create justice. The necessary procedures should be in place to promote adequate confidentiality, while adhering to appropriate transparency. The principle of redistribution of property should be observed to create equity.

*Obligation (Principle 4): Taxpayers have a duty to contribute towards the cost of a country.*

With this proposed fundamental principle the focus group indicated that paying taxes is a ‘social and civic responsibility’ of citizens in a civilised society. In theory, tax contribution should be voluntary, but in practice it is compulsory.

*Practicability (Principle 5): There must be a feasible time to pay taxes.*

With this proposed fundamental principle, the focus group indicated that when a tax payment is made, the payment must take place at the right moment: when it is most convenient to the taxpayer. The legislature should understand the business environment. The tax law must be structured to create a feasible situation where the tax law is neither too complex, nor oversimplified.

*Public benefit (Principle 6): A government should use its taxes to provide benefits and services to the public for development and the common good.*

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<sup>10</sup> Tax: the shortened version of ‘taxation’ was used by the focus group participants and the two forms are therefore used interchangeably in this discussion.

The focus group strongly associated the payment of taxes with public services. Income redistribution should be beneficial to people's lives, as well as to society in general.

*Raising revenue (Principle 7): Government finances are dependent on sustainable revenue.*

With this proposed fundamental principle, the focus group indicated that a government's finances are dependent on sustainable revenue collected from its country's citizens. Two key concepts are: the basic threshold, where the government must protect low income earners; and the tax rate, to ensure that enough revenue is collected, while the taxpayer has a sustainable portion of income left.

*Tax compliance (Principle 8): A tax-paying culture is needed where there is a 'willingness to voluntarily' pay taxes.*

With this proposed fundamental principle, the focus group emphasised the importance of the tax moral(s) in a country, where trust should exist between taxpayers and the government. The government should support the taxpayers' perception that the taxpayers are heard. Compliance relates to tax incentives: when tax morals are negative, government will need stringent tax enforcement to discourage taxpayers from avoiding and/or evading tax.

*Tax understanding (Principle 9): There is a need for a tax education system.*

With this proposed fundamental principle, the focus group suggested that the essence of an understandable tax system lies in tax education. The question as to whether or not taxpayers are aware of the various taxes they may be liable to pay then arises.

*Value system (Principle 10): There should be a general belief in an ideal tax system.*

The focus group associated this proposed fundamental principle with an understanding that the social construction of truth underpins an ideal tax system. When conflicting interests exist, discussion is needed to reach a final consensus. Undisputed tax moral(s) should be the foundation of a tax system.

### 3.1.3 Completing the Affinity Relationship Table

Each participant in the focus group received the compiled document containing the formulated principles via e-mail. The participants were then requested to indicate whether they perceived any relationship between two principles and, if so, to indicate the direction of the relationship (in other words: does one principle influence the other principle? Does one principle have power over another? Should one principle be placed first and should it then be followed by another principle? Is one principle more important than another?) The IQA research method calls this a simple Affinities Relationship Table invitation (see Appendix) completed by each participant (Northcutt & McCoy, 2004). In other words, the participants were given pairs of affinities and then every participant as individual decided which principle of every two was the most influential.

To complete a more detailed Affinities Relationship Table (individual theoretical coding), the participants were asked to include a brief explanation of the identified relationship, using their own experiences and perceptions: these are called 'if/then' statements (for example: if a tax system has good internal organisation and contains a

well-ordained set of rules and procedures, then it is predictable for taxpayers, thereby offering them legal certainty). The completed detailed Affinities Relationship Table documents were returned to the researchers, who used the information to construct a summarised Affinities Relationship Table for the focus group as a whole (Northcutt & McCoy, 2004). The summarised Affinities Relationship Table was constructed to reflect the focus group's mutual perceptions of the phenomenon of the fundamental principles of taxation.

### 3.2 Drawing a Systems Influence Diagram

The main purpose of the IQA research method is to ultimately draw a picture of the system (called a Systems Influence Diagram) which represents a mind map of the focus group's views in terms of a specific phenomenon (Northcutt & McCoy, 2004): in this case, the fundamental principles of taxation. The final Systems Influence Diagram for the current research can be found later in this section in Diagram 4. Diagram 4 is not inserted here as this may hinder the flow of thought.

The data contained in the summarised Affinities Relationship Table is used when applying the Pareto principle.<sup>11</sup> Northcutt and McCoy (2004) suggest that using the Pareto principle yields an acceptable group composite for the focus group. The Pareto principle is frequently used by management and systems theorists, who refer to it as the 'trivial many and the significant few principle', with specific reference to the idea that 20% of the variables in a system account for 80% of the total variation in the outcomes of that system (Northcutt & McCoy, 2004). Essentially, this means that a minority of relationships in any system account for the majority of disparities in that system. It is accepted that in any group there will be some disagreement on possible relationships. The Pareto principle is thus a rigorous and commanding technique used to attain and document the degree of consensus in a focus group.

A Pareto principle analysis was performed (see Table 3) on the summarised data. The MinMax Criterion of the Pareto principle analysis provides criteria for deciding which relationships should be included in an Interrelationship Diagram. The cut-off relationship is identified at the point where the maximum variation in the system (the cumulative percentage based on frequency) coincides with the minimum number of relationships (cumulative percentage based on relation).

Table 3 only represents the first 50 relationships out of the total of 90 relationships identified in the research, as the remainder of the relationships were below the cut-off point indicated by the power score (see the last column in Table 3). The power score reaches its maximum of 31.0 at relationship number 41. Relationship number 41 (shaded dark grey) is therefore the cut-off point. This means that the first 41 of the total of 90 relationships in the current system represent 76.5% of the variance in the system.

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<sup>11</sup> The Pareto principle is named after the nineteenth-century economist, Wilfredo Pareto (1843-1913). It states that 'something like 20% of the variables in a system will account for 80% of the total variation in outcomes' (Northcutt & McCoy, 2004, p. 156).

**Table 3: Pareto Principle Analysis**

No.	Affinity pair relationship	Frequency (descending)	Cumulative frequency	Cumulative percentage (relation)	Cumulative percentage (frequency)	Power score
1	1 → 8	8	8	1.1	3.3	2.2
2	2 → 8	8	16	2.2	6.6	4.4
3	3 → 8	8	24	3.3	9.9	6.6
4	5 → 8	8	32	4.4	13.2	8.8
5	2 → 9	7	39	5.6	16.0	10.4
6	8 ← 9	7	46	6.7	18.9	12.2
7	4 → 8	6	52	7.8	21.4	13.6
8	7 ← 8	6	58	8.9	23.9	15.0
9	8 ← 10	6	64	10.0	26.3	16.3
10	1 → 9	5	69	11.1	28.4	17.3
11	3 → 4	5	74	12.2	30.5	18.3
12	3 → 10	5	79	13.3	32.5	19.2
13	4 → 6	5	84	14.4	34.6	20.2
14	4 → 7	5	89	15.6	36.6	21.0
15	5 → 7	5	94	16.7	38.7	22.0
16	6 → 8	5	99	17.8	40.7	22.9
17	7 ← 10	5	104	18.9	42.8	23.9
18	1 → 3	4	108	20.0	44.4	24.4
19	1 → 4	4	112	21.1	46.1	25.0
20	1 → 7	4	116	22.2	47.7	25.5
21	2 → 7	4	120	23.3	49.4	26.1
22	2 → 10	4	124	24.4	51.0	26.6
23	3 → 7	4	128	25.6	52.7	27.1
24	4 ← 9	4	132	26.7	54.3	27.6
25	6 → 7	4	136	27.8	56.0	28.2
26	6 ← 7 (?)	4	140	28.9	57.6	28.7
27	7 ← 9	4	144	30.0	59.3	29.3
28	1 → 2	3	147	31.1	60.5	29.4
29	1 ← 2 (?)	3	150	32.2	61.7	29.5
30	1 ← 3 (?)	3	153	33.3	63.0	29.7
31	1 → 5	3	156	34.4	64.2	29.8
32	1 → 6	3	159	35.6	65.4	29.8
33	1 → 10	3	162	36.7	66.7	30.0
34	2 → 3	3	165	37.8	67.9	30.1
35	2 ← 3 (?)	3	168	38.9	69.1	30.2
36	2 → 6	3	171	40.0	70.4	30.4
37	3 ← 6	3	174	41.1	71.6	30.5
38	4 ← 5	3	177	42.2	72.8	30.6
39	6 ← 9	3	180	43.3	74.1	30.8
40	6 ← 10	3	183	44.4	75.3	30.9

No.	Affinity pair relationship	Frequency (descending)	Cumulative frequency	Cumulative percentage (relation)	Cumulative percentage (frequency)	Power score
41	9 → 10	3	186	45.5	76.5	31.0
42	2 → 4	2	188	46.7	77.4	30.7
43	3 ← 5	2	190	47.8	78.2	30.4
44	3 → 6	2	192	48.9	79.0	30.1
45	3 ← 7	2	194	50.0	79.8	29.8
46	3 → 9	2	196	51.1	80.7	29.6
47	3 ← 9	2	198	52.2	81.5	29.3
48	3 ← 10	2	200	53.3	82.3	29.0
49	4 ← 6	2	202	54.4	83.1	28.7
50	4 → 9	2	204	55.6	84.0	28.4

Affinities: 1-Certainty, 2-Coherence, 3-Fairness, 4-Obligation, 5-Practicability, 6-Public benefit, 7-Raising revenue, 8-Tax compliance, 9-Tax understanding, 10-Value system

Since relationship number 41 was the cut-off point, relationships numbers 1 to 41 were used to complete an unsorted Interrelationship Diagram (see Diagram 1). The Interrelationship Diagram is a matrix containing the affinity pairs or relationships in the system. For every relationship in this system, two arrows were drawn. The first relationship is 1→8, which means that Affinity 1 has power over Affinity 8. In the unsorted Interrelationship Diagram (Diagram 1), the affinities are indicated from 1 to 10 on both the horizontal and vertical axes. To indicate the first relationship, one needs to start at Affinity 1 on the vertical axis, moving in the row (on the horizontal axis) to the column of Affinity 8. In accordance with the Pareto principle analysis (see Table 3), the arrow must point upwards, indicating that Affinity 1 influences Affinity 8. For the second arrow, the point of departure is Affinity 1 on the horizontal axis, moving downwards in Column 1 to the row of Affinity 8 on the vertical axis. In line with the same result in the Pareto principle analysis (Table 3), the first arrow must now point to the left, confirming that Affinity 8 is influenced by Affinity 1.

This process was completed for every one of the 41 relationships. Once the process was completed, all the arrows pointing upwards in a specific row were counted and recorded in the column entitled 'Out'. All the arrows pointing to the left in a specific row were counted and recorded in the column titled 'In'. Then the delta ( $\Delta$ ) was calculated for each row by subtracting the number under 'In' from the number under 'Out'.

**Diagram 1: Unsorted Interrelationship Diagram**

	1	2	3	4	5	6	7	8	9	10	Out	In	$\Delta$
1		↑	↑	↑	↑	↑	↑	↑	↑	↑	9	0	9
2	←		↑			↑	↑	↑	↑	↑	6	1	5
3	←	←		↑		←	↑	↑		↑	4	3	1
4	←		←		←	↑	↑	↑	←		3	4	-1
5	←			↑			↑	↑			3	1	2
6	←	←	↑	←			↑	↑	←	←	3	5	-2
7	←	←	←	←	←	←		←	←	←	0	9	-9
8	←	←	←	←	←	←	↑		←	←	1	8	-7
9	←	←		↑		↑	↑	↑		↑	5	2	3
10	←	←	←			↑	↑	↑	←		3	4	-1

Affinities: 1-Certainty, 2-Coherence, 3-Fairness, 4-Obligation, 5-Practicability, 6-Public benefit, 7-Raising revenue, 8-Tax compliance, 9-Tax understanding, 10-Value system

The Interrelationship Diagram in Diagram 1 was then sorted according to the delta ( $\Delta$ ), from the highest to the lowest number. Diagram 2 shows the sorted Interrelationship Diagram.

**Diagram 2: Sorted Interrelationship Diagram**

	1	2	3	4	5	6	7	8	9	10	Out	In	$\Delta$
1		↑	↑	↑	↑	↑	↑	↑	↑	↑	9	0	9
2	←		↑			↑	↑	↑	↑	↑	6	1	5
9	←	←		↑		↑	↑	↑		↑	5	2	3
5	←			↑			↑	↑			3	1	2
3	←	←		↑		←	↑	↑		↑	4	3	1
4	←		←		←	↑	↑	↑	←		3	4	-1
10	←	←	←			↑	↑	↑	←		3	4	-1
6	←	←	↑	←			↑	↑	←	←	3	5	-2
8	←	←	←	←	←	←	↑		←	←	1	8	-7
7	←	←	←	←	←	←		←	←	←	0	9	-9

Affinities: 1-Certainty, 2-Coherence, 3-Fairness, 4-Obligation, 5-Practicability, 6-Public benefit, 7-Raising revenue, 8-Tax compliance, 9-Tax understanding, 10-Value system

In the Pareto principle analysis, four ambiguous relationships were identified: relationships 1 and 3, 6 and 7, 1 and 2, and 2 and 3 (shaded pale grey in Table 3). Ambiguous relationships refer to the situation in which the power between two affinities is strong in both directions, and both directions were included in the selection of relationships above the cut-off point (for example: Affinity 1 influences Affinity 2 and Affinity 2 influences Affinity 1). These relationships with power in both directions were included in the 41 relationships identified through the Pareto principle analysis (Table

3). In the unsorted Interrelationship Diagram (see Diagram 1), only one direction of power between two affinities could be included. As both relationships (e.g., 1→2 and 2→1) were selected by the Pareto principle analysis, the ambiguity had to be resolved. According to Northcutt and McCoy (2004), there are two possible resolutions for ambiguity. The first possibility is that there is an ‘undetected common influence’ that may be identified in the course of drawing the Systems Interrelationship Diagram; and the second possibility is an ‘undetected feedback loop’. These ambiguities may also be resolved during the creation of the Systems Influence Diagram (Northcutt & McCoy, 2004, p. 162). As a relationship in both directions cannot be included in the Interrelationship Diagram, the first occurrence (or the highest frequency) of the relationship must be chosen (see Diagram 1). If the ambiguous relationship is not resolved by this method, then an alternative resolution has been advised by Northcutt (2015) (see Box 1).

The sorted Interrelationship Diagram (see Diagram 2) yielded drivers<sup>12</sup> and outcomes<sup>13</sup> in the system. Drivers are identified as positive deltas ( $\Delta$ ), while negative deltas are outcomes. Drivers and outcomes can be classified as either primary or secondary. When a driver has no ‘In’ count (Diagram 2), it is classified as a primary driver. The same scenario can be applied to outcomes with no ‘Out’ count: they are classified as primary outcomes. A driver or outcome with ‘In’ or ‘Out’ counts, respectively, is classified as secondary. Tentative Systems Influence Diagram assignments (see Table 4) represent the identification of drivers and outcomes. The tentative Systems Influence Diagram assignments were used to create the Cluttered Systems Influence Diagram (see Diagram 3).

**Table 4: Tentative Systems Influence Diagram Assignments**

Affinity number	SID assignments
1	Primary driver
2	Secondary driver
9	Secondary driver
5	Secondary driver
3	Secondary driver
4	Secondary outcome
10	Secondary outcome
6	Secondary outcome
8	Secondary outcome
7	Primary outcome

Affinities: 1-Certainty, 2-Coherence, 3-Fairness, 4-Obligation, 5-Practicability, 6-Public benefit, 7-Raising revenue, 8-Tax compliance, 9-Tax understanding, 10-Value system

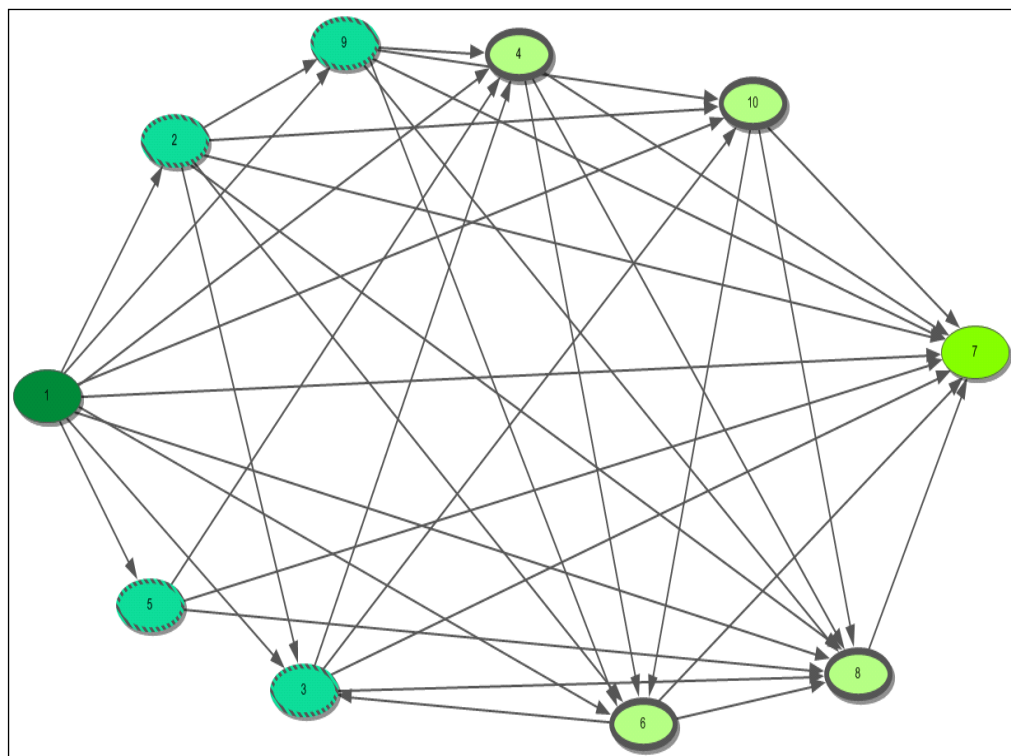
<sup>12</sup> Primary drivers are elements that can be seen as the fundamental causes/sources of influence on affinities in a system. Secondary drivers are elements that are influenced by the primary drivers and are referred to as relative causes.

<sup>13</sup> Primary outcomes are significant effects caused by many of the affinities. Secondary outcomes reveal only relative effects.



In a Cluttered Systems Influence Diagram, the primary drivers are plotted on the far left of the diagram, and the secondary drivers are placed to the right of the primary drivers. The primary outcomes are plotted on the far right of the diagram, with the secondary outcomes to the left of the primary outcomes. The sorted Interrelationship Diagram (see Diagram 2) was used to draw the Systems Influence Diagram. All the arrows in the Interrelationship Diagram were also indicated on the Systems Influence Diagram as arrows. The direction of said arrows was the same as the direction in the sorted Interrelationship Diagram. Thus, if the sorted Interrelationship Diagram indicated that  $1 \rightarrow 8$  (1 influences 8), then the base of the arrow on the Systems Influence Diagram would be placed at 1, with its tip ending at 8. This procedure was followed for every relationship indicated in the sorted Interrelationship Diagram. The product was a Cluttered Systems Influence Diagram (see Diagram 3).

**Diagram 3: Cluttered Systems Influence Diagram**

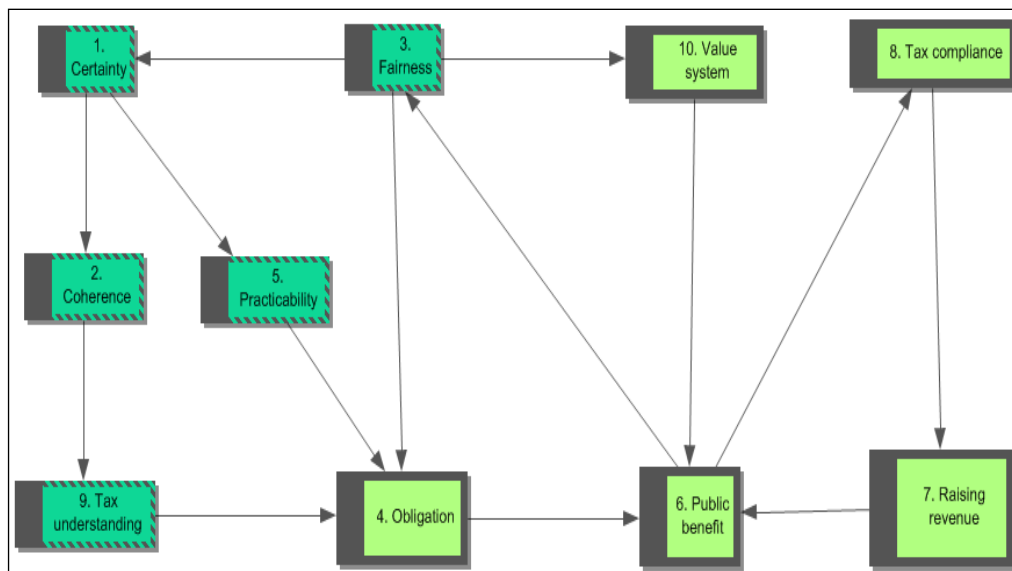


Affinities: 1-Certainty, 2-Coherence, 3-Fairness, 4-Obligation, 5-Practicability, 6-Public benefit, 7-Raising revenue, 8-Tax compliance, 9-Tax understanding, 10-Value system

For each relationship between two affinities, only one pathway should exist. The process of uncluttering therefore then had to be followed. The researchers commenced on the left side of Diagram 3. For every direct relationship marked (for example:  $1 \rightarrow 8$ ), the researchers looked for an alternative pathway (such as:  $1 \rightarrow 5 \rightarrow 8$ ). When the alternative pathway was found, the direct pathway was deleted. This was a very important process, as redundant pathways needed to be eliminated from the Systems Influence Diagram. The result was a Systems Influence Diagram that adhered to the

principle of the ‘trivial many and the significant few’, called an Uncluttered Systems Influence Diagram (see Diagram 4).

**Diagram 4: Uncluttered Systems Influence Diagram**



According to Northcutt and McCoy (2004), ambiguous relationships should be resolved through the Systems Influence Diagram. However, in the current Systems Influence Diagram, the ambiguous relationships were not resolved.

Using the new suggestions provided by Northcutt (Box 1), the Uncluttered Systems Influence Diagram (see Diagram 4) was revisited to reconcile the conflicts. The second occurrence, or lowest frequency, of each ambiguous relationship (see Table 3) was included in the Uncluttered Systems Influence Diagram. The Systems Influence Diagram was examined, focusing on the ambiguous relationships that created bi-directional (‘double-headed’) arrows. After the process of uncluttering, each bi-directional arrow was resolved by identifying a different pathway for that relationship. By means of the new systematic approach, all the conflicts could be resolved.

#### **Box 1: Reconciling Conflicts in the Systems Influence Diagram**

##### **Reconciliation process to consolidate the Systems Influence Diagram and the ambiguous relationships**

- Step 1: Remove all the redundant links from the Cluttered SID. For each ambiguous relationship, insert the second relationship into the Uncluttered SID still in the delta circular formation.
- Step 2: Examine the system, noting conflicts that create a ‘double-headed arrow’ situation.
- Step 3: Starting from bottom right (primary outcome) to top left (primary driver), remove any double-headed arrow (conflicting relationship) if there is another path. Do not remove any of the original relationships that are part of the double-headed arrow pair. If there is no alternate path for the conflicting double-headed arrow, let it remain to be addressed later.

Step 4: Perform the backward-arrow removal process as you would in any Uncluttered SID. However, do not remove any of the original relationships.

Source: Northcutt (2015)

The final Uncluttered Systems Influence Diagram (Diagram 4) represents a mind map of the focus group's activity with regard to the fundamental principles of taxation.

### 3.3 Strengths and limitations of IQA as a research method

One of the strengths of IQA is the fact that the participants of the focus group activity generate their own themes and then continue to code the data themselves (Bargate, 2014; Human-Vogel & Van Petegem, 2008; Northcutt & McCoy, 2004). The researchers are not involved in the process of data generation or data coding and therefore cannot influence the process or outcomes. A potential limitation of qualitative research in general is possible research bias by the researcher towards the data and its generation (Lasserre-Cortez, 2006). The IQA process, however, addresses the risk of researcher bias (Northcutt & McCoy, 2004). The original voices of the focus group participants are therefore preserved. In the current study, bias was further addressed by using an independent facilitator to conduct the focus group activity.

During the IQA process, themes are identified and coded, and the relationships between the themes are then explored. One strength of the IQA process is that every relationship is explored and no relationship is neglected, which ensures that the various relationships are thoroughly examined, leading to a systematic illustration in the resulting Systems Influence Diagram (Human-Vogel & Van Petegem, 2008). A further strength is the fact that an audit trail exists for the entire process followed during the research (Northcutt & McCoy, 2004).

A potential limitation of the approach is the fact that the IQA process does not allow for individual voices to be distinguished after the focus group activity (Human-Vogel & Van Petegem, 2008) as the outcome of the focus group activity produces a combined voice. For this article, this limitation is not a problem as the purpose of this research was to obtain the combined voice of the focus group participants. Although each participant did complete the individual Affinity Relationship Table, the documents were combined in the Pareto principle analysis to obtain a combined Systems Influence Diagram.

A final possible limitation is the time required to complete the entire IQA process (Bargate, 2014). The time required of the focus group participants was two hours to attend the focus group activity, 30 minutes to complete the document with the descriptions of the principles, and 45 minutes to one hour for the final document containing the individual Affinity Relationship Table. Thus, the time required from the participants for the entire research process was between three and four hours. This limitation was communicated to the participants at the start of the process: the letter of invitation specified the time that would be required, and the independent facilitator described the different stages of the process and the time required for each stage.

### 3.4 Analysis of the Systems Influence Diagram

In a standard Systems Influence Diagram, the system is dominated by one or more primary drivers and there are one or more primary outcomes (Northcutt & McCoy, 2004). However, for the fundamental principles of taxation, the system does not deliver

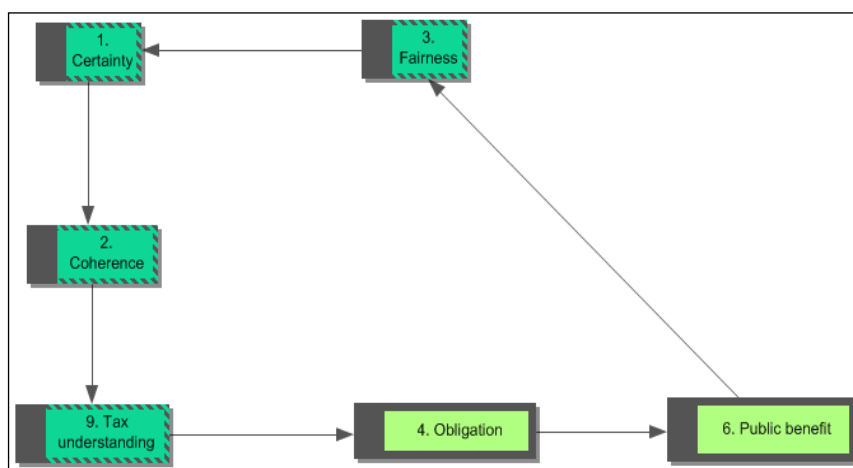
a primary driver or primary outcome. This result confirms the idea that the fundamental principles of taxation are not driven by a single force but that they are all part of a system and that they all influence one another. The same can be deduced from the fact that there is no single primary outcome in the system, which indicates that the principles of taxation do not conclude in a single principle.

The Systems Influence Diagram (Diagram 4) ultimately presented five feedback loops, confirming the interconnected nature of the fundamental principles of taxation. A feedback loop is the circular motion of principles within the system, where there is no beginning or end. The number of feedback loops in the current system is indicative of the multiple influences of the fundamental principles of taxation on one another. The continual influences between the principles at the various stages of the Systems Influence Diagram support the assertion that the fundamental principles of taxation should not be evaluated in isolation, as each principle is influenced by the other principles.

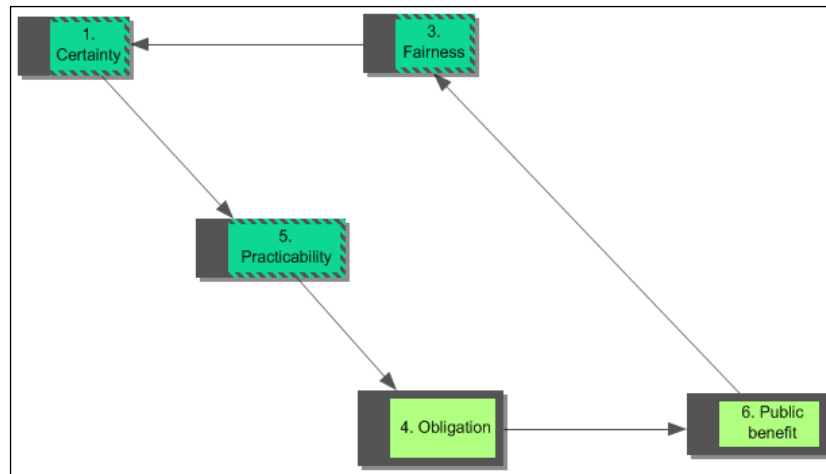
A further noteworthy finding is that *public benefit*, a secondary outcome, is part of all five feedback loops, suggesting that the focus group participants regarded it to be an essential consideration in taxation. It is therefore already possible to assume that the participants ascribed a conditional status to *public benefit* in relation to the other principles, and that they saw taxation as standing or falling on the basis of the public benefit principle.

Feedback Loop 1 (see Diagram 5) can be described as follows: ‘educated taxpayers will understand their duties and benefits in a fair and certain (unambiguous) set of guidelines’.

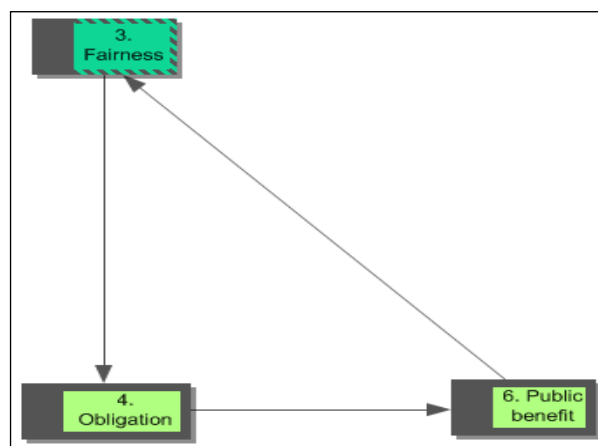
**Diagram 5: Feedback Loop 1**



Feedback Loop 2 (see Diagram 6) can be described as follows: ‘convenience of payment contributes to a sense of fairness’.

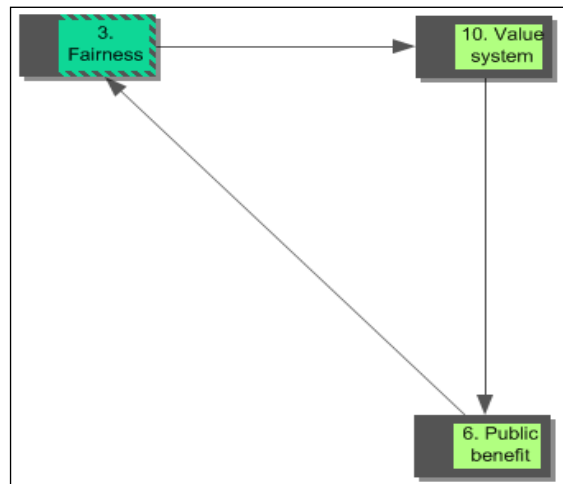
**Diagram 6: Feedback Loop 2**

Feedback Loop 3 (See Diagram 7) can be described as follows: ‘tax ethics motivates contribution to public benefits’.

**Diagram 7: Feedback Loop 3**

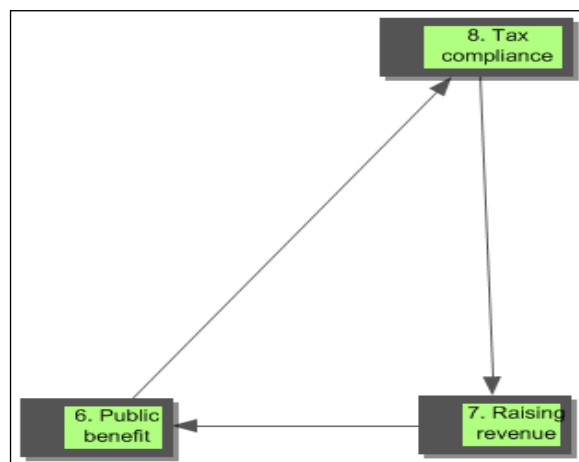
Feedback Loop 4 (see Diagram 8) can be described as follows: ‘an ideal tax system provides fair public benefits’.

**Diagram 8: Feedback Loop 4**



Feedback Loop 5 (see Diagram 9) can be described as follows: ‘public benefits are sustained through a tax-paying culture’.

**Diagram 9: Feedback Loop 5**



#### 4. INTEGRATING THE PRINCIPLES FROM THE IQA WITH THE HISTORICAL EXTRACT

For the integration of the affinities formulated by the focus group with taxation history, the titles of the affinities were used to ensure consistency and to enhance the credibility of the research. For future reiterations of the fundamental principles of taxation, the reformulation of the headings may be necessary.

With the principles that emerged through the integration of taxation history (1776 – 2015) with the IQA, the following observation can be made: of the ten principles identified through the IQA, two were not confirmed through the integration with history (1776 – 2015). These two principles are *obligation* (taxpayers have a duty to contribute

towards the cost of a country); and *value system* (there should be a general belief in an ideal tax system).

The remaining eight IQA principles were confirmed through the integration with the principles from taxation history as summarised in Table 1 in section 2 above. The principles that emerge from history are indicated in brackets and italics in the explanations which follow.

#### **4.1 Certainty: the tax system must be non-arbitrary**

The importance of legal certainty and administrative discretion in the tax system (*certainty*) is confirmed. Although discretion is an important aspect of taxation, tax administrators should be consistent (*constant*).

#### **4.2 Coherence: a set of guiding principles and rules should be used as a yardstick to move from chaos to order in the tax environment**

The importance of a tax administration developing procedures in order to apply the guiding principles and rules set out in tax legislation is confirmed (*stability*). Procedures in the tax system and in the courtroom should support existing policies in creating an efficient administrative system (*efficiency, practicality*). The neutrality of the tax system should be protected by legislation (*neutrality*).

#### **4.3 Fairness: taxpayers with equal ability will contribute equally**

Tax ethics is vitally important. The system should ensure the accountability and participation of all to create justice (*accountability*). The necessary procedures should be in place to promote adequate confidentiality while adhering to appropriate transparency (*transparency and visibility*). The principle of redistribution of property should be observed to create equity (*equity, fairness, reasonable, tax according to ability, properly-targeted, and minimise the tax gap*).

#### **4.4 Practicability: there must be a feasible time to pay taxes**

When a tax payment is made, the payment must take place at the right moment: when it is most convenient to the taxpayer (*convenience of payment and economy in collection*). The legislature should understand the business environment. The tax law must be structured to create a feasible situation where the tax law is neither too complex, nor oversimplified (*simplicity and flexibility*).

#### **4.5 Public benefit: a government should use its taxes to provide benefits and services to the public for development and the common good**

A strong association exists between the payment of taxes and public services (*fiscal dimension, financial control, and macroeconomic considerations*). Income redistribution should be beneficial to people's lives, as well as to society in general (*minimising the negative effect on welfare*).

#### **4.6 Raising revenue: government finances are dependent on sustainable revenue**

Government finances are dependent on sustainable revenue collected from a country's citizens (*appropriate government revenue*). Two key concepts are: the basic threshold, where the government must protect low income earners; and the tax rate, to ensure that

enough revenue is collected while still leaving the taxpayer a sustainable portion of income (*economic growth and sustainability*).

#### **4.7 Tax compliance: a tax-paying culture is needed where there is a ‘willingness to voluntarily’ pay taxes**

The importance of the tax moral(s) in a country should be emphasised; trust should exist between taxpayers and the government. The government should support the taxpayers’ perception that the taxpayers are heard. Compliance relates to tax incentives (*compliance*). When tax morals are negative, the government will need stringent tax enforcement to discourage taxpayers from avoiding and/or evading tax (*cost of administration and effectiveness*).

#### **4.8 Tax understanding: there is a need for a tax education system**

The essence of an understandable tax system lies in tax education. The question as to whether or not taxpayers are aware of the various taxes they may be liable to pay then arises (*policy consistency and tax buoyancy*).

### **5. CONCLUSION**

Confirming the fundamental principles of taxation is an exercise that might always be controversial due to the interdisciplinary role of taxation in the international economic and socio-political environments, where policy and the implementation of tax systems are embedded in the context of the unique circumstances of every country. The role of taxation in the management and development of a country should direct the focus of adjustments to the fundamental principles of taxation for that particular country.

This article provides scientific grounding for the fundamental principles of taxation. By applying the IQA research method through the use of a focus group, a set of ten principles of taxation was identified and formulated. When these ten principles are compared with the principles of taxation that have been identified historically, it is evident that the existing fundamental principles of taxation have been scientifically confirmed by this research and that two additional principles have been added.

The limitations of the study can be summarised as follows:

- only one Third World country tax review (South Africa) is included in Table 1. This limitation is, however, due to the restricted availability of such Third World reviews as a result of language differences and access issues;
- a general limitation in using a focus group is the possibility that there may be participants in the group who feel insecure about voicing their opinions on the research problem (Welman et al., 2005). This was overcome through the IQA method used for the research;
- another general limitation is research bias by the researcher towards the data and its generation (Lasserre-Cortez, 2006). This was addressed through the use of a facilitator during the focus group;
- the IQA process does not allow for individual voices to be distinguished after the focus group activity (Human-Vogel & Van Petegem, 2008). For the current



research, this was not a limitation as the contribution of the IQA is the voice of the focus group as a whole, and

- a final possible limitation is the time required to complete the entire IQA process (Bargate, 2014). Although time is always a restraint, this was communicated to the participants in the original letter of invitation.

From Diagram 4, it is clear that all of the fundamental principles of taxation identified exercise an influence on each other to some extent (whether great or small). The significance of this observation lies in the fact that, according to the participants of the IQA focus group, all the fundamental principles identified and defined can be seen to influence each other. A fundamental principle of taxation should therefore not be considered in isolation, but should be interpreted and applied with all of the other fundamental principles in mind.

Based on the findings from Diagram 4, the focus group assigned a pivotal role to the principle, *public benefits*, when considering taxation. Therefore, it can be assumed that the focus group believed that the principle of public benefits takes centre stage in the taxation realm.

For future research, the set of principles should be disseminated to experts in taxation from as many countries as possible for their commentary and critique. Their input is vital in the further development and a possible final set of principles in the future. Experts should include tax practitioners, tax advisors, fiscal policy-makers, government tax administrators, tax academics, and the general public. The following questions could be posed:

- critique each principle to support or exclude the principle from the set of fundamental principles of taxation;
- explain the unique situation in your country that could justify additional proposed fundamental principles of taxation;
- explain how the proposed fundamental principles of taxation could thus be adapted to include/exclude principles specific to your country.

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**7. APPENDIX****Simple Affinities Relationship Table invitation****IN SEARCH OF THE FUNDAMENTAL PRINCIPLES OF TAXATION**

Dear Dr XXX

Your continuous support for my research is highly appreciated.

You are invited to participate in the final stage of this phase of the research project aimed at initiating the conversation on the fundamental principles of Taxation.

Your participation in this research project is voluntary and confidential. You will not be asked to reveal any information that will allow your identity to be determined.

If you are willing to participate in this study, please sign this letter as a declaration of your consent, i.e. that you participate in this project willingly and that you understand that you may withdraw from the research project at any time.

Dr. XXX's signature .....: Date: .....

Researcher's signature.....: Date: .....

Yours sincerely

**XXXXXXX**

## FUNDAMENTAL PRINCIPLES OF TAXATION FORMULATED BY THE FOCUS GROUP:

### Principle descriptions

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**1 CERTAINTY:** *A non-arbitrary tax system*

With this principle the focus group described the importance of legal certainty and administrative discretion in the tax system. Although discretion is an important aspect of taxation, the tax administrators should be consistent.

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**2 COHERENCE:** *A set of principles and rules to be used as a yardstick to move from chaos to order in the tax environment*

With this principle the focus group emphasised the importance for a tax administration to develop procedures in order to apply the principles and rules as set out in the tax legislation. Procedures in the tax system and in the courtroom should support existing policies in creating an efficient administrative system. The neutrality of the tax system should be protected by legislation.

---

**3 FAIRNESS:** *Taxpayers with equal ability will contribute equally*

The focus group described this principle as the vital importance of tax ethics. The system should ensure the accountability and participation for all to create justice. The necessary procedures should be in place to promote adequate confidentiality while adhering to appropriate transparency. The redistribution of property should be observed to create equity.

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**4 OBLIGATION:** *A duty to contribute towards the cost of a country*

With this principle, the focus group indicated that paying taxes is a “social and civic responsibility” of citizens in a civilized society. In theory, the contribution should be voluntary, but in practice, it is compulsory.

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**5 PRACTICABILITY:** *A feasible time to pay taxes*

With this principle, the focus group indicated that when a tax payment is made it must take place at the right moment when it is most convenient. The legislator should understand the business. The tax law must be structured to create a feasible situation where the tax law is not too complex, or oversimplified.

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**6 PUBLIC BENEFIT:** *A government that uses its taxes to provide benefits and services to the public for development and common good*

The focus group drew a strong association between the payment of taxes and public services. Income redistribution should beneficially impact on people's lives as well as society.

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**7 RAISING REVENUE:** *Government finances are dependent on sustainable revenue*

With this principle the focus group indicated that government finances are dependent on sustainable revenue collected from a country's citizens. Two key concepts are the basic threshold where the government must protect the lower income earners and the tax rate to ensure that enough revenue is collected while the taxpayer has a sustainable portion of income left.

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**8 TAX COMPLIANCE:** *A taxpaying culture where there is a "willingness to voluntarily" pay taxes*

With this principle the focus group emphasised the importance of the tax moral(s) in a country, where trust should exist between the taxpayer and the government. The government should support the taxpayer's perception that he is heard. Compliance relates to tax incentives. When tax morals are negative, the government will then need stringent tax enforcement to deter taxpayers from tax avoidance and evasion.

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**9 TAX UNDERSTANDING:** *The need for a tax education system*

With this principle the focus group suggested that the essence of an understandable tax system lies in tax education. The question to be asked is whether the taxpayer is aware of the different taxes he may be liable to pay.

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**10 VALUE SYSTEM:** *A general belief in an ideal tax system*

The focus group associated this principle with an understanding that the social construction of truth underpins an ideal tax system. When conflicting interests exist, argumentation is needed for a final consensus. Undisputed tax moral(s) should be the foundation of a tax system.

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**DETAILED AFFINITY (PRINCIPLE) RELATIONSHIP TABLE (DART)**

Please complete the attached table below by indicating what you think the direction of the relationship between two principles is. Use the principle descriptions that are supplied with this table to help you with this task.

For example:

If you think that 1 influences 2, then indicate  $1 \rightarrow 2$

If you think that 2 influences 1, then indicate  $1 \leftarrow 2$

If you think that there is no relationship between 1 and 2, then indicate  $1 < > 2$ .

**PLEASE NOTE: An arrow may only go in one direction. Although you may feel that the direction of the relationship can go both ways, you must indicate the direction you think illustrates the strongest or most important influence.**

**Example:**

An example of an IF/THEN statement in the case where  $1 \rightarrow 2$  may look as follows:

*If a tax administrator uses discretion when assessing a tax return, then the same discretion should be used in similar taxpayers' assessments.*

**PLEASE NOTE: Use a specific example from your own experience to illustrate your point rather than a vague statement.**

*Thank you for the time and effort that you are willing to put into this research project.*

**Below is the list of the principles you are requested to consider. Please also refer to the list of principle descriptions for completing the table below. Remember that an arrow can go either left or right, but not in both directions.**

<b>Principles</b> 1.Certainty 2.Coherence 3.Fairness 4.Obligation 5.Practicability 6.Public benefit 7.Raising revenue 8.Tax compliance 9.Tax understanding 10.Value system			<b>Possible relationships</b>  If Principle 1 influences Principle 2 then:  $1 \rightarrow 2$  If Principle 2 influences Principle 1 then:  $1 \leftarrow 2$  If there is no relationship between principles:  $1 < > 2$
Principle pair			Give an example in natural language using an IF/THEN statement to explain the relationship according to your personal experience
1		2	
1		3	
1		4	
1		5	
1		6	
1		7	
1		8	
1		9	
1		10	
2		3	
2		4	
2		5	
2		6	



<b>2</b>		<b>7</b>	
<b>2</b>		<b>8</b>	
<b>2</b>		<b>9</b>	
<b>2</b>		<b>10</b>	
<b>3</b>		<b>4</b>	
<b>3</b>		<b>5</b>	
<b>3</b>		<b>6</b>	
<b>3</b>		<b>7</b>	
<b>3</b>		<b>8</b>	
<b>3</b>		<b>9</b>	
<b>3</b>		<b>10</b>	
<b>4</b>		<b>5</b>	
<b>4</b>		<b>6</b>	
<b>4</b>		<b>7</b>	
<b>4</b>		<b>8</b>	
<b>4</b>		<b>9</b>	
<b>4</b>		<b>10</b>	
<b>5</b>		<b>6</b>	
<b>5</b>		<b>7</b>	
<b>5</b>		<b>8</b>	
<b>5</b>		<b>9</b>	
<b>5</b>		<b>10</b>	
<b>6</b>		<b>7</b>	

<b>6</b>		<b>8</b>	
<b>6</b>		<b>9</b>	
<b>6</b>		<b>10</b>	
<b>7</b>		<b>8</b>	
<b>7</b>		<b>9</b>	
<b>7</b>		<b>10</b>	
<b>8</b>		<b>9</b>	
<b>8</b>		<b>10</b>	
<b>9</b>		<b>10</b>	

Thank you for your participation!

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# Developing place of activity rules for the South African value-added tax: a comparative research approach

Erich Bell,<sup>1</sup> Anculien Schoeman<sup>2\*</sup> and Gerhard Nienaber<sup>3</sup>

## ***Abstract***

The globalisation of the world economy has led to a rapid increase in cross-border trade. The jurisdiction having taxing rights to a cross-border supply for Value-Added Tax (VAT) purposes is, however, not always clear. The South African VAT Act does not contain a standalone place of activity section, which many other countries do have. This could result in cross-border supplies involving South Africa being subject to either double taxation or double non-taxation. A standalone place of activity section was developed by the authors for the South African VAT Act by following a consultative process in terms of which South African VAT experts critiqued and commented on the proposed section, adding value to come up with a final proposed place of activity section for the South African VAT Act.

**Key words:** value-added tax, cross-border supplies, place of activity, OECD International VAT/GST Guidelines

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<sup>1</sup> Masters student in the Department of Taxation at the University of Pretoria, South Africa, bellerich35@gmail.com.

<sup>2</sup> Senior lecturer in the Department of Taxation at the University of Pretoria, ancullen.schoeman@up.ac.za.

\* Corresponding author.

<sup>3</sup> Associate Professor and Director of the School of Accountancy, University of South Africa, nienasg@unisa.ac.za.

## 1. INTRODUCTION

... [C]oming to grips with the concept of the place of consumption is, to steal a phrase used in a different context, ‘like trying to get your hands around a piece of jelly’ (Millar, 2004).

The globalisation of the world economy has led to a rapid increase in cross-border trade and hence in the interaction among the 164 value-added tax (VAT) systems in the world (Organisation for Economic Co-operation and Development (OECD), 2014). Without the proper coordination of these VAT systems through generally accepted place of supply rules, especially for intangible services, there is a risk that cross-border trade could lead to double taxation or double non-taxation (Davis Tax Committee (DTC), 2014). This could be curtailed if jurisdictions make use of generally accepted place of supply rules (Terra, 1998). This will benefit both the consumers and the tax collectors.

The place of supply rules in the South African *Value-Added Tax Act 89 of 1991* (VAT Act) are not explicitly listed in a separate section, but are indirectly woven into the different sections of the VAT Act. This is, however, only true for a limited number of specific transactions. Literature related to VAT suggests that numerous ambiguities exist with regard to the application of the different indirect place of supply rules in the VAT Act for both taxpayers and tax authorities when determining whether cross-border supplies should be subject to VAT in South Africa (Millar, 2008a; OECD, 2017; Schneider, 2000). The literature also suggests that it is not clear when an enterprise or activity is conducted ‘in the Republic [of South Africa] or partly in the Republic’, as required by the definition of ‘enterprise’ in section 1(1) of the Act<sup>4</sup> (Janse van Rensburg, 2011). It is also not clear when a service would be ‘utilised or consumed in the Republic’ for purposes of the definition of ‘imported services’ in section 1(1) (Botha, 2015). This is where the proverbial jelly slips through the fingers: trying to establish in whose jurisdiction the VAT is due. The ambiguity associated with the place of supply rules in the VAT Act suggests the need for clarity and consolidation.

Owing to South Africa’s positive features, such as its sizeable economy and extensive tax treaty network, it is regarded as a holding company gateway into Africa (National Treasury, 2010). However, double taxation and unclear tax rules deter foreign investment (OECD, 2006). In order to remain lucrative as a holding company gateway into Africa and not fall behind other competing African countries, such as Mauritius, it is important that cross-border supplies involving South Africa are not subject to double taxation. Preventing double taxation can be achieved by inserting clearly defined place of supply rules in line with the OECD International VAT/GST (Goods and Services Tax) Guidelines (OECD Guidelines) into the VAT Act, as South Africa has observer status in the OECD.

The main objective of this article is therefore to develop a standalone place of activity section for the VAT Act to align South Africa’s place of supply rules with those of other jurisdictions (DTC, 2014). This proposed legislative provision should adhere to the OECD Guidelines to increase certainty and to minimise the potential for cross-border supplies involving South Africa to be subject to double taxation or unintended double non-taxation.

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<sup>4</sup> All references to sections are to the sections in the South African VAT Act, unless stated otherwise.

The article is organised as follows: section 2 considers the VAT system in South Africa in order to provide the appropriate context. This is followed (also in section 2) by an analysis of the place of supply rules as they apply in South Africa, Australia and New Zealand.<sup>5</sup> Like South Africa, Australia and New Zealand operate ‘modern’ or New World VAT systems, in contrast to the more traditional or Old World European systems.<sup>6</sup> Section 2 concludes with an initial proposed place of activity section, which was discussed with five South African VAT experts. Section 3 examines the results of the consultative process, making use of a thematic analysis of the open-ended questions. The final section (section 4) concludes with a refined legislative provision that could be used by National Treasury to introduce place of activity rules into the VAT Act as a standalone provision, in addition to the other provisions that have already been implemented.

## 2. BACKGROUND AND CONTEXT

In order to set the backdrop for this study, this section explains how the South African VAT system operates and the place of supply and place of activity rules which are included in New Zealand’s and Australia’s GST systems. The OECD Guidelines for a ‘good’ VAT system are also considered.

### 2.1 Background to the South African VAT system

VAT was initially introduced in South Africa in 1991 at a standard rate of 10% and was subsequently increased to 14% in 1993 (Go, Kearney, Robinson & Thierfelder, 2005). The VAT Act is largely based on New Zealand’s *Goods and Services Tax Act 1985* (New Zealand GST Act), although critically it does not contain a standalone place of activity section. Although there are specific place of supply rules regarding some types of supplies, there is no general place of activity section (DTC, 2014). Schneider (2000) believes that the lack of place of activity rules in the VAT Act can be attributed to the Republic’s isolation from the world economy as a result of the sanctions imposed on it by other countries during the apartheid regime. The lifting of these sanctions after 1994 has led to an increase in the openness of the Republic’s economy and therefore in its involvement in cross-border trade (Du Plessis & Smit, 2006).

VAT is a general consumption tax that is collected through a staged collection process where a portion of the VAT is collected on the value added by a taxable person at each stage of the production or distribution chain (OECD, 2014). The value added is the difference between the value of the goods and services sold by a ‘VAT registered supplier’ and the value of the goods and services used as inputs in producing such goods and services. This process ensures that the economic burden of VAT rests on the final consumer of the goods and services.

South Africa’s VAT system is a destination-based VAT system, meaning that exports are zero-rated and imports and domestic consumption are subject to the standard rate of VAT (Millar, 2009). This ensures that the VAT revenue is collected in the jurisdiction where the goods and services are *consumed*. This places all firms competing in a given jurisdiction on an even footing, enhancing neutrality in international trade (OECD, 2017). The purpose of internationally aligned place of taxation rules (including place of

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<sup>5</sup> The data was collected during May 2016, and therefore the review of legislation of New Zealand and Australia (except where otherwise expressly stated) included legislation as it was up until 30 April 2016.

<sup>6</sup> The VAT is also known as Goods and Services Tax (GST) in other countries.

supply rules) is to avoid double taxation or double non-taxation owing to colliding taxing jurisdictions (Ecker, 2013).

The application of the destination principle to a cross-border supply of tangible goods is relatively simple as such a supply is required to pass through border controls where the destination of the goods can be verified. However, since the supply of cross-border services and intangibles cannot be subject to border controls in the same manner as tangible goods, difficulties are encountered in determining the place of taxation of these supplies and therefore also with implementing the destination principle (OECD, 2017).

Place of taxation rules refer to the collective rules used by a jurisdiction to establish whether it has the substantive right to tax a particular cross-border supply. Under a New World VAT system, place of taxation rules include a jurisdiction's place of activity, import VAT and zero-rating rules (Millar, 2009).

Section 7(1)(a) of the VAT Act determines that VAT must be levied at the standard rate '... on the supply by any vendor of goods or services supplied by him ... in the course or furtherance of any enterprise carried on by him ...'. The limited place of supply rules woven into various sections of the VAT Act are based on the modern VAT system on the basis that place of taxation is determined through the collective workings of the definition of 'enterprise' in section 1(1), the import VAT rules in sections 7(1)(b) and (c) and the zero-rating rules in section 11 (De Swardt & Oberholzer, 2006). The VAT Act does not differentiate between business-to-business and business-to-consumer supplies as do the VAT systems of many other countries (DTC, 2014). Other countries also have more prominent place of supply sections included in their VAT legislation. Place of supply rules are discussed next.

## **2.2 An introduction to place of supply rules**

Place of supply rules can be based either on a pure consumption test that determines where the actual consumption of a supply takes place, or on a proxy (also referred to as a 'marker') that approximates where the actual consumption of a supply is likely to take place. This approximation is based on the features of the supply that are known to the supplier at the time of the supply (OECD, 2017). The use of proxies is necessitated by the fact that VAT must be levied by the supplier on consumption expenditure at the time the expenditure is incurred. This will either be before consumption or at the time that consumption takes place (Millar, 2008a). Should a supply not be consumed at the time and place the consumption expenditure is incurred, the supplier would have no or limited information as to when and where the supply would eventually be consumed (Millar, 2004). Proxies are therefore required to assist suppliers in predicting where the supply is likely to be consumed by identifying a connection between the supply and a particular jurisdiction (Millar, 2004). Jurisdictions primarily rely on proxies and only occasionally resort to pure consumption tests (Millar, 2004; Ecker, 2013).

Where a supply of goods is made, the place of supply usually follows the delivery of the goods. This is, however, not that easy with the supply of intangible services. For business-to-business supplies, it is preferred general practice to use the customer's location as the place of supply. There are, however, various deviations from this rule to ensure that a supply of a service is not zero-rated if it is consumed in the jurisdiction of the supplier. Administrative difficulties could be encountered where the actual consumption test is applied. For this reason, proxies are sometimes used to determine

the place of taxation. The reverse charge mechanism can also be applied to solve this burden (Ecker, 2013).

For business-to-consumer supplies, the place of consumption is deemed to be in the jurisdiction in which the customer has his/her usual place of residence. If the customer has more than one country of residence, the place of consumption would be deemed to be in the jurisdiction in which the customer spends most of his/her time (OECD, 2001).

Since VAT systems do not have any bilateral or multilateral treaties to prevent double taxation, a taxable person whose supply is subject to double taxation due to inter-jurisdictional conflicts would not be entitled to relief (Schenk, 2009). In this regard, Schenk (2009) argues that there is a growing need for bilateral or multilateral VAT treaties to assign taxing rights to cross-border transactions.

The OECD advocates a different approach to prevent double taxation in terms of which all member states are encouraged to follow the neutrality and place of supply guidelines advocated in the OECD Guidelines (OECD, 2017).

### **2.3 OECD International VAT/GST Guidelines**

The OECD's mission is to assist in the 'economic and social well-being of people around the world' by, amongst other things, assisting in drafting international standards to harmonise tax.<sup>7</sup> The International VAT/GST Guidelines are aimed at increasing certainty and reducing the occurrence of double taxation and unintended non-taxation. This is achieved by promoting an internationally accepted understanding of the place of supply rules used to implement the destination principle on the most common cross-border supplies of services and intangibles. The purpose of the Guidelines is therefore to promote the consistent application of similar place of supply proxies by different jurisdictions (OECD, 2017).

The Guidelines advocate eight place of supply rules for purposes of implementing the destination principle. Guideline 3.1 determines that: 'For consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption'. It advocates the implementation of the destination principle and forms the overarching objective of the place of supply rules for both business-to-business and business-to-consumer supplies (OECD, 2017). Guideline 3.2 sets out the general place of supply rule for business-to-business supplies that must be interpreted in conjunction with Guidelines 3.3 and 3.4. Guidelines 3.5 and 3.6 provide the general place of supply rules for business-to-consumer supplies. Guidelines 3.7 and 3.8 provide the instances in which it may be appropriate to base place of supply rules on proxies other than those advocated by the general rules for business-to-business and business-to-consumer supplies (OECD, 2017). Under both the general rule for business-to-business supplies in Guideline 3.2 and Guidelines 3.5 and 3.6 for business-to-consumer supplies, the place of supply rules are based on the location of the customer (OECD, 2017).

### **2.4 Place of supply rules in the VAT Act**

The OECD released the Guidelines briefly discussed above, advocating a set of generally accepted place of supply rules for cross-border supplies of services and

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<sup>7</sup> See OECD, 'About the OECD' and 'What we do and how', <http://www.oecd.org/about/>.

intangibles. Although South Africa has observer status to the OECD, it is one of the few countries that does not have clearly defined place of supply rules that are explicitly listed in a separate section. The rules are merely captured into different sections of the VAT Act such as definitions of ‘enterprise’ and ‘imported services’ and in some paragraphs of the zero-rating section of the VAT Act (Millar, 2008a).

The place of supply rules currently contained in the VAT Act are discussed below, including the potential problems encountered.

First, paragraph (a) of the definition of ‘enterprise’ in section 1(1) refers to any enterprise or activity that is carried on ‘in the Republic or partly in the Republic’. The VAT Act does not provide guidance as to when an activity is regarded as being carried on ‘in the Republic or partly in the Republic’. This lack of guidance leads to uncertainty when determining whether an enterprise is carried on for South African VAT purposes (Millar, 2008a). Guidance on this topic is referred to as ‘place of activity rules’.

Paragraph (b)(iv) was inserted into the VAT Act in 1997 with effect from a date still to be proclaimed. It includes within the ambit of an ‘enterprise’ ‘... the activities of any person who continuously or regularly supplies telecommunication services to any person who utilises such services in the Republic’. Such proclamation date has, however, never been announced. Further, ‘telecommunication services’ are not defined in section 1(1) so as to differentiate between telecommunication services and electronic services. This creates uncertainty as some telecommunication services could potentially fall within the ambit of ‘electronic services’ as defined in section 1(1) (Meiring, 2014).

Paragraph (b)(vi) of the definition of ‘enterprise’ in section 1(1) deals with the supply of electronic services: the definition of ‘enterprise’ in section 1(1) and the compulsory registration requirements in section 23 were amended by the *Taxation Laws Amendment Act 31 of 2013* to require foreign suppliers of electronic services to South African customers to register as vendors at the end of the month in which the total value of taxable supplies made by such suppliers exceeded ZAR 50,000. This amendment has the effect that such foreign suppliers would be liable to levy output VAT on their electronic services supplied to South African customers in terms of the general charging provision in section 7(1)(a) (Meiring, 2014).

Proviso (ii) to the definition of ‘enterprise’ in section 1(1) and section 8(9), deal with branches or main businesses of enterprises permanently situated at premises outside the Republic. Section 8(9) specifically deems supplies made by the vendor to its branch or main business so excluded from the definition of enterprise to be made in the course or furtherance of the vendor’s enterprise. This allows the vendor to zero-rate such supplies if the requirements of section 11(2)(o) are met, to ensure that neutrality is maintained (Botes, 2018).

Proviso (vi) to the definition of ‘enterprise’ in section 1(1) deals with the conclusion of insurance contracts by Underwriting Members of Lloyd’s of London in the Republic. With effect from 1 January 2001, the activity of underwriting insurance business by Underwriting Members of Lloyd’s of London is deemed to constitute the carrying on of an ‘enterprise’ to the extent that such insurance contracts are concluded in the Republic.<sup>8</sup> The place of conclusion of such contracts is therefore used as proxy. Schneider (2000)

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<sup>8</sup> Explanatory memorandum on the Revenue Laws Amendment Bill, 1999.



expresses concern about the fact that this provision is open to manipulation as Underwriting Members can simply decide to conclude all contracts outside of the Republic in order to avoid carrying on an enterprise in the Republic.

Section 7(1)(b) of the VAT Act levies VAT on imported goods. Goods imported into the Republic are subject to import VAT at 14% in accordance with the destination principle. The location of the goods therefore serves as proxy for purposes of section 7(1)(b).

The definition of 'imported services' in section 1(1) of the VAT Act refers to services 'utilised or consumed in the Republic'. This definition therefore makes use of a pure consumption test, rather than a proxy (Janse van Rensburg, 2011). Numerous previous studies have concluded that the application of this phrase is not clear (Van Zyl, 2013a; Van Zyl, 2013b; Olivier & Honiball, 2011; Silver & Beneke, 2016).

Section 11(1) zero-rates the export of goods. The place of taxation of exported goods is determined by the destination of the goods (Millar, 2008a).

Section 11(2) zero-rates the export of services. The zero-rating provisions for exported services in the VAT Act differentiate between services provided to immovable property, movable property and intellectual property. The provisions also contain specific rules for services supplied to non-residents.

Section 11(2)(f) zero-rates services that are '... supplied directly in connection with land, or any improvement thereto, situated in any export country'. Section 11(2)(f) does not find application to the supply of the use of, or right to use immovable property under a rental agreement, since section 8(11) would deem such a supply to be a supply of goods rather than a supply of services (Olivier & Honiball, 2011). The location of the land therefore serves as proxy for section 11(2)(f) (Millar, 2008a).

Section 11(2)(g)(i) zero-rates services that are '... supplied directly in respect of ... movable property situated in any export country at the time the services are rendered'. The location of the goods therefore serves as proxy for section 11(2)(g)(i) (Millar, 2008a). Silver and Beneke (2016) contend that the phrase 'directly in respect of' should be given a narrow interpretation.

Section 11(2)(m) applies to intellectual property and provides a zero-rating if the service comprises:

- (i) the filing, prosecution, granting, maintenance, transfer, assignment, licensing or enforcement, including the incidental supply by the supplier of such services of any other services which are necessary for the supply of such services, of intellectual property rights, including patents, designs, trade marks, copyrights, know-how, confidential information, trade secrets or similar rights; or

- (ii) the acceptance by any person of an obligation to refrain from pursuing or exercising in whole or in part any such rights,

where and to the extent that those rights are for use outside of the Republic.

Given the fact that the zero-rating applies only insofar as the rights are for use outside the Republic, an apportionment of the service would have to be made in terms of section 8(15) if the intellectual property rights are used both within and outside the Republic

(Botes, 2018). The portion of the service that relates to the use of the right in the export country would be zero-rated under section 11(2)(m)(i), while the South African portion of the service would be subject to VAT at the standard rate in terms of section 7(1)(a). Section 11(2)(m) therefore uses the place of effective use or enjoyment of intellectual property as proxy (Millar, 2008a).

Section 11(2)(k) provides for a zero-rating for services physically rendered outside the Republic. The place of performance of the services is therefore used as proxy (Millar, 2008a). As from 1 April 2015, section 11(2)(k) no longer applies to electronic services supplied by offshore suppliers that fall within paragraph (b)(vi) of the definition of 'enterprise' in section 1(1).<sup>9</sup>

Millar (2008a) notes that section 11(2)(k) has a wider application than its counterpart contained in section 11A(1)(j), read together with section 11A(1B) in the New Zealand GST Act. Section 11A(1B) would only allow the section 11A(1)(j) zero-rating if the nature of the services is such that they can only be received at the time and place where they are physically performed. Millar contends that the wide ambit of section 11(2)(k) could lead to the non-taxation of services that are in fact consumed in the Republic. This is because section 11(2)(k) of the VAT Act will zero-rate services performed from outside of the Republic, irrespective of whether such services are intangible services or on-the-spot supplies. If such services are supplied by a registered vendor from outside of the Republic to a recipient in the Republic who consumes such services in the Republic but who is not a 'resident of the Republic' then such services would qualify for the zero-rating in section 11(2)(k) of the VAT Act while simultaneously not constituting 'imported services' as defined in section 1(1) of the VAT Act. This will only be the case for services which do not constitute 'on-the-spot supplies' as on-the-spot supplies that are consumed from within the Republic require the supplier to be physically present in the Republic when such services are performed.

Section 11(2)(l) provides a zero-rating for the following services if supplied to a person who is not a resident of the Republic:

- ... services ... not being services which are supplied directly-
- (i) in connection with land or any improvements thereto situated inside the Republic; or
- (ii) in connection with movable property ... situated inside the Republic at the time the services are rendered, except movable property which-
- (aa) is exported to the said person subsequent to the supply of such services; or
- (bb) forms part of a supply by the said person to a registered vendor and such services are supplied to the said person for purposes of such supply to the registered vendor; or
- (iii) to the said person or any other person, other than in circumstances contemplated in subparagraph (ii)(bb), if the said person or such other person is in the Republic at the time the services are rendered,

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<sup>9</sup> Explanatory memorandum on the Taxation Laws Amendment Bill, 2014.

and not being services which are the acceptance by any person of an obligation to refrain from carrying on any enterprise, to the extent that the carrying on of that enterprise would have occurred within the Republic...

In order for a service supplied to a non-resident to be zero-rated in terms of section 11(2)(l), it must pass all three of the exclusions listed in section 11(2)(l)(i) to (iii).<sup>10</sup> The so-called 'round-tripping rule' that provides an exclusion from the zero-rating in section 11(2)(l)(iii) in instances where a non-resident or any other person is in the Republic at the time the services are rendered, is aimed at ensuring that any consumption or use of the service in the Republic is not zero-rated (Botes, 2018). The only instance in which the zero-rating would be allowed if the non-resident or any other person is present in the Republic, would be if the circumstances of section 11(2)(l)(ii)(bb) are met.<sup>11</sup> The proxies used by section 11(2)(l) are the residency status of the recipient, the location of the land or goods and the place of effective use or enjoyment of the service (Millar, 2008a).

Section 11(2)(g)(ii) provides a zero-rating for services supplied directly in connection with '... goods temporarily admitted into the Republic from an export country that are exempt from tax on importation under Items 470 and 480 of paragraph 8 of Schedule 1' of the VAT Act. These goods are exempt from import VAT in terms of section 13(3). Item 470 applies to goods temporarily admitted for processing, repair, cleaning, reconditioning or for the manufacture of goods exclusively for export. Item 480 applies to other goods that are temporarily admitted into the Republic for specific purposes after which the goods must be exported. Examples of items to which Item 480 applies include goods for display at exhibitions, meetings, fairs and similar events, and containers used for packing purposes. The proxy used in section 11(2)(g)(ii) is therefore the location of the goods (Millar, 2008a).

As is evident from the above discussion, the place of supply rules in the VAT Act make use of various proxies, including the location of movable and immovable property; the location of the consumer or quasi-consumer; the place of performance of services; and the residency status of the recipient. The definition of 'imported services' in section 1(1) and section 11(2)(m) make use of a pure consumption test.

There is uncertainty, however, when determining whether an activity is carried on 'in the Republic or partly in the Republic' for purposes of paragraph (a) of the definition of 'enterprise' in section 1(1) and whether a service is 'utilised or consumed in the Republic' for purposes of the definition of 'imported services' in section 1(1). A place of activity section would thus assist in determining when an activity is carried on 'in the Republic or partly in the Republic'.

## 2.5 Place of supply sections applied in New Zealand and Australia<sup>12</sup>

South Africa's place of supply rules consist of: (i) the definition of 'imported services' in section 1(1) read together with section 7(1)(c) which operate the reverse charge

<sup>10</sup> South African Revenue Service (SARS), 'The Master Currency case and the zero-rating of supplies made to non-residents', Interpretation Note No. 85, 2015.

<sup>11</sup> Ibid.

<sup>12</sup> As stated in n 5 above, the data was collected during May 2016, and therefore the review of legislation of New Zealand and Australia (except where otherwise expressly stated) included legislation as it was up until 30 April 2016.

mechanism; (ii) the definition of ‘enterprise’ in section 1(1), and (iii) South Africa’s zero-rating rules in section 11. All three categories of rules operate together to ensure that the South African VAT Act effectively implements the destination principle.

The primary purpose of this article is to develop a place of activity section applying to activities carried on by an entity in South Africa, thus for category (ii) above. In order to develop the proposed place of activity section, it is necessary to consider the zero-rating provisions for exported services of other New World VAT systems such as Australia and New Zealand. Such a consideration also aids in determining whether South Africa’s zero-rating provisions for services use place of supply proxies similar to those used by other New World VAT systems.

In general, section 8(1) of the New Zealand GST Act determines that GST must be levied at 15% on ‘... the supply (but not including an exempt supply) in New Zealand of goods and services ... by a registered person in the course or furtherance of a taxable activity carried on by that person ...’. The residency of the supplier is used as proxy for purposes of determining whether a supply is made in New Zealand (Millar, 2004).

The out-in-out-in analysis of the New Zealand GST Act works as follows. The default position under the GST Act is to deem the place of supply for supplies made by a non-resident to be outside New Zealand. Should the goods supplied by the non-resident be in New Zealand at the time of the supply, or if the supply consists of services that are physically performed by a person who is in New Zealand at the time the services are performed, such a supply would be deemed to be made in New Zealand in terms of section 8(3). However, if the goods or services are supplied by the non-resident to a registered person who would use such goods or services for purposes of carrying on its taxable activity, section 8(4) would deem such goods or services to be supplied by the non-resident outside New Zealand, unless the supplier and the recipient agree out of this provision (Millar, 2008a; McKenzie, 2012). If the supplier and consumer agree out of the provision, then the supply of the goods that are physically located in New Zealand at the time of the supply or on-the-spot services performed in New Zealand would be deemed to be made in New Zealand in terms of its place of supply rules.

Section 5B, read together with section 8(4B), operate New Zealand’s reverse charge mechanism. The reverse charge mechanism relies on a consumption-based proxy (DTC, 2014). It finds application to services supplied by a non-resident that are treated as being made outside New Zealand by the out-in-out-in analysis if the services are supplied to a resident who utilises them for less than 95% taxable purposes and if that supply would have been a taxable supply if it had been supplied by a registered person in the course or furtherance of a taxable activity in New Zealand (McKenzie, 2012). With the exception of fine metals, all goods imported into New Zealand are subject to import GST in accordance with section 12 (McKenzie, 2012).

The following table provides a summary of the place of supply proxies for services in New Zealand.

**Table 1: New Zealand Place of Supply Proxies for Services**

Section	Rule	Proxy
s11A(1)(e)	Services supplied directly in connection with land situated outside New Zealand or any improvement thereto.	Location of land
s11A(1)(f)	Services supplied directly in connection with moveable personal property, other than choses in action, situated outside New Zealand when the services are performed.	Location of goods
s11A(1)(j) & s11A(1B)	Services physically performed outside New Zealand, provided that the services can only be physically received at the time and place of its performance.	Place of performance of services
s11A(1)(k), s11A(2), s11A(3) & s11A(3B)	Services supplied to a non-resident who is outside New Zealand at the time of performance if the services are neither directly in connection with land in New Zealand or goods in New Zealand at the time the services are performed, nor the acceptance of an obligation not to carry on a taxable activity in New Zealand.	Residence and location of recipient plus location of land plus location of goods plus place of use or enjoyment
s11A(1)(n) & s11A(4)	Services in relation to intellectual property rights that are for use outside New Zealand.	Character of supply and place of use or enjoyment

Source: NZ GST Act, Millar (2008a)

For Australia, section 9-25(1) to (3) determine that goods will be connected with Australia if they are delivered or made available to a recipient in Australia; the supply involves the goods being removed from Australia; or the supply involves goods being brought into Australia if the supplier either imports the goods into Australia or installs or assembles the goods in Australia (*A New Tax System (Goods and Services Tax) Act 1999*, 'Australian GST Act').

(Note that, as from 1 July 2017, all supplies other than supplies of goods or real property will be connected with Australia (relevantly defined as the 'indirect tax zone') if, amongst other possibilities, they are made to an 'Australian consumer'. An Australian consumer is an Australian resident who is not registered for GST or, if registered for GST, the supply is not to any extent acquired for purposes of the enterprise it carries on (section 9-25(7) of the Australian GST Act)).

According to sections 9-26(1) and (2) of the Australian GST Act, a supply by a non-resident is not connected with Australia if the supplier is a non-resident; the supply is not made through an enterprise in Australia; and the supply relates to an inbound intangible supply, intangible supply between non-residents or supply of leased goods between non-residents. The entity is an Australian business recipient if, subject to the other salient requirements of section 9-26, it is registered in Australia, it carries on an enterprise in Australia and the supply received is not solely for private or domestic purposes.

An enterprise is seen to be carried on in Australia when it is carried on by an individual in Australia either through a fixed place in Australia, or through one or more places in

Australia for more than 183 days in a 12 month period, or there is an intention of the individual to carry on an enterprise in Australia for more than 183 days in a 12 month period (section 9-27 of the Australian GST Act).

A supply of services that is not connected with Australia must be reverse charged in terms of section 84-5(1) in instances where a recipient acquires the services solely or partly for an enterprise carried on in Australia, but not solely for a creditable (taxable) purpose; the supply is for a consideration; the recipient is registered or is required to be registered; and the supply is not one otherwise of various supplies specified in the section.

The following Table provides a summary of the place of supply proxies for services in Australia.

**Table 2: Australian Place of Supply Proxies for Services**

Section	Rule	Proxy
Rule 1 in section 38-190	Services directly connected with real property situated outside Australia.	Location of real property
Rule 2 in section 38-190	Services directly connected with goods situated outside Australia.	Location of goods
Rule 3 Item 2(a) in section 38-190	Services supplied to a non-resident who is outside Australia at the time of performance if the supply is neither a supply of work physically performed on goods in Australia when the work is performed, nor directly connected with real property in Australia.	Location & residence of recipient plus location of land plus location of goods
Rule 4 Item 2(b) in section 38-190	Services supplied to a non-resident, who is outside Australia at the time of performance if the recipient acquires the services in carrying on its enterprise, but is neither registered nor required to be registered for GST.	Location & residence of recipient plus registration status of recipient
Rule 5 Item 3 in section 38-190	Services supplied to a recipient who is outside Australia at the time of performance if the effective use or enjoyment of the supply would be outside Australia, excluding supplies of work performed to goods situated in Australia at the time the services are performed and supplies directly in connection with real property in Australia.	Location of recipient plus effective use or enjoyment plus location of goods plus location of real property
Rule 6 Item 4(a) in section 38-190	Supplies in relation to rights if the rights are for use outside of Australia.	Character of supply and place of use or enjoyment
Rule 7 Item 4(b) in section 38-190	Supplies in relation to rights if the supplies are made to a non-resident who is outside Australia at the time of performance.	Location & residence of recipient

Section	Rule	Proxy
Rule 8 Item 5 in section 38-190	Supplies involving the repair, renovation, modification or treatment of goods from outside Australia that are destined for a location outside Australia.	Location of goods plus place of effective use or enjoyment
Section 38-190(2)	For all items above, the supply is not GST-free if it is a supply of a right or option to acquire something, the supply of which would be connected with Australia and which would not be GST-free.	Place of effective use or enjoyment
Section 38-190(2A)	For items 2, 3 and 4, the supply is not GST-free if its acquisition relates directly or indirectly, wholly or partly, to making a wholly or partly exempt supply of real property in Australia.	Location of real property
Section 38-190(3)	For item 2, the supply is not GST-free if it is made under an agreement with a non-resident, but is provided to another entity in Australia.	Place of effective use or enjoyment
Section 38-190(4)	For item 3, the recipient would be treated as being outside Australia if the supply is made under an agreement with a resident in terms of which the supply is provided to another entity outside Australia.	Location of recipient

Source: Australian GST Act; Millar (2008b)

## 2.6 Developing an initial place of activity section for South Africa

From an examination of extant literature, practical guides from the OECD and other countries' VAT/GST legislation, it is evident that there are various proxies that could be used to determine the place of supply for various types of transactions. The current zero-rating rules in the VAT Act are based on those of New Zealand and Australia and they work effectively from a place of supply point of view as the proxies effectively implement the destination principle. The study therefore does not address such rules further. The VAT Act does not have an explicit place of activity section other than for electronic services. The main purpose of the study is, accordingly, to develop a place of activity section that deals with all transactions other than electronic services as defined in section 1(1) read with the Regulations.

The following proposed place of activity section for the South African VAT Act was produced by the authors. The proposed section also does not consider the place of supply rules applicable to international transportation.

**1A. Place of activities.**-(1) For purposes of the definition of enterprise, an activity would be carried on in the Republic if it is a supply of

- (a) goods, other than fixed property, if such goods are
  - (i) delivered or made available in the Republic to the recipient or at the recipient's request, to any other person;
  - (ii) installed, assembled or produced in the Republic;
  - (iii) imported into the Republic;
  - (iv) removed from the Republic;

Provided that a supply referred to in paragraph (a) would, at the election of the supplier, be deemed to be carried on outside the Republic if such an activity would, but for this proviso, constitute a taxable supply made to a registered vendor who utilises or consumes such a supply wholly for purposes of making taxable supplies or if such a supply is exported;

- (b) fixed property situated in the Republic or goods supplied directly in connection with fixed property situated in the Republic;
- (c) a real right or option directly in connection with goods ordinarily situated in the Republic or fixed property situated in the Republic;
- (d) services physically rendered in the Republic;
- (e) services, other than services referred to in paragraph (b)(vi) of the definition of enterprise and paragraphs (d) and (f) of this section, connected with any supply that is treated as being made in the Republic in terms of this section, not being services supplied directly in connection with
- (i) fixed property situated outside the Republic;
- (ii) moveable property ordinarily situated outside the Republic; or
- (iii) intellectual property to the extent that the rights are for use outside the Republic;
- (f) intellectual property to the extent that the rights are for use in the Republic; or
- (g) goods or services supplied by a vendor in the course or furtherance of an enterprise carried on by the vendor.

In order to refine the standalone place of activity section developed from the theory above, this proposed section was discussed with five VAT experts to establish the validity of the proposed section and also for them to make further suggestions for improvement. This could be described as a quasi-Delphi research methodology: the Delphi method entails administering a number of rounds whereby experts give comments on an idea or concept, the idea is amended with the comments and is then discussed again, in order to reach consensus (Evans & Collier, 2012). In this article, however, only one round was administered. It was not deemed necessary to send the amended section back to the experts for further scrutiny as their comments were carefully considered and then the appropriate changes were brought about.

For purposes of this study, a VAT expert is considered to be an employee of an accounting or law firm who serves or has served on the VAT committee of a Recognised Controlling Body (RCB). Such employees are recognised by RCBs as thought leaders in the field of VAT.<sup>13</sup> It is therefore submitted that such employees are in possession of the requisite knowledge to scrutinise and add value to the place of supply section developed by this study. Each of the experts has at least ten years' experience in VAT (some over 20 years) and have dealt with many clients over this time. There is also representation from more than one profession: the respondents are chartered accountants and lawyers. It is, however, a limitation that respondents from a limited group of professions were involved in the study. It is evident from the discussion in the next section that their responses are aligned to some extent and thus it is expected that no new information would have been obtained if more experts from the same limited pool had been consulted. It is assumed that the VAT experts who completed the questionnaire have sufficient knowledge to properly scrutinise the proposed place of supply section for the VAT Act and answer the questions honestly and without any bias. Academics were not consulted as they are not involved in practice and do not deal with this situation as regularly as the experts that are in practice.

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<sup>13</sup> Email from L Seforo, South African Institute of Chartered Accountants (SAICA) to authors, 11 November 2016.



There were five categories of questions put to the experts, with each category containing one closed and one open-ended question. The five categories of questions were developed in order to simplify the data analysis phase of the study and to ensure that each respondent would scrutinise all the different factors taken into account in developing the proposed place of activity section. The five categories of questions were aimed at gathering information on whether the proposed place of activity section:

1. would increase certainty in determining whether an enterprise is carried on in the Republic (Questions 1 and 2);
2. is in line with the Guidelines (Questions 3 and 4);
3. deals satisfactorily with all the different types of supplies (Questions 5 and 6);
4. contains any words or phrases that could lead to interpretational difficulties (Questions 7 and 8); and
5. would lead to an increase in the jurisdictional reach of the VAT Act (Questions 9 and 10).

Each of the five categories started with a closed-ended question asking whether the proposed place of activity section adheres to the requirement investigated by that category. If the answer was 'No', the respondent was required to answer an open-ended question by providing reasons. If the answer was 'Yes', the respondent was asked the next category's closed-ended question.

A thematic analysis technique was used to identify themes in the primary data collected through the consultation process. This was done by reading and re-reading the data, assigning codes to the excerpts and grouping codes with similar characteristics together into themes and subthemes (Fereday & Muir-Cochrane, 2006). To reduce the risk of inconsistently assigning codes to the excerpts in the data set, the authors compiled a coding manual for the open-coding process. These themes were scrutinised and used to amend the proposed place of activity section. The flexibility of the approach makes it an appropriate data-analysis technique for the analysis of the unique and diverse responses provided by the VAT experts to the open-ended questions (Braun & Clarke, 2006, p.16).

The results of this consultative process are discussed next.

### **3. RESULTS AND DISCUSSION**

Useful feedback was received from the respondents on the proposed section. The general responses are discussed first, followed by the more specific issues. The discussion then examines how these responses were used to amend the proposed place of activity section.

#### **3.1 Results**

##### *3.1.1 General findings*

Three respondents were of the opinion that the proposed section would increase certainty when determining whether an activity was carried on 'in the Republic or partly in the Republic'. The other two indicated that the proposed section contained words and phrases that were ambiguous, which undermined this certainty.

Three respondents indicated that the proposed section was aligned with the Guidelines. The other two indicated that although the proposed section adheres to the requirements of the Guidelines, there are specific definitions in the proposed section that are unclear.

Four respondents indicated that the proposed section would lead to an increase in the jurisdictional reach of the VAT Act. The other respondent held that it was impossible to predict whether the proposed section would lead to either an increase or a decrease in the jurisdictional reach of the VAT Act.

In addition to the above general concerns regarding the proposed section, seven practical difficulties with specific subsections were also identified.

### 3.1.2 *Specific practical difficulties*

All five respondents foresaw practical difficulties with specific subsections of the proposed section, which can be summarised as follows:

1. contradiction of the proposed section with another existing section;
2. double taxation arising from the proposed section;
3. duplication by the new proposed section of an existing section;
4. location of the supplier being problematic;
5. unwanted exclusions in the proposed section;
6. contradiction of the proposed section with case law; and
7. uncertainty of the purpose of a part in the proposed section.

Other practical difficulties were also identified, such as that the proposed section did not cater for specific types of supplies, nor did it deal with the 'level of activity' required for an enterprise to come into existence.

Finally, interpretational difficulties were encountered by the experts regarding certain words or phrases that is discussed below.

All these difficulties identified by the experts are now considered in amending the proposed place of activity section.

## 3.2 **Revision of the place of activity section**

Valuable critiques and reviews were received from the participating experts to improve the proposed place of activity section. The issues identified by these experts with the proposed section and their reasoning were considered and evaluated against other sources. From this evaluation, it was decided whether the amendment suggested should be made, or whether the proposed section should remain the same.

A summary of the practical difficulties with specific sections of the proposed place of activity rules are discussed below:

### 3.2.1 *Proposed section 1A(1)(a)(i): goods delivered or made available in the Republic*

It was pointed out that proposed section 1A(1)(a)(i) contravenes the policy reasons behind the section 12(k) exemption that applies to so-called 'pre-entry sales' by foreign persons. In the absence of section 12(k), pre-entry sales by foreign persons would lead to such persons carrying on an enterprise in the Republic, where their pre-entry sales are concluded 'continuously or regularly'. Such foreign persons would then be required to levy output VAT in terms of section 7(1)(a) on their pre-entry sales if they have

exceeded the compulsory registration thresholds in section 23(1). The goods supplied under pre-entry sales would then again be subject to import VAT in terms of section 7(1)(b) when cleared for home consumption at ports or border posts. Section 12(k) was therefore introduced to prevent such foreign persons from having to register for VAT as a result of their pre-entry sales and to prevent the goods supplied under pre-entry sales from being subject to VAT twice.

This comment is true from a policy perspective. However, the practical application of the proposed section 1A(1)(a)(i) would not influence the *status quo* as such foreign suppliers would still not be required to register as vendors in the Republic and their pre-entry sales would continue to be exempt from VAT in terms of section 12(k). This is based on the fact that proviso (v) to the definition of 'enterprise' in section 1(1) determines that an activity would not be deemed to be the carrying on of an enterprise to the extent that it involves the making of exempt supplies. Therefore, even though the proposed section 1A(1)(a)(i) would deem pre-entry sales to constitute an activity carried on in the Republic, proviso (v) to the definition of 'enterprise' in section 1(1) would deem such pre-entry sales as not forming part of an enterprise in the Republic. The *status quo* would therefore remain as the pre-entry sales of foreign persons would continue to be exempt from the liability of VAT registration after the introduction of the proposed section. The proposed section was not amended.

### 3.2.2 *Proposed section 1A(1)(a)(iii): goods imported into the Republic*

One of the respondents held that proposed section 1A(1)(a)(iii) would lead to double taxation. This response was based on the fact that imported goods are subject to VAT in terms of section 7(1)(b). If an offshore supplier of goods with no business presence in the Republic is required to register for VAT in the Republic as a result of the proposed section 1A(1)(a)(iii), such a supply would again be subject to VAT in terms of section 7(1)(a).

The respondent's view is acknowledged and *section 1A(1)(a)(iii)* is thus deleted from the proposed section.

### 3.2.3 *Proposed section 1A(1)(c): real rights and options*

A recommendation was made to delete proposed section 1A(1)(c) because the definition of 'goods' in section 1(1) already includes 'real rights' in goods. The place of activity of real rights is therefore already determined in terms of proposed section 1A(1)(a). The respondent further held that options constitute services and as such should qualify to be dealt with in terms of the proposed section 1A(1)(e).

The respondent's view is acknowledged and this proposed subsection is thus deleted.

### 3.2.4 *Proposed section 1A(1)(d): services physically rendered in the Republic*

One respondent expressed concern over the fact that this proposed section would include the activities of foreign service providers in the Republic. In this regard the respondent held the following:

Foreign service suppliers with no physical or business presence in South Africa often render services via subcontractors, agents or intermediaries. A transaction often encountered is where a foreign company second staff to a local entity to render services under [the] supervision and for the benefit of

the local entity in South Africa. To require these foreign entities to register for VAT in South Africa when they recover only the actual employee cost, seems to be counter-productive.

This view is accepted when considered against the fact that the South African Revenue Service (SARS) does not currently have a simplified compliance and administrative regime for foreign service providers where such services do not constitute ‘electronic services’ as defined in section 1(1). However, such services are consumed in the Republic and as such must be subject to VAT in the Republic, irrespective of the administrative burden that may be experienced by such foreign service providers in having to register as vendors and having to submit VAT returns regularly. This subsection was not amended.

### 3.2.5 *Proposed section 1A(1)(e): services not dealt with elsewhere in the proposed section*

One respondent held that the exclusions in subparagraphs (i) to (iii) of proposed section 1A(1)(e) should be deleted on the grounds that proposed section 1A(1)(e) would only apply to services that are connected with any supply treated as being made in the Republic in terms of the proposed section. Such services would therefore, by necessary implication, not be connected to other supplies that have their place of consumption outside the Republic.

The respondent’s view is acknowledged and thus subparagraphs (i) to (iii) of proposed section 1A(1)(e) is deleted.

### 3.2.6 *Proposed section 1A(1)(f): intellectual property rights for use in the Republic*

Two respondents held that the proposed section 1A(1)(f) is in contravention of the judgment handed down in *Stellenbosch Farmers’ Winery Ltd v Commissioner of the South African Revenue Service* 2012 (5) SA 363, 74 SATC 235 (SCA). In this case it had to be determined whether the surrender of an exclusive distribution right by a vendor, granted to the vendor by an offshore business, may be zero-rated in terms of section 11(2)(l) dealing with services supplied to a person who is not a resident. The supply was zero-rated because the court held that the *situs* of incorporeal property (the location thereof) is where the debtor ‘resides’ and that the surrender of the distribution right can therefore not be connected with the vendor’s movable property in the Republic as the debtor was a company based in the United Kingdom. The principle resulting from *Stellenbosch Farmers’ Winery Ltd v CSARS* cannot be applied to the definition of ‘enterprise’ to hold that the place of supply of intellectual property by offshore businesses to recipients in the Republic is outside the Republic.

Section 11(2)(m), not section 11(2)(l), is the section that deals with the zero-rating of outbound supplies of intellectual property rights. Section 11(2)(m) applies a pure consumption test as it would only exempt intellectual property rights to the extent that they are used outside the Republic. Proposed section 1A(1)(f) is based on section 11(2)(m), with the only exception being that it applies to inbound supplies of intellectual property rights.

One of the respondents commented that this section is in contravention of the views expressed by SARS in VAT News 37, where it was held that offshore businesses supplying intellectual property to consumers in the Republic need not register for VAT in the Republic if they do not have a physical presence or fixed place of business in the

Republic, and provided that the activities resulting in their fees are completely ‘passive’ in nature (SARS, 2011).

We do not agree with this view. The purpose of the proposed section is to determine when an activity would be carried on in the Republic for purposes of applying the definition of ‘enterprise’ in section 1(1). Even if the proposed section determines an activity to be carried on in the Republic, all the other elements of the definition of ‘enterprise’ in section 1(1) must still be satisfied before an enterprise could be carried on in the Republic. An offshore business supplying intellectual property to recipients in the Republic would therefore still only carry on an enterprise in the Republic if its activities in the Republic are carried on ‘continuously or regularly’ as required by the definition of ‘enterprise’ in section 1(1). The views expressed by SARS in VAT News 37 would therefore continue to apply, in spite of the introduction of the proposed section that would hold the supply of intellectual property for use in the Republic to constitute the carrying on of an activity in the Republic.

The section was not amended.

### 3.2.7 *Proposed section 1A(1)(g): extent of activities forming part of an enterprise*

Two respondents stated that the purpose of proposed section 1A(1)(g) is unclear. After careful consideration, it was decided that this section is not necessary to be included in the proposed section.

### 3.2.8 *Other practical difficulties pertaining to the proposed section*

One of the respondents maintained that the proposed section did not cater for specific types of supplies and commented as follows:

The suggested wording assumes a homogenous population of transactions to which generic rules can apply. The world we live in today is categorised by complexity and diversity and changes on a daily basis.

The VAT Act is based on the modern VAT system making use of a broad set of rules that must be applied on an iterative basis to all types of supplies imaginable (OECD, 2003). The proposed section was developed on this premise and therefore this comment was not accepted.

Another respondent indicated that the proposed section did not deal with the ‘level of activity’ that is required in order for an enterprise to come into existence. According to this respondent,

[i]t is not clear as to whether a foreign company that is involved in a once-off contract with a South African entity would be considered to carry on an enterprise in South Africa if such activities are carried out for a short period of only three to six months, as opposed to a longer period.

Although the literature review indicated that practical difficulties are encountered in establishing the level of activity required for an enterprise to come into existence, it is submitted that such difficulties cannot be remedied through a place of activity section. This submission is based on the fact that the level of activity that is required for an enterprise to come into existence is determined by the phrase ‘continuously or regularly’ in the definition of ‘enterprise’ in section 1(1), and not by the phrase ‘in the Republic or partly in the Republic’ in the definition of ‘enterprise’ in section 1(1). It is for the

latter phrase as opposed to the former for which the proposed section was developed and this comment is therefore not accepted.

### 3.2.9 Interpretational difficulties

All the respondents indicated that there are interpretational difficulties with the following words: ‘delivered or made available’, ‘utilises or consumes’, ‘goods supplied directly in connection with fixed property’, ‘goods ordinarily situated in the Republic’, ‘services physically rendered’, ‘services ... connected with any supply’ and ‘ordinarily situated outside the Republic’.

The phrase ‘delivered or made available’ is based on section 9-25(1) of the Australian GST Act. This phrase covers the physical delivery of goods or goods physically made available to a recipient in the Republic by a foreign supplier. It will also cover instances where a foreign supplier acquires goods in the Republic which are then made available or delivered to a recipient in the Republic. The phrase also includes instances where a foreign supplier imports goods into the Republic that are subsequently delivered or made available to a recipient in the Republic. It will, however, not include instances where the recipient imports the goods into the Republic, as such goods will not be delivered or made available in the Republic by the supplier.<sup>14</sup>

The phrase ‘utilises or consumes’, as it appears in the proviso to proposed section 1A(1)(a), is based on the phrase ‘utilised or consumed’ as it appears in the definition of ‘imported services’ in section 1(1). As identified in previous studies, the phrase ‘utilised or consumed’ is ambiguous (Van Zyl, 2013a; Van Zyl, 2013b; Olivier & Honiball, 2011; Silver & Beneke, 2016). The proviso to proposed section 1A(1)(a) is based on section 8(4) of the New Zealand GST Act. Section 8(4) of the New Zealand GST Act makes use of the phrase ‘supplies goods and services ... to a registered person for the purposes of carrying on the registered person’s taxable activity’. It is submitted that the phrase ‘for purposes of carrying on’ in section 8(4) of the NZ GST Act is similarly based on a pure consumption test. Therefore, replacing the phrase ‘utilised or consumed’ with the corresponding phrase in section 8(4) of the New Zealand GST Act would not increase certainty when interpreting the proviso to proposed section 1A(1)(a). It is therefore submitted that the exact meaning of the phrase ‘utilised or consumed’ should rather be clarified by way of an interpretation note issued by SARS. SARS’ interpretation of the phrase can then be applied for purposes of both the definition of ‘imported services’ in section 1(1) and the proviso to proposed section 1A(1)(a).

The phrase ‘goods supplied directly in connection with fixed property’ will be deleted from proposed section 1A(1)(b) as such goods are adequately dealt with in proposed section 1A(1)(a).

Proposed sections 1A(1)(c) and 1A(1)(e)(ii) are based on section 142(1) of the Canadian GST legislation (in *Excise Tax Act*, RSC 1985, c. E-15). The phrase ‘ordinarily situated’ requires the adoption of a practical test, based on all surrounding facts and circumstances available to the supplier, to determine whether the moveable property will be ordinarily situated inside or outside of the Republic. Based on the responses received from the VAT experts, section 1A(1)(c) and subparagraphs (i) to (iii) of

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<sup>14</sup> Australian Taxation Office, ‘Goods and services tax: supplies connected with Australia’, GSTR 2000/31 (consolidated to 10 August 2016).

proposed section 1A(1)(e) will be deleted. The phrase ‘ordinarily situated’ will therefore be removed from the proposed section.

The phrase ‘services physically rendered in the Republic’ requires the supplier to be physically present in the Republic when the services are supplied. Proposed section 1A(1)(d) is not limited to on-the-spot supplies. It would therefore apply to any other supply of services if the supplier is physically present in the Republic while the supply is being made, irrespective of whether the supply is made to a recipient located inside or outside the Republic and would be zero-rated.

To ensure that services consumed in the Republic do not escape the Republic’s VAT net, a deliberate decision was taken to include the phrase ‘connected with’ as opposed to ‘directly connected with’ in proposed section 1A(1)(e). The phrase ‘connected with’ requires a causal link between the services and the supply connected with the Republic. Such a causal link need not be a direct link. In *ITC 885*, 23 SATC 336, 338 (1959) (C) it was held that the words ‘in connection with’ should be given a wide meaning, but not so wide that it includes a remote or completely indirect connection.

From the above it is evident that the respondents had some concerns with the proposed place of activity section. A thematic analysis was done to identify the main themes emerging from their concerns.

### 3.3 Thematic analysis

The thematic analysis process led to the identification of two main themes. The first one holds that the proposed section should only apply to the activities of persons who are not residents of the Republic. The introductory sentence in the proposed subsection (1) was amended by specifically referring to ‘an activity of a person who is not a resident of the Republic’. This would ensure that the proposed section does not apply to residents of the Republic.

The second theme holds that offshore suppliers should be brought into the Republic’s VAT net only if their introduction would lead to an increase in the revenue accruing to the *fiscus* and provided that they are actually carrying on activities in the Republic.

This theme consists of two subthemes which are:

- the revenue requirement for the introduction of foreigners into the Republic’s VAT net; and
- the physical activities of the foreigners in the Republic.

#### 3.3.1 Subtheme 1: revenue requirement for foreigners

Some of the respondents provided commentary to the effect that the proposed section would require foreign persons to register as vendors even though such registrations would not lead to an increase in revenue accruing to the *fiscus*. In this regard, one of the respondents commented:

It makes no logical sense to bring all non-resident suppliers of ... intellectual property into the Republic’s VAT net where such supplies are made to persons who use the same wholly for taxable purposes.

The proposed section would have the effect of requiring such foreign persons to register as vendors and to submit VAT returns regularly if they ‘continuously or regularly’

supply services such as intellectual property to recipients located in the Republic and if the value of such supplies exceeds the compulsory registration thresholds in section 23(1). Such foreign persons would then be required to incur administrative and compliance costs in the Republic without any additional revenue accruing to the *fiscus*. No additional revenue would accrue to the *fiscus* if the recipients in the Republic use the supplies wholly for purposes of making taxable supplies as the full amount of output tax raised by such foreign persons on their supplies would be allowed as input tax credits to the recipients.

### 3.3.2 *Subtheme 2: physical activities of foreigners in the Republic*

VAT registrations for foreign persons without any place of business in the Republic should be limited to the greatest possible extent. One of the respondents said that unnecessary registrations must be avoided so as not to deter foreign companies from undertaking meaningful operations in South Africa.<sup>15</sup>

Proposed section 1A(1)(a)(iii) would require a foreign supplier of goods to register for VAT in the Republic if the recipient of the goods initiates the importation into the Republic, and if the value of the goods so imported from the foreign supplier exceeds the compulsory registration thresholds in section 23(1). This would apply even if the foreign supplier does not initiate the importation and irrespective of whether or not the foreign supplier has a place of business in the Republic.

It is submitted that relief could, to a limited extent, be provided to foreign suppliers of goods by deleting subparagraph (iii) of the proposed section 1A(1)(a). This would have the effect that the importation of goods into the Republic that was initiated by the recipient would not give rise to a VAT registration liability in the Republic for the foreign supplier. In such an instance the recipient would be required to levy import VAT on the imported goods in terms of section 7(1)(b), read together with section 13. The place of taxation for goods imported into the Republic at the instance of the recipient would therefore continue to be within the Republic. The deletion of the proposed section 1A(1)(a)(iii) would, however, not dissolve the registration liability for foreign suppliers who initiate the importation of the goods into the Republic. In such a case, the proposed section 1A(1)(a)(i) would deem such an importation to constitute an activity carried on by the offshore supplier in the Republic. To provide more clarity that the proposed section would only deem an activity to be carried on in the Republic when it is the foreign supplier who imports the goods into the Republic as opposed to the recipient, proposed section 1A(1)(a)(i) will be amended by specifically requiring the goods to be delivered or made available in the Republic by the foreign supplier.

### 3.3.3 *Conclusion on the responses*

To increase clarity, three of the seven phrases that were identified by the respondents as ambiguous were removed from the proposed section. These phrases are ‘goods supplied directly in connection with’, ‘goods ordinarily situated in the Republic’ and ‘ordinarily situated outside the Republic’. The meanings of the phrases ‘delivered or made available’, ‘services physically rendered’ and ‘services connected with any supply’ were provided. It is submitted that SARS should issue an interpretation note to clarify the

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<sup>15</sup> Explanatory memorandum on the Taxation Laws Amendment Bill, 2012.



meaning of ‘utilised or consumed’ for purposes of the proviso to the proposed section and for the definition of ‘imported services’ in section 1(1).

The next and final section draws a conclusion based on the results from this research and provides the amended proposed place of activity section that could be included into South Africa’s VAT Act.

#### 4. SUMMARY AND CONCLUSION

The main objective of this study was to develop a standalone place of activity section for the VAT Act that adheres to the OECD Guidelines. This is in line with the suggestions by a former Minister of Finance, Mr Trevor Manuel (National Treasury, 2006) and the Davis Tax Committee (DTC, 2014). The importance of such a section is that it increases certainty when determining whether a supply should be subject to VAT in the Republic and whether a foreign supplier should register as a vendor in the Republic. This makes cross-border supplies involving the Republic less susceptible to double taxation or double non-taxation and may therefore lead to an increase in foreign direct investment in the Republic.

The final proposed section was drafted after evaluating the critique and comments of the experts collected through the survey:

**1A. Place of supply.** (1) For purposes of the definition of enterprise, an activity of a person who is not a resident of the Republic will be deemed to be carried on in the Republic to the extent that it consists of a supply of

- (a) goods, other than fixed property, if such goods are-
  - (i) delivered or made available in the Republic by the supplier to the recipient or at the recipient’s request, to any other person;
  - (ii) installed, assembled or produced in the Republic; or
  - (iii) removed from the Republic;
- (b) fixed property situated in the Republic;
- (c) services physically rendered in the Republic;
- (d) services, other than services referred to in paragraph (b)(vi) of the definition of enterprise and paragraphs (c) and (e) of this section, connected with any supply that is treated as being made in the Republic in terms of this section; or
- (e) intellectual property to the extent that the rights are for use in the Republic;

Provided that an activity referred to in paragraphs (a) to (e) would, at the election of the supplier, be deemed to be carried on outside the Republic if such an activity would, but for this proviso, constitute a taxable supply made to a registered vendor who utilises or consumes such a supply wholly for purposes of making taxable supplies.

The study has a number of limitations: A standalone place of supply section was developed by considering the legislation of only two other countries: Australia and New Zealand. Furthermore, only one round to the experts for comment on the proposed section was administered, which is a deviation from the normal Delphi method. Although we are of opinion that sufficient responses were received from the experts to develop the section, it is a limitation that only five experts were consulted. The fields from which the experts were selected are also limited as it does not include academics and also no representatives from SARS.

Should this section be promulgated, modifications are required in other sections that could become void or irrelevant. These modifications to other sections were not considered for purposes of this study. As suggested in the article, interpretation notes should be issued explaining some of the problematic phrases. This study did not, however, intend to draft these interpretation notes. Further research could be undertaken by addressing the abovementioned limitations.

From a theoretical point of view, this study developed a standalone place of activity section for the VAT Act that adheres to the OECD Guidelines. From a policy and technical perspective, this study can assist the National Treasury in developing a specific place of activity section for the VAT Act. The fact that the participating experts had differences of opinion as to what we presented, confirms that determining the place of consumption, which was used to develop place of supply rules for a nation, is like 'wrapping one's hands around a piece of jelly'.

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# Implementing corporate tax cuts at the expense of neutrality? A legal and optimisation analysis of fundamental reform in practice

Ann Kayis-Kumar\*

## ***Abstract***

Governments and policy-makers are increasingly faced with the trade-off of protecting their tax revenue bases while maintaining their international competitiveness. This is exemplified by the international trend of jurisdictions reducing their headline corporate tax rates, which is often justified on the basis that these cuts will lead to improved efficiency and integrity outcomes. This article explores whether it is more efficient to implement corporate tax cuts or an alternative reform such as an economic rent tax which may better achieve the tax policy goals of efficiency and integrity.

In doing so, this article bridges the gap between applied legal research, economic theory and practical optimisation modelling. Specifically, this research presents a simulation analysis of the behavioural responses of a tax-minimising multinational enterprise to both existing and proposed tax regimes and compares efficiency and integrity outcomes upon implementing corporate tax cuts. This is complemented by a legal comparative analysis featuring case studies of an economic rent tax; namely, the Allowance for Corporate Equity (ACE) as introduced in Belgium and Italy. These case studies will focus on the political hurdles to implementing and sustaining these reforms, which will highlight key lessons learnt from the implementation of the ACE in practice.

**Key words:** Tax neutrality, Corporate tax reform, Allowance for Corporate Equity

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\* BCom(Finance)/LLB(Hons) (UNSW), PhD (UNSW), School of Taxation and Business Law (incorporating Atax), UNSW Australia, Solicitor of the Supreme Court of New South Wales, Federal Court and High Court of Australia, a.kayis@unsw.edu.au. The author is grateful to her PhD supervisors, Professor Neil Warren and Professor John Taylor, for their invaluable insights and to Professor Miranda Stewart and Professor Reuven Avi-Yonah for their helpful comments.

## 1. BACKGROUND

The advent of the global digital economy has heightened opportunities for aggressive tax planning by multinational enterprises (MNEs) and has spurred harmful tax competition between governments. Governments and policy-makers are increasingly faced with the trade-off of increased international competitiveness to encourage investment from MNEs with the need to protect their tax revenue bases.

Recently, prominent members of the G20 have signalled their intention to eventually reduce their headline corporate tax rates; this is exemplified by the US and the UK, who are both now targeting reductions to their corporate income tax (CIT) rates; to possibly as low as 15 per cent.<sup>1</sup>

There is a perception that cross-border anti-avoidance rules such as thin capitalisation and transfer pricing rules effectively protect the tax revenue base from aggressive tax planning behaviour in the cross-border intercompany context. However, the ability of these rules to restrict tax deductibility is often conflated with their ability to attain efficiency and integrity outcomes. Previous research by the author has demonstrated that these rules do not eliminate tax-induced distortions, which would be required to attain efficiency. On the other hand, economic rent taxation is generally considered in the economic literature to be an appropriate mechanism to eliminate tax-induced distortions.

Given the tension commonly experienced by policy-makers between lowering the headline rate of CIT as opposed to implementing economic rent taxes, this article compares the efficiency and integrity outcomes between these two reform approaches.

Academics and commentators such as De Mooij and Ederveen highlight the normative value in the argument for ‘a neutral tax treatment of incomes earned in different legal forms’.<sup>2</sup> Previous research by the author has examined the conceptual case for why it might be appropriate and feasible to restrict the tax deductibility of cross-border intercompany interest, dividends, royalties and lease payments given their mobility and fungibility.<sup>3</sup> As such, it is arguably preferable for MNEs to be subject to economic rent taxation, as is attained through reform proposals such as the allowance for corporate equity (ACE), in this context.

Even though the cross-border issue cannot be isolated from the rest of the tax system,<sup>4</sup> the focus of this article is the cross-border dimension because distortions in tax laws are highly problematic in this context. For example, the phenomenon of thin capitalisation arises from the decisions of revenue authorities to create a tax-induced cross-border debt

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<sup>1</sup> See, for example, Mike Lane, ‘Autumn Statement 2016: The Impact on Multinationals’ (2016) 1333 *Tax Journal* 10.

<sup>2</sup> Ruud A de Mooij and Sjef Ederveen, ‘Corporate Tax Elasticities: A Reader’s Guide to Empirical Findings’ (2008) 24(4) *Oxford Review of Economic Policy* 680, 696.

<sup>3</sup> Ann Kayis-Kumar, ‘International Tax Planning by Multinationals: Simulating a Tax-Minimising Intercompany Response to the OECD’s Recommendation on BEPS Action 4’ (2016) 31(2) *Australian Tax Forum* 363; Ann Kayis-Kumar, ‘Taxing Cross-Border Intercompany Transactions: Are Financing Activities Fungible?’ (2015) 30(3) *Australian Tax Forum* 627.

<sup>4</sup> Harry Grubert and Rosanne Altshuler, ‘Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income’ in John Diamond and George Zodrow (eds), *Fundamental Tax Reform: Issues, Choices, and Implications* (MIT Press, 2008) 319, 319-321.

bias, which presents opportunities for tax base erosion.<sup>5</sup> The tax-induced cross-border debt bias incentivises behavioural responses to take advantage of the international classification differences between debt and equity,<sup>6</sup> and distorts MNEs' corporate financing decisions.

## 2. AGGRESSIVE TAX PLANNING AND THE NEUTRAL TAX TREATMENT OF INCOMES

A central thread in the literature concerning MNEs' aggressive tax planning behaviour is that the opportunities for these behaviours are created by governments and policy-makers themselves through the design of tax rules.<sup>7</sup> This article assumes that where a tax-minimising MNE has the opportunity to benefit from tax planning given the design of tax rules (including transfer pricing, thin capitalisation and debt/equity rules), it will adjust its behaviour accordingly. This could involve, for example, maximising overall deductions in higher-tax jurisdictions to minimise the group-wide tax liability and, in turn, the MNE's overall net profit after tax. This highlights that there is an urgent imperative for tax rules impacting cross-border intercompany transactions to be designed such that efficiency and integrity outcomes are both prioritised and attained.

Accordingly, section 2.1 below highlights the policy challenge presented by tax-minimising behaviours by MNEs and how international tax competition may have the unintended consequence of encouraging aggressive tax planning. This is followed by an analysis in section 2.2 of the challenge presented by the existence of economic inefficiencies – or tax-induced distortions – in the tax treatment of cross-border intercompany activities, which of themselves give rise to tax planning opportunities for MNEs. Finally, section 2.3 observes that, given the trade-off between international competitiveness and tax revenue base protection, it is arguably more efficient – and, in turn, more effective – to instead align the tax treatment of cross-border intercompany transactions to eliminate the incentive for tax planning behaviours.

### 2.1 Profit shifting: aggressive tax planning and international tax competition

Despite criticisms of aggressive tax planning behaviour by MNEs, the philosophical framework of free market capitalism appears to justify this behaviour.<sup>8</sup> This is exemplified in the 'efficiency' argument, which is oft-cited by MNEs as a justification for utilising tax havens on the basis that tax-minimising behaviour can encourage greater investment by MNEs. While the economic literature espouses that the profit motive ensures that resources are being allocated efficiently, this reasoning hinges on the simplifying theoretical assumptions that firms operate in free and competitive markets. Yet, these underlying theoretical assumptions do not exist in the current global financial system. Only the largest MNEs are best positioned to exploit differences in

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<sup>5</sup> Ann Kayis-Kumar, 'Thin Capitalisation Rules: A Second-Best Solution to the Cross-Border Debt Bias?' (2015) 30(2) *Australian Tax Forum* 299; see also Dean Hanlon, 'Thin Capitalisation Legislation and the Australia/United States Double Tax Convention: Can They Work Together?' (2000) 3(1) *Journal of Australian Taxation* 4.

<sup>6</sup> Mihir A Desai, Testimony before the US Senate Committee on Finance and the US House Committee on Ways and Means (13 July 2011) 4, available at:

<http://www.finance.senate.gov/imo/media/doc/DesaiTestimonyFinal.pdf>.

<sup>7</sup> Philipp Genschel and Peter Schwarz, 'Tax Competition: A Literature Review' (2011) 9(2) *Socio-Economic Review* 339, 364.

<sup>8</sup> The profit motive provides the justification for internalising benefits while externalising costs, which includes the minimisation of taxation.

jurisdictions' tax systems to minimise their tax liability. This process of tax arbitrage does not improve productivity nor does it constitute 'true' innovation.<sup>9</sup>

Using intercompany transactions, MNEs can shift intercompany expenses to, and intercompany income from, source countries to minimise tax payable with relative ease.<sup>10</sup> De Mooij and Ederveen<sup>11</sup> note the empirical evidence on profit shifting yielding the largest corporate tax base elasticities. However, the scale of the problem is considered to be even more significant with academics including Seto positing that '... an unknown but presumably significant number of companies use aggressive intercompany pricing to reduce their overall tax liabilities and get away with doing so'.<sup>12</sup>

Given the significance afforded to the design of rules countering aggressive tax planning behaviour by MNEs, it is necessary to consider the impacts of changing these rules, as detailed in the empirical literature. Keen has observed that, even though both multilateral cooperation and unilateral anti-avoidance rules may reduce MNEs' propensity to engage in profit shifting, this will likely also increase competitive pressure on foreign direct investments. So, if MNEs in high-tax jurisdictions are rendered unable to engage in profit shifting there may be a greater incidence of relocating production to other jurisdictions.<sup>13</sup> This is tested through the simulation analysis conducted in section 4 below.

## 2.2 Base erosion: tax neutrality theories and cross-border intercompany transactions

A central premise of this article is that wherever possible tax-induced reductions in economic efficiency ought to be minimised. This is in line with the tax neutrality principle, which states that tax systems should strive to be neutral such that decisions are made on their economic merits, rather than for tax reasons. This is particularly problematic because economic inefficiencies – or tax-induced distortions – in the tax treatment of cross-border intercompany activities give rise to tax planning opportunities for MNEs. As such, there is an urgent imperative for a tax treatment of cross-border intercompany transactions with a strong conceptual basis.

However, the international tax literature often does not consider the fungibility of passive or highly mobile income in the cross-border intercompany context. This translates to a lack of funding neutrality in the design and evaluation of cross-border tax rules.

This is arguably at odds with a central goal of economics and the economic analysis of law; namely, efficiency optimisation.<sup>14</sup> Admittedly, when applied in the tax law context,

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<sup>9</sup> Michael Porter and Mark Kramer, 'Creating Shared Value' (2011) 89(1/2) *Harvard Business Review* 62.

<sup>10</sup> The OECD has noted '...the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities (MFEs). This capital can then be invested in assets used within the MNE group, creating base eroding payments to these MFEs': see further OECD, *Public Discussion Draft, BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)*, 1 December 2014 – 6 February 2015 (OECD, 2014) 38. For completeness, residence issues are beyond the scope of this article.

<sup>11</sup> De Mooij and Ederveen, above n 2, 683-684.

<sup>12</sup> Theodore P Seto, 'Four Principles of Optimal Tax System Design' (Legal Studies Paper No 2008-36, Loyola Law School, March 2013) 5-6.

<sup>13</sup> Genschel and Schwarz, above n 7, 364.

<sup>14</sup> See, for example, Alex Raskolnikov, 'Accepting the Limits of Tax Law and Economics' (2013) 98(3) *Cornell Law Review* 523, 551; Lena Hiort af Ornäs Leijon, 'Tax policy, economic efficiency and the



the unique complexity of the tax optimisation problem renders the task of designing the optimal tax system immensely difficult compared to other areas of law such as competition policy, corporate law and securities regulation.<sup>15</sup> There are three key challenges that give rise to this unique complexity.<sup>16</sup> First, taxation inevitably gives rise to inefficiencies and some taxpayers' inefficient responses to taxation cannot be fully deterred by legal rules (the 'undeterrability problem'). Second, it is impossible to fully resolve both the undeterrability problem and the 'redistribution problem'; however, it is in theory possible to reach a compromise which balances the benefits of redistribution with the inevitable costs of tax-induced distortions. Third, there exists a fundamental disconnect between actual tax regimes and the design of optimal tax rules.

These issues are dramatically amplified in the cross-border setting, where the existing system is 'so far from the optimal income tax baseline that the effort to reference it would be decidedly doomed'.<sup>17</sup> Raskolnikov notes that there is no optimal rule for allocating interest expense by MNEs, nor is there an optimal theory of international taxation, corporate tax or capital income taxation.<sup>18</sup> This sentiment is echoed by Weisbach, who makes the following two critiques: '[s]tandard optimal tax models do not even have firms ... Neutralities, the standard tool of international tax policy, are not helpful'.<sup>19</sup>

In this context, this article makes two additional critiques. First, the literature does not consider 'optimised' behavioural responses by MNEs in the limited context of tax minimisation; nor does it anticipate how policy-makers could respond to those behavioural responses. Second, the tax neutrality theories that have been introduced as criteria for achieving economic efficiency at the international level have limited usefulness in the context of designing tax rules targeting base erosion by MNEs.<sup>20</sup>

As such, it is meaningful to consider economic efficiency benchmark criteria for company taxation and apply those principles to the cross-border setting. Specifically, Warren provides a synthesis of neutrality criteria for company taxation, as extracted in Fig. 1 below.<sup>21</sup>

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principle of neutrality from a legal and economic perspective' (Uppsala Faculty of Law, Working Paper 2015:2) 17.

<sup>15</sup> Raskolnikov, above n 14, 524-525.

<sup>16</sup> Ibid 525-527.

<sup>17</sup> Ibid 551.

<sup>18</sup> Ibid.

<sup>19</sup> David A Weisbach, 'The Use of Neutralities in International Tax Policy' (University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No 697, 18 August 2014) 14-19.

<sup>20</sup> Grubert and Altshuler, above n 4, 331-333; see further Michael J Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies' (2001) 54(3) *Tax Law Review* 261, 280-282, who observes that increasing worldwide welfare does not necessarily increase national welfare in the case of international tax policy, thereby supporting national welfare, rather than worldwide efficiency, as a policy goal; see also Daniel Shaviro, 'Why Worldwide Welfare as a Normative Standard in US Tax Policy?' (2007) 60(3) *Tax Law Review* 155, 164-165, who contends that, even if worldwide welfare improves national welfare by encouraging cooperative behaviour, unobserved defections should improve national welfare.

<sup>21</sup> Neil Warren, 'Modelling the Economic Outcomes from TVM: Is It Practical and Meaningful?' in Yuri Grbich and Neil Warren (eds), *Tax Value Method Consultative Conference, 23-24 July 2001* (Australian Tax Research Foundation, 2001), 197-215.

**Fig. 1: Economic Efficiency Benchmark Criteria**

<i>Economic efficiency</i>	
<i>Criteria</i>	<i>Description</i>
<i>Funding neutrality</i>	<i>Does not distort the decision on how to fund a business (eg debt vs equity)</i>
<i>Risk neutrality</i>	<i>Permits risk offset and adjustment</i>
<i>Business structure neutrality</i>	<i>Incorporated and unincorporated companies treated similarly</i>
<i>Net income neutrality</i>	<i>Neutral in its treatment of different income and expenditure sources and asset and liability types</i>
<i>Payout neutrality</i>	<i>Neutral between dividends and retentions; and neutral in its impact on financial innovation (bifurcation vs aggregation)</i>
<i>Taxpayer neutrality</i>	<i>Incentives to different groups should result in the same outcome for individuals, whatever structure is invested in</i>
<i>Capital import/export neutrality</i>	<i>Benefit to resident and offshore investors should be similar</i>
<i>Institutional neutrality</i>	<i>No prejudice or favour by government to sectors or groups (and if so, any market intervention should be efficiently targeted, transparent and costed)</i>

Source: Warren (2001)

Cross-referencing Warren's conceptual framework with Raskolnikov's earlier critique, one key aspect that remains missing from the international neutrality debate is that of 'funding neutrality' (listed as criterion 1 in the above Fig. 1).<sup>22</sup>

In addition to the challenges presented by the complexity of cross-border intercompany transactions, these funding options are often economically equivalent (or 'fungible') but are subject to disparate tax treatments. For example, the cost of debt financing is deductible whereas the cost of equity financing is not deductible. This is particularly problematic because such non-neutral tax treatments present opportunities for base erosion. However, fundamental reforms that aim to equalise the tax treatment across debt and equity financing do exist; for example, the Allowance for Corporate Equity

<sup>22</sup> Funding neutrality is arguably a subset of 'capital ownership neutrality', which has a broad focus on '... the welfare impact of the importance of ownership to productivity in the design of international tax systems. This emphasis on ownership effects is consistent with the modern theory of foreign direct investment, which is based on a transaction-cost approach under which the market advantages of multinational firms arise from the benefits of joint ownership of assets across locations': James R Hines, Jr, 'Reconsidering the Taxation of Foreign Income' (2009) 62(2) *Tax Law Review* 269, 279.

(ACE) as introduced in Belgium and Italy, which is the focus of the legal analysis<sup>23</sup> in section 3 and the modelling in section 4.

### 2.3 Implementing corporate tax cuts at the expense of funding neutrality: the trade-off between international competitiveness and base protection

Governments and policy-makers are increasingly faced with the trade-off of increased international competitiveness to encourage investment from MNEs with the need to protect their tax revenue bases. Tax competition is often considered a force that drives down corporate income taxes across countries in a ‘race to the bottom’.<sup>24</sup> This is a product of reactionary policies and the outcome of a reduced revenue take is reduced scope for fiscal stimulus due to tightened budget constraints.

The central argument of this article is that tax-induced behavioural distortions (or inefficiencies) create profound problems for governments and policy-makers<sup>25</sup> and so should not be overlooked when enacting tax reforms such as corporate tax cuts.

The Organisation for Economic Co-operation and Development (OECD) is currently considering best practice approaches to designing rules to prevent base erosion and profit shifting (BEPS) by MNEs. However, the OECD makes a distinction between combating BEPS and reducing distortions between the tax treatment of various methods of financing.<sup>26</sup>

Yet, it is the decision of the revenue authorities to create distortions which actually results in these tax base erosion opportunities.<sup>27</sup> Rather than merely addressing the behavioural symptoms of these distortions, such as debt shifting via excessive interest deductions,<sup>28</sup> it is arguably more effective to instead align the tax treatment of cross-border intercompany transactions to eliminate the tax incentive for said tax planning behaviour. Accordingly, the behaviourally distortive effects of tax rules should be of primary concern regardless of one’s normative perspective and policy-makers concerned about tax planning need to consider the efficiency of the lines they draw. For example, while reducing the headline CIT rate may in turn reduce the magnitude of allowable debt deductions, eliminating the debt distortion requires more than reductions to corporate tax rates.

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<sup>23</sup> The rationale grounding this analysis is that tax policy developments can be better understood when legal analysis is synthesised with economic and political science analysis, thereby providing a more nuanced understanding of the underlying purpose, scope and timing of reforms.

<sup>24</sup> Marta Božina Beroš and Marin Beroš, ‘Fairness through Regulation? Reflections on a Cosmopolitan Approach to Global Finance’ (2013) 7(1) *The Journal of Philosophical Economics* 2; Genschel and Schwarz, above n 7.

<sup>25</sup> Distortive effects are not merely inefficient; they also affect fairness and administrability: Seto, above n 12, 3.

<sup>26</sup> It is clear that both the OECD’s BEPS project and the thin capitalisation rules’ *raison d’être* are primarily concerned with protecting national tax revenue bases. ‘In discussing fixed ratio rules it is important to note that in some cases these tests were also introduced to play a wider tax policy role rather than with a focus on combating base erosion and profit shifting. For example, a number of countries introduced such rules specifically to reduce existing distortions between the tax treatment of debt and equity’: OECD, *BEPS Action 4: Interest Deductions and Other Financial Payments: Public Discussion Draft*, 18 December 2014-6 February 2015 (OECD, 2014) 47.

<sup>27</sup> Hanlon, above n 5.

<sup>28</sup> Previous work by the author conceptualises the cross-border debt bias as the ‘disease’ and the behavioural response of MNEs of engaging in debt shifting or thin capitalisation as merely the ‘symptom’: Kayis-Kumar, ‘Thin Capitalisation Rules’, above n 5.

Indeed, an ACE such as that introduced in Belgium and Italy presents a more robust approach to eliminating the debt distortion. These reforms are examined in turn in section 3 below.

### 3. CASE STUDIES OF ACE-VARIANTS: TO IMPLEMENT CORPORATE TAX CUTS OR INTRODUCE AN ACE-VARIANT?

As highlighted in the previous section, there is a marked tension commonly experienced by policy-makers between either lowering the CIT rate (coupled with base broadening measures) or implementing an economic rent tax such as the ACE (which is often associated with a reduction in tax revenue).<sup>29</sup> Further, leading commentators observe that, where a jurisdiction has repealed its ACE-variant, this was not brought about by any fundamental problem with the theoretical ACE,<sup>30</sup> nor any technical flaw in the ACE system.<sup>31</sup> Rather, the abolition of these ACE-variants was simply in line with the dominant trend of reducing headline corporate income tax rates in the context of ‘tax-rate cut-cum-base broadening’.<sup>32</sup>

There has generally been bipartisan support for a target of lowering CIT rates in the face of increasing international tax competition, largely prompted by the forces of globalisation as countries pursue highly mobile capital investments made by large MNEs.<sup>33</sup>

However, the theory of capital income taxation in a small open economy, which concludes that the tax incidence for small open economies is shifted entirely to the domestic factors of production such as labour and land, assumes perfect capital mobility.<sup>34</sup>

It remains unclear who ultimately bears the burden of corporate taxes, with Menezes observing that:<sup>35</sup>

The argument for a reduction in the corporate tax rate was predicated in part in the simple theory of tax incidence expounded above. There are, however, several reasons why labour might not bear most of the burden of corporate taxes. Indeed, the issue of who effectively bears the burden of corporate income tax is yet to be resolved.

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<sup>29</sup> Daniel Shaviro, ‘Should Corporate Tax Reform Efforts Emphasize an “Allowance for Corporate Equity” (ACE)?’, 3; available at: [http://www.law.nyu.edu/sites/default/files/ECM\\_PRO\\_068214.pdf](http://www.law.nyu.edu/sites/default/files/ECM_PRO_068214.pdf).

<sup>30</sup> Alexander D Klemm, ‘Allowances for Corporate Equity in Practice’ (IMF Working Paper WP/06/259, November 2006).

<sup>31</sup> Michael Keen and John King, ‘The Croatian Profit Tax: An ACE in Practice’ (2002) 23(3) *Fiscal Studies* 401, 417.

<sup>32</sup> Ibid.

<sup>33</sup> John Diamond, George Zodrow and Robert Carroll, ‘Macroeconomic Effects of Lower Corporate Income Tax Rates Recently Enacted Abroad’ (Ernst & Young Report, Prepared for the Reforming America’s Taxes Equitably (RATE) Coalition, March 2013) 18.

<sup>34</sup> Theoretically, it is also suboptimal for a small open economy faced with perfect capital mobility to levy a source-based tax on the normal return to capital: Peter Birch Sørensen and Shane Matthew Johnson, ‘Taxing Capital Income: Options for Reform in Australia’ in Melbourne Institute (ed), *Australia’s Future Tax and Transfer Policy Conference, Proceedings of a Conference* (Melbourne Institute of Applied Economic and Social Research, 2010) 179, 187.

<sup>35</sup> Flavio M Menezes, ‘The Business Tax Reform Agenda’ (2012) 31(1) *Economic Papers* 3, 4.

While this article does not purport to enter this debate, given the global trend of lowering CIT rates it is instructive to briefly earmark the six reasons set out below against said reform.<sup>36</sup>

First, the home bias persists, capital markets are not perfect<sup>37</sup> and a CIT rate reduction in the host country only transfers tax revenues to countries that tax their MNEs on their worldwide income but allow foreign tax credits for the corporate taxes paid at source, thereby failing to change both the effective tax burden and the investment behaviour of MNEs.<sup>38</sup>

Second, the empirical evidence on the actual corporate tax burden borne by wages remains unclear, with the literature strongly questioning the theoretical suggestion that the tax incidence for small open economies is shifted entirely to the domestic factors of production such as labour and land. Further, reducing the CIT rate does not result in immediate flow-on benefits to workers in the form of extra capital, higher productivity and wages.<sup>39</sup>

Third, since the CIT is levied on both normal returns to capital and rents, a reduction in the headline CIT rate will necessarily reduce the tax on economic rents; thereby reducing the tax on investment that would occur in any event.<sup>40</sup>

Fourth, reducing the CIT rate will disproportionately benefit larger, more profitable firms, with no impact on already loss-making firms.

Fifth, the emerging literature focusing on the real economic effects of CIT rate changes shows that while CIT rate increases uniformly reduce employment and income, CIT rate reductions are ineffectual in boosting economic activity<sup>41</sup> except when implemented during recessions.<sup>42</sup>

Sixth, further reductions to the CIT rate will widen the wedge between the highest personal income tax bracket and the CIT rate, implying that further reductions in the CIT rate should not be made in isolation from changes in personal income tax because this presents a further deviation from business structure neutrality.<sup>43</sup>

These factors create considerable uncertainty regarding the benefits of CIT reductions.

Further, it is noteworthy that the CIT system has the highest efficiency costs among Australia's federal taxes, with the efficiency losses resulting from taxing normal returns

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<sup>36</sup> Further, it is arguable that simply lowering the headline CIT rate does not constitute tax reform *per se*.

<sup>37</sup> Kalok Chan, Vicentiu Covrig and Lilian Ng, 'What Determines the Domestic Bias and Foreign Bias? Evidence from Mutual Fund Equity Allocations Worldwide' (2005) 60(3) *Journal of Finance* 1495; Menezes, above n 35, 4.

<sup>38</sup> So, in order to protect the domestic corporate tax base, many countries implement thin capitalisation rules, transfer pricing rules, controlled foreign corporation (CFC) rules and additional anti-avoidance tax rules: OECD, *Tax Policy Reform and Economic Growth*, OECD Tax Policy Studies No 20 (OECD Publishing, 2010) 54.

<sup>39</sup> Menezes, above n 35, 4, and references cited therein.

<sup>40</sup> Menezes, above n 35, 4.

<sup>41</sup> Alexander Ljungqvist and Michael Smolyansky, 'To Cut or Not to Cut? On the Impact of Corporate Taxes on Employment and Income' (NBER Working Paper No 20753, National Bureau of Economic Research, December 2014) 31-32, and references cited therein.

<sup>42</sup> *Ibid* 8.

<sup>43</sup> Menezes, above n 35, 5.

likely to be above 40 per cent.<sup>44</sup> On the other hand, taxing only economic rents results in no deadweight loss. However, as observed by Ganghof, '[t]he result was not only neoliberalism by surprise<sup>[45]</sup> but also neoliberalism by default ...interactions of economic, partisan and institutional factors may lock countries into rather inefficient tax structures, at least temporarily'.<sup>46</sup> Accordingly, it is imperative to increase the efficiency of business taxation, where possible.

In this context, there are many reform proposals addressing the business taxation distortion, including the ACE, Cash flow tax, Comprehensive Business Income Tax (CBIT), dual income tax (DIT) and Residence-based shareholder tax.<sup>47</sup> Specifically, this article's focus is the distortion between debt and equity financing. Of various fundamental reform proposals only the ACE has been experimented with in practice, so this is the focus of this article.

The ACE maintains the current deductibility of actual interest payments and adds a notional return on equity to be deductible against corporate profits, at the risk-free nominal<sup>48</sup> interest rate.<sup>49</sup>

The ACE has garnered substantial support from leading academics since its theoretical inception and is experiencing increased interest from policy-makers internationally.<sup>50</sup> In terms of its historical development, the ACE originated in the 1970s with the basic economic idea contained in the report of the Meade Committee,<sup>51</sup> which proposed alternatives to the UK tax system. This was followed by research published by leading commentators Boadway and Bruce,<sup>52</sup> and was further elaborated in detail by the IFS Capital Taxes Group,<sup>53</sup> and Devereux and Freeman.<sup>54</sup>

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<sup>44</sup> Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (Henry Review); Menezes, above n 35, 5.

<sup>45</sup> Susan C Stokes, *Mandates and Democracy: Neoliberalism by Surprise in Latin America* (Cambridge University Press, 2001).

<sup>46</sup> Steffen Ganghof, 'The Politics of Tax Structure' (MPIfG Working Paper 06/1, Max Planck Institute for the Study of Societies, January 2006) 26-27.

<sup>47</sup> See Peter B Sørensen, 'Can Capital Income Taxes Survive? And Should They?' (2007) 53(2) *CESifo Economic Studies* 172, 218, Table 4.

<sup>48</sup> That is, 'calculated by reference to a normal commercial rate of interest, fixed by the government': see further, Malcolm Gammie, 'Corporate Tax Harmonization, An "ACE" Proposal: Harmonizing European Corporate Taxation through an Allowance for Corporate Equity' (1991) 31(8) *European Taxation* 238.

<sup>49</sup> Ruud A de Mooij and Michael P Devereux, 'An Applied Analysis of ACE and CBIT Reforms in the EU' (2011) 18(1) *International Tax and Public Finance* 93, 96.

<sup>50</sup> Christian Keuschnigg, 'The Design of Capital Income Taxation: Reflections on the Mirrlees Review' (2011) 32(3) *Fiscal Studies* 437; Gammie, above n 48; Michael P Devereux and Peter B Sørensen, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform' (European Commission Economic Paper 264, December 2006).

<sup>51</sup> Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee chaired by Professor J E Meade* (George Allen & Unwin, 1978).

<sup>52</sup> Robin Boadway and Neil Bruce, 'A General Proposition on the Design of a Neutral Business Tax' (1984) 24(2) *Journal of Public Economics* 231.

<sup>53</sup> Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s*, Fourth report of the IFS Capital Taxes Group, Commentary No 26 (Chameleon Press, 1991), available at: <http://www.ifs.org.uk/comms/comm26.pdf>.

<sup>54</sup> Michael Devereux and Harold Freeman, 'A General Neutral Profits Tax' (1991) 12(3) *Fiscal Studies* 1.

The literature has predominantly focused on economic concepts, despite recognising the relevance and importance of law, accountancy and politics.<sup>55</sup> Further, the ACE literature currently has a corporate tax neutrality focus grounded in the economics paradigm. Importantly, ACE-based reforms have great potential from an anti-avoidance law perspective, which is especially pertinent for international company tax purposes.<sup>56</sup> Further, simulations by de Mooij and Devereux show that even with the inclusion of tax havens, which halve the positive welfare effect of implementing a revenue-neutral ACE in high-tax countries, a European ACE still raises welfare. De Mooij and Devereux observe that the benefits of a more efficient tax system in terms of both investment and financial structure significantly outweigh the negative spillovers *vis-à-vis* profit shifting.<sup>57</sup>

The original objectives and perceived benefits of the ACE include encouraging domestic investment and employment, and achieving tax neutrality by granting tax relief for equity financing. In principle, many leading commentators, policy-makers and corporations support the ACE. However, implementing and sustaining fundamental reform of the corporate income tax system is difficult. Accordingly, it is necessary to consider how an ACE eventuates in practice. De Mooij and Devereux observe that the Belgian and Italian ACE-variants are the closest to the theoretical ACE.<sup>58</sup> As such, these two jurisdictions are the focus of this article.

### 3.1 Applied literature analysing ACE-variants

The majority of the English-language ACE literature provides a distinct focus on economic modelling rather than engaging in any legal analysis.<sup>59</sup> One exception is an OECD report providing a descriptive exposition with detailed reference to particular amendments and developments, yet there remains a gap in relation to a critical analysis geared at suggesting design improvements for similar reforms in the future.<sup>60</sup>

A recent contribution in this area has been the comparative analysis of the Belgian and Italian ACE-variants by Zangari,<sup>61</sup> who presents the case for why the design of the Italian ACE-variant allows for a more robust reform than the Belgian NID; namely, due to its anti-avoidance framework. However, Zangari provides a comparison between the

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<sup>55</sup> Alan Auerbach, Michael Devereux and Helen Simpson, 'Taxing Corporate Income', in Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles and James M Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review, Vol 1* (Oxford University Press, 2010) 837; see also Keuschnigg, above n 50; see further, Graeme Cooper, 'Implementing an Allowance for Corporate Equity' (2012) 27(2) *Australian Tax Forum* 241.

<sup>56</sup> S Bond, 'Company Tax Issues' (Presentation delivered to The Institute for Fiscal Studies, 2006).

<sup>57</sup> De Mooij and Devereux, above n 49, 115.

<sup>58</sup> Ruud de Mooij and Michael Devereux, 'Alternative Systems of Business Tax in Europe: An Applied Analysis of ACE and CBIT Reforms' (European Union Taxation Papers, Working Paper No 17, 2009).

<sup>59</sup> Alessandra Staderini, 'Tax Reforms to Unfluence Corporate Financial Policy: The Case of the Italian Business Tax Reform of 1997-98' (Banca D'Italia Working Paper No 423, November 2001); Silvia Giannini, 'Le riforme italiane nella tassazione di impresa negli anni '90 in una prospettiva europea' (Paper presented at Seminario di Economia Pubblica Istituto di Economia e Finanza, Università Cattolica del Sacro Cuore, 22 February 2001); Filippo Oropallo and Valentino Parisi, 'Will Italy's Tax Reform Reduce The Corporate Tax Burden? A Microsimulation Analysis' (SIEP Working Paper No 403, May 2005); Daniela Federici and Valentino Parisi, 'Corporate Taxation and Exports' (MPRA Paper No 41012, 3 September 2012).

<sup>60</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013).

<sup>61</sup> Ernesto Zangari, 'Addressing the Debt Bias: A Comparison between the Belgian and the Italian ACE Systems' (European Commission Taxation Papers, Working Paper No 44, July 2014) 49.

technical aspects of these ACE-variants in practice, rather than in-depth comparative legal analysis. Accordingly, there remains scope in the literature to provide a more thorough comparative analysis, with an emphasis on legislative drafting and the underlying policy intentions for amendments over time.

As such, sections 3.2 and 3.3 below analyse the Belgian and Italian ACE-variant experiences, with a focus on the political hurdles to implementing and sustaining these reforms.

### 3.2 Belgium's ACE-variant

The Belgian corporate tax system is considered a classical double taxation system, modified by an exemption for dividends from qualifying participations held by corporate shareholders and a reduced rate for dividends from participations held by individual shareholders.<sup>62</sup> Tax practitioners have long considered Belgium an interesting jurisdiction for various tax-planning and structuring purposes.<sup>63</sup>

Even prior to the introduction of the Notional Interest Deduction (NID),<sup>64</sup> dividends could be received nearly tax-free, interest paid on loans taken out to acquire shares was tax-deductible and capital gains on shares were generally tax-exempt.<sup>65</sup> The NID (otherwise known as the '*Intérêts notionnels et déduction fiscales pour capital à risque*', "*Notionele Interestaftrek*" or 'Capital Risk Deduction') was introduced in 2005 to encourage equity financing following two key pressures; first, pressure from the European Commission to abandon the Belgian coordination centre regime,<sup>66</sup> and second, pressure resulting from the expansion of the European Union to countries with lower corporate tax rates, such as Cyprus, Latvia, Lithuania, and Hungary, which emphasised the need for Belgium to strengthen its position on the international tax map.

#### 3.2.1 The Belgian NID: political hurdles to implementation

When initially introduced in Belgium, leading commentators observed that Belgium's NID reform was very close to the pure version of the ACE,<sup>67</sup> with the Parliamentary focus appearing to be the tax neutrality property of the NID to overcome the debt-equity

<sup>62</sup> Jan Široký, 'There are several factors, which influence the actual range of the corporate tax: the relation between the personal income tax and the corporate income tax' (2006) 5, available at: [http://kvf.vse.cz/storage/1168944278\\_sb\\_siroky.pdf](http://kvf.vse.cz/storage/1168944278_sb_siroky.pdf).

<sup>63</sup> Howard Liebman, 'International Tax Planning: Belgium Is Taking Steps to Enhance Its Attractiveness', Jones Day Commentary (July 2005), available at: <http://www.jonesday.com/international-tax-planning-belgium-is-taking-steps-to-enhance-its-attractiveness-07-26-2005/>.

<sup>64</sup> *Loi du 22 juin 2005 instaurant une déduction fiscale pour capital à risque – Wet tot invoering van een belastingaftrek voor risicokapitaal van 22 juni 2005* [Law introducing an allowance for corporate equity of 22 June 2005], published in Belgian Official Gazette of 30 June 2005, p 30077 (*Notionele Interestaftrek*, *Belgisch Staatsblad* / *Loi instaurant une déduction fiscal pour capital à risqué*, *Moniteur Belge*).

<sup>65</sup> Liebman, above n 63.

<sup>66</sup> Marc Quaghebeur, 'Belgium Targets Risk Capital Deduction Abuses' (2007) 48 *Tax Notes International* 627. Belgium introduced this regime in 1982, which aimed at providing MNEs with a tax-effective vehicle to coordinate and centralise their management and financial services in so-called 'coordination centres'.

<sup>67</sup> Marcel Gérard, 'Belgium Moves to Dual Allowance for Corporate Equity' (2006) 46(4) *European Taxation* 156; André Decoster, Marcel Gerard and Christian Valenduc, 'A Decade of Tax Cuts', in Etienne de Callataÿ and Françoise Thys-Clément (eds), *The Return of the Deficit: Public Finance in Belgium over 2000-2010* (Leuven University Press, 2012) 95, 111-112.



distortion.<sup>68</sup> The originating explanatory notes<sup>69</sup> detail the political, philosophical, economic and tax policy rationales for implementing the Belgium ACE-variant, and the anticipated impact of this reform.

However, it is also important to recognise that Belgium did not have wide political support for the NID reform; indeed, the green and socialist parties opposed the NID, which was criticised as being used as ‘a weapon in the election campaign of 2004’.<sup>70</sup> Further, the rationale of highlighting the urgency of the NID in light of the dramatic decline in investment in Belgium was criticised in the parliamentary debates as a rushed and underhanded political strategy.<sup>71</sup> Despite ongoing political debate for over one year, which resulted in limitations to the NID, there were only two parliamentary sittings, which was criticised as resulting in insufficient debate on the broader reform of corporate income tax.<sup>72</sup> This was considered especially problematic by opposition parties, who made comparisons to the reform processes in neighbouring countries such as the Netherlands.<sup>73</sup>

Nonetheless, the parliamentary debates indicate that a large majority of the committee subscribed to the philosophy underpinning the reform, with the proposal receiving generally positive feedback and unconditional approval by the VLD (the Flemish liberal party).<sup>74</sup> However, the design parameters had mixed reviews; some parliamentarians believing the design was too generous and others considering it inadequate. Finance Minister Didier Reynders interpreted this as indicating that the Bill was balanced,<sup>75</sup> and earmarked an evaluation period to identify areas for improvement.<sup>76</sup> At its inception, this Bill was touted as a pioneer in tackling tax discrimination between debt and equity finance.<sup>77</sup>

However, there has been much scepticism about the real motivation for implementing this reform, as observed by the National Bank of Belgium:<sup>78</sup>

The memorandum put to the Parliament stresses the neutrality property of the reform because it enables corporate income tax to overcome the well-known debt equity bias. It ends by indicating that the reform also provides an alternative for financial companies using the coordination centre regime. Most would argue – rightly – that of the two motivations the second was the more important and the neutrality properties are more a consequence of the reform than its main policy motivation.

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<sup>68</sup> Decoster, Gerard and Valenduc, above n 67, 112.

<sup>69</sup> *Loi du 22 juin 2005 instaurant une déduction fiscale pour capital à risque – Wet tot invoering van een belastingaftrek voor risicokapitaal van 22 juni 2005* (Belgium) [Law introducing an allowance for corporate equity of 22 June 2005], 30 June 2005, 30077.

<sup>70</sup> *Chambre des Représentants de Belgique, Compte Rendu Intégral avec Compte Rendu Analytique Traduit des Interventions – Belgische Kamer van Volksvertegenwoordigers, Integraal Verslag met Vertaald Beknopt Verslag van de Toespraken* (Belgium) [House of Representatives, Full Report with a Summary Record of Translated Interventions], 22 June 2005, 59 [15.02].

<sup>71</sup> *Ibid* [15.12].

<sup>72</sup> *Ibid* 59-60 [15.12].

<sup>73</sup> *Ibid* 61 [15.20].

<sup>74</sup> *Ibid* 53 [15.01].

<sup>75</sup> *Ibid* 53-54 [15.01].

<sup>76</sup> *Ibid* 58 [15.01].

<sup>77</sup> *Ibid* 58-59 [15.01].

<sup>78</sup> Decoster, Gerard and Valenduc, above n 67, 112.

When it was introduced, Finance Minister Didier Reynders and Prime Minister Guy Verhofstadt organised roadshows in Asia, the United States, and India to promote the NID and explain that the deduction reduced the corporate income tax rate from 33.99 per cent to about 26 per cent.<sup>79</sup> They were accompanied by representatives of some banks and tax advisory firms who explained how the NID could be used for group finance companies and treasury centres, for acquisition structures, and for post-acquisition restructuring.<sup>80</sup> Subsequently, many MNEs moved their corporate treasury centres to Belgium.<sup>81</sup>

It is important to recognise the context to these statements. Even though the official tax rate has fallen over 7 per cent in three years, the effective tax rate at the time was over 21 per cent – higher than the EU average, as noted in the explanatory materials.<sup>82</sup> The extrinsic materials also indicate that parliamentarians made reference to the Forbes suggestion that Belgium had the third highest marginal tax rate in the world; cited as support for the proposition that Belgium's tax rates were high and corporate investment and economic stimulus was in need of bolstering (taking into account considerations of economics and taxation). Further, the parliamentary debates refer to the high unemployment rate as an economic problem with the NID presented as a strategy to lowering corporate tax and giving the Belgian economy a new impetus.<sup>83</sup>

Budgetary issues generally tend to pose one of the most significant political hurdles to implementing fundamental tax reform. Even though the budgetary cost of the NID was a significant issue, the government mentioned that it expected a EUR 58 million return on the NID reform.<sup>84</sup> This was despite the revenue cost of EUR 566 million, which was largely accepted by parliament, with budgetary compensation measures and savings provisions (including abolishing corporate tax credits and opting-in to the NID at the expense of opting-out of 'investment reserve' provisions) amounting to EUR 400 million. The extrinsic materials make reference to the following 10-point benefits of the NID, anticipating that the NID would: (i) incentivise equity finance thereby encouraging investment; (ii) facilitate employment; (iii) stimulate financing; (iv) reduce bankruptcy risk thereby improving credit ratings; (v) anchor investments in Belgium thereby reducing relocation risk; (vi) stimulate the establishment of new companies; (vii) ensure consistency with EU guidelines thereby providing the necessary legal certainty; (viii) facilitate an attractive investment climate; (ix) improve Belgium's competitiveness,<sup>85</sup> and (x) facilitate private corporations' investment in construction and property through equity finance.<sup>86</sup>

The parliamentary debates highlight the criticisms in the design of the NID. For example, one of the major obstacles to the implementation of the NID was contained in Article 9, which barred companies from distributing the portion of their profits that corresponds to the NID deduction by way of a dividend unless they retained an amount equal to the amount of the NID deduction for a period of at least four years. In the

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<sup>79</sup> Quaghebeur, above n 66.

<sup>80</sup> Quaghebeur, above n 66.

<sup>81</sup> Marc Quaghebeur, 'Belgium Removes Obstacle to Risk Capital Deduction', *Worldwide Tax Daily* 229-3 (30 November 2005).

<sup>82</sup> *Chambre des Représentants de Belgique*, above n 70, 62 [15.20].

<sup>83</sup> *Ibid* 60-61 [15.19]-[15.20].

<sup>84</sup> *Ibid* 53 [15.01].

<sup>85</sup> *Ibid* 55 [15.02].

<sup>86</sup> *Ibid* 59 [15.02].

extrinsic materials prepared in June 2005, one of the key anti-abuse mechanisms contained in Article 9 was reduced to three years following concerns that a period of four years would make equity less appealing than debt finance and could undermine the effectiveness of the NID. Even though the design was the subject of passionate political debate<sup>87</sup> and was ultimately a compromise, the parliament considered that Article 9 should be further relaxed in subsequent legislative amendments.<sup>88</sup> Nonetheless, this provision was amended even before the commencement date of the NID, with Belgian Prime Minister Guy Verhofstadt delivering a public announcement on 17 November 2005 that this obstacle to the NID would be lifted.<sup>89</sup> While this revision arguably aligned the NID more closely to its theoretical underpinnings in the ACE, it is largely an administrative issue rather than one of tax policy design which encourages the use of equity financing at the risk of making the system more vulnerable to abuse from aggressive tax planning. The key criticism was that the NID was largely agreed to in principle, but the provisions and administrative aspects were unnecessary to the point that it was criticised as largely missing its objectives in practice.<sup>90</sup> This highlights how translating ACE theory into practice through a robust tax reform design is one of its most challenging aspects, as anticipated by the wider ACE literature<sup>91</sup> and as experienced by jurisdictions in the past.<sup>92</sup>

Separately, there was political opposition to the limited scope of the NID, which some parliamentarians argued ought to be extended to personal income tax.<sup>93</sup> This reflects the ACE literature, which anticipates that one key challenge in designing and implementing ACE reform is that it does not operate as a backstop to the personal income tax system.<sup>94</sup> Even though leading commentators have suggested that tax neutrality cannot be achieved unless there is a personal-level ACE,<sup>95</sup> the domestic shareholder position is less relevant in a small, open economy where the marginal investor is likely to be a foreign investor.<sup>96</sup> While it is difficult to pinpoint the non-resident investor as the marginal investor, it is plausible for a small, open economy like Belgium.<sup>97</sup>

### 3.2.2 *The Belgian NID: subsequent amendments and economic, political and administrative issues*

The NID has been continually amended by the Belgian parliament since its introduction in 2005, culminating in the continued reduction in the NID rate and the abolition of carry-forwards further limiting the scope of the NID. These two legislative changes have taken the NID further away from its original legislative purpose and underlying ACE

<sup>87</sup> Parliamentary reports show dialogue such as ‘Mr. Bogaert, I suggest that you take the sequel to the market stand, because you are very good at selling apples that look like pears’. Ibid 57 [15.02].

<sup>88</sup> Ibid 69 [15.52].

<sup>89</sup> Quaghebeur, above n 81.

<sup>90</sup> *Chambre des Représentants de Belgique*, above n 70, 64 [15.20].

<sup>91</sup> John Isaac, ‘A Comment on the Viability of the Allowance for Corporate Equity’ (1997) 18(3) *Fiscal Studies* 303.

<sup>92</sup> The ACE-variant adopted in Brazil is more akin to a system of dividend deductibility; see further, Klemm, above n 30, 24.

<sup>93</sup> *Chambre des Représentants de Belgique*, above n 70, 58 [15.11].

<sup>94</sup> OECD, *Reforming Corporate Income Tax*, OECD Observer: Policy Brief (2008).

<sup>95</sup> OECD, *Fundamental Reform of Corporate Income Tax*, OECD Tax Policy Studies No 16 (OECD Publishing, 2007) 88, 139.

<sup>96</sup> Business Tax Working Group (Chris Jordan, chair), *Discussion Paper* (August 2012) 21, available at: [https://static.treasury.gov.au/uploads/sites/1/2017/06/BTWG\\_discussion\\_paper\\_2012.pdf](https://static.treasury.gov.au/uploads/sites/1/2017/06/BTWG_discussion_paper_2012.pdf).

<sup>97</sup> Belgium has been recently described as a small, open economy by economists; see, for example, Philip Du Caju, François Rycx and Ilan Tojerow, ‘Wage Structure Effects of International Trade in a Small Open Economy: The Case of Belgium’ (2012) 148(2) *Review of World Economics* 297.

principles. First, reducing the tax deduction provided for equity financing risks eliminating the neutrality properties of the ACE and simply providing a sweetener for equity financing;<sup>98</sup> and second, abolishing carry-forwards exacerbates the asymmetric treatment of profits and losses.<sup>99</sup>

However, when considering any subsequent legislative amendments to the NID reform, a holistic understanding of the political landscape is an imperative starting point. From 2007, Belgium was confronted by an ongoing political crisis at federal level.<sup>100</sup> During that time, the outgoing conservative/socialist government continued to handle current affairs, and in October 2007, following much political pressure, decided to conduct an investigation into alleged abuses by Belgian companies and Belgian banks of the NID.<sup>101</sup>

A key political issue in practice is that the NID is thought to benefit the larger MNEs more so than small and medium enterprises (SMEs). This is because the larger MNEs are able to put substantial amounts of equity capital into their treasury arms or internal finance companies thereby eroding their corporate tax base.<sup>102</sup> This challenges whether the NID is genuinely beneficial for the domestic economy or whether it presents a tax break for the most profitable MNEs who are able to tax plan and bypass anti-avoidance rules and maintain very low effective tax rates. However, leading practitioners and economists observe that the NID also benefit SMEs by incentivising business capitalisation and thereby protecting businesses during the global financial crisis (GFC).<sup>103</sup> Further, it is arguable that this is an obvious feature of the NID which is why it was such an attractive investment reform to begin with. Some legal practitioners have observed that ‘the purpose of introducing the notional interest deduction was just to make Belgium fiscally attractive to foreign investors and to offer a credible and competitive alternative for the coordination centres whose system was condemned by the European authorities’.<sup>104</sup> Indeed, it is arguable that since the NID resulted in substantial investment by both local and overseas MNEs, it thereby encouraged a larger capital base, which ensured that those companies were well-positioned to withstand the GFC because of their capital buffers.

Nonetheless, the pressure from lobby groups and media sentiment that MNEs were unfairly advantaged by the NID remains substantial. By way of background, SMEs and

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<sup>98</sup> The Mirrlees Review recommended that the normal rate of return be utilised; see further, Auerbach, Devereux and Simpson, above n 55; Rachel Griffith, James R Hines, Jr and Peter Birch Sørensen, ‘International Capital Taxation’, in Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles and James M Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review, Vol 1* (Oxford University Press, 2010) 914.

<sup>99</sup> Stephen R Bond and Michael P Devereux, ‘On the Design of a Neutral Business Tax under Uncertainty’ (1995) 58(1) *Journal of Public Economics* 57.

<sup>100</sup> Marc Hooghe, ‘The Political Crisis in Belgium (2007-2011): A Federal System without Federal Loyalty’ (2012) 48(1) *Representation* 131.

<sup>101</sup> Quaghebeur, above n 66.

<sup>102</sup> Projet de Loi-Programme, Chambre des Représentants de Belgique, 24 February 2012, Doc 53 2081/001, 95, available at: <http://www.lachambre.be/FLWB/pdf/53/2081/53K2081001.pdf>.

<sup>103</sup> F-X G [François-Xavier Giot], ‘Renforcer le système des intérêts notionnels’, *L’avenir* (online) (2 February 2013), available at: [http://www.lavenir.net/article/detail.aspx?articleid=DMF20130202\\_00263523](http://www.lavenir.net/article/detail.aspx?articleid=DMF20130202_00263523).

<sup>104</sup> N Thémelin, ‘The only consequence of the announcement effects of notional interest: the legal uncertainty’, Afschrift news report (19 September 2013), available at: [http://www.afschrift.be/en/the-only-consequence-of-the-announcement-effects-of-notional-interest-the-legal-uncertainty.html?cmp\\_id=8&news\\_id=2325](http://www.afschrift.be/en/the-only-consequence-of-the-announcement-effects-of-notional-interest-the-legal-uncertainty.html?cmp_id=8&news_id=2325) (accessed 11 December 2013).

MNEs currently have an average tax rate of approximately 34 per cent and 5 per cent respectively. This has resulted in industry lobby groups such as Le Syndicat des Indépendants & des PME calling for reform to the NID to 'reconcile the existing blatant discrimination between hundreds of small SMEs that pay 3-4 times more taxes than multinational companies'.<sup>105</sup>

Political concerns regarding aggressive tax planning led to the broadening of Belgium's thin capitalisation rule, which specifically targets inter-company loans with a 5:1 debt to equity ratio limitation. Further, subsequent explanatory notes<sup>106</sup> reveal a link between the reduced scope of the NID and the increased incidence of thin capitalisation rules in Belgium. The relationship between reducing the scope of the ACE-variant and the increased implementation of thin capitalisation rules in Belgium suggests an inversely proportional relationship between these two reforms which has not been addressed in the English-language literature. Future research by the author will explore this aspect in further detail.

This presents arguably the most substantial hurdle to implementing and sustaining ACE-based reform; it is politically very difficult to quantify (and therefore justify) the benefit of the NID and very easy to point to the loss of revenue; for example, in Belgium EUR 3-4 billion is claimed in NID deductions annually. However, in an increasingly globalising economy with capital mobility there is no certainty that regulatory tightening will prevent a loss of revenue. Belgium's thin capitalisation rules are relatively lenient. Even so, many MNEs are now moving out of Belgium as a result of the overall regulatory tightening including *inter alia* tightening thin capitalisation rules, increasing interest withholding tax rates, tightening anti-abuse rules and levying capital gains tax on shares.

So, even though MNEs were subject to relatively low effective tax rates under the NID reform it is conceivable that this at least incentivised businesses to operate from, and develop in, Belgium – this influx in inbound investment may have, in turn, had a multiplier effect.

Nonetheless, the most significant political pressure point and media criticism of Belgium's NID is in relation to its cross-border impact; specifically, the tax avoidance opportunities that it presents for MNEs. However, policy-makers are unable to deliver targeted reform in the cross-border context due to EU anti-discrimination law. This exemplifies the impact that politics has on tax policy developments and practice, most recently culminating in the European Court of Justice determining on 4 July 2013 that the NID rules and in particular the refusal to apply the NID to a foreign permanent establishment's net assets violates the freedom of establishment.<sup>107</sup> It goes without saying that this resulted in the Council of Ministers resolving to amend the legislative provisions within three months of the judgment of the European Court of Justice.

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<sup>105</sup> 'Intérêts notionnels: le SDI plaide pour un système plus "fair-play"', *Le Soir* (online) (5 July 2013), available at: <http://www.lesoir.be/275803/article/actualite/fil-info/fil-info-belgique/2013-07-05/interets-notionnels-sdi-plaide-pour-un-systeme-plus-fair-play> (author translation) (accessed 11 December 2013).

<sup>106</sup> *La Chambre des représentants de Belgique – Belgische Kamer van volksvertegenwoordigers* [Senate Explanatory Notes], *Project de Loi-Programme du 24 février 2012 – Ontwerp van Programmawet van 24 februari 2012* (n° 53-2081/001), Art 139, 94-98 (Belgium).

<sup>107</sup> *Argenta Spaarbank NV* (C-350/11) case law of the European Court of Justice of 4 July 2013.

Over the past few years, there has been increased media pressure and pressure from all sides of politics to abolish the NID. This resulted in the NID becoming a ‘hot topic’ at the 2014 Federal election.<sup>108</sup>

Media reports indicated that political parties such as the Christian democratic party *Centre démocrate humaniste* (CDH) promised to abolish the NID as part of their election campaigns.<sup>109</sup>

The gain for public finances would be reinvested without waiting for the new term in a decrease of 10 per cent of the corporate tax rate, benefiting all, whether SMEs, TPE or independent ... This reform that we can carry out without delay ... deleting a liberal but also socialist mismanagement ... Notional interest for everybody, right now: SME, SOHO and independent.

It goes without saying that the tax policy uncertainty from first implementing, then modifying, phasing down, and now considering the abolition of the NID erodes business confidence. Leading practitioners agree that abolishing the NID will diminish the attractiveness of Belgium as a destination for inbound investment.<sup>110</sup>

It is therefore true that the notional interest deduction has allowed many companies to reduce their taxable result, but that is precisely the goal that is pursued, with full knowledge of the facts, by the political parties that were at the origin of the construction and of which some criticize the construction heavily today ... This constant legal uncertainty incites some companies to seek calmer climes, sometimes by establishing themselves at just a few miles from our borders, this to the detriment of competitiveness, the economy and the image of Belgium on the international stage. This is of course regrettable.

The fate of the Belgian NID remains unclear, with the reform surviving the 2014 Federal election despite talks of its abolition. Meanwhile ACE-variants have been the subject of other European governments’ reviews of comprehensive corporate taxation reform options, with Switzerland characterising their potential ACE-variant also as a ‘notional interest deduction’.<sup>111</sup>

### 3.3 Italy’s ACE-variants

Prior to 1997, the Italian corporate income tax system, which was designed as a full imputation system,<sup>112</sup> had not been subject to major reforms for nearly three decades. However, by 2004, Italy transitioned from an imputation system to a classical system, with a participation exemption regime introduced to mitigate double taxation of

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<sup>108</sup> Thémelin, above n 104.

<sup>109</sup> ‘Le cdH veut supprimer les intérêts notionnels pour baisser sans attendre l’impôt’, *Le Vif* (online) (31 August 2013), available at: <http://www.levif.be/info/actualite/belgique/le-cdh-veut-supprimer-les-interets-notionnels-pour-baisser-sans-attendre-l-impot/article-4000387901382.htm> (author translation).

<sup>110</sup> Thémelin, above n 104.

<sup>111</sup> Regarding Switzerland, see: PwC, ‘The impact of Swiss Corporate Tax Reform III (CTR III)’ (Position paper of PwC Switzerland, May 2015); the Swiss Federal Council recently removed the NID measure from the CTR III reform package. PwC opines that it ought to be reintroduced in the course of the parliamentary debate. See also, for example, in relation to Sweden: Linklaters, ‘Proposed new tax regime for cost of capital’ (12 June 2014), available at: <http://www.linklaters.com/News/LatestNews/2014/Pages/Proposed-new-tax-regime-cost-capital.aspx>.

<sup>112</sup> Lothar Lammersen and Robert Schwager, *The Effective Tax Burden of Companies in European Regions: An International Comparison*, ZEW Economic Studies Vol 28 (Springer, 2006) 75.

corporate profits.<sup>113</sup> Italy's move away from an imputation system is in line with many other EU member countries.

Italy provides a unique and interesting case study because it implemented two ACE-variants under two different corporate-shareholder tax systems. The first was the ACE-variant operating in Italy from 1998-2001 termed the Dual Income Tax (Italian DIT). Although inspired by the Nordic DIT, Italy's DIT was very different as it only affected capital income. This has leading commentators describing it as "the most confusing name".<sup>114</sup> Companies were liable to pay the statutory corporate income tax rate on above-normal profits; with the normal return on capital subject to a reduced tax rate fixed by the government; a nominal return on capital calculated by reference to the average interest rate on bonds plus a risk premium.

The second is the new ACE implemented in 2012, termed the *Aiuto alla Crescita Economica* (Italian ACE). Leading commentators observe that the Italian ACE shares the main characteristics of the theoretical ACE.<sup>115</sup> The Italian tax system also has elements of a Comprehensive Business Income Tax (CBIT) due to the local business tax, the IRAP, and also because of the limit to the deductibility of interest, in force since 2008. Accordingly, the Italian corporate income tax system can be characterised as combination of a partial ACE and a partial CBIT, thereby mitigating the debt-equity distortion from both directions.

### 3.3.1 *The Italian DIT: political hurdles to implementation*

An understanding of Italy's political dynamics is imperative in assessing tax policy reforms. Originating from a context of taxpayer discontent and widespread tax planning and tax evasion, the then centre-left government introduced the Italian DIT as part of its 'Visco' reforms. The relevant extrinsic materials detail that the Italian DIT was introduced to encourage greater neutrality in corporate financing decisions and facilitate competitiveness by making Italy an attractive investment destination.<sup>116</sup>

### 3.3.2 *The Italian DIT: subsequent amendments and economic, political and administrative issues*

Revenue neutrality concerns resulted in two key restrictions being placed on the original DIT which reduced its initial effectiveness.<sup>117</sup> First, the opportunity cost of equity finance was not deductible from taxable income, rather it was taxed at a reduced rate;

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<sup>113</sup> 'Effective for tax periods starting on or after 1 January 2004, Italy applies a classical system of taxation of corporate profits. The former imputation system is abolished and replaced by a 95% participation exemption for corporate shareholders and a 60% exemption for individual shareholders who hold the participation in a business capacity. Individual shareholders not holding the participation in a business capacity are also entitled to the 60% exemption if they own more than 2% of the voting power or 5% of the capital in listed companies, or more than 20% of the voting power or 25% of the capital in other companies (substantial participation). Otherwise, dividends derived by individuals are subject to a final withholding tax at a rate of 12.5%'; see further, A Uricchio, 'Italian Individual Taxation' (Lecture, University of Bari, 2014) 18; available at: [https://nanopdf.com/download/italian-individual-taxation\\_pdf](https://nanopdf.com/download/italian-individual-taxation_pdf).

<sup>114</sup> Klemm, above n 30, 7.

<sup>115</sup> Antonella Caiumi, Lorenzo Di Biagio and Marco Rinaldi, 'Corporation Tax in Italy: Evidence from Tax Return Data' (2013), available at: [https://editorialexpress.com/cgi-bin/conference/download.cgi?db\\_name=IIPF69&paper\\_id=460](https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=IIPF69&paper_id=460).

<sup>116</sup> Luigi Bernardi, 'Some Issues on the Italian Tax Reforms and the European Tax Environment: Introductory Remarks' (Società Italiana di Economia Pubblica, Working Paper No 457, September 2005).

<sup>117</sup> Staderini, above n 59.

and second, only post-reform equity is considered in the Italian DIT deduction calculations under an incremental approach (similarly to the Belgian NID).

While leading academics observed that over time, the second restriction would not be problematic in the long term, the short-term political repercussions were significant. The Italian DIT was criticised as largely benefiting large and profitable firms, who were more likely to issue new equity, while companies in the South and SMEs were less likely to issue equity, despite their higher cost of debt.<sup>118</sup> This runs contrary to ACE theory, which anticipates that the ACE would increase the tax burdens on the most profitable firms and encourage innovation by SMEs by lowering the tax burden on marginal projects.

One of the key legislative amendments that aligned the Italian DIT more closely to the original ACE was the recognition by parliament that both personal and corporate income tax may need to be reformed in tandem to prevent inefficiencies in the type of organisational form. This culminated in the reorganisation of the personal income tax in order to facilitate the capitalisation of companies.

In any event, it is arguable that the technical and social teething process suggests that the transition to the Italian DIT had not been completed, with the Senate stenographic report indicating:<sup>119</sup>

We have also further strengthened the tools to support new investments, through the extension and improvement of the Visco reforms, and the extension and acceleration of the Dual Income Tax ... its complexity both from a technical point of view and from a social impact, required a long preparation ... 2000, therefore, should reap the benefits of this long preparatory phase.

The Italian DIT was a restricted version of the standard ACE, subject to ‘an excess of changes’<sup>120</sup> and complicated interactions with other taxes, resulting in leading academics observing that this rendered both theoretical and empirical analysis difficult.<sup>121</sup>

It is noteworthy that this reform package was not fully completed due to the change of the government’s coalition following elections in 2001, which resulted in the repeal of the Italian DIT in favour of a single-rate corporate tax scheme. Leading commentators have observed that, interestingly, the abolition of the Italian DIT resulted in a higher tax burden for most companies.<sup>122</sup> Further, administrative issues surrounding the continued ‘reform of the reform’ resulted in a detrimental level of uncertainty which stunted

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<sup>118</sup> Alessandro Santoro, ‘Ex-post Evaluation of Tax Reforms: The Case of the Italian Partial Ace’, 2005 (unpublished paper, University of Milano-Bicocca).

<sup>119</sup> Senate of the Republic of Italy, Senate Public Meeting 702a, Stenographic Report, 3 November 1999, 5-6; available at: [http://www.senato.it/japp/bgt/showdoc/frame.jsp?tipodoc=Resaula&leg=13&id=00005402&part=doc\\_dc-allegatob\\_rs:1-gentit\\_dcdddl4236e4237-intervento\\_giaretta&parse=no&stampa=si&toc=no](http://www.senato.it/japp/bgt/showdoc/frame.jsp?tipodoc=Resaula&leg=13&id=00005402&part=doc_dc-allegatob_rs:1-gentit_dcdddl4236e4237-intervento_giaretta&parse=no&stampa=si&toc=no).

<sup>120</sup> P Bosi and M C Guerra, ‘Lezione 1: Scienza delle finanze II – CLEP’ (2006); available at: <https://slideplayer.it/slide/570656/>.

<sup>121</sup> Klemm, above n 30, 6-9.

<sup>122</sup> Oropallo and Parisi, above n 59.



growth, with leading commentators highlighting the ‘need for stability and completion of reforms for greater coherence and rationality of the system’.<sup>123</sup>

### 3.3.3 *The Italian ACE: political hurdles to implementation*

Parliamentary transcripts provide detailed insights into the political spectrum and background rationales for why the Italian ACE was implemented in the midst of a recession.<sup>124</sup> Specifically, parliamentarians from centrist parties observed in the explanatory materials that ‘today’s speakers clearly witness the change in the political phase, which led to the opening of scenarios that seemed unthinkable just a few months ago’.<sup>125</sup> There is specific reference to the fact that the new reforms such as the Italian ACE are ‘owing to the heterogeneity of the coalition forces supporting it ... the Decree-Law is only justified in light of this particular political and institutional framework’.<sup>126</sup>

This political solidarity culminating in the legislative reform under pressure of a ‘very dangerous’ economic situation appears to have resulted in a renewed confidence in the Italian financial markets; ‘the political stability provided by the new government has had a positive impact on the financial markets with a reduction in the order of 200 points on the yield spread between Italian government bonds and German ones’.<sup>127</sup>

The Italian ACE<sup>128</sup> was introduced to stimulate the capitalisation of companies by reducing tax on income from capital funding risk; reduce the imbalance in the tax treatment between companies that are financed with debt and companies that are financed with equity, thereby strengthening the capital structure of Italian companies; and to encourage, more generally, the growth of the Italian economy.<sup>129</sup>

However, the Italian ACE was not implemented without political opposition. Parliamentarians from opposition parties such as Il Popolo della Libertà (Christian democrat party launched by Silvio Berlusconi) commented that the national and international press were talking about the Italian situation in alarmist terms and observed that ‘real growth in Italy is likely to be negative for a long time’.<sup>130</sup> The Italian ACE was also strongly opposed by regionalist minority parties such as Lega Nord

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<sup>123</sup> Bosi and Guerra, above n 120.

<sup>124</sup> International Monetary Fund, ‘Italy: 2013 Article IV Consultation’ (IMF Country Report No 13/298, September 2013), available at: <http://www.imf.org/external/pubs/ft/scr/2013/cr13298.pdf>.

<sup>125</sup> Bulletin of the Legislature, The Referral - Commissions V and VI Finance, Budget and Treasury; Examination and Referral, 8 December 2011, 68; available at: [http://translate.googleusercontent.com/translate\\_c?act=url&depth=1&hl=en&ie=UTF8&prev=\\_t&rurl=translate.google.com.au&sl=auto&tl=en&u=http://documenti.camera.it/leg16/resoconti/commissioni/bollettini/html/2011/12/08/0506/comunic.htm&usg=ALkJrhgaCPDv5kzf9KDih88kWjR8JErnA#data.20111208.com0506.bollettino.sede00010.tit00010](http://translate.googleusercontent.com/translate_c?act=url&depth=1&hl=en&ie=UTF8&prev=_t&rurl=translate.google.com.au&sl=auto&tl=en&u=http://documenti.camera.it/leg16/resoconti/commissioni/bollettini/html/2011/12/08/0506/comunic.htm&usg=ALkJrhgaCPDv5kzf9KDih88kWjR8JErnA#data.20111208.com0506.bollettino.sede00010.tit00010) (author translation).

<sup>126</sup> Ibid 5.

<sup>127</sup> Ibid 75.

<sup>128</sup> Decree-Law December 6, 2011, n. 201, containing urgent measures for growth, equity and consolidation of the public finances; Law 214/2011 (22 December 2011) and Decree by the Ministry of Economy and Finance dated 14 March 2012; presented by the Government on 5 December 2011; official gazette 19 March 2012.

<sup>129</sup> Cortellazzo & Soatto, ‘Aiuto alla Crescita Economica (ACE): incentivo alla patrimonializzazione delle imprese’ (2012) 13(1) *C & D Informa*, available at:

<http://www.cortellazzo-soatto.it/Approfondimenti/TemieContributi/AiutoallaCrescitaEconomicaACEincentivoall.aspx>.

<sup>130</sup> Commissions V and VI Finance, Budget and Treasury, above n 125, 63.

Piemont, who believed that this reform would further depress growth, especially in their electoral areas in the North.<sup>131</sup>

As originally drafted, the Italian ACE evokes the Italian DIT in some respects. A substantial improvement on the Italian ACE is that, while the Italian DIT incentivised capitalisation by applying a reduced rate to the portion of profit identified by the notional return on capital, the Italian ACE provides a tax deduction in respect of the notional return on new equity. Further, the Italian ACE was introduced with retroactive effect, or to also apply for the whole of 2011. This ensured the Italian ACE was more closely aligned to the original ACE principles,<sup>132</sup> directly and immediately allowing deductions for equity financing and not providing an upper limit to the increases in equity financing.<sup>133</sup> Importantly, the Italian ACE also applies to corporations, individual firms and limited partnerships, the inclusion of which promotes neutrality in organisational form.<sup>134</sup>

### 3.3.4 *The Italian ACE: subsequent amendments and economic, political and administrative issues*

While the Italian ACE is still in a relatively early stage, commentators praise the reform as a comprehensive package consistent with preventing MNEs from under-capitalising their Italian operations.<sup>135</sup> Indeed, the introduction of the Italian ACE has not led to the modification of Italian rules on the deductibility of interest. Currently interest barrier rules are in place instead of thin capitalisation rules, whereby the limitation of interest deductibility is now based on an operating income test, rather than debt-to-equity ratios.

An equally promising development was announced in October 2013, with the government releasing a list of measures it intends to implement to make Italy more attractive for foreign investors and to strengthen business conditions. Most relevant is Measure 19, which proposes the introduction of the ‘super ACE’, which targets companies intending to go public. Although there is currently little detail surrounding this proposal, the government has announced that the ‘approach would be the same used in the current ACE, which enhances a company’s cost-effectiveness and “transparency” after listing’.<sup>136</sup> It will be very interesting to observe whether this reform is implemented and, if so, whether in practice it more closely aligns the Italian ACE to the original ACE principles.

Operationally, the new benefit results in a deduction from the total income of an amount corresponding to the notional return of new equity. This return, for the first three years of application of the rule (2011-2013) is fixed at 3 per cent; however, since 2014 the rate which is determined by decree of the Minister of Economy and Finance had increased to 4.75 per cent for the period ending 31 December 2016. This took into

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<sup>131</sup> Commissions V and VI Finance, Budget and Treasury, above n 125, 75.

<sup>132</sup> See further, IFS Capital Taxes Group (Malcolm Gammie, chair), ‘Equity for Companies: A Corporation Tax for the 1990s’ (IFS Commentary No 26, Institute for Fiscal Studies, London, April 1991).

<sup>133</sup> Cortellazzo & Soatto, above n 129.

<sup>134</sup> See further Paolo Panteghini, Maria Laura Parisi and Francesca Pighetti, ‘Italy’s ACE Tax and Its Effect on a Firm’s Leverage’ (Economics Ejournal Discussion Paper No 2012-31, 2 June 2012), available at: <http://www.economics-ejournal.org/economics/discussionpapers/2012-31>.

<sup>135</sup> Assonime, ‘La disciplina dell’ACE (aiuto alla crescita economica)’ (Direct Taxation, Circular No 17, 7 June 2012).

<sup>136</sup> Government of Italy, ‘Destinazione Italia: A Plan to Attract Foreign Direct Investment in Italy’ (19 September 2013) 18, available at: <http://destinazioneitalia.gov.it/wp-content/uploads/2013/10/destinazioneitaliaEnglishVersion.pdf>.

account the average financial returns of public bonds,<sup>137</sup> and there was the option of the notional return being increased by a further percentage point to more closely align with the risk-free nominal return. However, the 10-year Italian government bond yield has declined considerably in the past five years. Currently 10-year Italian government bonds are returning approximately 2 per cent, down from 6.5 per cent in 2012. While this is an improvement on the record low of 1.05 per cent in August 2016, it provides the context for the recent amendments to the Italian ACE. Specifically, the recently enacted *Finance Act 2017*<sup>138</sup> has implemented two key changes; first, it partially amends the legislation to reduce the rate of the notional return to 2.3 per cent for the tax period ending on 31 December 2017; and second, it subjects SMEs to the same calculation method as that designed for corporations. The former more closely aligns the Italian ACE rate to the market's risk-free nominal return. The latter ensures neutrality of tax treatment in the context of various legal forms, consistent with the criteria of business structure neutrality. Accordingly, it will be interesting to continue observing the developments to the Italian ACE, particularly since the recent reduction in the Italian ACE rate has coincided with a corporate tax cut from 27.5 per cent to 24 per cent.

This relationship between implementing corporate tax cuts while reducing the scope of policies that aim to eliminate funding neutrality is the focus of the modelling in the next section. Specifically, section 4 adopts a modelling approach to evaluate the extent to which the tax policy goals of efficiency and integrity are effectively attained through the implementation of corporate tax cuts or whether an ACE-variant better achieves these policy goals.

#### **4. OPTIMISATION MODELLING: DO HIGH-TAX JURISDICTIONS BENEFIT FROM CORPORATE TAX CUTS?**

This section introduces the model used to simulate a tax-minimising multinational enterprise's behavioural responses. It also expands the literature by simulating cross-border intercompany tax planning strategies in responses to both current and proposed tax laws; in particular, the existence (and abolition) of ACE-variants and implementation of corporate tax cuts.

##### **4.1 Developing the Multinational Tax Planning (MTP) model**

In an increasingly globalising economy with capital mobility, a lack of transparency makes it very difficult to observe how an MNE structures its internal affairs in a tax-optimal manner. This gives policy-makers little information on the size and scope of the problem, which in turn makes targeting tax-minimisation techniques even more challenging.<sup>139</sup> Given the importance of tax revenue base protection, this presents a particularly pressing issue for capital importing jurisdictions such as Australia.

However, previous research by the author observes that the challenge presented by this 'invisibility' of cross-border intercompany transactions may be bypassed by

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<sup>137</sup> Cortellazzo & Soatto, above n 129.

<sup>138</sup> *Gazzetta Ufficiale, Bilancio di previsione dello Stato per l'anno finanziario 2017 e bilancio pluriennale per il triennio 2017-2019* (Art. 67, L. 11 dicembre 2016, n. 232) 11 December 2016, 16G00242 (Italy) (Finance Act 2017), available at: <http://www.gazzettaufficiale.it/eli/id/2016/12/21/16G00242/sg>.

<sup>139</sup> Kevin S Markle and Douglas A Shackelford, 'Cross-Country Comparisons of the Effects of Leverage, Intangible Assets, and Tax Havens on Corporate Income Taxes' (2012) 65(3) *Tax Law Review* 415, 417-432.

conceptualising MNEs' funding decisions as a linear optimisation problem.<sup>140</sup> Specifically, the Multinational Tax Planning model (MTP model) was introduced by the author in previous research and its application to this article is outlined in Annexure 1.<sup>141</sup> The MTP model utilises linear programming to simulate the cross-border intercompany tax planning responses of an MNE to both existing and proposed tax regimes.

Even though the literature suggests that international tax planning decisions can be approximated as an optimisation problem,<sup>142</sup> the use of mathematical optimisation remains largely unexplored in the international tax planning context.

Yet mathematical optimisation is one of the most powerful and widely-used quantitative techniques for making optimal decisions. It is possible to utilise mathematical optimisation in the international tax planning context by formulating the tax minimisation objective (described as the 'objective function', 'Z'), which is determined based on the relationship between the 'decision variables' (denoted as ' $x_1$ ', etc below) and the 'cost' to be optimised (whether through minimisation or maximisation, where  $c_1, c_2, \dots, c_n$  are constants).

This can be expressed as follows:<sup>143</sup>

$$\text{Minimise (or Maximise): } Z = c_1x_1 + c_2x_2 + \dots + c_nx_n$$

Once the objective function has been formulated, the 'constraints' – which set out the limitations – need to be determined. Applied in the context of observing how an MNE may structure its internal affairs in a tax-minimising manner, the linear programming problem expresses the 'objective function' as minimising the total tax payable for the MNE. The 'decision variables' represents the profit in each jurisdiction in which the MNE has a subsidiary and the 'constants' are those respective jurisdictions' corporate income tax rates.

Further, given that the focus of this article is on 'pure' profit shifting by a tax-minimising MNE through intercompany financing, the 'constraints' consist of, first, the flows from intercompany transactions that can increase or decrease the profit figures for each jurisdiction (the 'primary constraints'), and second, the tax laws applicable to the MNE, which can be fine-tuned to particular jurisdictions' specific tax rules (the 'secondary constraints').

Previous work by the author has focused on modelling the tax-minimising behavioural responses of MNEs to changes in interest limitation rules; specifically, thin capitalisation rules and the OECD's recommendation for a fixed ratio rule. This article

<sup>140</sup> Kayis-Kumar, 'International Tax Planning by Multinationals', above n 3.

<sup>141</sup> Ibid; see also Ann Kayis-Kumar, 'What's BEPS Got to Do with It? Exploring the Effectiveness of Thin Capitalisation Rules' (2016) 14(2) *eJournal of Tax Research* 359.

<sup>142</sup> Jaroslav Brada and Tomáš Buus, 'Detection of Possible Tax-Evasive Transfer Pricing in Multinational Enterprises' (2009) 4(2) *European Financial and Accounting Journal* 65; see also M A Vasarhelyi and D Moon, 'Optimizing Tax Allocation among Countries in the Multinational Entity: A Tale of Many Contingencies' (Presentation delivered at the TTN Taxation Seminar New York 2011, Morgan Lewis Bockius LLP, New York, 16 May 2011) 6.

<sup>143</sup> P Sankara Iyer, *Operations Research* (Tata McGraw-Hill, 2008) 3.

builds on this previous work by simulating a tax-minimising MNE's behavioural response to introducing an ACE and/or reducing corporate income tax rates, and compares the respective integrity outcomes of both reforms.

#### 4.2 Comparing the impact of corporate tax cuts coupled with reducing the scope of ACE-variants in Belgium and Italy

In an increasingly globalising and internationally competitive business environment, governments are under considerable pressure to lower their headline CIT rates. Belgium and Italy are no exception and there has been much political pressure to lower their CIT headline rates.<sup>144</sup> The justification is that Belgium and Italy will be able to collect more tax revenue by being more regionally and internationally competitive. However, it is important to concede that the economic rent portion of funds may escape tax.

This model's ability to isolate and observe the behaviour of pure profits facilitates an objective assessment of whether, *ceteris paribus*, a reduced CIT headline rate in Belgium or Italy can benefit the taxing jurisdiction, using the change in global Total Tax Payable (TTP) as proxy for this measure. The proxy for MNE tax-aggressiveness is when the Net Profit Before Tax (NPBT) booked in the taxing jurisdiction (either Belgium or Italy) is between 0–20 out of a total of 100 (where 100 is the least tax-aggressive).

For completeness, it is necessary to acknowledge that modelling generally involves a trade-off between realism in scope and simplicity to facilitate meaningful analysis. So, the results extracted below may not necessarily reflect the only behavioural responses suited to each variation. Rather, these figures simply reflect optimised TTP results which are based on simplified assumptions to present an abstraction of reality. This does not make the observations any less meaningful, since the purpose of model building is to learn about relations between variables.

In relation to the Belgian subsidiary, even if the ACE-variant is abolished the TTP falls only marginally. Upon the implementation of CIT rate cuts the Effective Tax Rate (ETR) in the taxing jurisdiction falls only marginally for the most tax-aggressive MNEs to a flat 24.7 per cent.

On the other hand, for the Italian subsidiary even upon abolition of the ACE-variant the tax revenue base is protected by the existence of the Italian fixed ratio rule. In relation to CIT rate cuts, the TTP remains at an ETR of 27.8 per cent for the majority of increments of tax-aggressiveness until a reduction in the Italian CIT rate to 25.1 per cent. From that point onwards there is no longer an additional incentive for profit shifting behaviour and TTP falls to a flat ETR of 25.1 per cent for all levels of tax-aggression, as shown in the below Table 1.

However, an unintended consequence is that for the relatively less tax-aggressive MNEs a reduction in the CIT rate in place of an ACE-variant results in significantly lower TTP, as illustrated in the below Table 1. In other words, if Belgium and Italy were to abolish

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<sup>144</sup> Belgium's headline corporate income tax rate was reduced from 33.99 per cent to 29.58 per cent on 29 December 2017: *Loi portant réforme de l'impôt des sociétés* (Belgium) [Corporate Income Tax Reform Act of 29 December 2017]. Similarly, in Italy, the 2017 Budget approved on 15 October 2016 a reduction to the headline rate from 27.5 per cent to 24 per cent: J Politi, 'Italy's Renzi unveils spending plans in 2017 budget' *Financial Times* (16 October 2016); available at: <https://www.ft.com/content/473a99b0-9336-11e6-a80e-bcd69f323a8b>.

their ACE-variants and instead synchronise their CIT rate cuts with the US then a reduction in their CIT rates to below 24.7 per cent and 25.1 per cent respectively would simply forfeit tax revenue from economic rents.

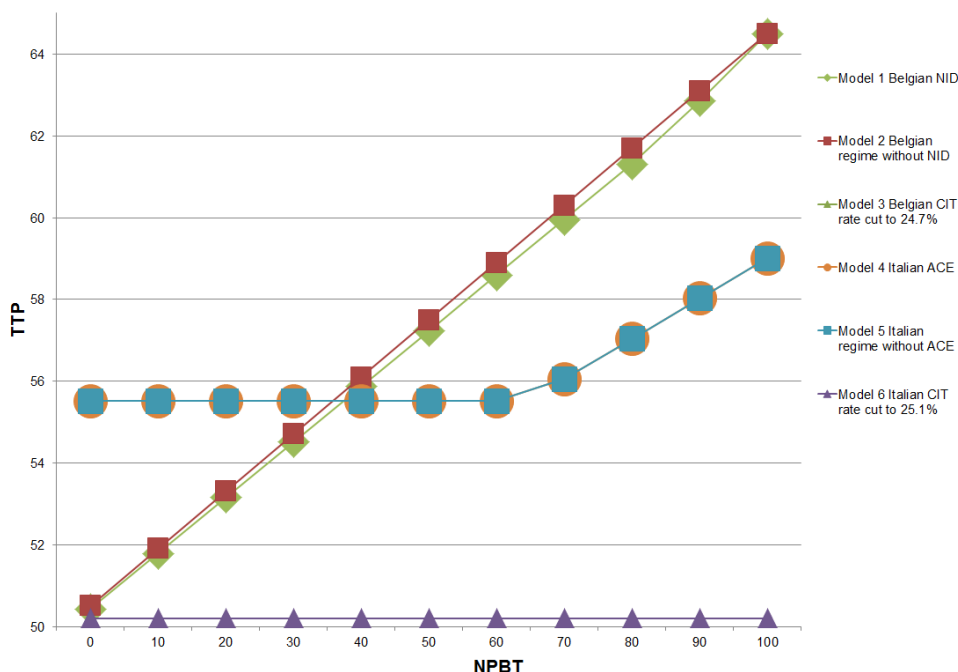
Specifically, where these variations are modelled with NPBT increments between 0–100, the ETR ranges between 25.2–32.3 per cent and 27.8–29.5 per cent for Belgium and Italy respectively, thereby simply enabling relatively less tax-aggressive MNEs to further reduce their TTP. This is shown in Table 1 below.

**Table 1: Results of Modelling a Headline CIT Rate Cut on the Belgian and Italian Subsidiaries' ETRs**

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>
	<i>Belgian</i>	<i>Belgian</i>	<i>Belgian</i>	<i>Italian</i>	<i>Italian</i>	<i>Italian</i>
	<i>NID</i>	<i>regime</i>	<i>CIT rate</i>	<i>ACE</i>	<i>regime</i>	<i>CIT rate</i>
		<i>without</i>	<i>cut to</i>		<i>without</i>	<i>cut to</i>
<i>NPBT</i>		<i>NID</i>	<i>24.7%</i>		<i>ACE</i>	<i>25.1%</i>
0	25.2%	25.3%	24.7%	27.8%	27.8%	25.1%
10	25.9%	26.0%	24.7%	27.8%	27.8%	25.1%
20	26.6%	26.7%	24.7%	27.8%	27.8%	25.1%
30	27.3%	27.4%	24.7%	27.8%	27.8%	25.1%
40	27.9%	28.1%	24.7%	27.8%	27.8%	25.1%
50	28.6%	28.8%	24.7%	27.8%	27.8%	25.1%
60	29.3%	29.5%	24.7%	27.8%	27.8%	25.1%
70	30.0%	30.2%	24.7%	28.0%	28.0%	25.1%
80	30.7%	30.9%	24.7%	28.5%	28.5%	25.1%
90	31.4%	31.6%	24.7%	29.0%	29.0%	25.1%
100	32.3%	32.3%	24.7%	29.5%	29.5%	25.1%

Further, assuming that immobile economic rents will also be taxed at a reduced rate, the findings of this study suggest that a reduction in the CIT rate significantly below 25 per cent will result in, at best, no difference in the tax benefit and at worst, a reduced tax benefit to the taxing jurisdictions.

For completeness, it should be noted that this study does not attempt to model investment behaviour over time in response to global tax changes. Rather, it observes that pure profits do not shift and economic rents are forfeited from a CIT rate reduction in place of an ACE-variant under both the Belgian and Italian regimes. Further, these results also suggest that a combination of an ACE-variant combined with a mechanism similar to a fixed ratio rule may present a more effective tax revenue base protection measure. This is the subject of further research by the author.

**Fig. 2: Results of Modelling a Headline CIT Rate Cut on the Belgian and Italian Subsidiaries**

It goes without saying that international tax competition issues cannot be eliminated. However, the findings of this model question whether jurisdictions such as Belgium and Italy would benefit from coordinated multilateral reductions to their CIT rates. This model assumes that coordination would only occur between higher-tax jurisdictions; that is, the Belgian and Italian subsidiaries, and the US. The findings are that while TTP behaves in the way illustrated by the above Fig. 2, the most tax-aggressive MNE never nominates to place any NPBT into the Belgian and Italian subsidiaries; rather it channels its profit shifting into the very lowest taxing jurisdictions available to it, ie, specifically, in the context of this model, to Singapore and Hong Kong. This indicates that Belgium and Italy would not be the ‘winners’ from a coordinated multilateral corporate tax cut.

## 5. CONCLUSION

This article approaches the extensive literature exploring MNEs’ aggressive tax planning behaviour from a novel perspective by exploring the tension commonly experienced by policy-makers between lowering the headline CIT rate as opposed to implementing tax reforms which aim to reduce economic distortions such as ACE-variants. In doing so, through a comparative legal analysis of the Belgian and Italian ACE-variants in section 3, this article identifies four key recurring trade-offs that present political challenges to the implementation of such fundamental reforms: first, the trade-off between revenue neutrality and ACE system integrity; second, the trade-off between implementing an ACE (at the expense of tax revenue) as opposed to reducing the headline corporate income tax rate; third, on a domestic level, that politically the ACE is perceived to benefit MNEs disproportionately more so than

SMEs, and fourth, on an international level, that there is a trade-off between the desire to make inbound investment more attractive and the risk of base erosion from aggressive tax planning by MNEs.

Since economic distortions are likely to increase incentives for tax-induced behaviours, in particular, aggressive tax planning, there is an urgent imperative for tax rules impacting cross-border intercompany transactions to be designed such that efficiency and integrity outcomes are both prioritised and attained. Through an optimisation modelling approach in section 4, this article demonstrates that simply implementing corporate tax cuts will not necessarily achieve these outcomes. This gives rise to the following two observations. First, this article demonstrates that simply implementing corporate tax cuts will not achieve efficiency and integrity outcomes. Specifically, relatively less tax-aggressive MNEs will likely be indifferent to a unilateral corporate tax cut. This is particularly problematic because if Belgium and Italy were to reduce their corporate tax rates to the thresholds modelled in this article (namely, below 24.7 per cent and 25.1 per cent respectively) they would simply be forfeiting tax revenue from economic rents without impacting MNEs' profit shifting behaviours. This is a timely finding given Italy's corporate tax rate was cut in January 2017 to 24 per cent. This unintended consequence is contrary to the underlying policy objective of implementing corporate tax cuts, namely, to bolster foreign investment.

Second, the most tax-aggressive MNEs will likely be indifferent to a multilateral corporate tax cut by higher taxing jurisdictions. This is because these MNEs never nominate to shift any profits into the higher taxing jurisdictions, instead channelling profits into the very lowest taxing jurisdictions available. As such, Belgium and Italy would not be the 'winners' from a coordinated multilateral corporate tax cut.

Ultimately, it is hoped that this research will present a platform for further discussion on the tax treatment of cross-border intercompany transactions, and facilitate the development of design improvements to cross-border tax policy and reforms.

## ANNEXURE 1

### Determining the objective function

It is possible to represent the optimisation problem formulaically. This entails a two-step approach; first, defining and applying the objective function; and second, defining and applying the constraints.<sup>145</sup>

The general optimisation problem is the minimisation of the objective function by adjusting the design variables and at the same time satisfying the constraints. Since this model is only concerned with the intercompany activities conducted to minimise tax, the only relevant constraints relate to these intercompany transactions, rather than extending to 'real' economic activities.

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<sup>145</sup> Importantly, the term 'constraints' when used in this context is distinct and separate from the 'positive constraint' of revenue neutrality and the 'normative constraints' of satisfying legislative objectives and attaining stability.



In the present analysis, the objective function is the minimisation of total tax payable ( $T$ ) for the corporate group.<sup>146</sup> The modelling will occur in two concurrent iterations: first, Belgium ('Co B') and second, Italy ('Co I'). The headline corporate income tax rates are 33 per cent and 24 per cent, respectively.

$$\text{Minimise: } T = \sum_{i=1}^n NPBT_{i,n+1} \times t_i \quad (1)$$

Since this model is only concerned with the intercompany activities conducted to minimise tax, the only relevant constraints relate to these intercompany transactions, rather than extending to 'real' economic activities.

Accordingly, this optimisation problem is subject to four 'primary constraints'. Each constraint relates to one of the four categories of fungible intercompany funding that constitute the focus of this article: namely, debt financing, equity financing, licencing and finance leasing ( $D_{ij}$ ,  $E_{ij}$ ,  $L_{ij}$  and  $F_{ij}$ , respectively).<sup>147</sup> These can be characterised as the underlying capital amounts ( $C_{ij}$ ). The 'flow' ( $W_i$ ) or remuneration derived therefrom constitutes interest, dividends, royalties and finance lease payments ( $I_i$ ,  $V_i$ ,  $R_i$  and  $P_i$ , respectively).

This is formulated as follows for each constraint:

$$W_i = \sum_{i=1, i \neq j}^n C_{ij} \times r_{ij}^C \quad (2)$$

In other words, the 'flow' or remuneration ( $W_i$ ) is received by company  $i$ , where  $C_{ij}$  is the underlying capital provided by company  $i$  to company  $j$ , at a cost of capital of  $r_{ij}^C$ . Given the fungibility between these intercompany funding activities, the rate of return is uniform. For ease of reference, this cost of capital ( $r$ ) is set at 10 per cent in the baseline iteration.

As a consequence, this model assumes that an increase in the profitability of the MNE does not generate shareholder pressure to increase the rate of return on equity (in the form of increased dividends on intercompany equity financing). However, this shareholder pressure is more likely to arise in a widely-held company rather than a wholly-owned subsidiary that prioritises global tax-minimisation. On the other hand, the latter situation applies to the model developed by this study. Nonetheless, the model is designed so that ' $r$ ' can later be adjusted to simulate the impact of tax rules which directly influence the particular cost of capital, enabling a more complex analysis of MNE behaviour in future iterations.

For completeness, there are three key qualifications to this characterisation that certain types of debt, equity, licencing and leasing are 'fungible'. First, this analysis is confined

<sup>146</sup> While this is a reasonable objective for a US-based MNE, if the MNE were Australian-owned then the objective function may have instead been the minimisation of foreign taxes; see further, Catherine Ikin and Alfred Tran, 'Corporate Tax Strategy in the Australian Dividend Imputation System' (2013) 28(3) *Australian Tax Forum* 523.

<sup>147</sup> For completeness, in the context of leases, this model focuses on finance leases only and this iteration does not contemplate the impact of depreciation.

to ‘pure’ profit shifting, as opposed to applying in the context of real economic flows. For example, dealings with relatively immobile assets such as land are beyond the scope of this characterisation. Second, fungibility does not apply to all classes of intercompany debt, equity, licencing and leasing – only those that are economically equivalent. In this context, it is instructive to contrast a financing lease payment with an operating lease payment, whereby the former would be reasonably characterised as economically equivalent to interest. Third, this model assumes that it will be possible for the MNE to switch between methods of financing upon changes to tax laws. However, this may not be possible in all cases, particularly where doing so would give rise to potentially adverse tax implications and other costs.

Further, this optimisation problem can be remodelled by layering secondary constraints (which can also be conceptualised as limitations or parameters) that reflect the tax laws applicable to each reform variation, as detailed below.

### Overlaying the ‘secondary constraints’

This section delineates concurrent and/or alternative tax rules which constitute the ‘secondary constraints’, to simulate the impact of various rules on MNEs’ tax planning behaviour.

These parameters make it possible to address the question of what the most likely behavioural responses would be to alternative types and rates of tax being levied on otherwise fungible intercompany activities. This enables a more complex analysis to be conducted which also highlights the breadth of the problem, which is that the literature has thus far been too focused on modification of one parameter at a time.

These parameters are as follows:<sup>148</sup>

- thin capitalisation rules;
- withholding taxes; and,
- foreign tax credits.

For completeness, parameters such as transfer pricing rules and the CFC regime are beyond the scope of this iteration of the model. Instead, subsequent research by the author will build in these additional complexities.

Further, two additional assumptions are made by this study. First, this model assumes that MNEs can relocate almost instantly and free of transaction cost. This assumption is used for simplicity and is in line with the approach adopted in the OECD’s BEPS project.<sup>149</sup> Second, as with the OECD’s BEPS project,<sup>150</sup> industry- or sector-specific features are beyond the scope of this iteration of the model.

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<sup>148</sup> For completeness, parameters such as the transfer pricing rules and the CFC regime are beyond scope.

<sup>149</sup> See further, Jörg Hülshorst, Maximilian Tenberge, Svetlana Kuzmina, Alexander Hoß and Andreas Westermaier, ‘Germany - Transfer Pricing Implications of Action 4 under the OECD’s BEPS Initiative’ (2016) 23(2) *International Transfer Pricing Journal* 128, 131.

<sup>150</sup> ‘Moreover, the formula of fixed cap does not match best with every sector and firm. That is why the Action 4 report recognizes the need to develop suitable and specific rules that address BEPS risks in banking and insurance industries. Although it does make sense to respect the specific features of banking and insurance industries, other industries might also claim the special treatments from the BEPS project. It is

### Thin capitalisation rules

Belgium's regime adopts a 5:1 debt-to-equity ratio under their general thin capitalisation rules applicable to intercompany loans. This can be expressed algorithmically as follows:

$$D_{ij} - 1.5 \times E_{ij} \leq 0$$

With the above algorithm, it is possible to target both or either inbound and outbound investment.

On the other hand, Italy utilises the fixed ratio approach with a benchmark ratio currently set at 30 per cent. This can be expressed algorithmically as follows:

$$|I_i + P_i| \leq (BFR\% \times NPBT_{i,t+1})$$

Despite the complexities arising in the calculation of the EBITDA, this study makes the simplifying assumption that *NPBT* is effectively equivalent to EBITDA.

### Withholding taxes

Unlike most of the other parameters built into the model, withholding tax rates are beyond the unilateral control of governments. Each tax treaty – and, by extension, each withholding tax rate within each treaty – is the result of a distinct and separate bilateral negotiation process. Since withholding tax rates cannot be unilaterally increased (although they can be unilaterally decreased) without renegotiation of the bilateral arrangements, this parameter can be conceptualised as a ‘supernational parameter’.

Specific withholding tax rates apply for each of the types of intercompany flows examined in this model.

Table 2 and Table 3 below indicate the withholding tax rates for each type of intercompany funding applicable for each jurisdiction (with notation in the second column representing a flow from country ‘*j*’ to country ‘*i*’, given the notation of the underlying transfer would be ‘*ij*’).

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not realistic to design the specific rules for every firm, industry or sector’: Reuven S Avi-Yonah and Haiyan Xu, ‘Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight’ (2016) 6(2) *Harvard Business Law Review* 185, 217.

**Table 2: Overview of Withholding Tax Rates in Belgium**

<i>Withholding tax rates</i>					
		<i>Interest</i>	<i>Dividends</i>	<i>Royalties</i>	<i>Lease payments</i>
<i>Belgium</i>	<i>U, B</i> <sup>151</sup>	0/15%□	0/5/15%●	0%	0/15%
	<i>B, U</i>	0/15%	0/5/15%●	0%	0/15%
	<i>S, B</i> <sup>152</sup>	5%◇	0%	3/5%◆	5%
	<i>B, S</i>	5%	5/15%●	5%	5%

Key: ◇ government authorities/ financial institutions are afforded a withholding tax exemption; □ interest on certain 'portfolio debt' obligations are exempt from withholding tax; ◆ withholding tax exemption applies to interest paid in relation to either a sale on credit of goods, merchandise or services, or a sale on credit of industrial, commercial or scientific equipment; ● higher withholding rates apply if there is a lower level of participation.

**Table 3: Overview of Withholding Tax Rates in Italy**

<i>Withholding tax rates</i>					
		<i>Interest</i>	<i>Dividends</i>	<i>Royalties</i>	<i>Lease payments</i>
<i>Italy</i>	<i>U, I</i> <sup>153</sup>	0/10%◇◆	5/15%●	0/5/8% <sup>154</sup>	0/10%◇◆
	<i>I, U</i>	0/10%◇◆	5/15%●	0/5/8% <sup>155</sup>	0/10%◇◆
	<i>S, I</i> <sup>156</sup>	12.5%◇	0%	15/20% <sup>157</sup>	12.5%
	<i>I, S</i>	0/12.5%◇	10%	15/20%	0/12.5%◇

Key: ◇ government authorities/ financial institutions are afforded a withholding tax exemption; □ interest on certain 'portfolio debt' obligations are exempt from withholding tax; ◆ withholding tax exemption applies to interest paid in relation to either a sale on credit of goods, merchandise or services, or a sale on credit of industrial, commercial or scientific equipment; ● higher withholding rates apply if there is a lower level of participation.

<sup>151</sup> See *Convention between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, signed 27 November 2006 (entered into force 28 December 2007).

<sup>152</sup> See *Agreement between the Government of the Republic of Singapore and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, signed 6 November 2006 (entered into force 27 November 2008).

<sup>153</sup> See *Convention between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion*, signed 25 August 1991 (entered into force 16 December 2009).

<sup>154</sup> Francesco Avella, 'Italy: Treaty Withholding Rates Table' (1 February 2016), IBFD Country Analyses, Individual Taxation, section 7.4.1.5.

<sup>155</sup> For completeness, the 0 per cent rate applies to royalties for copyrights of literary, artistic or scientific works (excluding royalties for computer software, motion pictures, films, tapes or other means of reproduction used for radio or television broadcasting). The 5 per cent rate applies to royalties for the use of, or the right to use, computer software or industrial, commercial or scientific equipment. In all other cases, the 8 per cent rate is imposed on the gross amount of the royalties: *ibid.*

<sup>156</sup> See *Agreement between the Government of the Republic of Singapore and the Government of the Italian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, signed 29 January 1977 (entered into force 12 January 1979).

<sup>157</sup> The lower 15 per cent rate applies to copyright royalties: see Avella, above n 154.

For completeness, in

Table 2 and Table 3 where one form of intercompany funding may be subject to varying rates of withholding tax, the rate used by the model is highlighted in bold.

Further, this iteration of the model does not make a distinction between portfolio and non-portfolio dividends.<sup>158</sup> These rules are nuanced and jurisdiction specific, whereas this iteration of the model aims to provide a general expression of the current tax rules influencing cross-border tax planning decisions. Similarly, this study acknowledges that various other rules may apply; for example, non-portfolio dividends received by a resident company from a foreign-resident country may be exempt or non-assessable non-exempt income. However, this level of detail is beyond the scope of this iteration of the model. The ultimate issue of repatriation is also not considered, given the short-term nature of this single-period iteration of the model. For the purposes of the optimisation model, the existence of withholding tax gives rise to a potentially increased  $T$ . This necessitates a modification to the objective function, as follows:

$$\text{Minimise: } T = \dots + (D_{ij} \times r_{ji}^{WHT^I} + E_{ij} \times r_{ji}^{WHT^V} + L_{ij} \times r_{ji}^{WHT^R} + F_{ij} \times r_{ji}^{WHT^P})$$

where  $r_{ij}^{WHT}$  represents the potential marginal increase in  $TTP$ , which is a function of the rates of return ( $r$ , assumed to be 10 per cent in the baseline iteration for all types of funding) multiplied by the respective ‘relative value’ for each decision variable (denoted as  $WHT$ , with each ‘relative value’ shown in

Table 2 and Table 3 above).

A run-time test indicates that the MNE will funnel all funds through a combination of the decision variable with the lowest withholding tax rate and the jurisdiction with the lowest corporate income tax rate. This can be further validated by a two-fold analysis: first, anecdotal evidence from leading tax practitioners suggests that this reflects MNEs’

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<sup>158</sup> An area for further research is to consider the ultimate flow through to the final shareholder in the model, which would require distinguishing portfolio and non-portfolio dividends – whereas this model assumes that an MNE engages in tax planning in relation to its non-portfolio dividends. As Daurer and Krever have noted:

An important principle of tax design is that taxes should have a minimal impact on business decisions and with this in mind, tax treaties commonly distinguish between small passive investments in local companies (known as ‘portfolio’ investments, as they are assumed to be part of the foreign shareholder’s investment portfolio) and more substantial (non-portfolio) direct investments in a local operating company ... [T]reaties may set two caps on dividend income with a higher rate allowed on dividends paid to portfolio shareholders and a lower rate allowed on dividends paid to non-portfolio shareholders. The provisions setting out the dual caps for portfolio and non-portfolio investors provide the only instance in which the UN model treaty is more favourable to the capital exporting nation than the OECD model treaty. Under the OECD model, the capital importing country will be required to use the lower withholding tax rate when the investor has a 25 per cent or greater interest in the company paying dividends. Under the UN model, the capital importing country must apply the lower rate when dividends are paid to investors with only 10 per cent or greater interests in a local company.

Veronika Daurer and Richard Krever, ‘Choosing between the UN and OECD Tax Policy Models: An African Case Study’ (2014) 22(1) *African Journal of International and Comparative Law* 1, 15.

behaviour; second, from the perspective of the MNE as a group, withholding taxes increase the cost of capital of the funding type by the amount of the tax rate withheld.<sup>159</sup>

This relationship can be expressed as follows:

$$r^{WHT} = r (1 + \tau)$$

where  $r^{WHT}$  is the cost of capital following the imposition of withholding taxes,  $r$  is the rate of return prior to the imposition of withholding taxes and  $\tau$  is the withholding tax rate.

### Foreign tax credits

To avoid double taxation, foreign income may be exempt from tax under the relevant jurisdiction's foreign tax credit (FTC) regime. Each jurisdiction unilaterally controls its FTC system, rendering this a parameter.

It is noteworthy that FTC systems and rates differ markedly between jurisdictions. In order to convert the FTC regime into an algorithmic expression, it is instructive to first articulate the operation of this system. The FTC is limited to the domestic tax liability that would be due on the foreign source income.<sup>160</sup> Specifically, a jurisdiction's FTC is the lower of: (A) the amount of tax attributable to the foreign source income; or (B) the actual amount of foreign tax paid.

In other words, if the amount of tax attributable to the foreign source income (A) exceeds the actual amount of foreign tax paid (B), then  $T$  will increase by the difference: namely,  $A - B$ . If, however, the actual amount of foreign tax paid (B) exceeds the amount of tax attributable to the foreign source income (A), then  $T$  will remain unchanged, because there will be no increase to domestic tax liability.

For the purposes of the optimisation model, FTC can be built into the objective function with the addition of the following notation:

$$\begin{aligned} \text{Minimise: } T = \dots + \sum_j \sum_{\substack{k \\ i \neq j}} (D_{ijk} + E_{ijk} + L_{ijk} + F_{ijk}) (r_{ijk} \times r_{ijk}^{FTC} \\ - r_{ijk} \times r_{kji}^{WHT}) \end{aligned}$$

where  $ijk$  represents the inclusion of all three jurisdictions,  $r_{ijk}$  is the initial rate of return (assuming the 'tax attributable' is calculated on the gross-up, this is the same as

<sup>159</sup> European Commission, 'The Economic Impact of the Commission Recommendation on Withholding Tax Relief Procedures and the FISCO Proposals' (European Commission Staff Working Document, 24 June 2009) 44.

<sup>160</sup> 'Essentially, the foreign tax credit is limited to the US tax liability that would be due on the foreign source income': Review of Business Taxation (John Ralph, chair), *An International Perspective: Discussion Paper, Examining How Other Countries Approach Business Taxation* (December 1998) 107 ('International Taxation').

the initial rate of return of 10 per cent),  $r_{ijk}^{FTC}$  represents the amount of tax attributable to the foreign source income and  $r_{kji}^{WHT}$  represents the actual amount of foreign tax paid.

Both Belgium and Italy provide some level of relief from double taxation of foreign source income. Belgium's FTC<sup>161</sup> is limited to a lump-sum amount equal to 15/85 of the amount of the net foreign source income, with a separate calculation applying to interest withholding tax, with it too capped at 15 per cent. On the other hand, Italy's FTC is calculated on a country-by-country basis.<sup>162</sup> However, for simplicity, none of these nuances are included in the initial iterations of the optimisation model.

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<sup>161</sup> Called the QFIE system (“*quotité forfaitaire d’impôt étrangers*”): Patrick A A Vanhaute, *Belgium in International Tax Planning* (IBFD Publications, 2nd ed, 2008) 91-92, 159.

<sup>162</sup> See further, Avella, above n 154.

# Superannuation and economic inequality among older Australians: evidence from HILDA

Helen Hodgson<sup>1</sup> and Alan Tapper<sup>2\*</sup>

## ***Abstract***

This article seeks to identify the effect that the current superannuation system has on economic inequality in later life. The analysis uses income and wealth data from the Household Income and Labour Dynamics in Australia (HILDA) survey, collected between 2002 and 2014, to examine wealth inequality, which includes the balance of a superannuation accumulation account, and income inequality, which includes private pension income. The main findings are that inequality in superannuation holdings is considerably higher than wealth inequality among older Australians and that inequality increases with age, but overall the age pension and home ownership have had a moderating effect on income and wealth inequality over this period.

**Key words:** Economic inequality; superannuation; income distribution; wealth distribution

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<sup>1</sup> Associate Professor, Curtin Law School, Curtin University, helen.hodgson@curtin.edu.au (corresponding author).

<sup>2</sup> Senior Research Fellow, John Curtin Institute of Public Policy, Curtin University.

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## 1. INTRODUCTION

This article examines the extent of economic inequality among Australians over 55 years of age, and seeks to identify the effect, if any, that the current superannuation system is having on economic inequality in later life. It examines inequality by reference to wealth, which includes the balance of a superannuation accumulation account, and by reference to income, which includes private pension income. It uses income and wealth data from the Household Income and Labour Dynamics in Australia (HILDA) survey, collected between 2002 and 2014.

Economic inequality encompasses income inequality and wealth inequality. Income inequality refers to the distribution of income across a given population. Wealth inequality is a measure of the distribution of net worth across a population. Wealth is concentrated among older age groups as it represents surplus earnings accumulated during working life. However, a significant proportion of this wealth is locked into non-productive assets and so older Australians are frequently ‘asset rich but income poor’.

Superannuation is represented in both income and wealth distributions. Superannuation accumulation funds form part of the wealth data. However, if the purpose of superannuation is to support a person in their retirement (Financial System Inquiry Panel, 2014), the asset must be converted to an income flow as an annuity or pension, and this income flow will appear in the income distribution data.

The retirement income system in Australia is built on three pillars: the Age Pension; the Superannuation Guarantee; and other retirement savings. Saving through the superannuation system, whether mandatory or voluntary, is supported by tax concessions. Recent debate has highlighted the unequal distribution of superannuation, and the consequential unequal distribution of tax concessions (Australian Treasury, 2015b, p. 90; Daley & Coates, 2015).

Government policy in a number of areas will need to address the aging of the population: the age dependency ratio (the ratio of those age 65 and over to those aged 15 to 64) is expected to decrease from 4.5 in 2014-15 to 2.7 in 2054-55 (Australian Treasury, 2015a). The extent of inequality among older Australians is important in designing policy in a number of core areas, including the age pension; health and aged care; housing; and—most importantly for this article—superannuation.

A recent report by the Organisation for Economic Co-operation and Development (OECD, 2017), *Preventing Ageing Unequally*, highlights concern that modern economies are tending to increase economic inequality in general and amongst the elderly in particular. The report (OECD, 2017, p. 15) says:

“Ageing unequally” refers to inequality that develops throughout the life course and materialises in old age. It is often the result of specific episodes during people’s lives that tend to cumulate their detrimental effects on health and income at old age. Ageing unequally is not a new phenomenon, but while the current generation of older people is experiencing higher incomes and lower poverty risks than previous ones in most countries, the younger generations are likely to face again higher inequality in old age. They are expected to live longer, but have been experiencing more unstable labour market conditions and widening inequalities in the distribution of earnings and household income.

The present study can be seen in this context as part of the necessary monitoring of inequality trends amongst the older population. It provides some benchmark data against which future trends can be measured.

This article proceeds as follows. Section 2 discusses the state of economic inequality in Australia in recent years. Section 3 reviews the development of the superannuation system, identifying the significant reforms and when they occurred. Section 4 sets out the methodology we used in our examination of the effect of superannuation on inequality among older Australians. Section 5 details our findings. Finally in section 6 we present our general conclusions and identify the implications of our analysis on the development of retirement income policy.

## **2. INEQUALITY IN AUSTRALIA**

It is generally understood that income and wealth are each related to age but the two trajectories are importantly different. Income generally peaks in mid-life and falls in later life. Wealth rises with age more slowly than income and levels off or falls less sharply in later life. A typical life-cycle moves from an asset poor but income rich phase in early life to an income poor but asset rich phase in later life, with an income rich and asset rich phase in mid-life. The joint effect can be thought of as age-related economic well-being.

There has been much recent debate over economic inequality trends globally (Keeley, 2015; Piketty, 2014). The Australian data show that neither income nor wealth inequality overall is increasing in the period since 2000, although there does seem to be an increasing share of income and wealth at the top percentile level (Fenna & Tapper, 2015; Leigh, 2013; Wilkins, 2015 and OECD data (OECD.Stat)). However, there has been little analysis of trends in inequality among older Australians as a subset of the population. Two very different questions arise here. One, are older Australians more or less economically equal than the general population? Two, is the trend amongst the older population tending to decrease or increase inequality? The second question is especially apposite given that the Australian superannuation system is shaping retirement wealth and incomes as it progressively evolves. These two questions are the focus of this article.

## **3. THE DEVELOPMENT OF THE SUPERANNUATION SYSTEM**

Australia's retirement income system is often described as being based on three pillars (Australia's Future Tax System Review Panel (Henry Review), 2009). However, the World Bank framework takes a broader policy perspective, identifying five tiers (World Bank, 2008):

1. a basic income safety net in retirement;
2. contributory pensions;
3. mandatory retirement savings schemes;
4. self-provision, which may be encouraged through tax concessions; and
5. a non-financial fourth pillar that includes housing and social services including health and aged care.

This extended framework acknowledges the importance of housing and social services in maintaining well-being into retirement.

The three pillars formalised in the Australian retirement income system are the basic income safety net, mandatory retirement savings, and self-provision. Contributory pensions were rejected as a policy option in Australia in the first half of last century. In 1972 the Hancock Inquiry recommended the introduction of earnings-related supplementary contributions to the age pension that could raise the pension to levels of around 30% of average weekly earnings (AWE) (National Superannuation Committee of Inquiry, 1976), but this proposal was rejected by the Fraser government. Accordingly the age pension is funded through general revenue and is not calculated by reference to pre-retirement income, occupation or contributions. In the Australian system self-provision is encouraged through voluntary additions to the mandatory level of superannuation.

Superannuation in Australia is often described as a maturing system. It has long been a feature of the Australian retirement income system, with schemes for white collar, public sector, and self-employed workers having been in place for many years; however by 1986 less than 40% of employees had superannuation coverage (Australian Treasury, 2001). Superannuation has been supported as a savings retirement vehicle through the federal income taxation system since its introduction in 1915. The *Income Tax Assessment Act 1915* allowed tax deductions for superannuation contributions paid by employers in respect of employees, and exempted the earnings of a superannuation fund, to the extent those earnings supported pension payments.

Employees paid under award agreements were included in award-based schemes from 1987 following the Accord Mark II agreement under which the unions deferred 3% of cost of living wage increases into superannuation: the precursor of the Superannuation Guarantee. The mandatory superannuation guarantee based on a proportion of employee earnings dates from only 1993, when it was introduced to provide ‘an equitable and attractive retirement income arrangement for ordinary Australians’ (Keating, 1991), with superannuation savings encouraged through favourable tax treatment. Notably, Keating did not envisage the mandatory superannuation as replacing the age pension, but a supplement that would maintain retirement income at around 30% of AWE.

Superannuation guarantee contributions were initially set at 3%, increasing to 9% by 2002. The first generation of workers to have had access to the superannuation guarantee for their entire working life will not begin to retire until around 2040. Accordingly a person who retired in 2002 will have been subject to the superannuation guarantee for nine years, at rates below 9% whereas a person who retired in 2014 will have accumulated significantly higher superannuation guarantee entitlements as they will have been covered for 21 years and contributions for half of that time will have been at 9%.

The next significant reform was in 2007. The ‘Simpler Super’ changes (*Tax Laws Amendment (Simplified Superannuation) Act 2007*) saw the exemption of pensions paid from superannuation fund earnings to a person over 60 and the introduction of generous contribution caps to replace reasonable benefit limits encourages contributions at a rate higher than that required to provide a comfortable level of income in retirement.

Contributions to, and investment earnings of, superannuation funds have been taxed at a flat 15% rate since 1988. The tax rate applied to contributions is applied to

contributions from sources that have not been taxed, notably superannuation guarantee contributions and other voluntary contributions directly from salary (salary sacrifice contributions). As these contributions are taxed at a flat rate of 15%, where a person is paying a marginal tax rate that is over 15%, there is a tax advantage in diverting income into superannuation. However the second tax expenditure, 15% on the earnings of superannuation funds, creates a potentially greater opportunity to exploit the difference between personal marginal tax rates and the concessional tax rate paid by the superannuation fund. This arbitrage is increased when the fund goes into retirement phase as the earnings on assets set aside to provide a pension are exempt from income tax under section 295-385 of the *Income Tax Assessment Act 1997*.

Superannuation funds are used to support the 'self-provision' retirement income pillar, allowing members to make contributions from other forms of savings. The concessional rate of tax creates incentives to use superannuation as an investment vehicle, an outcome that is specifically encouraged by the policy, but also encourages the use of superannuation accounts as a form of wealth creation rather than as a retirement product.

Clearly some limitation on savings is an important part of superannuation policy. Prior to 2007 this was achieved by the application of reasonable benefit limits, which restricted the amount that could be withdrawn from superannuation at tax preferred rates. The reforms in 2007 simplified the system by removing maximum withdrawal limits but imposing caps on the amount that can be contributed to superannuation. However these caps were very generous, particularly in respect of non-concessional contributions (voluntary, post-tax contributions). This further encouraged the use of superannuation funds as a form of tax preferred savings.

In this context, concern has been expressed regarding the tax expenditures associated with the current superannuation savings regime (Australian Council of Social Service (ACOSS), 2012; Australian Treasury, 2015b, p. 90; Daley & Coates, 2015). In 2015 it was estimated that more than half of the superannuation tax expenditures were received by the wealthiest 20% of Australians who have a greater capacity to save into superannuation (Daley & Coates, 2015).

The most recent reforms, introduced with effect from 1 July 2017 (*Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016*), addressed the escalating tax expenditures by reducing the contribution caps, and limiting the amount that can be held tax free in retirement phase. These reforms were introduced after 2014, and therefore are not reflected in the data analysed in this article.

A key element of the superannuation guarantee system is portability of benefits, in contrast to earlier schemes that were linked to employer support. This encourages savings in accumulation type schemes, as opposed to defined benefit schemes. In 1982 82% of superannuation funds were defined benefit funds, but by 2000 that percentage had dropped to 14%, with 86% being accumulation funds (Australian Treasury, 2001).

An accumulation fund is defined as 'a superannuation fund where your retirement benefit depends on the money put in by you and your employers and the investment return generated by the fund'.<sup>3</sup> A member account in an accumulation scheme is recognised as an investment asset that is accessible after a condition of access has been

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<sup>3</sup> See Australian Securities and Investments Commission (ASIC), 'Glossary – accumulation fund', <https://www.moneysmart.gov.au/glossary/a/accumulation-fund>.

met, generally at retirement, death or upon reaching age 65. A retiree may draw on this as a lump sum or use it to generate an income stream as a pension or annuity.

A minority of retirees are entitled to a pension from a defined benefit scheme, which is 'a super fund where your retirement benefits are calculated by a predetermined formula. Retirement benefits are usually calculated using your average salary over the last few years before you retire and the number of years you worked in the company or public service...'.<sup>4</sup> These retirees are likely to be either former public sector workers and/or older retirees who were a member of a defined benefit fund before the changes consequential on the introduction of the superannuation guarantee.

For the purposes of this study, which is examining wealth and income inequality, this raises questions over the relationship between superannuation as an asset and the resulting income stream. Superannuation as an asset is a factor in wealth inequality, but as an income stream it is reflected in income inequality. This limitation is also noted by the OECD when discussing the high income inequality rate among the elderly in Australia (OECD, 2017, p. 249).

#### 4. METHODOLOGY

The article identifies and examines trends in inequality from 2002 to 2014 amongst Australians over the age of 55, using the Gini index and the P75:P25 ratio. The Gini index or Gini coefficient is an index of the inequality among values of a frequency distribution. A Gini coefficient of zero represents perfect equality, while a Gini coefficient of one represents perfect inequality. The P75:P25 ratio compares wealth or income at the 75th percentile with wealth or income at the 25th percentile of the population (with the 75th being the wealthier/richer). Both the Gini coefficient and the P75:P25 ratio can be applied to give an indication of the inequality of the distribution of wealth or income.

The wealth module of the HILDA survey is released every four years, with data appearing in waves 2, 6, 10 and 14, collected in 2002, 2006, 2010 and 2014. The time period examined in this article is based on these data waves. The sample size is 36,848 observations over the four waves. For this analysis older Australians are grouped by age in five age bands: 55–59, 60–64, 65–69, 70–74, 75–79 and 80 and over. The resulting sample sizes are considered to be adequate for the level of analysis undertaken.

All monetary data used in the analysis are adjusted to the consumer price index (CPI) in 2014 dollars. Where the data is household data it has been equivalised for household size using the modified OECD equivalence scales which assign a value of 1 to the household head, 0.5 to each additional adult member of the household and 0.3 to each child (aged under 15).

The analysis uses both cross-sectional analysis and panel data to examine trends. The cross-sectional data provides a snapshot of the wealth and income of the participants at the time of the survey, and is used to examine changes across the survey population between each survey wave. Cross-sectional analysis is used to examine trends between age groups across the four waves of data.

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<sup>4</sup> See ASIC, 'Glossary – defined benefit fund', <https://www.moneysmart.gov.au/glossary/d/defined-benefit-fund>.

HILDA panel data also allows analysis of changes between cohorts over time. As shown in Table 1, the panels are selected on the basis of their age at the commencement of the survey, but all reached retirement age during the period under review.

**Table 1: Selection of Panels for Analysis**

	<b>2002</b>	<b>2006</b>	<b>2010</b>	<b>2014</b>
Panel 1	50–53	54–57	58–61	62–65
Panel 2	54–57	58–61	62–65	66–69
Panel 3	58–61	62–65	66–69	70–73
Panel 4	62–65	66–69	70–73	74–77
Panel 5	66–69	70–73	74–77	78–81

Source: HILDA 2002–2014

Panel data analysis is used to observe financial trends by following the panel of participants through the four waves of data, and comparing them to the data for other panels at the same age.

## **5. FINDINGS**

### **5.1 Wealth inequality**

In the HILDA survey, net wealth is calculated as: the sum of (a) monetary wealth in bank accounts, superannuation, cash investments, shares, trust funds, and the cash-in value of life insurance policies, and (b) non-financial assets including the family home, other property, business assets, collectables, and vehicles, minus (c) debts comprising home debt, other property debt, credit card debt, HECS debt, other personal debt, loans from friends or relatives, and business debt.

The first stage of analysis is based on cross-sectional analysis, and examines the wealth of the participants in each data wave who were in the specified age group.

Our first finding (see Table 2) is that wealth inequality among Australians aged over 55 is lower than that for the general population.

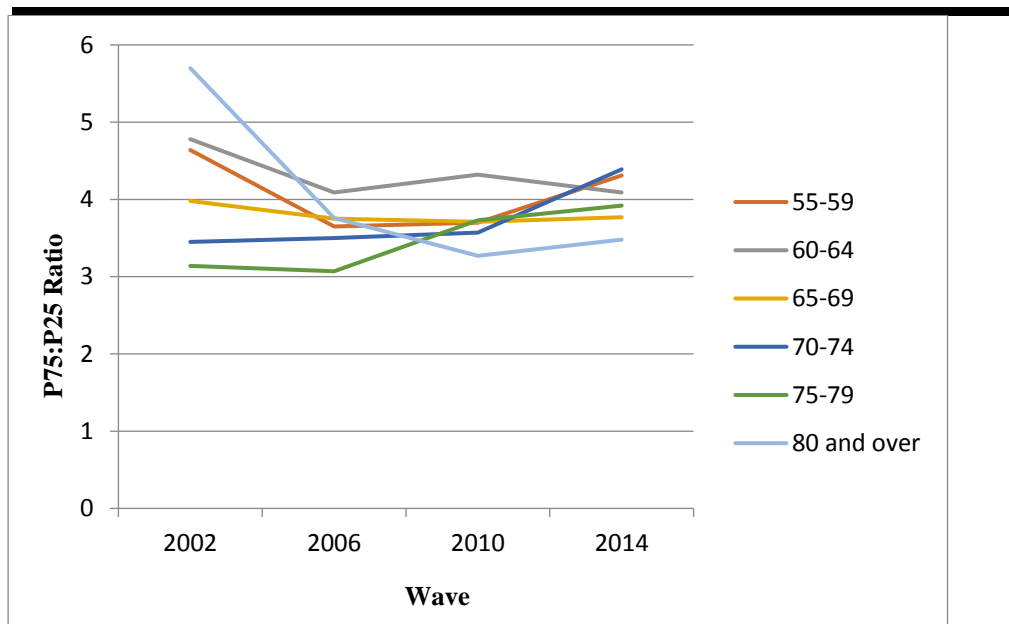
**Table 2: Equivalent Household Net Wealth Distribution by Age, HILDA 2002–2014, Gini Coefficients**

Age Cohort		55–59	60–64	65–69	70–74	75–79	80 and over	All households
Data Wave	2002	0.57	0.57	0.55	0.52	0.51	0.55	0.60
	2006	0.52	0.56	0.58	0.57	0.50	0.51	0.60
	2010	0.50	0.56	0.56	0.52	0.58	0.49	0.60
	2014	0.51	0.56	0.54	0.58	0.57	0.52	0.61
	Average	0.53	0.56	0.56	0.55	0.54	0.52	0.60

Source: HILDA 2002–2014

In each of the older age groups there is some fluctuation in the figures over the four waves, with no clear trend emerging. However, wealth is consistently more equally distributed among the over-55s than among the general population.

Chart 1 and Table 3, using the P75:P25 ratio, show that the spread of wealth has narrowed over the four waves of the survey in these age groups between 2002 and 2014. However, the trend over this period is generally U-shaped. Generally speaking, inequality fell after 2002 and rose after 2010. The lowest ratio was generally in either 2006 or 2010, with the exception of the 60–64 age group in which the ratio fell between 2010 and 2014 to the same level as in 2006, and the 70–74 age group in which the ratio rose consistently over this period. There is no clear reason that can be linked to the superannuation system that might explain this U-shaped pattern.

**Chart 1: Household Net Wealth P75:P25 Ratio by Age: HILDA 2002–2014****Table 3: Distribution of Household Equivalent Net Wealth by Age, 2002–2014, HILDA, P75:P25 Ratios**

	Age Cohort	55–59	60–64	65–69	70–74	75–79	80 and over
Data Wave	2002	4.64	4.78	3.98	3.45	3.14	5.70
	2006	3.65	4.09	3.75	3.50	3.07	3.76
	2010	3.70	4.32	3.71	3.57	3.73	3.27
	2014	4.31	4.09	3.77	4.39	3.92	3.48

Source: HILDA 2002–2014



### 5.1.1 Superannuation

The relevant HILDA variables identify superannuation holdings as a component of household net worth. For superannuation holdings to be valued as an asset the superannuation must either be held as an accumulation account or the capital value of the retirement income stream must be able to be determined, as in a case where an annuity has been purchased. However, it is problematic to determine the capital value of a defined benefit scheme as such a scheme provides an income stream for life, based on factors determined at the time of retirement. Accordingly, the value of defined benefits will not be included in the wealth data.

Table 4 shows the Gini coefficients for superannuation holdings among people aged 55 and over.

**Table 4: Distribution of Household Equivalent Superannuation by Age, HILDA 2002–2014, Gini Coefficients**

	Age Cohort	55–59	60–64	65–69	70–74	75–79	80 and over
Data Wave	2002	0.67	0.72	0.81	0.87	0.90	0.89
	2006	0.67	0.68	0.76	0.81	0.87	0.89
	2010	0.61	0.71	0.75	0.79	0.88	0.90
	2014	0.59	0.68	0.73	0.78	0.85	0.91

Source: HILDA 2002–2014

Consistent with other analysis (Clare, 2014), we see that superannuation holdings are unequally distributed and that this inequality increases with age. However, there is also a reduction in inequality over time within each age group, with the exception of households with head aged 80 and over.

In these age groups, superannuation holdings are more unequal than wealth in general, as can be seen in Table 5. (Here the net wealth and superannuation figures are non-equivalised, and hence the Gini coefficients are slightly higher than those shown in Tables 2 and 3.)

**Table 5: Comparison of Net Wealth Distribution with Superannuation Distribution by Age, HILDA 2002–2014, Gini Coefficients**

	Age Cohort	<b>55–59</b>		<b>60–64</b>		<b>65–69</b>		<b>70–74</b>		<b>75–79</b>		<b>80 and over</b>	
	Asset	Super	Wealth	Super	Wealth	Super	Wealth	Super	Wealth	Super	Wealth	Super	Wealth
Data Wave	2002	0.67	0.57	0.72	0.57	0.81	0.55	0.87	0.52	0.90	0.51	0.89	0.55
	2006	0.67	0.52	0.68	0.56	0.76	0.58	0.81	0.57	0.87	0.5	0.89	0.51
	2010	0.61	0.5	0.71	0.56	0.75	0.56	0.79	0.52	0.88	0.58	0.9	0.49
	2014	0.59	0.51	0.68	0.56	0.73	0.54	0.78	0.58	0.85	0.57	0.91	0.52

Source: HILDA 2002–2014

The finding that inequality in superannuation holdings is related to age in each wave is consistent with the maturing of the superannuation system outlined in the introduction. Older cohorts of retirees are likely to fall into one of two groups: in most cases they would have no superannuation coverage before the introduction of the superannuation guarantee in 1993, but a minority would have been a member of a pre-existing scheme. This dichotomy would result in higher levels of superannuation inequality among older age groups.

The cross-sectional analysis also shows that inequality declined in each age group up to age 80 over the period from 2002 to 2014. This finding is also consistent with the maturing of the superannuation system as successive waves have accrued larger superannuation accounts through the application of the superannuation guarantee for longer periods of time.

As shown in Table 6, the proportion of assets held in superannuation by each age group has increased considerably between data waves. Each wave shows that holdings decrease with age, consistent with retired people drawing down on their superannuation in retirement. However, the proportion of wealth held in superannuation by each age group has increased between each wave, consistent with savings being directed to superannuation prior to retirement.

**Table 6: Proportion of Assets held in Superannuation by Age, HILDA 2002–2014**

Data Wave	Age Group	55–59	60–64	65–74	70–74
	2002	22%	17%	12%	8%
	2006	26%	22%	14%	11%
	2010	27%	25%	17%	11%
	2014	33%	28%	22%	17%

Source: HILDA 2002–2014

Although superannuation is increasing over time as a proportion of assets, it is still distributed more unequally than total wealth within the same age group, as was shown in Table 5. Therefore, we conclude that other assets must have a moderating effect on wealth inequality.

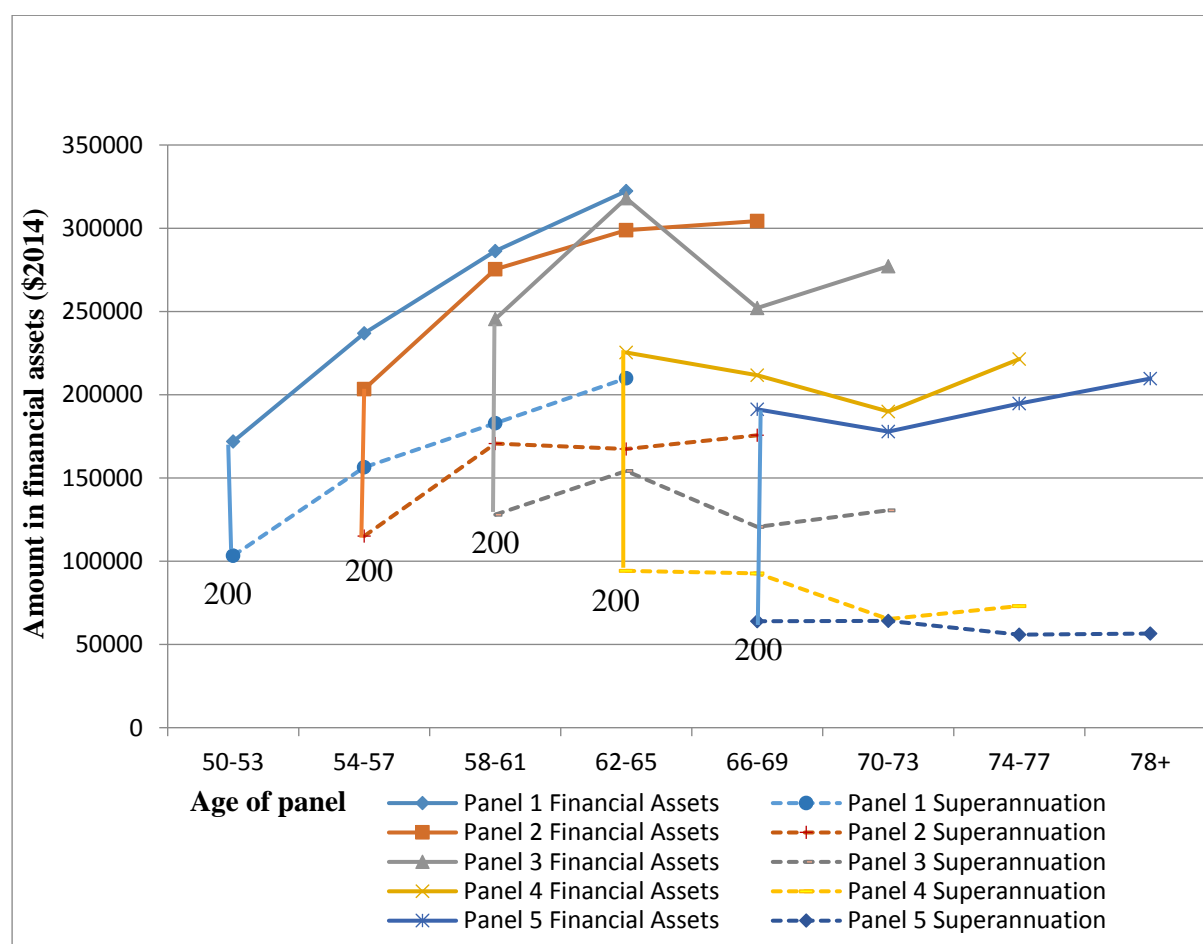
### 5.1.2 Panel data analysis: superannuation

Panel data analysis was used to examine financial asset holdings in more detail. Table 1 provides details of the panels which were based on age in each wave of data. The panel analysis in Chart 2 shows several trends.

The median balance held in superannuation is higher in the younger age groups, consistent with the maturation of the superannuation system. Superannuation balances decrease in the older age groups, consistent with withdrawals during retirement. However, the median balance of all financial assets, including superannuation, showed a similar increasing trend across panels. This is consistent with other research findings that older Australians are net savers (Cassells et al., 2015).

Panel 3, those aged 58–61 in 2002, showed a higher level of financial assets in 2006, but also recorded a decline between 2006 and 2010, which corresponds to reaching retirement age (ages 62–65 for most workers) during the Global Financial Crisis.

The panel data also show that the trend to reduce balances around the time of retirement is less pronounced in younger age panels: the median asset balance for panel 2 has levelled off when the age group reaches retirement age (ages 65–69).

**Chart 2: Trends in Financial Assets by Panel, HILDA 2002–2014**

Source: HILDA 2002–2014

### 5.1.3 The home

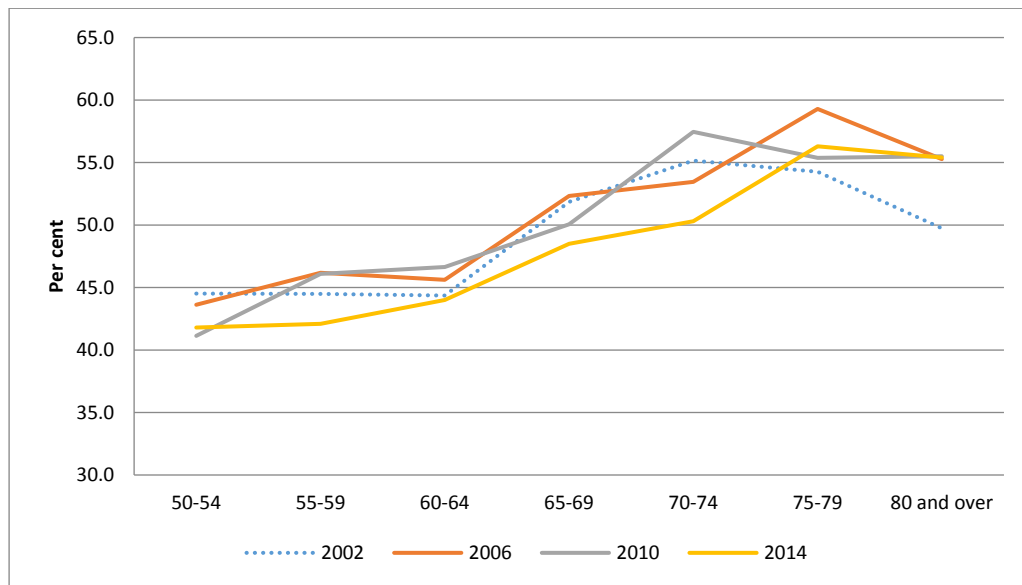
Given that the level of inequality in superannuation holdings significantly exceeds the overall Gini coefficient, the data were then re-examined to identify other asset holdings that may have an equalising effect in later life.

HILDA identifies the home as an asset separately from investment properties, and mortgages on the home are also recorded separately from mortgages on other property. The data in this analysis is based on the home and excludes investment properties. The net value of the home is the market value reduced by the mortgage attributable to the home.

Consistent with the literature (Dockery et al., 2015, p. 58; Productivity Commission, 2015b), we found that the most valuable asset held by most older Australians is the home. Home ownership levels among Australians aged 65 and over were 85.5% in 2014 (Australian Bureau of Statistics (ABS), 2015). Chart 3 shows that the net value of residential property increases as a proportion of net wealth until around age 70, at which

stage it levels off or decreases slightly. This reflects the reduction in housing debt among older age groups and the increased value of residential property relative to more liquid assets that will be consumed first in retirement.

**Chart 3: Net Value of the Home as a Per cent of Net Wealth by Age, HILDA 2002–2014**



Source: HILDA 2002–2014

Table 7 shows the Gini coefficients for equivalent net housing assets by age. In general these are below the Gini scores for equivalent net wealth by age, as can be seen by comparing them with the findings in Table 8.

**Table 7: Distribution of Equivalent Net Wealth in the Home by Age, HILDA 2002–2014, Gini Coefficients**

	<b>55–59</b>	<b>60–64</b>	<b>65–69</b>	<b>70–74</b>	<b>75–79</b>	<b>80 and over</b>
2002	0.52	0.48	0.50	0.47	0.48	0.58
2006	0.47	0.48	0.44	0.51	0.47	0.53
2010	0.48	0.48	0.48	0.43	0.51	0.49
2014	0.53	0.51	0.46	0.48	0.44	0.49
Average	0.50	0.49	0.47	0.47	0.47	0.52
Average for equivalent net wealth	0.53	0.56	0.56	0.55	0.54	0.54

Source: HILDA 2002–2014

**Table 8: Comparison of Equivalent Net Wealth by Age with Equivalent Net Wealth in the Home by Age, HILDA 2002–2014, Gini Coefficients**

		<b>55–59</b>		<b>60–64</b>		<b>65–69</b>	
		Home	Wealth	Home	Wealth	Home	Wealth
Data Wave	2002	0.52	0.57	0.48	0.57	0.50	0.55
	2006	0.47	0.52	0.48	0.56	0.44	0.58
	2010	0.48	0.5	0.48	0.56	0.48	0.56
	2014	0.53	0.51	0.51	0.56	0.46	0.54
		<b>70–74</b>		<b>75–79</b>		<b>80 and over</b>	
		Home	Wealth	Home	Wealth	Home	Wealth
Data Wave	2002	0.47	0.52	0.48	0.51	0.58	0.55
	2006	0.51	0.57	0.47	0.5	0.53	0.51
	2010	0.43	0.52	0.51	0.58	0.49	0.49
	2014	0.48	0.58	0.44	0.57	0.49	0.52

Source: HILDA 2002–2014

ABS data (see Table 9) show that over this period the Residential Property Housing Index grew at a substantially faster rate than CPI and the increase in house prices was widespread despite regional variations in timing.

**Table 9: Increase in Residential Property House Index, ABS**

<b>Increase from June quarters</b>	<b>2002–06</b>	<b>2006–10</b>	<b>2010–14</b>
Increase in Residential Property House Index: 8 capital cities	31%	35%	11%
CPI	12%	11%	10%

Source: (ABS, *Consumer Price Index*, Cat. 6401.0; *Residential Property Price Indexes*, Cat. 6416.0)

Accordingly, the net value of residential housing moderated the unequal distribution of other assets, including superannuation accounts due to the high rates of home ownership in this age group and the widespread growth in the value of residential housing over this period.

It must be noted that non-home owners have not benefited from this increase in the value of housing; and changes in debt ratios of home owners will also be reflected in net asset values. These factors would be reflected in inequality measures.

## **5.2 Income inequality**

Turning to income inequality, we find that disposable income inequality is higher among older Australians than among the general population. Disposable income is private income plus government cash transfers minus income taxes.

Based on the cross-sectional data we examined HILDA disposable income data from 2002 to 2014. Table 10 shows the Gini coefficient for equivalent disposable income across all age groups from age 55.

**Table 10: Equivalent Disposable Income Distribution by Age, HILDA 2002–2014, Gini Coefficients**

	Age	55–59	60–64	65–69	70–74	75–79	80 and over	Total population aged 55 and over
Data Wave	2002	0.38	0.38	0.39	0.34	0.29	0.35	0.34
	2006	0.37	0.42	0.45	0.42	0.31	0.30	0.34
	2010	0.32	0.35	0.43	0.42	0.28	0.30	0.33
	2014	0.32	0.42	0.39	0.39	0.33	0.37	0.33
	Average 2002–2014	0.35	0.39	0.42	0.39	0.30	0.33	0.34

Source: HILDA 2002–2014

There is some change in inequality in the lower age groups which is difficult to explain by reference to policy changes. It is likely that this is related to the number of people in the sample that describe themselves as retired at each point in time. After retirement income declines significantly as employment income decreases and is only partially substituted by pension and investment income, therefore the difference in income between retired and employed respondents would be reflected in higher levels of inequality.<sup>5</sup>

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<sup>5</sup> Wilkins (2018, p. 33) comments on:

...the high level of [disposable income] inequality among people aged 65 and over, and more particularly, the large increase in inequality between 2003 and 2008. Since 2008, the Gini coefficient for this age group has remained in excess of 0.34. Later retirement could potentially explain some of this rise, since a growing minority of the age group is not retired (and therefore receiving higher incomes). However, it may also be that growth in the number of retirees with significant superannuation holdings and other assets has increased inequality among this age group.

This valuable study was received too late to be fully considered here.



**Table 11: Proportion of Respondents Retired in Each Wave by Age, HILDA 2002–2014**

Data Wave	Age	55–59	60–64	65–69	70–74	75–79	80 and over
	2002	31%	58%	79%	89%	93%	93%
	2006	25%	50%	78%	84%	92%	93%
	2010	19%	41%	73%	89%	90%	94%
	2014	19%	38%	69%	87%	93%	95%

Source: HILDA 2002–2014

Table 11 shows a trend to deferred retirement, with fewer respondents taking retirement before age 65. Reasons for this would include the financial uncertainty created during the Global Financial Crisis, the increase in pension eligibility age for women and proposals to increase the pension eligibility age for men, although this change does not affect men born before 1956.

We note that the findings in relation to disposable income do not take account of social transfers in kind, such as public expenditures on health and housing, or consumption taxes. The ABS measure of final income is more comprehensive: ‘household private income plus social assistance benefits in cash (e.g., age and disability support pensions, Family Tax Benefit) and social transfers in kind less income taxes and taxes on production (e.g., GST and taxes on alcohol and cigarettes)’.<sup>6</sup> This is particularly significant in relation to older Australians as the value of government expenditure on health care received increases with age (Tapper & Phillimore, 2014).

Table 12 shows the Gini coefficient for final income using ABS data. This is not directly comparable to the HILDA data, but it does show a lower level of income inequality by comparison with disposable income. In the older age groups this reduction of inequality is quite noteworthy. The trend over time is towards increased equality.

<sup>6</sup> ABS, *Household Income and Wealth*, Australia, Cat. 6523.

**Table 12: Distribution of Equivalent Final Income by Age, Gini coefficients, 2003–04 and 2009–10, ABS**

	All households	55–64	65–74	75+	Trend with Age
2003–04	0.24	0.30	0.21	0.16	More equal
2009–10	0.23	0.28	0.17	0.13	More Equal
Trend over time	More Equal	More Equal	More Equal	More Equal	

Source: ABS (2012, microdata and calculations therefrom)

The next stage of the inequality analysis examines the P75:P25 ratio to determine whether income is more evenly distributed across the population. In Table 13 the HILDA data are segmented into age groups. The trends can be examined over time and by age.

**Table 13: Equivalent Disposable Income Inequality Ratio: P75:P25, HILDA 2002–2014**

	55–59	60–64	65–69	70–74	75–79	80+	Trend across age
2002	2.62	2.76	2.29	1.93	2.05	1.79	More equal
2006	2.31	2.53	2.39	1.99	1.90	1.87	More equal
2010	2.00	2.33	2.30	1.95	1.76	1.88	More equal
2014	2.11	2.48	2.17	2.02	1.94	1.78	More Equal
Trend Across time	More equal	More equal	More equal	Less equal	More equal	Flat	

Source: HILDA 2002–2014

Overall, there are two trends evident in Table 13. Firstly, in each wave the P75:P25 ratio tends to decrease with age after age 60, although in 2002 there is an increase in the ratio between 70–74 year olds and 75–79 year olds. Secondly, within most age groups the P75:P25 ratio declined between 2002 and 2014. There was some volatility, with age groups other than 65–69 and over 80s reaching the lowest ratio in 2010 and moving upward to 2014, but with the exception of the 70–74 age group the overall trend is downward.

### 5.2.1 Public transfers

Although there are significant differences in salary and wage income, public transfers, in particular the Age Pension, tend to reduce inequality after Australians have retired. As income from salary and wages decreases as a proportion of total income, income from transfer payments increases. As shown in Table 14, in each wave the income received from transfer payments increased with age as a proportion of equivalent gross income.

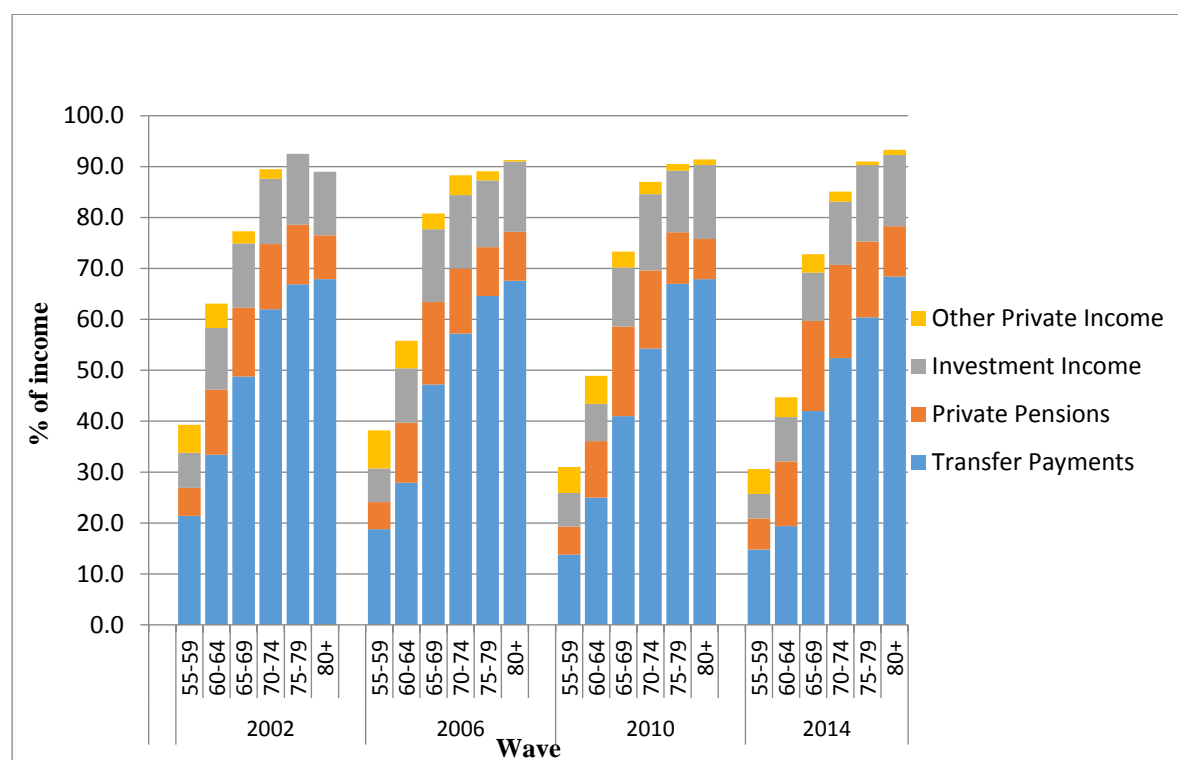
**Table 14: Fraction of Disposable Income from Public Transfers by Age and Wave, HILDA 2002–2014**

Year	Age Groups					
	55–59	60–64	65–69	70–74	75–79	80+
2002	21.4	33.4	48.8	62.0	66.9	67.9
2006	18.8	27.9	47.2	57.2	64.6	67.6
2010	13.8	25.0	41.0	54.3	67.0	67.9
2014	14.8	19.4	42.0	52.4	60.4	68.4

Source: HILDA, 2002–2014

Chart 4 illustrates the proportion of gross (pre-tax) income that is made up of private pension income and investment income relative to transfer payments. In all waves the proportion of investment income remains relatively stable. Private pension income is generally highest in the 65–69 age group, although in the 2014 wave there is a small increase from 17.7% to 18.3% in the 70–74 age group.

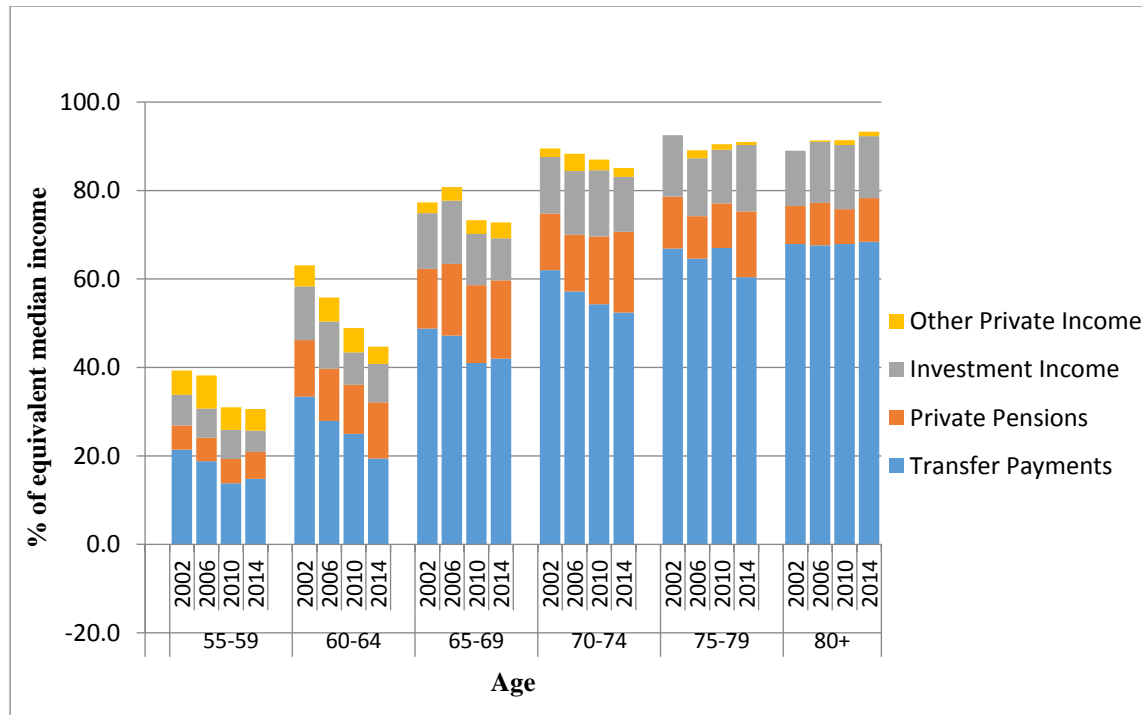
**Chart 4: Sources of Gross Income (Excluding Salary and Wages) in each Wave by Age, HILDA 2002–2014**



Source: HILDA, 2002–2014

Comparing age groups across the four waves, Chart 5 shows the proportion of income from transfer payments has generally decreased in each wave as a proportion of equivalent gross income in each age group up to the 75–79 year age group. The proportion of income from transfer payments is highest and most stable in the 80 years and over age group, with a relatively small overall decline in the 75–79 age group. The overall trend is down despite some fluctuation between 2006 and 2010 in the 75–79 age group and between 2010 and 2014 in the 55–59 and the 65–69 year age groups.

**Chart 5: Sources of Gross Income (Excluding Salary and Wages) by Age, HILDA 2002–2014**



Source: HILDA, 2002–2014

Our analysis shows that the provision of the Age Pension has an equalising effect on the income of older Australians. The other two pillars of the retirement income system, private pensions and investments, contribute less than 30% of income in retirement for Australians aged 55. It must be noted that income classified as private pension income in the HILDA survey is defined more broadly than superannuation pensions, as it also includes payments received from workers compensation or disability insurance. Such payments are usually only payable until the recipient reaches age pension age at age 65.

Among people aged 65 and over, the proportion of income reported from private pensions has increased over the duration of the study. There is a reduction in the proportion of income received from private pensions between 2002 and 2006 in the 75–79 age group; and between 2006 and 2010 in the 80+ age group; however the trend is an increase between 2002 and 2014 in every age group. The age groups to receive the highest proportion of income from private pensions were the two middle age groups. The 65–69 age group received the highest proportion from 2002 to 2010, but in the 2014 data wave the 70–74 age group received a slightly higher proportion.

### 5.3 The top quintile

Analysis by the Association of Superannuation Funds of Australia (ASFA) (Clare, 2015) shows that a small number of people have very high levels of superannuation savings. There is also evidence that more than half of superannuation tax expenditures are received by the wealthiest 20% of households (Daley & Coates, 2015) and that the

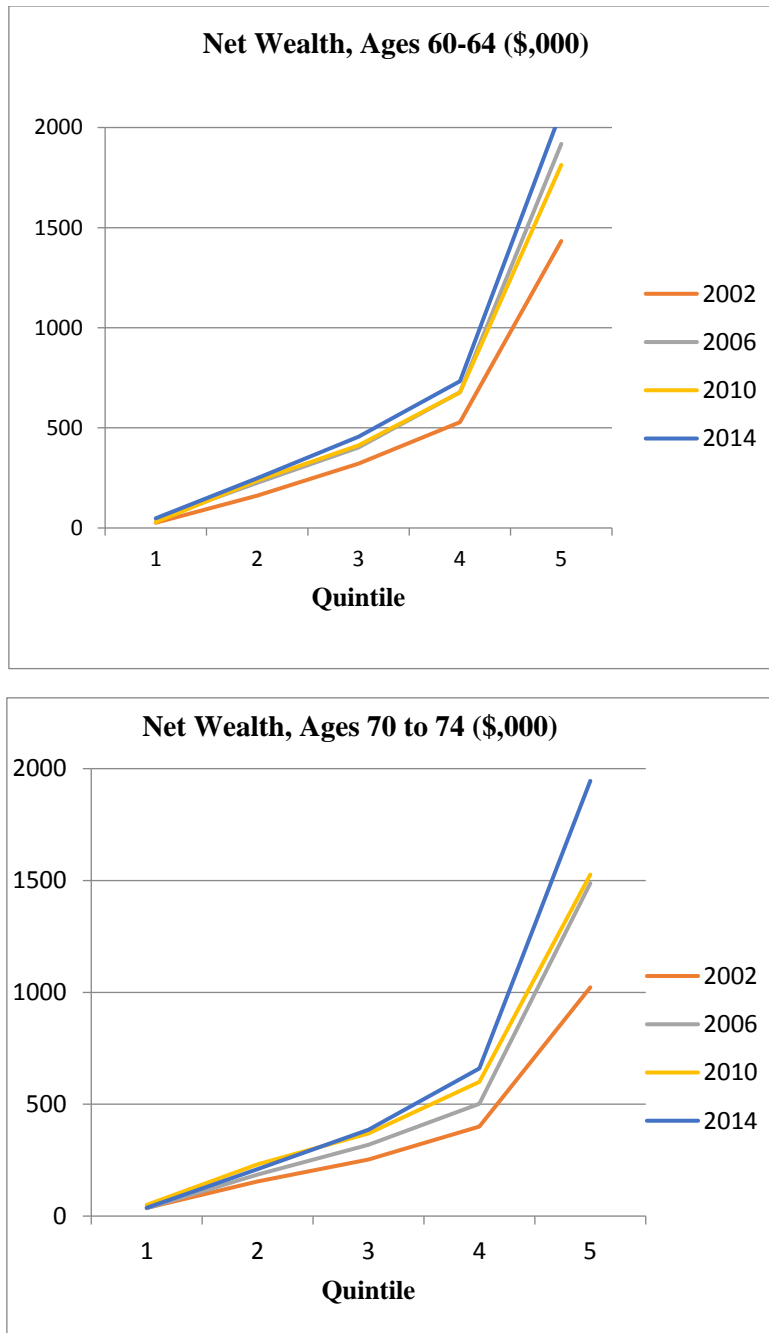
wealthiest 20% of Australian households own 75% of total household savings, including 68% of superannuation assets (Cassells et al., 2015). Accordingly, the final analysis returns to the original question: what is the extent of inequality among older Australians, and what effect, if any, has the current superannuation system had on economic inequality between 2002 and 2014?

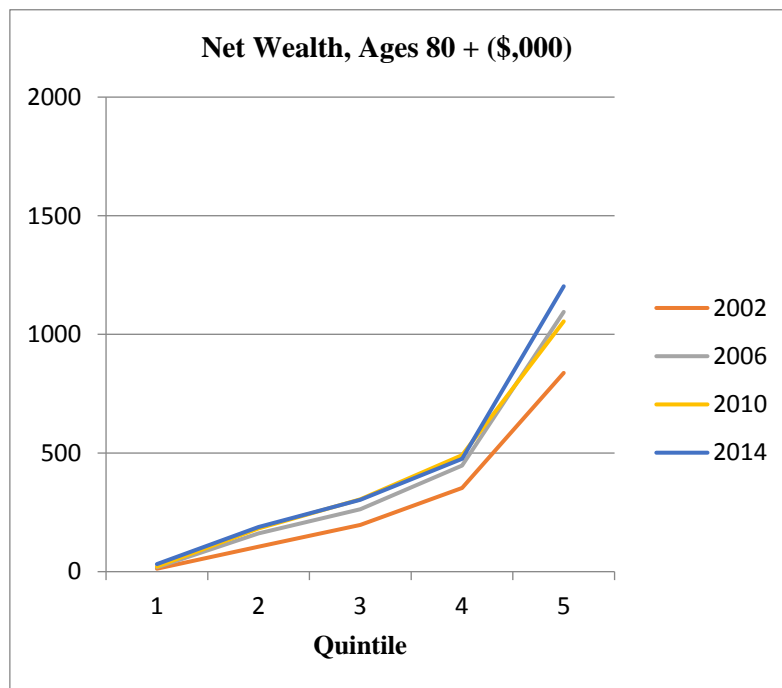
Our analysis shows that superannuation is becoming slightly more equal, and that the effect of housing and the age pension provide a protective effect.

Quintile analysis was applied to test this finding (see Charts 6 and 7 below). When mean wealth and disposable income are plotted against quintiles in the older age groups, the mean wealth and disposable income increase slightly across the first four quintiles, consistent with the protective effects conferred by relatively high home ownership levels and targeted access to the age pension. However, in the top quintile mean wealth and disposable income increase dramatically.

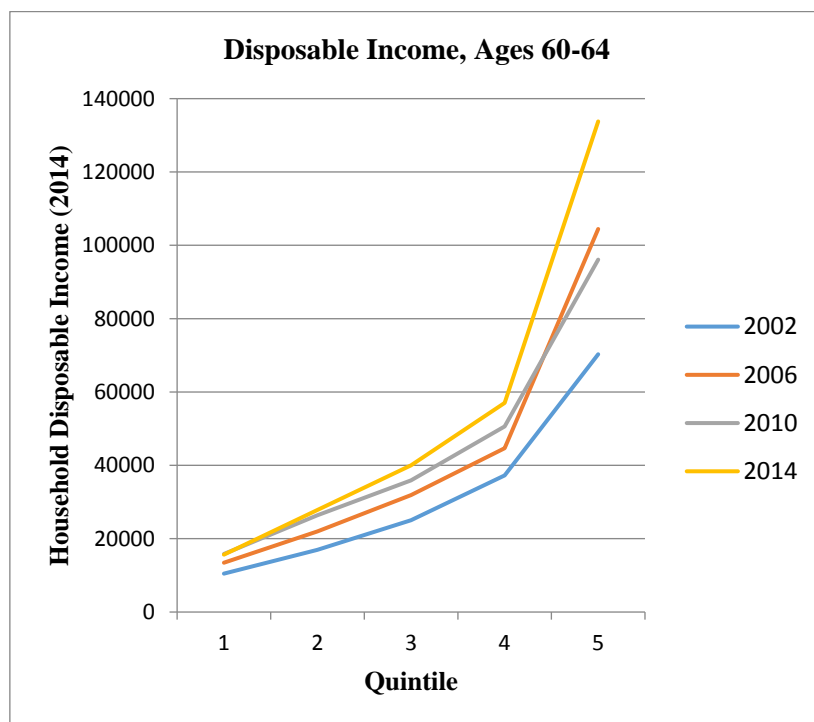
The data also show that mean wealth and disposable income decrease with age: there is a reduction in both. For example in 2014 the mean income in the top quartile was 3.34 times the mean income of the middle income for people aged 60–64, but this reduced to 3.26 for people aged over 80. The difference in net wealth is more significant at 4.57 times for 60–64 year olds, down to 3.97 times for people aged over 80.

**Chart 6: Quintile Analysis of Net Wealth for Certain Age Groups, HILDA, 2002-2014**

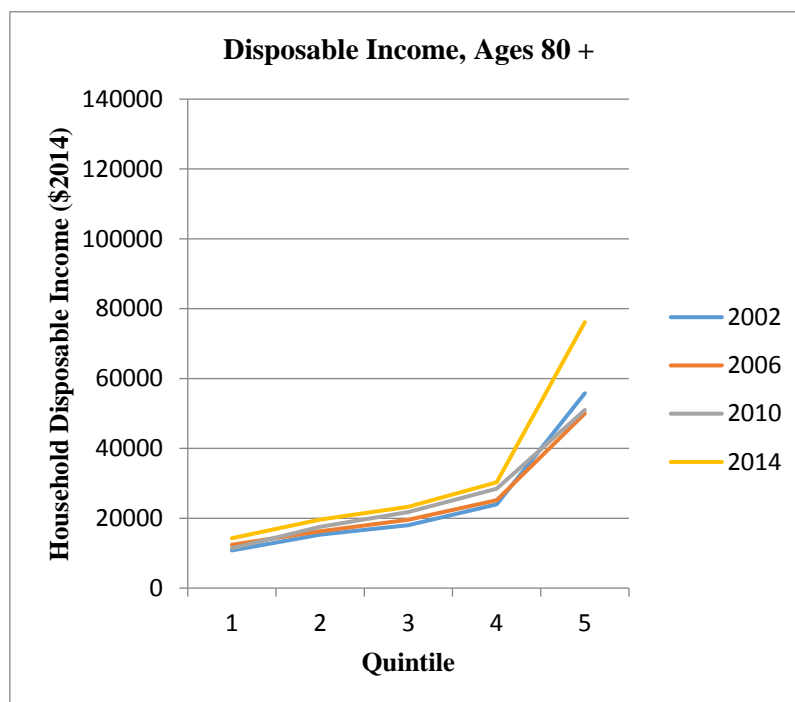
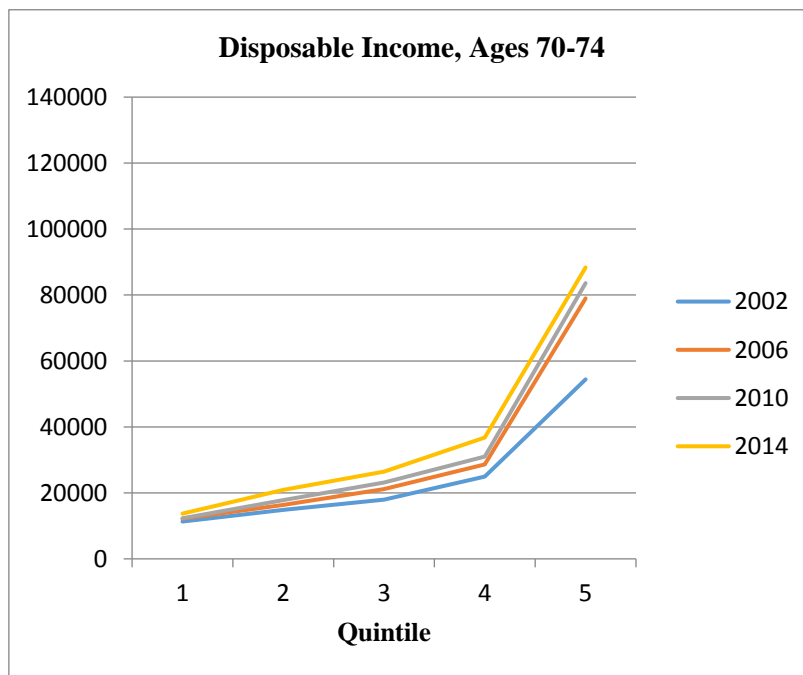




**Chart 7: Quintile Analysis of Disposable Income for Certain Age Groups, HILDA, 2002-2014**







Source: HILDA 2002–2014

## 6. CONCLUSIONS AND POLICY IMPLICATIONS

Our examination of the HILDA data shows that trends in income and wealth inequality among older Australians have not changed significantly between 2002 and 2014. There has been some volatility in trends in inequality, which is likely to be attributable to prevailing global economic conditions that have affected the value of and return on investments that form the basis of superannuation investment portfolios, and for this reason it has not been possible to discern any changes in trends that can be directly related to the 2007 changes to superannuation policy.

We have also noted that despite the overall levels of inequality among older Australians being stable, there is a significant disparity in wealth and income between the top 20% of the population and the remaining 80% of the population across all age groups, and this disparity is increasing.

However inequality in superannuation holdings is considerably higher than wealth inequality among older Australians, and that inequality increases with age. This is consistent with the maturing superannuation system for three reasons:

- the inequality in superannuation between the 40% of employees with superannuation coverage and those without coverage prior to the introduction of the superannuation guarantee would have persisted until retirement.
- following retirement, as people draw on their superannuation accounts, those with lower balances will exhaust those balances more quickly, which would exacerbate the existing inequality; and
- the data used to measure wealth inequality recognises the value of superannuation is an asset, which is more appropriate for accumulation funds than defined benefit funds. As noted earlier, pre-1986 superannuation funds were more likely to be defined benefit funds which would not be reflected in the data.

As discussed in section 3, wealth inequality amongst the elderly is moderated by home ownership. This has important policy implications as there is evidence that home ownership rates are falling significantly among younger Australians (Wilkins, 2017, p. 89). Levels of indebtedness are also increasing among Australians approaching retirement (Productivity Commission, 2015b, p. 75), with superannuation being accessed to retire that debt on retirement (Productivity Commission, 2015a, p. 46). As fewer Australians enter retirement owning a home, non-home owners will need to apply accumulated superannuation to the provision of housing, which will dilute the equalising effect of the superannuation system.

Our study also shows that disposable income inequality among older Australians is higher than across the general population, but this is moderated by direct and indirect transfers. Older Australians are major beneficiaries of income support through the age pension in addition to health and aged care programs, which are not measured specifically in this study.

### 6.1 Research limitations

There are three limitations to note here.

First, as the inequality measures used are the Gini coefficient and the P75:P25 ratio, our findings are not informative about the outliers: the top 5% and the lowest 5% of the population. Regardless of whether the superannuation changes are reducing inequality among the population as a whole, policy measures need to address the circumstances of those in most need.

Second, the data spanned the period of the Global Financial Crisis (2007-2009). To the extent that superannuation balances are affected by changes in the value of investments, this external shock will be reflected in the data. As growth in superannuation balances is a combination of investment growth and mandatory contributions, we have not been able to control for this factor.

Third, the relationship between wealth inequality and income inequality is complex, and out of scope of this research. We do not know how closely the two forms of material well-being are correlated at the household level (OECD, 2017, p. 249). Superannuation assets are identified as wealth, but the purpose of superannuation is to support the conversion of this asset to an income stream. This relationship cannot be identified in the HILDA modules used in this project.

## 6.2 Policy implications

This study shows that as people age, reliance on the age pension becomes more universal (Chart 5), consistently making up more than 60% of the income of people over the age of 75. As access to the age pension becomes more tightly means tested, there is some concern among older Australians that access to the age pension will not be maintained, either through increased means testing or decreased rates of payment. This study addresses the period to 2014, so our data does not take account of the changes to means testing of the age pension that have occurred since that date, specifically the 2017 changes to the thresholds and taper rates; or the more targeted 2015 changes to the assessment of certain private pensions. However, it does reinforce the importance of the age pension as the first pillar of the retirement income system.

Our conclusion is that inequality is not increasing among older Australians, although the top 20% continues to hold a disproportionate share of both wealth and income. However, this takes account not only of the well-recognised three pillars of age pension, superannuation guarantee and voluntary savings, with tax preferences if saved into superannuation. It is also a function of housing and social services, which are incorporated in the extended World Bank framework. Threats to any of these will affect levels of inequality.

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