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The Journal of Australian Taxation is a peer reviewed scholarly journal publishing articles on all issues relating to taxation. From 2017 (volume 19) it will be published progressively during the year.

Under new editors John McLaren (Charles Darwin University) and John Passant (Australian National University) the Journal will continue its broad scope. It will embrace discussions on any aspect of taxation from any jurisdiction. The new editors would like to acknowledge the former editorship of Keith Kendall and thank him for his excellent service to the Journal.

From 2017, the Journal will be open source and available online.

Submissions: The editors are now calling for submissions. There is no deadline. Submissions will be received at any time during the year and once refereed and accepted the relevant article will be published online as part of the volume for that year. Any methodology is acceptable, including but not limited to legal, economic, accounting, critical, empirical and comparative approaches. Articles between 8,000 and 12,000 words are preferred and it is unlikely that submissions of less than 5,000 words would be accepted. They must be submitted in the style recommended in the latest edition of the Australian Guide to Legal Citation, in a Word document.

For more information or to make a submission, contact John McLaren at john.mclaren@cdu.edu.au or John Passant at john.passant@anu.edu.au

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EDITORIAL

The Journal of Australian Taxation has always adopted a policy of publishing articles on a wide range of tax topics. This volume is no exception. It contains seven articles from tax practitioners and academics on Australian and New Zealand tax issues.

The articles in this volume deal with a wide range of topics. Thus the first article, by Lisa Marriott and Dalice Sim, examines the attitude of over 3,000 New Zealand and Australian residents to tax evasion and welfare fraud. This is extremely timely in light of the controversial automated welfare overspending recovery program by Australian authorities. The respondents to the survey saw tax evasion as just as serious a crime as welfare fraud. This, the authors argue, conflicts with policy settings in both countries which treat welfare fraud as more serious than tax evasion. It has implications for policy makers and the judicial system alike.

In the second article Sunita Jogarajan examines the need for external scrutiny of the Australian Tax Office given the extent of the powers of the Commissioner of Taxation. The author argues that the current range of external bodies that have a role in scrutinising the ATO may be ineffective. Given the need for taxpayers to have certainty under the self-assessment system, this article provides a thought-provoking overview of the current situation.

Jonathan Nguyen in the third article looks at the Australian dividend imputation system and in particular the implications for corporations of a company tax rate reduction and the differential in the value of the imputation credits. It is a very timely discussion given the Australian Government's drive to reduce the company tax rate.

Cyrus Thistleton is the author of a most comprehensive article on the general anti-avoidance rule contained in Australia's Goods and Services Tax legislation. In particular the author discusses the basis on which the Commissioner of taxation is empowered or required to cancel any tax benefit obtained by the taxpayer. This article is important reading for academics and tax practitioners who wish to increase their understanding of the GST GAAR.

The fifth article, by James Murray, examines the taxation consequences of companies making distributions to their shareholders by way of bonus shares; dividend reinvestment plans and profit distribution plans. The article is based on New Zealand taxation law and New Zealand's imputation system and resident withholding tax.

The sixth article was written by David Jones, a retired tax academic from RMIT, and John Passant and John McLaren. It should be noted that this article was refereed and approved for publication prior to John McLaren and John Passant assuming the editorship of the journal. The article argues that the test of residence for a company not incorporated in Australia may be deemed to be a resident if its central management and control is in Australia without the need to show that it is also carrying on a business in Australia. This means that the ATO's approach to this issue, contained in tax ruling TR 2004/14, may be open to serious doubt.

The last article in this edition, by Brian Dollery and Joseph Drew, illustrates the breadth of topics published in the *Journal of Australian Taxation*. The article critically examines the financial, efficiency and equity effects on councils and ratepayers as a result of the forced amalgamations of some local government councils in New South Wales. The article provides an excellent insight into this area of local government operations and the imposition of rates, which are a form of land tax.

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February 2017

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COMPARISONS OF TAX EVASION AND WELFARE FRAUD:
HOW WELL DOES POLICY IN AUSTRALIA AND NEW ZEALAND
REFLECT PUBLIC ATTITUDES TO THESE CRIMES?

LISA MARRIOTT* AND DALICE SIM†

ABSTRACT

This study reports on attitudes towards tax evasion and welfare fraud. Data is collected in an online survey with 3,000 respondents from Australia and New Zealand. The results challenge the assumption that society views tax evasion as less serious than welfare fraud. This finding is important for the Australian and New Zealand justice systems, where policy settings treat welfare fraud as more serious than tax evasion. In highlighting societal views towards tax evasion and welfare fraud, the study challenges extant policy arrangements that allow for different outcomes where crimes result in similar harm.

Keywords Tax evasion, Welfare fraud, Survey, Social Justice; Comparative

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I. INTRODUCTION: THE POLICY ISSUE

Research has shown that those who commit crimes that may be considered 'blue-collar' in nature are likely to receive harsher treatment in the criminal justice system than those who commit crimes that may be considered as 'white-collar'. This situation is typically justified with reference to societal preferences. However, there is no research that comprehensively establishes whether this is an accurate reflection of public attitudes.

This study examines attitudes towards tax evasion and welfare fraud as proxies for white- and blue-collar crime, respectively. The study assesses how well public attitudes towards these crimes is reflected in their treatment in the criminal justice systems of New Zealand and Australia.

Tax evasion is the deliberate non-payment of tax obligations to the state. Welfare fraud is the deliberate taking of payments from the state that one is not entitled to. Tax evasion and welfare fraud are adopted for comparative purposes in this study as they are conceptually similar: they are both deliberate, financial offences that have the same victim - the government and society. Moreover, both offences result in the same outcome, which is less resources for the government to invest in society.

Government policy does not set out to actively discriminate between different 'types' of people. However, the outcomes in the criminal justice system lead to discriminatory treatment. To the extent that extant policy arrangements allow for, and facilitate, such outcomes, this needs to be highlighted and challenged. This is particularly the case where the outcomes cannot be justified with reference to societal attitudes or other transparent explanation.

It has been established that those engaging in tax evasion and welfare fraud in New Zealand and Australia can expect to receive different treatments in the justice system.¹ For a lesser amount of financial harm, those engaging in welfare fraud have a greater chance of being awarded a prison sentence.² To the extent that the justice system reflects the views of society, it was expected that harsher attitudes would be visible in relation to the crime of welfare fraud, when compared to the crime of tax evasion. However, the opposite result was found when a survey was undertaken with 3,000 respondents in New Zealand and Australia. The study also reports on the variables that help to explain the differences found.

The article commences with a brief outline of the relevant literature on white- and blue-collar crime. This is followed with a description of the theoretical framework used for analytical purposes. A methodology section follows, which incorporates the research design,

¹ Lisa Marriott, 'Tax Crime and Punishment in New Zealand' (2012) *British Tax Review* 5.

² Lisa Marriott, 'Justice and the Justice System: A comparison of tax evasion and welfare fraud in Australasia' (2014) *Griffith Law Review* 22.

research questions and describes the characteristics of the survey respondents. Findings are presented in the penultimate section with conclusions drawn in the final section of the article.

II. BACKGROUND

This section provides a brief outline of the literature that establishes the issue of different treatments of white- and blue-collar crime in the justice system. While the primary areas of interest in this study are tax evasion and welfare fraud, the broader literature pertaining to white- and blue-collar crime is examined in this section, in order to provide a more thorough examination of this literature.

The different treatment of different types of people in the courts is not a recent phenomenon. From the mid-19th century, questions were raised in relation to the treatment of different classes of people in the justice system. Sutherland is among the most well-known early challengers to the perceived leniency towards those who were committing white-collar crime, suggesting that:

*persons of the upper socio-economic class are more powerful politically and financially and escape arrest and conviction to a greater extent than persons who lack such power, even when guilty of crimes. Wealthy persons can employ skilled attorneys and in other ways influence the administration of justice in their own favour more effectively than can persons of the lower socio-economic class.*³

Following Sutherland, multiple studies have indicated that blue-collar criminals may expect to receive harsher treatments at various stages of the justice system, such as prosecution and sentencing, than their white-collar counterparts.⁴ Studies also find that white-collar offenders receive more lenient sentences for their white-collar crimes; a practice that does not extend to blue-collar offenders committing white-collar crimes.⁵ The study by Hagan, Nagel and Albonetti observes a general tendency for white-collar crimes to result in lighter sentences than common crimes and common crimes of common criminals to result in the most severe sentences.⁶ This last finding corresponds with the view that individuals with a

³ Edwin Sutherland, *White Collar Crime* (Holt, Reinhart and Winston, 1949) 8.

⁴ Hazel Croall, *Understanding White Collar Crime* (Open University Press, 2001); Karen Gustafson, 'The Criminalization of Poverty' (2009) *Journal of Criminal Law and Criminology* 99; Barbara Hudson, *Penal Policy and Social Justice* (MacMillan Press, 1993); David Nelken, 'White-Collar Crime' in Mike Maguire, Rod Morgan and Robert Reiner (eds) *The Oxford Handbook of Criminology* (Oxford University Press, 1997); Tony Poveda, *Rethinking White-Collar Crime* (Praeger, 1994); Lauren Snider 'Traditional and Corporate Theft: A comparison of sanctions' in Peter Wickman and Timothy Dailey (eds) *White-Collar and Economic Crime* (Lexington Books, 1982).

⁵ John Hagan, Ilene Nagel and Celesta Albonetti, 'The Differential Sentencing of White-Collar Offenders in Ten Federal District Courts' (1980) *American Sociological Association* 45.

⁶ *Ibid*, 809.

higher social status are treated less harshly in the justice system than those of a lower social status.⁷

In Australia, Marston and Walsh report that case law indicates that '*a sentence of imprisonment is generally considered to be the starting point by the courts in social security fraud cases*'.⁸ This is not the case in tax evasion, with the exception of the most serious cases of offending. This finding is supported by Weisburd, Wheeler, Waring and Bode,⁹ who investigate a range of white-collar offending including securities fraud, false claims, mail fraud, credit fraud and bank embezzlement, as well as tax fraud. The findings show that '*when our common criminals are sentenced to prison they get longer sentences than the white-collar offenders*'¹⁰ and conclude that with reference to common criminals that '*we suspect that they would benefit greatly if white collar crime sentencing criteria were applied to them*'.¹¹

Differences have been reported on people's attitudes towards different types of financial offending. For example, studies that ask participants to rank economic crimes along a measure of seriousness typically find that people view white-collar financial crimes, such as tax evasion, as less serious than blue-collar financial crimes, such as welfare fraud.¹² An Australian Institute of Criminology study reports on survey results that showed individuals viewed social security fraud as more serious than tax evasion or Medicare (health) fraud, despite the fact that the funds presented in the social welfare scenario were only 20 per cent of the tax and Medicare scenarios.¹³ A range of other research outputs indicate that individuals view white-collar crime and specifically tax offending as less serious than other offences involving similar financial amounts.¹⁴

There are multiple other areas where welfare fraud is reported as receiving harsher treatment than other financial offending. Examples include: greater tolerance reported

⁷ Hudson, above n 4; Nelken, above n 4; David Weisburd, Stanton Wheeler, Elin Waring and Nancy Bode, *Crimes of the Middle Classes: White-collar offenders in the federal courts* (Yale University Press, 1991).

⁸ Greg Marston and Tamara Walsh 'A Case of Misrepresentation: Social security fraud and the criminal justice system in Australia' (2008) *Griffith Law Review* 17, 292.

⁹ Weisburd, Wheeler, Waring and Bode, above n 7.

¹⁰ Weisburd, Wheeler, Waring and Bode, above n 7, 130.

¹¹ Weisburd, Wheeler, Waring and Bode, above n 7 163.

¹² Ranjana Gupta, 'Perceptions of Tax Evasion as a Crime: Evidence from New Zealand' (2006) *New Zealand Journal of Taxation Law and Policy* 12.

¹³ Australian Institute of Criminology, 'How the Public Sees Crime: An Australian survey' (1986) *Trends & Issues in Crime and Criminal Justice* 2.

¹⁴ Francis Cullen, Bruce Link and Craig Polanzi, 'The Seriousness of Crime Revisited' (1982) *Criminology* 20; Stewart Karlinsky, Hughlene Burton and Cynthia Blanthorne 'Perceptions of Tax Evasion as a Crime' (2004) *eJournal of Tax Research* 2; Ruth McIntosh and John Veal, 'Tax Evasion and New Zealanders' Attitudes Towards It' (2001) *New Zealand Journal of Taxation Law and Policy* 7; Geoffrey Smith, Mark Button, Les Johnston and Kwabena Frimpong, *Studying Fraud as White Collar Crime* (Palgrave MacMillan, 2011).

towards tax evasion;¹⁵ greater resourcing of investigations and prosecutions of welfare fraud;¹⁶ and greater leniency towards repayment of tax debts as compared to welfare debts.¹⁷

Also relevant to this study is the literature that suggests that the criminal justice system *should* reflect the views of society. In 1997, Bratcher observed that *'a criminal justice system cannot function unless it reflects the values and mores of the society that it is meant to serve and protect'*.¹⁸ Subsequent to this time, studies both recommend and conclude that courts attempt to reflect the preferences of society when making sentencing decisions.¹⁹ Research also suggests that judges should take into account the views of society when determining sentence decisions. For example, Roberts suggests that most commentators concur that *'some degree of correspondence should exist between the criminal law and the community to which it applies ... there is general agreement that the criminal justice system should be responsive to the community that it was created to protect'*.²⁰ Many research outputs reach the similar conclusion that judges *do* take into account public perceptions in determining their sentencing outcomes.²¹

As observed by Wheeler, Mann and Sarat, the sentencing process and outcome is one of the most pivotal events in the administration of justice.²² Not only does the sentence determine the short- and/or long-term future of the offender, for society it *'gives expression to our sentiments and understandings regarding crime and criminals'*.²³ However, where it is

¹⁵ Robin Anne Bright, 'Dole Bludgers or Tax Dodgers: Who is the deviant?' in Paul Wilson and John Braithwaite (eds) *Two Faces of Deviance: Crimes of the powerless and powerful* (University of Queensland Press, 1978); Marston and Walsh, above n 8.

¹⁶ Paul Henman and Greg Marston, 'The Social Division of Welfare Surveillance' (2008) *Journal of Social Policy* 37.

¹⁷ Lisa Marriott, 'Unpaid Tax and Overpaid Welfare: A comparison of the debt recovery approaches in New Zealand' (2014) *New Zealand Journal of Taxation Law and Policy* 20.

¹⁸ ME Bratcher, *Attitudes to Crime, Punishment, and Rehabilitation: A New Zealand study* (1997) Masters of Arts dissertation, Victoria University of Wellington, New Zealand, 2.

¹⁹ Julian Roberts and Mike Hough, 'Public Attitudes to Punishment: The context' in Julian Roberts and Mike Hough (eds) *Changing Attitudes to Punishment: Public opinion, crime and justice* (Willan Publishing, 2002); Julian Roberts, 'Sentencing Policy and Practice: The evolving role of public opinion' in Arie Freiberg and Karen Gelb (eds) *Penal Populism, Sentencing Councils and Sentencing Policy* (Willan Publishing, 2008).

²⁰ Roberts, above n 19, 20.

²¹ Australian Institute of Criminology, above n 13; Jason Capps, 'Explaining Punitiveness: Right-wing authoritarianism and social dominance' (2002) *North American Journal of Psychology* 4; Nelken, above n 4; Lynne Roberts, Caroline Spiranovic and David Indermaur, 'A Country Not Divided: A comparison of public punitiveness and confidence in sentencing across Australia' (2011) *Australian and New Zealand Journal of Criminology* 44; Julian Roberts and Loretta Stalans, *Public Opinion, Crime, and Criminal Justice* (Westview Press, 2000).

²² Stanton Wheeler, Kenneth Mann and Austin Sarat, *Sitting in Judgment: The sentencing of white-collar criminals* (Yale University Press, 1988).

²³ *Ibid*, 1.

difficult to explain or justify sentences awarded, this challenges the '*fundamental sense of justice*' in society.²⁴

III. THEORETICAL FRAMEWORK

We use the dual-process model, comprising social dominance theory and right-wing authoritarianism, for analytical purposes. These two theories are outlined briefly below.

A. *Social Dominance Theory*

Social dominance theory highlights group-based prejudice and oppression. The theory proposes that '*societies minimize group conflict by creating consensus on ideologies that promote the superiority of one group over others*'.²⁵ Thus, the theory focuses on whether individuals prefer equality or indicate a preference for superiority among certain groups.

Social dominance theory suggests that dominant groups have 'possession of a disproportionately large share of positive social value, or all those materials and symbolic things for which people strive'.²⁶ These items of social value include power and authority, material possessions, and social status. Conversely, subordinate groups possess a large share of negative social value, such as little power and authority, few possessions and low social status. The theory is premised on the concept that groups will engage in behaviours to ensure that hierarchies are maintained.

The theory proposes that group-based oppression, such as that which is visible in the different treatments of tax evaders and welfare fraudsters in the justice system, is driven by systematic institutional as well as individual discrimination. The social dominance orientation (SDO) measure is used to capture preferences for equality among intergroup relations. This study uses the 16-question SDO measurement scale, which is provided in Appendix I. Social dominance theory is relevant for this study, as it allows for examination of the potential for different attitudes towards tax evasion and welfare fraud to be the result of discrimination.

²⁴ Ibid.

²⁵ Felicia Pratto, Jim Sidanius, Lisa Stallworth and Bertram Malle, 'Social Dominance Orientation: A personality variable predicting social and political attitudes' (1994) *Journal of Personality and Social Psychology* 67, 741.

²⁶ Jim Sidanius and Felicia Pratto, *Social Dominance: An intergroup theory of social hierarchy and oppression* (Cambridge University Press, 1999), 31.

B. *Right-Wing Authoritarianism*

Right-wing authoritarianism (RWA) is used to help explain prejudice and '*intergroup hostility*'.²⁷ The theory has developed over many decades and the format proposed by Altemeyer is that typically used.²⁸ Altemeyer defines RWA as '*an 'individual' factor, a personality variable, a 'trait' if you like, developed on the premise that some persons need very little situational pressure to (say) submit to authority, while others often require significantly more*'.²⁹

Altemeyer defines RWA as comprising three attitudinal clusters in a person.³⁰ These three attitudinal clusters are: authoritarian submission (belief in the legitimacy of those in authority); authoritarian aggression (aggressiveness towards certain types of people); and conventionalism (compliance with social conventions). The targets of those who score high on levels of RWA are those who are less conventional, such as minority groups.³¹ Thus, RWA is expected to be correlated with prejudice.³² We use the 10-item RWA scale, as outlined in Appendix I.

C. *Dual-Process Model*

This study adopts the dual-process model, which incorporates both SDO and RWA.³³ The advantage of the dual-process model is that SDO and RWA have different psychological and social causes, and exert their effects in different ways. Using the dual-process model allows capture of a broader range of attitudinal differences. For example, those scoring high on RWA, are likely to favour harsher punishment to ensure security is maintained, while those who score high on SDO are likely to favour harsher punishment to restore status and power relations or to establish a dominant position over offenders.³⁴ Thus, both SDO and RWA are likely to be of utility for analysing attitudes tax evasion and welfare fraud in New Zealand.

²⁷ Jost Stellmacher and Thomas Petzel, 'Authoritarianism as a Group Phenomenon' (2005) *Political Psychology* 26, 245.

²⁸ Robert Altemeyer, *Right-Wing Authoritarianism* (University of Manitoba Press, 1981); Robert Altemeyer, *Enemies of Freedom: Understanding right-wing authoritarianism* (Jossey-Bass Publishers, 1988).

²⁹ Altemeyer, 1988, above n 28, 3.

³⁰ Altemeyer, 1981, 1988, above n 28.

³¹ Altemeyer, 1981, 1988, above n 28.

³² Altemeyer, 1981, 1988, above n 28

³³ John Duckitt, 'A Dual-Process Cognitive-Motivational Theory of Ideology and Prejudice' (2011) *Advances in Experimental Social Psychology* 33.

³⁴ Monica Gerber, *A Dual-Process Motivational Model of Punitive Attitudes: The effects of right-wing authoritarianism and social dominance orientation on public punitiveness* (2012) Doctoral dissertation, London School of Economics and Political Science, United Kingdom, 56.

Research indicates that SDO and RWA capture different kinds of prejudice and have been shown to independently predict prejudice.³⁵ Along with SDO, RWA has also been shown to be among the most powerful and consistent predictors of ideological and intergroup phenomena.³⁶ However, RWA and SDO explain unique variance of different outcome variables and only correlate moderately.³⁷ Therefore they are both necessary inclusions in a study of this type.

IV. METHODOLOGY AND RESPONDENTS

This section outlines the research design adopted in this study. The section also outlines the characteristics of the survey respondents. Further information on the survey instrument is available from the authors on request.

A. Research Design

Data was collected via an online survey. A 7-point Likert scale was adopted for all applicable items using the measures of strongly disagree (1) to strongly agree (7). The survey instrument was distributed electronically to a representative sample of the New Zealand and Australian populations. The email was distributed by an independent research company holding a database of individuals belonging to the largest retail rewards programme in each country. Individuals emailed were rewarded with retail points from the retail reward scheme for participating in the survey. Using members of the retail rewards programme (via an independent research company) facilitated the targeting of responses from a representative sample of the population.³⁸ We excluded those aged under the age of 18 due to their limited engagement with the welfare or tax systems.

A large number of emails were sent by the database holder, and the survey was available for people to complete until the requisite number of completed surveys was received. In this instance, the number of responses desired was 1,500 in Australia and 1,500 in New Zealand. All respondents were required to answer all survey questions in order to receive their retail reward points, although for some questions (income, age, etc), people could respond 'Prefer not to say'. These were coded in the database as missing. When we included only the subjects with complete responses for all the demographic variables, we were left with 2,527 respondents, 1,266 (50.1%) from New Zealand, and 1,261 (49.9%) from Australia. We then

³⁵ Bart Duriez and Alain van Hiel, 'The march of modern fascism. A comparison of social dominance orientation and authoritarianism' (2002) *Personality and Individual Differences* 32.

³⁶ John Duckitt, Claire Wagner, Ilouize du Plessis and Ingrid Birum, 'The Psychological Bases of Ideology and Prejudice: Testing a dual-process model' (2002) *Journal of Personality and Social Psychology* 83.

³⁷ Gerber, above n 34, 55.

³⁸ The retail reward scheme comprises approximately half of the New Zealand and Australian populations. The size of the panel makes it possible for the holder of the database to select a sample that is representative of the populations.

considered the characteristics of the study participants, separately by New Zealand and Australian respondents.

This study reports on the outcomes of responses from New Zealand and Australian respondents on 17 questions pertaining to attitudes on tax evasion and welfare fraud; eight questions capturing the characteristics of survey participants; 16 questions relating to the SDO scale;³⁹ and 10 questions relating to the RWA scale.⁴⁰

B. *Research Questions*

The literature suggests that people will be treated differently in the justice system if they are committing welfare fraud or tax evasion. We start by examining whether this situation reflects societal attitudes to the crimes. Thus, research question one is: are attitudes towards welfare fraud different to attitudes towards tax evasion.

As the justice system is intended to reflect the views of society, we expect to see the more punitive treatment of welfare fraudsters also reflected in more negative attitudes towards welfare fraud. We are also interested in the variables that contribute an explanation to any attitudinal differences found. Thus, our second research question is: which variables contribute an explanation to attitudinal differences to welfare fraud and tax evasion.

C. *Characteristics of Survey Respondents*

In the interests of space, the characteristics of survey respondents have not been outlined in detail in this article. The authors are happy to provide a detailed breakdown of the characteristics of survey respondents on request. Information was collected on gender, age, ethnicity, education, income level, income source, occupation and whether the individual had ever received a welfare benefit.

In summary, we had a good balance of male and female respondents. Responses were only required from those aged 18 years and over. We received more responses from people aged 24 and under in Australia (14.2%) than in New Zealand (4.2%). Conversely, we received fewer responses from those aged 70 years and over in Australia (5.1%) than in New Zealand (13.4%). The survey received large numbers of European responses – New Zealand European in New Zealand and Australian European in Australia. New Zealand Māori and Pasifika are under-represented in New Zealand (based on census demographic information). Asian people have higher representation in Australia at 13.3% (where they comprise approximately 7% of the Australian population) and lower representation in New Zealand at 4.6% (where approximately 12% of the New Zealand population identify with at least one Asian ethnicity). Due to the high proportions of New Zealand and Australian Europeans,

³⁹ Sidanius and Pratto, above n 27.

⁴⁰ Andrew Robertson, *In Search of a Theoretical Explanation for the Relationship between Religiosity and Prejudice among Self-Identified Christians* (2006) Doctoral dissertation, Victoria University of Wellington, New Zealand.

when using the ethnicity variable in analysis, we collapse these two groupings into one called National Europeans.

Similar levels of education are visible in respondents across the two countries. However, there is a higher representation of those who have no formal qualifications from New Zealand respondents at 11.5%, as compared to Australia at 4%. Respondents are more highly represented in the lowest income group in Australia at 26.2%, as compared to 13.5% in New Zealand. In both Australia and New Zealand, the main source of income is from wages and salaries – 67% in New Zealand and 58% in Australia. We have a higher proportion of people reporting as being on a benefit in Australia. We separate old-age pensions and other welfare benefits in this grouping. The proportion of the working age population (18–64 years of age) in receipt of welfare benefit is 18% in Australia⁴¹ and 11% in New Zealand.⁴² Therefore, both countries are under-represented in the survey by individuals in receipt of welfare benefits.

We grouped respondents into three professional groups: unskilled; semi-skilled; and manager/professional. We also asked respondents if they had ever received a welfare benefit. Higher proportions of New Zealand respondents had never received a benefit, at 57.2%, as compared to Australian respondents at 42%. Around half of Australian respondents (49.7%) had received a benefit at some stage, compared to 34.2 per cent of New Zealand respondents.

V. FINDINGS

Attitudes were measured using 17 survey questions, all coded on a 1–7 Likert scale. Using exploratory factor analysis (Principal Components extraction, with a Varimax rotation), we restricted the analysis to three factors.

The first factor explained 42.1% of the variance in the data, and included the questions:

- I think welfare fraud is a more serious offence than tax evasion.
- Punishing those who commit welfare fraud is the only way to stop them from committing more crimes in the future.
- People who commit welfare fraud deserve to be punished.
- I believe welfare fraud is becoming more widespread in society.
- People commit welfare fraud because they know they can get away with it.
- I am concerned at the level of welfare fraud in society.

⁴¹ Australian Council of Social Services, *Social Security Trends – Snapshot – April 2014* (2014) Available at: http://acoss.org.au/images/uploads/Social_Security_Trends_ACOSS_policy_snapshot_April_2014.pdf, Retrieved 7 March 2015.

⁴² Ministry of Social Development, *Benefit Fact Sheets – All Main Benefits – December 2014 Quarter* (2014) Available at <http://msd.govt.nz>, Retrieved 7 March 2015.

- People who commit welfare fraud know full well what they are doing when they break the law.
- We should punish people who commit welfare fraud just as severely as we punish people who steal money.

We created a scale consisting of the average of the responses to these eight questions called 'Welfare Attitude'. It had a reliability (Cronbach's alpha) of 0.890.

The second factor explained a further 10.98% of the variance in the data, and included the questions:

- Tax evaders commit crimes because they know they can get away with it.
- Tax evaders know full well what they are doing when they break the law.
- I am concerned at the level of tax evasion in society.
- I believe tax evasion is becoming more widespread in society.
- Tax evaders deserve to be punished.
- Punishing Tax evaders is the only way to stop them from committing more crimes in the future.
- We should punish tax evaders just as severely as we punish people who steal money.

We created a scale consisting of the average of the responses to these seven questions, and called it 'Tax Evasion Attitude'. It had a Cronbach's alpha of 0.857. For both factors, a higher score corresponded to the respondent having a more negative attitude towards either Welfare Fraud or Tax Evasion. The mean values for the two attitude variables, separately for New Zealanders and Australians, are reported in Table 1.

Note that, for both New Zealanders and Australians, the score was, on average, higher for Tax Evasion than it was for Welfare Fraud, indicating that the respondents were more concerned about Tax Evasion than they were about Welfare Fraud, on average. This difference was statistically significant (paired t test, $t(1265) = -5.498$, $p < 0.0005$ for New Zealanders, and $t(1260) = -3.594$, $p < 0.0005$ for Australians). This finding is contrary to what was expected based on the treatment of welfare fraudsters and tax evaders in the justice systems.

For both Attitude variables, we compared the mean scores between New Zealanders and Australians, using both the one-way Analysis of Variance (which assumes normally distributed responses), and the Wilcoxon test (which does not). The p-values for these tests for equality of means between groups are presented in Table 1.

Table 1 shows that New Zealand respondents have a higher average score than Australians for both Attitude Variables, indicating a higher level of concern. The difference is less for welfare fraud than for tax evasion and the difference in attitude towards welfare fraud is not statistically significant when the Wilcoxon test is used. Note that, although the p-values are very low, signifying that the differences are highly significant, the differences in means are not large. As we have a large sample size, the statistical methods can be sure that even very

small differences are statistically significant. However, it could be argued that differences of this size are not very important.

Our next question is: who (which demographic subgroups in New Zealand and Australia) has higher levels of concern about Welfare Fraud and Tax Evasion.

Table 1: Mean Values for Three Variables

		Welfare Attitude	Tax Evasion Attitude
New Zealand	Mean	5.51	5.66
	N	1,266	1,266
	Std. Deviation	1.023	.904
	Median	5.63	5.71
Australia	Mean	5.40	5.48
	N	1,261	1,261
	Std. Deviation	1.153	1.027
	Median	5.63	5.57
Total	Mean	5.45	5.57
	N	2,527	2,527
	Std. Deviation	1.091	.971
	Median	5.63	5.71
ANOVA	p-value	0.009	0.000
Wilcoxon	p-value	0.051	0.000

A. *Predicting Welfare Attitudes*

To examine the effect of the demographic variables (country of residence, age, gender, ethnic group, education, income, income source, and occupation) on individual's attitudes to welfare fraud and tax evasion, while controlling for RWA, Dominance and Egalitarianism, we considered our two Attitude factors, and fit two models for each. These models are described below. For analytical purposes, and as per the standard practice with SDO, we subdivided SDO into 'Dominance' and 'Egalitarianism' (see Appendix I).

Model 1 included only the covariates: RWA, Dominance and Egalitarianism. When comparing the attitudes of the different groups above, we wanted to control for the measures of SDO (split as Dominance and Egalitarianism) and RWA which were measured in the survey. The R^2 for Model 1 therefore measures how much of the variability in Welfare Attitude and Tax Evasion Attitude is explained by our three covariates.

We next fit **Model 2**, which added to Model 1 the main effects of all the demographic variables. The change in R^2 was a measure of how much the demographic variables improved the prediction of the attitude variables over the SDO/ RWA variables alone.

We did also fit a third Model for each Attitude variable, which included all two-way interactions between the demographic variables. However, for both dependent variables, the number of parameters added did not improve the fit to the data.

For each level of each demographic variable the standardised coefficient and its p-value are reported, along with the baseline level for that variable. The size and direction of the standardised coefficient measures the difference (effect size) between that level and the baseline level, and the p-value is the p-value for that difference.

The results for the two models for Welfare Attitude are given in Table 2.

Inclusion of the demographic variables improves the R^2 from 0.06 with Model 1 to 0.139 with Model 2, neither of which are very high. The AIC values⁴³ however, indicate that there is an improvement in predictive power when the demographic variables are included. Interpretation of the standardised coefficients for each demographic variable lead to the following conclusions from Model 2 for Welfare Fraud:

- RWA, Dominance and Egalitarianism all had a significant, positive effect on Attitude towards Welfare Fraud.
- The highest score (highest level of concern) was found in the highest age group (75+), as all the other coefficients are negative. The averages for age groups from 18 to 49 were significantly lower than those for 50 and above.
- Women had a significantly higher level of concern than men.
- There were no significant differences by ethnicity.
- There were no differences among the education groups Less Than School Certificate / Some High School / Technical or Trade Qualification (that is, the three lowest levels of education), but these three groups had a significantly higher score than Other Tertiary / University Graduate / Post Graduate Qualification groups (that is, the three highest levels of education).
- The highest income group (\$70,000 +) had the highest level of concern for Welfare Fraud. All other income groups had a lower mean, with the means for those with < \$20,000, \$20,001 - \$30,000 and \$40,001 - \$50,000 achieving statistical significance.
- There was no difference by Occupation group.
- Table 3: Results for Tax Evasion Attitude with RWA, Dominance, Egalitarianism and demographic variables.
- Those whose main Income Source was from Capital had a significantly higher level of concern than those whose main Income Source was Wages (the baseline group). Those whose main Income Source was from Self Employment or Other / None had significantly lower levels of concern than did the Waged respondents.
- Australians had a significantly lower average level of concern than did New Zealanders.

B. *Predicting Tax Attitudes*

The results for the two models for Tax Evasion Attitude are given in Table 3.

⁴³ Hirotugu Akaike, 'A new look at the statistical model identification' (1974) *IEEE Transactions on Automatic Control* 19; KP Burnham and DR Anderson, *Model Selection and Multimodel Inference: A Practical Information-Theoretic Approach* (Springer-Verlag, 2002).

Table 2: Welfare Attitude (RWA, Dominance, Egalitarianism and Demographic Variables)

Variable	Model 1 R² = 0.06 AIC = 7464.06	Model 2 R² = 0.139 AIC = 7313.67
RWA	0.214, P = 0.000**	0.199, P = 0.000**
Dominance	0.082, P = 0.000**	0.125, P = 0.000**
Egalitarianism	0.043, P = 0.046*	0.001, P = 0.001**
Age 18-19 (baseline: 75+)		-0.079, P = 0.003**
Age 20-24		-0.097, P = 0.008**
Age 25-29		-0.131, P = 0.001**
Age 30-34		-0.102, P = 0.006**
Age 35-39		-0.072, P = 0.054
Age 40-44		-0.086, P = 0.030*
Age 45-49		-0.075, P = 0.042*
Age 50-54		-0.047, P = 0.229
Age 55-59		-0.053, P = 0.183
Age 60-64		-0.016, P = 0.684
Age 65-69		-0.012, P = 0.757
Age 70-74		-0.460, P = 0.646
Gender Female		0.097, P = 0.000**
Ethnic Group: NZ Maori (baseline = National European)		-0.036, P = 0.064
Pasifika		-0.004, P = 0.831
Asian		-0.014, P = 0.500
Other European		0.002, P = 0.929
Education LT school Cert (baseline = some high school)		0.000, P = 0.995
Technical/ Trade		-0.005, P = 0.827
Other Tertiary		-0.057, P = 0.009**
University graduate		-0.116, P = 0.000**
Post graduate qualification		-0.139, P = 0.000**
Income Group < \$20K (baseline: \$70,001 +)		-0.124, P = 0.000**
\$20,001 - \$30,000		-0.138, P = 0.000**
\$30,001 - \$40,000		-0.036, P = 0.108
\$40,001 - \$50,000		-0.056, P = 0.011*
\$50,001 - \$70,000		-0.040, P = 0.084
Occupation: semiskilled (baseline: unskilled)		-0.005, P = 0.856
Professional		0.052, P = 0.103
Income Source: other/ none (baseline: wages)		-0.044, P = 0.025*
Capital		0.045, P = 0.026*
Benefits		-0.040, P = 0.089
Super_pension		0.005, P = 0.880
Self Employed		-0.047, P = 0.021*
Country of Residence: Australia (baseline: NZ)		-0.060, P = 0.005*

* p < 0.05; ** p < 0.01

Table 3: Tax Evasion Attitude (RWA, Dominance, Egalitarianism and Demographic Variables)

Variable	Model 1 R ² = 0.051 AIC = 6899.14	Model 2 R ² = 0.165 AIC = 6644.35
RWA	0.113, P = 0.000**	0.086, p = 0.000**
Dominance	0.009, P = 0.682	0.084, p = 0.000**
Egalitarianism	0.214, P = 0.000**	0.244, p = 0.000**
Age 18–19 (baseline: 75+)		-0.148, p = 0.000**
Age 20–24		-0.259, p = 0.000**
Age 25–29		-0.245, p = 0.000**
Age 30–34		-0.197, p = 0.000**
Age 35–39		-0.194, p = 0.000**
Age 40–44		-0.172, p = 0.000**
Age 45–49		-0.157, p = 0.000**
Age 50–54		-0.131, p = 0.001**
Age 55–59		-0.111, p = 0.004**
Age 60–64		-0.046, p = 0.226
Age 65–69		-0.043, p = 0.250
Age 70–74		-0.019, p = 0.529
Gender Female		0.054, p = 0.006**
Ethnic Group: NZ Maori (baseline = National European)		-0.004, p = 0.848
Pasifika		-0.001, p = 0.945
Asian		-0.038, p = 0.063
Other European		-0.009, p = 0.617
Education LT school Cert (baseline = some high school)		0.002, p = 0.942
Technical/Trade		0.016, p = 0.448
Other Tertiary		-0.004, p = 0.855
University graduate		-0.015, p = 0.542
Post graduate qualification		-0.020, p = 0.389
Income Group < \$20K (baseline: \$70,001 +)		-0.071, p = 0.011*
\$20,001–\$30,000		-0.101, p = 0.000**
\$30,001–\$40,000		-0.043, p = 0.051
\$40,001–\$50,000		-0.034, p = 0.117
\$50,001–\$70,000		-0.027, p = 0.224
Occupation: semiskilled (baseline: unskilled)		0.013, p = 0.659
Professional		0.021, p = 0.509
Income Source: other/ none (baseline: wages)		-0.013, p = 0.507
Capital		0.028, p = 0.156
Benefits		-0.019, p = 0.402
Super pension		-0.001, p = 0.969
Self Employed		-0.073, p = 0.000**
Country of Residence: Australia (baseline: NZ)		-0.062, p = 0.003**

* p < 0.05; ** p < 0.01

As for Welfare Attitude, inclusion of the demographic variables improved the R^2 (from 0.051 with Model 1 to 0.165 with Model 2) for Tax Evasion, but neither of these are very high. However, the AIC values again indicate that there is an improvement in predictive power when the demographic variables are included. Interpretation of the standardised coefficients for each demographic variable lead to the following conclusions from Model 2 for Tax Evasion:

- RWA and Egalitarianism had significant, positive effects on Attitude towards Tax Evasion, but Dominance did not have a significant effect.
- The highest level of concern was for those in the highest age bracket (75+), with all other means being less. The difference becomes statistically significant for age groups below 59.
- Women have a significantly higher level of concern than Men.
- There were no differences by Ethnic Group.
- There were no differences by Level of Education.
- The highest level of concern was in the highest income group (\$70,001+), as all other Income groups were lower. However, only the two lowest groups (ie, those below \$30,001) had statistically significantly lower levels of concern than the highest income group.
- There were no differences by Occupation group.
- The only significant difference among the Income Source groups was between the Wages group and the Self-Employed, with the Waged group having a higher level of concern.
- Australians had a significantly lower level of concern than New Zealanders.

C. *Comparing Attitudes to Welfare Fraud and Tax Evasion*

For both Welfare Fraud and Tax Evasion, the pattern of the relationship with the demographic variables are similar. That is: older age groups show more concern about both Welfare Fraud and Tax Evasion; Women show more concern than Men; those in the highest Income Group show more concern than those in the lower Income Groups; those whose main Income Source is Wages show more concern than those who are Self-Employed; and New Zealanders show more concern than Australians. Subtle differences exist in that Dominance does not significantly predict Attitude towards Tax Evasion, but does predict Welfare Fraud Attitude; also those whose main Income Source is Capital have a significantly higher level of concern towards Welfare Fraud than those who are waged, but this difference is not statistically significant when considering Tax Evasion. There are significant differences with respect to Educational level for Welfare Fraud (the three lower education groups have higher levels of concern than the three higher groups), but not for Tax Evasion. These similarities and differences are illustrated in Table 4, which gives the estimated marginal means for both Welfare Fraud and Tax Evasion for each demographic group. Estimated Marginal means are based on Model 2 (in both cases), and therefore they include an adjustment for RWA, Dominance and Egalitarianism.

Table 4: Group Differences in Mean Welfare Attitude and Mean Tax Attitude

Age	Estimates			
	Welfare Mean	Std. Error	Tax Mean	Std. Error
18-19	4.9979	.17254	5.0344	.15114
20-24	5.1614	.12683	5.0101	.11110
25-29	5.0839	.11340	5.1793	.09933
30-34	5.1445	.12238	5.2596	.10720
35-39	5.2810	.11802	5.2904	.10338
40-44	5.2488	.11477	5.4202	.10054
45-49	5.2671	.11959	5.4220	.10476
50-54	5.3990	.11437	5.5619	.10019
55-59	5.3811	.11458	5.6333	.10037
60-64	5.5191	.11279	5.8503	.09880
65-69	5.5370	.11772	5.8710	.10312
70-74	5.5124	.13617	5.9228	.11928
75 Plus	5.5764	.15670	5.9996	.13726
Gender				
Male	5.2101	.09912	5.4441	.08682
Female	5.4222	.09802	5.5490	.08586
Ethnic Group				
NZ Māori	5.1269	.14890	5.5168	.13043
Pasifika	5.3157	.36661	5.5190	.32114
National Europeans	5.3938	.05342	5.5409	.04679
Asian	5.3407	.08572	5.4124	.07509
Other European	5.4034	.11636	5.4936	.10193
Education Group				
Primary/secondary-no formal qualifications	5.4729	.12283	5.5105	.10760
Some high school - formal qualifications	5.4724	.10220	5.5051	.08952
Technical or trade qualification	5.4575	.10536	5.5503	.09229
Other tertiary qualification	5.3003	.10712	5.4945	.09383
University graduate	5.1646	.10464	5.4707	.09166
Post graduate qualification	5.0291	.11133	5.4482	.09752
Income Group				
< \$20,000	5.1779	.10495	5.4515	.09193
\$20,001-\$30,000	5.0954	.10881	5.3509	.09531
\$30,001-\$40,000	5.3808	.11722	5.4797	.10268
\$40,001-\$50,000	5.3201	.11314	5.5179	.09910
\$50,001-\$70,000	5.4060	.10538	5.5555	.09231
\$70,001 +	5.5164	.10407	5.6237	.09117
Occupation Group				
Unskilled	5.2795	.09510	5.4727	.08330
Semi-skilled	5.2664	.10814	5.5006	.09473
Manager /professional	5.4025	.10821	5.5163	.09479
Income Source				
Other/No source	4.9574	.19888	5.4233	.17421
Capital	5.7515	.18252	5.7410	.15988

Benefits	5.2210	.11749	5.4647	.10291
Superannuation/Pension	5.3896	.11302	5.5282	.09900
Self-Employed	5.2017	.10661	5.2907	.09339
Wages	5.3755	.08641	5.5314	.07570

Covariates appearing in the model are fixed at the following values: RWA=3.2372; Dominance=2.8265; Egalitarianism=5.3705

Of the 44 mean responses shown in Table 4, only two showed lower means for tax evasion when compared to the means for welfare fraud. These two groups were people who only had earnings from capital and those aged 20–24. All other groups showed higher means for tax evasion than for welfare fraud, indicating that, in general, most respondents were more concerned about tax evasion and had a more negative attitude towards tax evasion than welfare fraud.

To further investigate the relationship between Attitudes to Welfare Fraud and Tax Evasion, a Multivariate Analysis of Variance (MANOVA) was conducted, with Welfare Fraud and Tax Evasion (Pearson correlation = 0.624) as dependent variables, RWA, Dominance and Egalitarianism as covariates, and the demographic variables as factors. Pillai's Trace was used to determine statistical significance, as the homogeneity of variances assumption did not hold (using either Box's test overall, or Levene's test for each dependent variable). The overall tests of significance for Welfare Fraud and Tax Evasion were the same as for the individual ANOVAs, with RWA, Dominance and Egalitarianism being statistically significant, as well as Age, Gender, Education Group, Income group, Income Source, and Country, but not Ethnic group ($p = 0.326$) or Occupation Group ($p = 0.097$).

VI. CONCLUSION

The first research question this study considers is whether attitudes towards welfare fraud were more negative than attitudes towards tax evasion. We had expected the survey results to show that attitudes were more negative towards welfare fraud. The reasons for this are twofold. First, in recent years it appears that attitudes towards welfare recipients have become increasingly hostile. This has been amplified with the development of televised documentaries (such as *Struggle Street* in Australia and *Benefits Street* in the United Kingdom), which serve to reinforce negative stereotypes of those who receive financial assistance from the state. Second, the harsher treatment in the justice system of those engaging in welfare fraud than those engaging in equivalent amounts of tax evasion, generated the expectation that this would reflect the views of society. However, the survey results reported above show that the treatment in the justice system does not reflect societal views. One explanation for this finding may be recent publicity relating to non-payment of tax obligations. While recent events are more specific to corporate manipulation of the tax system, rather than individual crime, it may have changed public concerns relating to payment of tax obligations.

The characteristics of survey respondents that help to explain the findings are age, gender, income and education, with greater concern for welfare fraud among those who are older, female, higher-income earners and more educated. This may, at least in part, reflect that those who are older, more educated and higher earners may have reduced use of the welfare system and therefore have reduced tolerance for its manipulation for fraudulent purposes. The presence of females showing more concern for welfare fraud than males was unexpected. This contrasts with much of the literature, which suggests that women are more likely to be more concerned about the well-being of others and particularly when those others are socially disadvantaged.⁴⁴ However, the literature also suggests that women do not emphasise individual rights and fairness as much as men and, instead, are sensitive to the needs of others.⁴⁵ Both welfare fraud and tax evasion reduce the welfare of others as they take away resources from the state that would otherwise be used to benefit society. Thus, the harsher attitudes towards welfare fraud and tax evasion visible among female respondents may result from concern about others, as predicted in the literature.

Tax evasion showed similar patterns with reference to increased age and levels of concern among female respondents. Education was not statistically significant in relation to attitudes to tax evasion, unlikely attitudes to welfare fraud. Again, this may be due to result high-profile media attention paid to tax evasion, which has generated less tolerance of tax evasion.

Of interest in this study are the differences between New Zealand and Australian respondents, with New Zealanders showing a significantly higher mean Welfare Attitude and a higher mean Tax Evasion Attitude than Australians. Thus, New Zealand respondents showed less tolerance of, and more concern for, both crimes than the Australian respondents. There is a key difference in the way employees are treated for tax purposes in Australia and New Zealand, which may contribute to the differences in attitudes towards tax evasion. In Australia, employees (as well as those who are self-employed) are entitled to claim tax deductions for work-related expenses. This is not an option for New Zealand employees: unless individuals are self-employed, no deductions may be claimed on work expenses. The Australian Tax Office frequently notes individuals' propensity to over-claim tax deductions or to claim deductions for expenditure that is not work-related. This opportunity for all workers to engage in tax evasion if they wish to is not available in New Zealand. This difference may help to explain why attitudes towards tax evasion are more lenient in Australia. However, this does not assist with the different attitudes towards welfare fraud between the two countries: there are no obvious differences in entitlements or policy that are likely to contribute to differences in attitudes to welfare fraud.

Perhaps the most interesting finding was the mean responses that showed only two of the demographic groups were more concerned about welfare fraud than tax evasion. These two

⁴⁴ See, for example, Brandon Applegate, Francis Cullen and Bonnie Fisher, 'Public Views towards Crime and Correctional Policies: Is there a gender gap?' (2002) *Journal of Criminal Justice* 30.

⁴⁵ *Ibid.*

groups were those earning income from capital and those aged 20–24. Those earning income from capital are likely to have greater opportunities to minimise their tax obligations. Therefore, it is understandable that this group would have greater tolerance for tax evasion when compared to welfare fraud. The younger age group may have less understanding about the financial implications of tax evasion and welfare fraud, which may help to explain the different attitude visible among this group.

The policy implications resulting from the survey findings are significant. Typically, different treatments in the criminal justice system of tax evaders and welfare fraudsters are justified with reference to societal preferences. As noted in section two, there is a strong literature supporting the proposal that the criminal justice system should reflect the views of society. However, this study suggests that the views of society are not reflected in outcomes from the criminal justice system in New Zealand and Australia for welfare fraud and tax evasion. If the criminal justice system was reflecting the views of society, this study suggests that tax evasion should be the crime receiving harsher treatment.

Policy changes that may help to resolve this situation include prosecution of all serious financial crime under the same legislation. This is particularly relevant in New Zealand. At the present time, welfare fraud and tax evasion may be prosecuted under different legislation. For example, in New Zealand, welfare fraud is likely to be prosecuted under the *Crimes Act 1960*, whereas tax evasion is likely to be prosecuted under the *Tax Administration Act 1994*. The two Acts have different maximum penalties, which may reflect why some welfare fraud cases result in harsher punishments than tax evasion cases. Prosecuting all serious financial crime under the same legislation may assist with greater equivalence in outcomes. In Australia, this problem is less evident: both offences are likely to be prosecuted under the Commonwealth *Criminal Code 1995* where the case is serious offending.

The introduction of guideline judgments for financial crime needs consideration. Such judgments contain guidelines to ensure consistency in sentencing across similar cases. As the harm generated by tax evasion and welfare fraud is financial, and therefore the harm is readily quantifiable, guideline judgments for such financial crime should not be complex to implement. Thus, when considering financial crime against the state, the introduction of guideline judgments appears both achievable and necessary.

When discussing views on the seriousness of crime, Davis and Kemp observe that the '*existence or otherwise of social consensus within a particular society should be demonstrated rather than assumed*'.⁴⁶ If treatment in the justice system is a reflection of the seriousness of an offence, the presumption appears to exist in New Zealand and Australia that society perceives welfare fraud as more serious than tax evasion. Historically this may have been correct. However, results from the survey reported herein suggest that this is no longer the case. This may be the result of recent high-profile cases of serious tax evasion that have

⁴⁶ Stephen Davis, and Simon Kemp, 'Judged Seriousness of Crime in New Zealand' (1994) *Australian and New Zealand Journal of Criminology* 27.

changed perceptions of tax evasion or tax compliance. Alternatively, it may be that in current times individuals have fewer opportunities to not pay their tax, so are less tolerant of people that take advantage of opportunities to illegally do so. In order for confidence to exist in the justice system, the system needs to represent the views of society, rather than to continue historical practice unquestioned.

APPENDIX I: SOCIAL DOMINANCE ORIENTATION AND RIGHT-WING
AUTHORITARIANISM QUESTIONS

Social Dominance Orientation	
Dominance	Egalitarianism
Some groups of people are just more worthy than others	All groups should be given an equal chance in life
In getting what your group wants, it is sometimes necessary to use force against other groups	Group equality should be our ideal
It's OK if some groups have more of a chance in life than others	We should do what we can to equalise conditions for different groups
To get ahead in life, it is sometimes necessary to step on other groups	We should increase social equality
If certain groups of people stayed in their place, we would have fewer problems	We would have fewer problems if we treated groups more equally
It's probably a good thing that certain groups are at the top and other groups are at the bottom	We should strive to make incomes more equal
Inferior groups should stay in their place	No one group should dominate in society
Sometimes other groups must be kept in their place	It would be good if all groups could be equal
Right-Wing Authoritarianism	
There is nothing wrong with premarital sex.	
Our country will be destroyed some day if we do not smash the perversions eating away at our moral fibre and traditional beliefs.	
There is absolutely nothing wrong with nudist camps.	
What our country really needs is a strong, determined leader who will crush evil, and take us back to our true path	
There is no 'ONE right way' to live life; everybody has to create their own way	
Our country desperately needs a mighty leader who will do what has to be done to destroy the radical new ways and sinfulness that are ruining us	
The only way our country can get through the crisis ahead is to get back to our traditional values, put some tough leaders in power, and silence the troublemakers spreading bad ideas	
Nobody should stick to the 'straight and narrow'. Instead, people should break loose and try out lots of different ideas and experiences	
It is wonderful that young people today have greater freedom to protest against things they don't like, and to make their own 'rules' to govern their behaviour	
It would be best for everyone if the proper authorities censored magazines so that people could not get their hands on trashy and disgusting material.	

REGULATING THE REGULATOR: ASSESSING THE EFFECTIVENESS OF THE ATO'S EXTERNAL SCRUTINY ARRANGEMENTS

SUNITA JOGARAJAN*

I. INTRODUCTION

In April 2016, the Standing Committee on Tax and Revenue ('SCTR') published its 'Report on the External Scrutiny of the Australian Taxation Office'.¹ The report was the result of concerns raised by the Australian Taxation Office ('ATO') that it faced excessive external scrutiny. The SCTR's terms of reference focused on the issues of duplication and overlap of reviews, cost to government of the reviews, and differential regulation (whether the ATO had demonstrated good risk management and high standards of performance such that differential regulation permitted by the *Public Governance, Performance and Accountability Act 2013* could be extended to reduce its external scrutiny). The SCTR found that the substantial external scrutiny placed on the ATO was warranted in light of the ATO's considerable resources and power, and importance to the general system of government. However, the SCTR only touched on the effectiveness of existing external ATO scrutiny arrangements in its report, as this question was not within its terms of reference.

Given the recognised importance of the ATO's external security arrangements, this paper examines the *effectiveness* of those arrangements using two case studies. The case studies indicate that the external scrutiny arrangements are not always effective and changes to those arrangements are warranted. The paper proceeds as follows. The next section briefly discusses the role of the ATO in the context of a self-assessment tax system while Section III outlines the ATO's existing external scrutiny arrangements. Section IV discusses two case studies which evidence issues with the ATO's existing practice and the ineffectiveness of the existing external scrutiny arrangements. The options for reform to improve the effectiveness of the ATO's external scrutiny arrangements are discussed in Section V, while Section VI provides some concluding remarks on the importance of improving the effectiveness of the ATO's external scrutiny arrangements.

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¹ Standing Committee on Tax and Revenue, Parliament of Australia, *External Scrutiny of the Australian Taxation Office* (April 2016).

II. SELF-ASSESSMENT AND THE ATO

The ATO was established in 1910 and is the government's principal revenue collection agency.² For the 2015–16 financial year, the ATO had an operating expense budget in excess of \$3 billion and more than 20,000 employees.³ The growth in ATO operations has matched the growth in the number of taxpayers, the rising sophistication of taxpayer arrangements and the increasing complexity of the Australian tax system.⁴

Prior to the introduction of self-assessment in 1986–87, taxpayers would lodge a return containing information from which ATO assessors would determine the amount of tax payable. The taxpayer had the right to object against the assessment. In 1983–84, there were more than 236,000 objections against assessments and it was thought that if the number of disputed returns continued to grow at the prevailing rate, the ATO would ultimately use more staff in reviewing assessments than in processing them.⁵ Further, the data indicated that ATO staff would be required to process 400 tax returns a day and would only be able to spend approximately one minute to assess an individual tax return and four minutes for a business tax return.⁶ Against this backdrop, an Assessing Review Group was established within the ATO in 1985 to explore the introduction of a self-assessment system. The first steps towards self-assessment were taken in 1986–87 with the ATO relieved of the obligation to examine returns at the assessment stage and the freed-up resources reallocated to post-assessment checking and taxpayer advisory services. In 1989–90, full self-assessment was introduced for companies and superannuation funds. These taxpayers were also required to determine their tax payable in addition to their taxable income.

At the time of introduction, self-assessment was mainly viewed as a means of increasing efficiency in the processing of tax returns and enabling ATO resources to be reallocated to targeting tax avoidance and evasion.⁷ However, it was soon recognised that broader reforms would be required to support the shift to full-assessment.⁸ These included the introduction of penalties and interest charges, fixed amendment periods and a system of private and

² Australian Taxation Office, *Commissioner of Taxation Annual Report 2015–16* (2016) 2. For historical background on the ATO and the introduction of self-assessment see, Joint Committee of Public Accounts, Parliament of Australia, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) 7–26, 63–74.

³ Australian Taxation Office, *Annual Report 2015–16*, above n 2, 95, 118.

⁴ Leigh Edmonds, *Working for All Australians 1910–2010: A Brief History of the Australian Taxation Office* (Australian Taxation Office, 2010).

⁵ Commissioner of Taxation, *Sixty-Third Annual Report* (1984) 8, cited in Joint Committee of Public Accounts, above n 2, 63.

⁶ Joint Committee of Public Accounts, above n 2, 64.

⁷ Commonwealth, *Parliamentary Debates*, House of Representatives, 20 August 1985, 63–72 (Paul Keating) (Appropriation Bill (No 1) 1985–86, Second Reading).

⁸ It has been said that the true implications of a shift to self-assessment were not fully understood at the time by the then Government, taxpayers or the tax profession: Brian Harmer, 'Self-Assessment Legislation: The Tip of the Taxation Iceberg' (1990) 1 *Revenue Law Journal* 1.

public rulings.⁹ A common theme in the reform projects is the importance of certainty in a self-assessment system:

*[T]he Government is receptive to views ... that areas of the present law, particularly ... taxpayer certainty issues, need to be reviewed as a priority task.*¹⁰

*The Priority Task initiatives are designed to make the taxation system fairer and more certain and, in doing so, to set clear standards for taxpayers in carrying out their tax obligations.*¹¹

*The Review is exploring ways to refine Australia's income tax self-assessment system to provide taxpayers with greater certainty ...*¹²

*The most important recommendations in this report improve certainty ...*¹³

The case studies discussed in Section IV indicate that taxpayer certainty is being eroded by the ATO's conduct. It was also recognised early on that the introduction of self-assessment significantly shifted the balance of power from the taxpayer to the ATO and necessitated the introduction of external scrutiny arrangements.¹⁴ The next section outlines the current arrangements for the external scrutiny of the ATO.

III. EXTERNAL SCRUTINY OF THE ATO

There are broadly five categories of external ATO scrutineers.¹⁵ First, the Australian National Audit Office ('ANAO') undertakes performance audits and financial statement audits of all Commonwealth public sector bodies with the aim of improving Commonwealth public sector administration and accountability. The ANAO's performance audits examine the non-financial performance of government entities and programs to determine whether administration has been carried out economically, efficiently, effectively and in accordance with any particular requirements. The ANAO is currently conducting two performance audits related to the ATO. The first is examining the ATO's implementation of recommendations made by the ANAO and parliamentary committees and the second is examining child support collection arrangements between the ATO and the Department of Human Services.

⁹ For a discussion of the various reforms to self-assessment over the years, see Michael Dirakis and Brett Bondfield, 'ROSA's Last Gasp: The Final Steps in Self Assessment's 21 Year Journey' (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 202, 204–11.

¹⁰ Australian Taxation Office, *A Full Self-Assessment System of Taxation: A Consultative Document* (1990) 2.

¹¹ John Kerin, *Improvements to Self-Assessment Priority Tasks – An Information Paper* (Commonwealth of Australia, 1991) iv.

¹² Australian Treasury, *Review of Aspects of Income Tax Self-Assessment* (Discussion Paper, March 2004) ix.

¹³ Australian Treasury, *Report on Aspects of Income Tax Self-Assessment* (August 2004) 4.

¹⁴ Joint Committee of Public Accounts, above n 2, 307–8, 317.

¹⁵ This section is adapted from Standing Committee on Tax and Revenue, *External Scrutiny*, above n 1, 5–19.

Second, the Inspector-General of Taxation ('Inspector-General') was established in 2003 to review and make recommendations to government on the ATO's systems to administer the tax laws. The establishment of the Inspector-General was in response to complaints about the ATO's administration of mass marketed investment schemes and the business activity statement.¹⁶ The investigative powers of the Commonwealth Ombudsman in relation to individual tax matters was transferred to the Inspector-General from 1 May 2015 on the basis that it was better to provide taxpayers with a dedicated body to investigate and handle complaints about all tax-related matters. The Inspector-General is broadly independent in deciding on its work program but generally confers with the ANAO, tax practitioners, the SCTR, the government, Treasury and the ATO in this regard. Previous Inspector-General reviews have covered areas such as tax disputes, valuations, penalties, transfer pricing, superannuation excess contributions tax, delayed refunds, cash economy benchmarking, and the superannuation guarantee surcharge.

Third, the Commonwealth Ombudsman still has a role in examining complaints about the ATO in relation to public interest disclosure. The *Public Interest Disclosure Act 2013* encourages public officials to disclose suspected wrongdoing in the Commonwealth public sector. The Commonwealth Ombudsman was also briefly responsible for investigating freedom of information complaints (from 1 January 2015 to 30 June 2016) but the Australian Information Commissioner has resumed the investigation of these complaints.

Fourth, the SCTR holds biannual hearings into the ATO's annual report and conducts inquiries referred to it by the Treasurer (such as the abovementioned inquiry into external scrutiny of the ATO). The SCTR has had this role since 2013. The role was previously undertaken by the Joint Committee of Public Accounts and Audit and its precursor, the Joint Committee of Public Accounts. In addition, the Senate Economics Committee has general oversight of Treasury and tax matters. There are also select Senate committees to review specific tax issues such as the Select Committee on a New Tax System in 1999 and the Select Committee on Scrutiny of New Taxes in 2011.

Finally, the courts and the Administrative Appeals Tribunal ('AAT') provide a form of scrutiny in that taxpayers can appeal a decision of the ATO to the courts or the AAT. However, this form of scrutiny is not 'automatic' and depends on action by the taxpayer and involves a direct cost to the taxpayer in most circumstances.¹⁷ The ATO's conduct in disputes is guided by the Commonwealth's (and its agencies) obligation to act as a model litigant.¹⁸ The 'model

¹⁶ Ibid 7.

¹⁷ A small number of cases may not incur a cost for the taxpayer under the ATO's test case litigation program. The program was established to fund cases that have broader implications beyond the individual dispute with the ATO. The program provides financial assistance to taxpayers to meet some or all reasonable litigation costs and in some cases, pre-litigation costs. See Australian Taxation Office, *Test Case Litigation Program* (29 March 2016) <<https://www.ato.gov.au/Tax-professionals/TP/Test-case-litigation-program>>.

¹⁸ Appendix B of the *Legal Services Directions 2005* (Cth) (commonly referred to as the 'model litigant rules'). See also, Gabrielle Appleby, 'The Government as Litigant' (2014) 37 *University of New South Wales Law Journal* 94.

litigant rules' seek to address the power imbalance between the government and private individuals. The obligation requires the Commonwealth and its agencies to act honestly and fairly in handling claims and litigation by:¹⁹

- a) dealing with claims promptly and not causing unnecessary delay in the handling of claims and litigation
- aa) making an early assessment of:
 - i. the Commonwealth's prospects of success in legal proceedings that may be brought against the Commonwealth; and
 - ii. the Commonwealth's potential liability in claims against the Commonwealth
- b) paying legitimate claims without litigation, including making partial settlements of claims or interim payments, where it is clear that liability is at least as much as the amount to be paid
- c) acting consistently in the handling of claims and litigation
- d) endeavouring to avoid, prevent and limit the scope of legal proceedings wherever possible, including by giving consideration in all cases to alternative dispute resolution before initiating legal proceedings and by participating in alternative dispute resolution processes where appropriate
- e) where it is not possible to avoid litigation, keeping the costs of litigation to a minimum, including by:
 - i. not requiring the other party to prove a matter which the Commonwealth or the agency knows to be true
 - ii. not contesting liability if the Commonwealth or the agency knows that the dispute is really about quantum
 - iii. monitoring the progress of the litigation and using methods that it considers appropriate to resolve the litigation, including settlement offers, payments into court or alternative dispute resolution, and
 - iv. ensuring that arrangements are made so that a person participating in any settlement negotiations on behalf of the Commonwealth or a Commonwealth agency can enter into a settlement of the claim or legal proceedings in the course of the negotiations
- f) not taking advantage of a claimant who lacks the resources to litigate a legitimate claim
- g) not relying on technical defences unless the Commonwealth's or the agency's interests would be prejudiced by the failure to comply with a particular requirement
- h) not undertaking and pursuing appeals unless the Commonwealth or the agency believes that it has reasonable prospects for success or the appeal is otherwise justified in the public interest, and
- i) apologising where the Commonwealth or the agency is aware that it or its lawyers have acted wrongfully or improperly.

The next section considers the effectiveness of the ATO's external scrutiny arrangements in the context of specific examples. The examples focus on the effectiveness of the Inspector-General's reviews and the courts and AAT (including the operation of the model litigant rules) as scrutineers. The effectiveness of the ANAO and parliamentary committees as scrutineers is currently the subject of an ANAO performance audit and is due to be tabled in April 2017.

¹⁹ Paragraph 2 of Appendix B of the *Legal Services Directions 2005* (Cth).

IV. CASE STUDIES

This section discusses two specific case studies – the misuse of the fraud or evasion allegation by the ATO and the ATO’s rulings program – to establish the ineffectiveness of the ATO’s existing external scrutiny arrangements.

A. *The (Mis)Use of the Fraud or Evasion Allegation*

One of the key recommendations in the 2004 Report on Self-Assessment was to ‘improve certainty by reducing the periods allowed to the Tax Office to increase a taxpayer’s liability in situations where the revenue risk of doing so is low or manageable’.²⁰ As a result of legislative changes in 2005, the Commissioner generally has two years from the date of assessment to amend an assessment.²¹ This period is extended to four years for taxpayers in particular circumstances. However, where a taxpayer has been involved in fraud or evasion, the fixed amendment periods do not apply and the Commissioner has unlimited time to amend an assessment. For some time, there has been concern that the ATO is misusing the fraud or evasion allegation to amend taxpayer returns beyond the statutory amendment periods.²² As outlined below, the issue has been raised periodically with the ATO’s external scrutineers over the last decade.

(a) 2006

The issue was brought to the Inspector-General’s attention in 2006 in the context of possible ATO breaches of the ‘model litigant rules’.²³ Submissions to the Inspector-General provided examples of the ATO re-classifying a case as involving fraud without any proper basis for doing so. The reclassification usually occurred just before the end of the fixed time period for amendment that would normally have applied to the cases. At the time, the Inspector-General recommended that the ATO should develop practical guidelines for staff on the application of the model litigant guidelines.²⁴ The ATO agreed with the recommendation. The Inspector-General’s recommendation was implemented through the publication of Practice Statement Law Administration PSLA 2007/12: Conduct of Tax Office Litigation in Courts and Tribunals (which has since been replaced by Practice Statement Law Administration PSLA 2009/9: Conduct of ATO Litigation and Engagement of ATO Dispute

²⁰ Australian Treasury, *Report on Aspects of Income Tax Self-Assessment*, above n 13, 5.

²¹ *Income Tax Assessment Act 1936* (Cth) s 170.

²² There have also been questions about the ATO’s conduct when alleging fraud or evasion; see, eg, Inspector-General of Taxation, *Review into the Taxpayers’ Charter and Taxpayer Protections* (December 2016) 45.

²³ Inspector-General of Taxation, *Review of Taxation Office Management of Part IVC Litigation* (28 April 2006) 268.

²⁴ *Ibid* 67.

Resolution).²⁵ The Practice Statement stipulates that the ATO must manage litigation in accordance with the model litigant obligation which

*requires the Commonwealth, its officers, solicitors and counsel, to act with complete propriety, fairly and in accordance with the highest professional standards in handling claims, noting that the agency is not to commence legal proceedings unless it is satisfied that litigation is the most suitable method of dispute resolution. Importantly, the obligation requires the Commissioner to not rely on technicalities and to not take advantage of claimants who lack the resources to litigate a legitimate claim.*²⁶

(b) 2011

The issue was raised again with the Inspector-General in 2011.²⁷ Submissions were made to the Inspector-General that, in the absence of evidence, the ATO continued to raise allegations of fraud or evasion to extend the periods of review. The Inspector-General noted that conclusions of evasion were internally reviewed but not suggestions of evasion. The Inspector-General recommended that the ATO should:

*Ensure that any suggestions of evasion are internally reviewed by senior officers before they are communicated to taxpayers and/or used as a reason to investigate matters; and in the event evasion is considered a risk by those senior officers, the case should be referred to the SME technical panel for further action and the taxpayer notified of this action.*²⁸

The ATO agreed with the recommendation but added that '[t]his is our current business process and we will ensure that all staff are aware of this and apply this process to their case work'.²⁹

(c) 2015

The issue was raised again in 2015 with the Inspector-General.³⁰ Submissions to the Inspector-General noted that allegations of fraud and abuse were being made without strong evidentiary bases or proper review, as a means of extending the amendment period. This was despite the publication of an ATO practice statement to curtail such behaviour. The Inspector-General recommended broad reform through the legislative creation of a separate

²⁵ Inspector-General of Taxation, *Follow-Up Review into the Tax Office's Implementation of Agreed Recommendations included in the Six Reports Prepared by the Inspector-General of Taxation between August 2003 and June 2006* (December 2007) 24–5.

²⁶ Australian Taxation Office, *Practice Statement Law Administration: Conduct of ATO Litigation and Engagement of ATO Dispute Resolution*, PS LA 2009/9, 19 December 2013, [13]–[14].

²⁷ Inspector-General of Taxation, *Review into the ATO's Compliance Approaches to Small and Medium Enterprises with Annual Turnovers between \$100 Million and \$250 Million and High Wealth Individuals* (December 2011) 57–8.

²⁸ *Ibid* 58 (Recommendation 3.3).

²⁹ *Ibid* 58.

³⁰ Inspector-General of Taxation, *The Management of Tax Disputes* (January 2015) 45, 120. The Inspector-General's review focused on tax disputes for large businesses and high wealth individuals while the SCTR review (below n 31) focused on individuals and small to medium enterprises.

Appeals Group headed by a new and dedicated Second Commissioner. The new group would be responsible for managing all aspects of tax disputes with all taxpayers. This recommendation was supported by the SCTR. The Government response is discussed below.

(d) 2015

The issue was also raised with the SCTR in 2015.³¹ The evidence to the SCTR regarding the misuse of the fraud or evasion allegation included a statement from a Deputy President of the AAT that the ATO sometimes had not even turned its mind to whether fraud and evasion occurred despite making such allegations. The SCTR recommended that the ATO amend its internal guidance so that findings or suspicion of fraud or evasion could only be made by a Senior Executive Service officer, that the ATO only make allegations of fraud against taxpayers when evidence of fraud clearly existed, and that the ATO ensure that allegations of fraud or evasion were addressed as soon as practicable in an audit or review. In response to the first recommendation, the ATO stated that it was reviewing its existing guidance material and working through how best to provide further clarity for its staff about the responsibilities and necessary considerations for an allegation or finding of fraud or evasion. In response to the second and third recommendations, the ATO stated that it was reviewing its existing guidance and working through how best to reinforce these messages for staff and to better distinguish between the situation of making enquiries, as opposed to making allegations of fraud and/or evasion.³² The SCTR also recommended that the Government introduce legislation to place the burden of proof on the ATO in relation to allegations of fraud and evasion after a certain period of time and to create a separate Appeals Group as per the Inspector-General's recommendation. The Government did not support the two recommendations.³³

(e) 2016

The problems with the fraud and evasion allegation were raised with the SCTR again in 2016.³⁴ The SCTR noted its earlier recommendations and accepted that the ATO is in the process of genuine cultural change which could take years at such a large organisation.

Despite at least 10 years of attention to the issue by the ATO's external scrutineers, ATO statistics indicate that complaints about the misuse of the fraud or evasion allegation are not without basis. In 2015–16, the ATO reported 319 new allegations of fraud, serious misconduct and other criminal activity.³⁵ Of these, 131 (41 per cent) were found to be unsubstantiated. Only 82 (26 per cent) were substantiated while the remaining allegations

³¹ Standing Committee on Tax and Revenue, Parliament of Australia, *Tax Disputes* (March 2015) 31–6, 108.

³² Australian Government, *Australian Government Response to the House of Representatives Standing Committee on Tax and Revenue Report: Tax Disputes* (December 2015) 10.

³³ *Ibid* 5.

³⁴ Standing Committee on Tax and Revenue, *External Scrutiny*, above n 1, 53–5.

³⁵ Australian Taxation Office, *Annual Report 2015–16*, above n 2, 83.

were considered indeterminable or actioned in other ways (60) or were still open at year-end (46). In 2014–15, the ATO reported 295 new allegations of fraud, serious misconduct and other criminal activity.³⁶ Of these, only 27 (9 per cent) were substantiated after investigation. More than 40 per cent (121) were found to be unsubstantiated while 109 were considered interminable or actioned in other ways and 38 were still outstanding at year-end. The difficulty in determining the true extent of the problem is that most disputes do not proceed to a hearing. The Inspector-General has found that 88 per cent of all litigated disputes referred to the AAT are resolved without any hearing, generally in the taxpayer's favour.³⁷

One recent example suggests that the ATO continues to misuse the fraud and evasion allegation. Over a period of almost two years (2015–16), the ATO maintained an allegation that a taxpayer's conduct constituted evasion which therefore enabled the ATO to amend 10 years of tax returns, resulting in a tax bill of approximately \$500 000 including interest and penalties.³⁸ However, just 10 days before the matter was due to be heard by the Federal Court, the ATO's solicitor wrote to the taxpayer's solicitor advising that

*[T]he Commissioner had reviewed his position in relation to the assessments and no longer contended that there had been evasion on the part of the taxpayer and thus would be taking steps to issue amended assessments reversing the adjustments which had been affected in the amended assessments the subject of the application.*³⁹

As described by Pagone J, the ATO's position was a 'damp squib' and there was 'no gunpowder in the cracker'.⁴⁰ By all accounts, the ATO was not provided any further information which resulted in the change of position and the allegation of evasion was unjustified. The taxpayer in this example benefited from the support of his professional organisation and press attention in refuting the allegation.⁴¹ The concern is that most taxpayers would not have the financial or mental strength to confront the ATO. Ten years of external scrutiny and recommendations does not appear to have had an impact on ATO conduct.

³⁶ Australian Taxation Office, *Commissioner of Taxation Annual Report 2014–15* (2015) 80.

³⁷ Inspector-General of Taxation, *Part IVC Litigation*, above n 23, 6.

³⁸ Robert Gottlieb, 'Landmark Case Will Reveal the Extent of the ATO's Cultural Problem', *The Australian*, 29 September 2016; Robert Gottlieb, 'ATO Attacks Mum and Dad Partnerships', *The Australian*, 19 October 2016. These facts are based on the statement of claim and are unverified as the case did not proceed.

³⁹ Transcript of Proceedings, *Douglass v Federal Commissioner of Taxation* (Federal Court of Australia, NSD 1700, Pagone J, 28 November 2016) 2 (O'Meara).

⁴⁰ *Ibid* 5.

⁴¹ See above n 38.

B. The Rulings System

[T]axpayers are more reliant upon the Tax Office to provide summarised, understandable statements that taxpayers may rely upon. In a system of self-assessment taxpayers expect that these statements will be timely, accurate and objective acknowledging court and tribunal decisions.⁴²

A key element of the Australian self-assessment regime is the system of public and private rulings which was introduced to improve certainty of the law in a self-assessment environment.⁴³ Although rulings are not binding on taxpayers, it has long been recognised that there is a general perception in the community that rulings are ‘quasi-law’ as taxpayers commonly follow rulings in order to avoid penalties.⁴⁴ As such, the external scrutiny of the rulings regime, tasked to the AAT and courts, is fundamental to the operation of the self-assessment system.⁴⁵ The ineffectiveness of the AAT and the courts as scrutineers in this regard was laid bare by the Court’s comments in *Indooroopilly*.⁴⁶ In that case, Allsop J (as the Chief Justice then was) said:⁴⁷

I wish, however, to add some comments about the attitude apparently taken by, and some of the submissions of, the [ATO]. From the material that was put to the Full Court, it was open to conclude that the [ATO] was administering the relevant revenue statute in a way known to be contrary to how this Court had declared the meaning of that statute. Thus, taxpayers appeared to be in the position of seeing a superior court of record in the exercise of federal jurisdiction declaring the meaning and proper content of a law of the Parliament, but the executive branch of the government, in the form of the [ATO], administering the statute in a manner contrary to the meaning and content as declared by the Court; that is, seeing the executive branch of government ignoring the views of the judicial branch of government in the administration of a law of the Parliament by the former. This should not have occurred. If the [ATO] has the view that the courts have misunderstood the meaning of a statute, steps can be taken to vindicate the perceived correct interpretation on appeal or by prompt institution of other proceedings; or the executive can seek to move the legislative branch of government to change the statute. What should not occur is a course of conduct whereby it appears that the courts and their central

⁴² David R Vos and Tasos Mihail, ‘The Importance of Certainty and Fairness in a Self-Assessing Environment’ (Speech delivered at the 7th International Tax Administration Conference, Coogee, 20–21 April 2006) quoted in Inspector-General of Taxation, *Review into Improving the Self-Assessment System* (August 2012) 17.

⁴³ Australian Taxation Office, *A Full Self-Assessment System of Taxation*, above n 10, 12–17; Kerin, above n 11, 10. See also, Duncan Bentley, ‘A Proposal for Reform of the Australian Rulings System’ (1997) 26 *Australian Tax Review* 57, 57–61; A H Slater, ‘Tax in Australian Society: An 80 Year Perspective’ (2007) 81 *Australian Law Journal* 681, 688–9.

⁴⁴ Joint Committee of Public Accounts, above n 2, 107. For discussion on the impact of the rulings system on the rule of law in Australia, see Geoffrey Walker, *The Tax Wilderness: How to Restore the Rule of Law* (Centre for Independent Studies, 2004) 4–6; Diana Scolaro, ‘Tax Rulings: Opinion or Law? The Need for an Independent Rule-Maker’ (2006) 16 *Revenue Law Journal* 109, 120–1, 128–30; Jennifer Batrouney, ‘Editorial Message: Rulings and the Rule of Law’ (2006) 10 *Tax Specialist* 2.

⁴⁵ Peter Harris, ‘Private Tax Rulings: An Advanced System’ (1994) 23 *Australian Tax Review* 22, 33; Bentley, above n 43, 60.

⁴⁶ *Federal Commissioner of Taxation v Indooroopilly Children Services (Qld) Pty Ltd* (2007) 158 FCR 325.

⁴⁷ *Ibid* 326–7 [3]–[7]. Edmonds and Stone JJ agreed with Allsop J’s comments in this regard.

function under ... the Constitution are being ignored by the executive in carrying out of its function under ... the Constitution, in particular its function under s 61 of the Constitution of the execution and maintenance of the laws of the Commonwealth.

It is the function of the courts exercising federal jurisdiction to declare the meaning of statutes of the Commonwealth Parliament in the resolution or quelling of controversies. To quote Marshall CJ in *Marbury v Madison* 5 US (1 Cranch) 137 (1803) at 177:

It is, emphatically, the province and duty of the judicial department to say what the law is.

This passage has been recognised as central to the administration of justice and to the relationship between the judiciary and executive in this country: *Attorney-General (NSW) v Quin* (1990) 170 CLR 1 at 35–36; *Corporation of the City of Enfield v Development Assistance Commission* (2000) 199 CLR 135 at [42]–[44] and *Truth About Motorways Pty Ltd v Macquarie Infrastructure Investment Management Ltd* (2000) 200 CLR 591 at [116].

Considered decisions of a court declaring the meaning of a statute are not to be ignored by the executive as *inter partes* rulings binding only in the earlier *lis*. As Mahoney J (as his Honour then was) said in *P & C Cantarella v Egg Marketing Board (NSW)* [1973] 2 NSWLR 366 at 383:

The duty of the executive branch of government is to ascertain the law and obey it. If there is any difficulty in ascertaining what the law is, as applicable to the particular case, it is open to the executive to approach the court, or afford the citizen the opportunity of approaching the court, to clarify the matter. Where the matter is before the court it is the duty of the executive to assist the court to arrive at the proper and just result.

There was some inferential suggestion in argument that the [ATO] was somehow bound by legislation (not specifically identified) to conduct [the] administration of the relevant statute by reference to [its] own view of the law and the meaning of statutory provisions, rather than by following what the courts have declared. It only need be said that any such provision would require close scrutiny, in particular by reference to issues raised by s 15A of the Acts Interpretation Act 1901 (Cth).

Prior to the Full Federal Court's decision in *Indooroopilly*, there were five judgments at first instance of different judges of the Federal Court. Chronologically, these were *Essenbourne*,⁴⁸ *Walstern*,⁴⁹ *Spotlight Stores*,⁵⁰ *Caelli Constructions*,⁵¹ and *Indooroopilly*.⁵² An issue in each of the cases was whether an employer's contribution to a trust or fund constituted a 'fringe benefit' for the purposes of the *Fringe Benefits Tax Assessment Act 1986*. The existence of a

⁴⁸ *Essenbourne Pty Ltd v Federal Commissioner of Taxation* (2002) 51 ATR 629 (Kiefel J, now of the High Court of Australia).

⁴⁹ *Walstern Pty Ltd v Commissioner of Taxation* (2003) 138 FCR 1 (Hill J).

⁵⁰ *Spotlight Stores Pty Ltd v Federal Commissioner of Taxation* (2004) 55 ATR 745 (Merkel J).

⁵¹ *Caelli Constructions (Vic) Pty Ltd v Commissioner of Taxation* (2005) 147 FCR 449 (Kenny J).

⁵² *Indooroopilly Children Services (Qld) Pty Ltd v Federal Commissioner of Taxation* (2006) 63 ATR 106 (Collier J). By the time the appeal in *Indooroopilly* was heard, the principle in *Essenbourne* was accepted as correct in a sixth Federal Court decision: *Cameron Brae Pty Ltd v Federal Commissioner of Taxation* (2006) 63 ATR 488 (Ryan J).

'fringe benefit' is fundamental to the imposition of fringe benefits tax. In *Essenbourne*, Kiefel J found that such a contribution was not a 'fringe benefit' as it was not paid in respect of any particular employee. The subsequent cases accepted the principle in *Essenbourne* that the existence of a 'fringe benefit' required the benefit to be provided to a particular employee. However, despite the principle established in *Essenbourne*, which had been accepted as correct by four other Federal Court judges, the ATO continued to administer the law in accordance with its interpretation set out in Taxation Ruling TR 1999/5 (ie. a 'fringe benefit' could arise in such situations although the benefit to the trust or fund was not provided in respect of a particular employee). The then Commissioner even publicly stated that the ATO did not accept the Court's comments in *Essenbourne* as correct.⁵³ For five years, until the Full Federal Court's decision in *Indooroopilly*, taxpayers were in the untenable position of having to accept the ATO's interpretation of the law, which the judiciary had stated was incorrect, or incurring the costs of challenging the ATO's position.⁵⁴ Rather than promote certainty, the ATO's public ruling only gave rise to increased uncertainty. Much has been written about the ATO's conduct in *Indooroopilly*, the Commissioner's response,⁵⁵ and the rule of law implications.⁵⁶ This is an important discussion but beyond the scope of this paper which is only concerned with the effectiveness of the ATO's external scrutiny arrangements. The following examples reveal that *Indooroopilly* was not an isolated occurrence and reform is necessary.

A long-standing example of the ineffectiveness of the external scrutiny of ATO rulings is Taxation Ruling TR 92/3 on whether profits on isolated transactions are income. In that ruling, the ATO adopts the view that, for an amount to be income

⁵³ Michael Carmody, 'Tensions in Tax Administration' (Speech delivered at the ICAA NAB Gala Luncheon, Melbourne, 14 March 2003) quoted in Inspector-General of Taxation, *Part IVC Litigation*, above n 23, 160.

⁵⁴ Broadly, the ATO felt unable to appeal the earlier Federal Court decisions to the Full Court as there was a related issue regarding the deductibility of the payments for income tax purposes and the ATO was successful on that issue (the deductions were denied). *Indooroopilly* only involved the fringe benefits tax question. Note, in *Caelli Constructions*, Kenny J accepted the principle in *Essenbourne* but held that fringe benefits tax was payable because the facts in that case were distinguishable from *Essenbourne*.

⁵⁵ The Commissioner defended the ATO's conduct on the basis of three advice opinions from the Commonwealth Solicitor-General, the Chief General Counsel of the Australian Government Solicitor and other legal counsel: Michael D'Ascenzo (Commissioner of Taxation), 'The Rule of Law: A Corporate Value' (Speech delivered at the Law Council of Australia Rule of Law Conference, Brisbane, 1 September 2007). However, writing extra-judicially, Edmonds J notes that even by its own criteria in the advice opinions, the ATO was not entitled to refuse to follow the single judge decisions as prompt action was not taken to clarify the position: Richard Edmonds, 'Recent Tax Litigation: A View from the Bench' (2008) 37 *Australian Tax Review* 79, 93. A former Commonwealth Ombudsman has previously raised concerns regarding government agencies not following single judge decisions: Dennis Pearce, 'Executive versus Judiciary' (1991) 2 *Public Law Review* 179, 189–91.

⁵⁶ Inspector-General of Taxation, *Part IVC Litigation*, above n 23, 159–66; Mark Robertson, 'A Disregard of the Law: Commissioner of Taxation v Indooroopilly Children Services (Qld) Pty Ltd' (2007) 41 *Taxation in Australia* 635; Mark Robertson, 'The Dangers of the ATO's 'Policy Intent' Approach to the Construction of Tax Acts' (2014) 43 *Australian Taxation Review* 22, 27–30; David Bloom, 'The Indooroopilly Saga' (2016) 45 *Australian Taxation Review* 78, 83–7.

[i]t is not necessary that the profit be obtained by a means specifically contemplated (either on its own or as one of several possible means) when the taxpayer enters into the transaction ... It is sufficient ... if a taxpayer enters into the transaction with the purpose of making a profit by one particular means but actually obtains the profits by a different means.⁵⁷

Later in Taxation Ruling TR 92/3, the ATO states:

We also consider that an assessable profit arises if a taxpayer enters into a transaction or operation with a purpose of making a profit by one particular means but actually obtains the profit by a different means. Thus, a taxpayer may contemplate making a profit by sale but may ultimately obtain it by other means (such as compulsory acquisition, through a company liquidation or a distribution in specie) that was not originally contemplated.⁵⁸

In the relevant case on the issue, Hill J (Gummow and Lockhart JJ concurring) stated:⁵⁹

[W]here a transaction falls outside the ordinary scope of the business, so as not to be a part of that business, there must exist, in my opinion, a purpose of profit-making by the very means by which the profit was in fact made. So much is implicit in the decision of the High Court in Myer.

The ATO addresses the inconsistency between Taxation Ruling TR 92/3 and Hill J's comments as follows:

Dicta of Hill J in Westfield have been cited as being contrary to this view. However, our view follows from the earlier Full Federal Court decision in Moana Sand Pty Ltd ...In any event, the law on the issue ... is not clear and, in our view, needs further judicial elucidation.⁶⁰

The ATO did in fact apply to the High Court for special leave to appeal prior to publishing Taxation Ruling TR 92/3. Counsel for the ATO stated that 'this case raises the question whether it is appropriate to place a limitation on what was said by [the High Court] in *Myer Emporium* and, if so, what limitations should be applied to the observations in that case'.⁶¹ In refusing the application for special leave, Mason CJ stated:⁶²

The Full Court of the Federal Court is the ultimate court of appeal in taxation matters subject only to the exceptional cases in which this court grants special leave to appeal. It follows that a question of fundamental principle must arise for decision in such a matter before this court will grant special leave.

Although the Commissioner contends that the decision of the Full Court of the Federal Court rests on a misinterpretation of this principle enunciated by this court in the Myer Emporium case, we consider that this case turns on its own facts and does not call for the grant of special leave to appeal.

⁵⁷ Australian Taxation Office, *Income Tax: Where Profits on Isolated Transactions are Income*, TR 92/3, 30 July 1992, [14].

⁵⁸ *Ibid* [57].

⁵⁹ *Westfield Limited v Commissioner of Taxation* (1991) 28 FCR 333, 344.

⁶⁰ Australian Taxation Office, TR 92/3, above n 57, [58].

⁶¹ *Federal Commissioner of Taxation v Westfield Ltd* (1991) 22 ATR 400, 401.

⁶² *Ibid* 402.

In a later case, counsel for the ATO submitted that ‘what Hill J said in [*Westfield*] was obiter, the views of only one judge, and wrong’.⁶³ The commentary in Taxation Ruling 92/3 was submitted in support of those assertions. The AAT responded that ‘those assertions are all wrong ... [Hill J’s comments] was not obiter ... [was] consistent with ... *Myer Emporium* ... and must therefore be taken to represent the law in this country. The relevant paragraphs in Taxation Ruling TR 92/3 are wrong and should be rewritten’.⁶⁴ Nonetheless, almost twenty-five years later, the ATO continues to deny the authority of Hill J’s pronouncement in *Westfield*.⁶⁵ A recent case suggests that the ATO still applies the law according to its interpretation and taxpayers must incur the costs to prove otherwise. In *Rosgoe*,⁶⁶ the ATO assessed the profit on the sale of a property as ordinary income and not a capital gain even though, on the ATO’s description of the facts, the property was acquired not for sale at a profit but rather for the carrying out of a profit-making scheme which later came to be abandoned.⁶⁷

Taxation Ruling TR 92/3 is not an isolated example of an ATO ruling being inconsistent with judicial authority.⁶⁸ More recently, two Draft Taxation Determinations were not withdrawn by the ATO until three months after the High Court reached the same conclusion as the Federal Court and the Full Federal Court.⁶⁹ The relevant question was whether a trustee or agent has an obligation to retain monies under paragraph 254(1)(d) of the *Income Tax Assessment Act 1936* prior to an assessment being issued. Logan J, at first instance, answered the question in the negative. The Full Federal Court and the High Court reached the same conclusion.⁷⁰ However, Draft Taxation Determination TD 2012/D6, which stated that the obligation to retain an amount under paragraph 254(1)(d) could arise in respect of tax that

⁶³ Case [1999] AATA 66; Case 1/99 (1999) 41 ATR 1117, 1122 [17].

⁶⁴ Ibid.

⁶⁵ For additional commentary on the inconsistency between Taxation Ruling TR 92/3 and judicial authority see, Robert Allerdice, ‘Ruling TR 92/3: The Voice of the Profit’ (1993) 27(7) *Taxation in Australia* 408; Julie Cassidy, ‘The Taxation of Isolated Sales Under Section 25(1) ITAA: TR 92/3 v Joint Submission’ (1994) 4 *Revenue Law Journal* 1; Jeff Waincymer, ‘If At First You Don’t Succeed ... Reconceptualising the Income Concept in the Tax Arena’ (1994) 19 *Melbourne University Law Review* 977, 1011; Rami Hanegbi, ‘Isolated Transactions: Current Income Tax Implications’ (2006) 35 *Australian Tax Review* 248, 256–7; Neil Young, ‘The Historical Significance of the High Court’s Decision in *Federal Commissioner of Taxation v The Myer Emporium Ltd*’ (2007) 31 *Melbourne University Law Review* 266, 285.

⁶⁶ *Rosgoe Pty Ltd v Federal Commissioner of Taxation* [2015] FCA 1231.

⁶⁷ The Federal Court (Logan J) concluded that the profit on sale was not assessable income but remitted the matter to the AAT for further hearing as there were other issues involved.

⁶⁸ For other examples of ATO rulings which are inconsistent with case law see, Scolaro, above n 44, 123–5.

⁶⁹ Australian Taxation Office, *Decision Impact Statement: Commissioner of Taxation v Australian Building Systems Pty Ltd (In Liquidation)* (23 March 2016).

⁷⁰ The High Court agreed with the Full Federal Court’s conclusion but found that Edmonds J’s reasoning as to the capacity in which liquidators are assessed was not quite in accord with the High Court’s decision in *Federal Commissioner of Taxation v Bamford* (2010) 240 CLR 481. At the Full Federal Court, Collier J concurred with Edmonds J’s judgment while Davies J generally agreed with Edmonds J’s reasons and conclusions but adopted different reasoning as to the capacity in which liquidators are assessed.

has not yet been assessed, and Draft Taxation Determination TD 2012/D7, which adopted the same view, were not withdrawn until after the High Court decision.

Although not involving a ruling, recent ATO conduct indicates that there is still an issue with ATO acceptance of Federal Court decisions. In *Financial Synergy Holdings*,⁷¹ the ATO received an unfavourable outcome at the Full Federal Court and was refused leave to appeal by the High Court.⁷² The Full Federal Court decision was handed down on 10 March 2016 while the High Court leave to appeal was heard on 7 October 2016. However, the relevant ATO advice (ATO ID 2014/14) which contains incorrect views has not been withdrawn as of December 2016.⁷³ The issue raised by these two examples is not the delay in withdrawing the ATO documents but the fact that they remained publicly as the ATO interpretation of the law despite judicial pronouncements to the contrary. In light of the abovementioned comments in *Indooroopilly*, the Draft Determinations and ATO ID should have been withdrawn immediately after a contradictory judgment, even if there was an appeal afoot.⁷⁴ Where there is no appeal on foot, the ATO appears to be addressing the implications of a contradictory decision as soon as is practicable.⁷⁵

The recent examples of *Australian Building Systems* and *Financial Synergy Holdings* raise the separate issue of the ATO's delay in amending its advice in response to court decisions. This appears to be an issue even when the ATO receives a favourable outcome in court proceedings. By way of example, Goods and Services Tax Ruling GSTR 2001/8: 'Apportioning the Consideration for a Supply that includes Taxable and Non-Taxable Parts' is still under review although the High Court refused the taxpayer's special leave to appeal in the relevant case in October 2014.⁷⁶ Similarly, Goods and Services Tax Ruling GSTR 2006/9: 'Supplies' is still under review although the related High Court judgment was handed down in December 2014.⁷⁷ The delay is undoubtedly a resourcing issue but the problem is that having rulings

⁷¹ *Financial Synergy Holdings Pty Ltd v Federal Commissioner of Taxation* (2016) 243 FCR 250.

⁷² Transcript of Proceedings, *Commissioner of Taxation v Financial Synergy Holdings Pty Ltd* [2016] HCATrans 232 (7 October 2016).

⁷³ Although not a ruling, ATO IDs set out a precedential ATO view and offer penalty and interest protection to taxpayers who rely on them: Australian Taxation Office, *Practice Statement Law Administration: ATO Interpretative Decisions*, PS LA 2001/8, 9 June 2016.

⁷⁴ These are only two examples from a review of the ATO's decision impact statements for 2015 and 2016 (35 in total). A broader review of the cases will no doubt reveal others.

⁷⁵ Australian Taxation Office, *Decision Impact Statement: Davies v Commissioner of Taxation* (23 September 2015). The ATO withdrew Taxation Determination TD 2014/21 approximately six weeks after receiving an unfavourable decision from a single judge (Perram J) of the Federal Court.

⁷⁶ Australian Taxation Office, *Decision Impact Statement: ATS Pacific Pty Ltd v Commissioner of Taxation* (12 November 2014).

⁷⁷ Australian Taxation Office, *Decision Impact Statement: Commissioner of Taxation v MBI Properties Pty Ltd* (22 December 2014).

which are ‘under review’ for a prolonged period does not provide taxpayer certainty which is the essential purpose of the rulings program.

The ATO’s rulings system was once described as a ‘world’s best’ by former Commissioner Michael D’Ascenzo.⁷⁸ However, the examples in this section suggest that the rulings program is failing in its primary purpose of providing taxpayer certainty. The current external ATO scrutiny arrangements are not adequate and the next section examines possible reform options.

V. OPTIONS FOR REFORM

This section canvasses a number of reform options to improve the effectiveness of the ATO’s external scrutiny arrangements. However, a detailed examination of the options for reform is beyond the scope of this paper. The options discussed here are not mutually exclusive and most likely a combination of reforms will be necessary.

One option for reform is to improve the effectiveness of the ‘model litigant rules’. Commentators have argued that the ATO’s conduct in *Indooroopilly* and the preceding Federal Court cases failed to comply with the model litigant rules.⁷⁹ However, the breach appears to have had little or no lasting consequence on the ATO’s conduct. The problem of compliance with the ‘model litigant rules’ due to difficulties in enforcement and sanction was identified by the Productivity Commission as an issue in its inquiry into access to justice arrangements.⁸⁰ The Productivity Commission recommended that ‘compliance should be monitored and enforced, including by establishing a formal avenue of compliance to government ombudsmen for parties who consider model litigant obligations have not been met’.⁸¹ In the context of the ATO, the Inspector-General is ideally placed as the appropriate avenue for receiving and monitoring complaints about any ATO breach of the ‘model litigant

⁷⁸ Michael D’Ascenzo, ‘Tax Administration into the 21st Century’ in Michael Walpole and Chris Evans (eds), *Tax Administration in the 21st Century* (Prospect Media, 2001) 4.

⁷⁹ Robin Woellner and Julie Zetler, ‘Judge Not Lest Ye Be Judged: The Trials of a Model Litigant’ (2013) 6 *Journal of the Australasian Law Teachers Association* 189, 194–7. Woellner and Zetler also provide the example of the ATO’s conduct described in *LVR (WA) Pty Ltd v Administrative Appeals Tribunal* [2012] FCAFC 90 as another example of the ATO’s failure to comply with the ‘model litigant rules’. In that case, the ATO’s counsel failed to advise the judge at first instance that the AAT’s reasons for its decision were almost entirely copied verbatim from the FCT’s submissions, without attribution. See also, Ron Jorgensen and Megan Bishop, ‘The Rule of Law and the Model Litigant Rules’ (2011) 45(11) *Taxation in Australia* 678. For a list of examples of possible breaches of the model litigant rules raised in submissions to the Inspector-General, see Inspector-General of Taxation, *Part IVC Litigation*, above n 23, 267–8. For a summary of previous reviews on the ATO and the model litigant rules, see Inspector-General of Taxation, *Taxpayers’ Charter*, above n 22, 99–116; Standing Committee on Tax and Revenue, *Tax Disputes*, above n 31, 43–8. For examples of failure to comply with the model litigant rules in other contexts, see Appleby, above n 18, 114–21.

⁸⁰ Productivity Commission, *Access to Justice Arrangements* (Productivity Commission Inquiry Report No 72, 5 September 2014) vol 1, 429–42. On the inadequacy of the current enforcement of the model litigant rules, see also Appleby, above n 18, 121–4.

⁸¹ Productivity Commission, above n 80, 442.

rules'.⁸² In its response to the Productivity Commission's recommendation, the Government has stated that 'the question of compliance with ... the Model Litigant Obligations, is a matter between the Attorney-General and the relevant Commonwealth agency or Department'.⁸³ A necessary first step in any future reform to strengthen the enforceability of the 'model litigant rules' is to ensure the reliability of the information rather than relying on anecdotal evidence. Making the Inspector-General the forum for receiving and monitoring breaches of the 'model litigant rules' by the ATO will serve this purpose. Further, external monitoring and public reporting of any breaches of the 'model litigant rules' may in itself serve as an effective control on ATO conduct. However, it should be noted that the ATO has disagreed with a recommendation from the Inspector-General that the ATO should publicly report on allegations of breaches of the model litigant rules, the outcome of investigations and any remedial action.⁸⁴

Another possibility is to introduce a legislative amendment or legal directions which stipulate that the ATO must follow the decisions of a single judge of the Federal Court in all instances. The ATO could still appeal the decision to the higher courts but taxpayers would receive the benefit of the doubt in the interim. The benefit in increased taxpayer certainty should outweigh any revenue or administrative concerns. However, this approach would represent quite a shift from the present position.⁸⁵ A compromise solution could be to require that the ATO obtain external legal advice prior to controverting a single judge decision. In defending the ATO's conduct in *Indooroopilly*, the then Commissioner noted that the ATO was not required to follow a single judge decision if, on the basis of legal advice (including internal ATO legal advice), there were good arguments that the decision was incorrect.⁸⁶ The efficacy of such a measure would be improved if the external legal advisors were chosen by an independent authority (such as the Inspector-General) rather than the ATO. This is not to suggest that there is any bias or error in internal ATO legal advice but to remove any such perception. The perception of fairness by the ATO is fundamental to taxpayer compliance.⁸⁷

A third possibility is to introduce a system of binding reviews or recommendations by the Inspector-General. For example, allegations of fraud or evasion could be referred to the

⁸² The Rule of Law Institute of Australia has made a similar suggestion: Rule of Law Institute of Australia, Submission on Model Litigant Rules, *Review into the Taxpayers Charter and Taxpayers Protections*, 17 December 2015.

⁸³ Australian Government, *Productivity Commission Recommendations Implemented by the Australian Government* (4 April 2016).

⁸⁴ Inspector-General of Taxation, *Taxpayers' Charter*, above n 22, 116.

⁸⁵ The ATO does not consider a legal position contained in a ruling to be impacted by a court decision until the legal process is completed.

⁸⁶ D'Ascenzo, 'The Rule of Law', above n 55.

⁸⁷ Australian Taxation Office, *Taxpayer Perceptions of Fairness Research* (30 September 2016) <<https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Annual-research/Perceptions-of-Fairness-in-Disputes-survey>>.

Inspector-General for a 'substantiation review'. Similarly, inconsistencies between ATO positions and judicial authority could be referred to the Inspector-General for review. In both cases, the results of the review should be binding on both parties. There is strong support from almost all stakeholders for the position of the Inspector-General and this approach should receive taxpayer support.⁸⁸ However, it may not receive ATO support as there are already problems with the quality of the communication between the Inspector-General and the ATO.⁸⁹ There is also a question as to whether this recommendation would go beyond the Inspector-General's existing mandate and legislative intervention (and adequate resourcing) may be required if this recommendation is considered worthwhile.

It is not considered appropriate to recommend any particular reform measure at this time as the ANAO is currently reviewing the effectiveness of the ANAO and parliamentary committees as scrutineers. Any proposal for reform should only be considered once the results of the ANAO's review are known. Further, the reform options considered in this section are limited to improving the effectiveness of the ATO's external scrutiny arrangements in the context of the existing system. Another approach would be to reform the system itself. For example, some commentators have recommended transferring the rulings function to a new independent rulings body.⁹⁰ Alternatively, the ATO could be required to refrain from publishing or to immediately withdraw any rulings which express an opinion which is contradictory to judicial authority.⁹¹

VI. CONCLUSION

*Particularly in a self-assessment system, it is vital that taxpayers are afforded some degree of certainty about how to calculate their own liabilities through the information provided by the ATO. The Ombudsman is of the view that certainty should be seen as fundamental to tax administration.*⁹²

This paper has argued for a change in the ATO's external scrutiny arrangements on the basis that the current arrangements are proving ineffective. It is acknowledged that the argument is based on a small number of case studies and the author certainly does not wish to suggest that there are widespread problems at the ATO. However, these examples demonstrate the

⁸⁸ Standing Committee on Tax and Revenue, *External Scrutiny*, above n 1, 44.

⁸⁹ *Ibid* 41.

⁹⁰ Bentley, above n 43, 64–9; Scolaro, above n 44, 132–40. The Henry Review considered the possibility of introducing a separate rulings body but ultimately concluded that it would be better to improve the existing system: *Australia's Future Tax System: Report to the Treasurer* (Commonwealth of Australia, December 2009) vol 2, 658–9.

⁹¹ This was one of the earliest recommendations for improving the rulings system: Joint Committee of Public Accounts, above n 2, 103.

⁹² Catherine McPherson, 'Improving the Avenues for Providing Taxpayer Certainty and Redress: The Commonwealth Ombudsman's View' in Michael Walpole and Chris Evans (eds), *Tax Administration in the 21st Century* (Prospect Media, 2001) 110.

ineffectiveness of the ATO's external scrutiny arrangements over an extended period of time. The ATO's external scrutiny arrangements are a costly exercise for the scrutineers and for the ATO which must divert significant resources to respond to the scrutineer's work.⁹³ This cost ultimately falls on the Australian taxpayer and therefore it is in the interests of all parties to introduce reforms to improve the effectiveness of the scrutiny.

As discussed in Section II and illustrated by the quote above, taxpayer certainty is central to an effective self-assessment system. The ATO conduct indicated by the case studies in Section IV erodes taxpayer certainty and should be addressed. The very first review into the administration of taxation laws in Australia found that the ATO had grown to ignore the people it served and that public perception of the ATO was one of the organisation's greatest challenges.⁹⁴ The review's suggestion that 'time alone will not alter those perceptions' is proving prescient.⁹⁵ Improving the effectiveness of the ATO's external scrutiny arrangements should assist in changing those perceptions. This is particularly important as research indicates that 'perceptions of procedural justice strongly shaped views about the legitimacy of the Tax Office'.⁹⁶ Further, 'feelings of legitimacy determine the level of cooperation exhibited by citizens; those who view an authority as having more legitimacy are more likely to cooperate and comply with that authority'.⁹⁷ Building taxpayer trust in the ATO continues to be one of the ATO's stated goals.⁹⁸ It is hoped that this paper will contribute to the discussion and action on reforming the effectiveness of the ATO's external scrutiny arrangements to assist the ATO in achieving that goal.

⁹³ Standing Committee on Tax and Revenue, *External Scrutiny*, above n 1, xvii.

⁹⁴ Joint Committee of Public Accounts, above n 2, vii.

⁹⁵ *Ibid.*

⁹⁶ Kristina Murphy, 'Regulating More Effectively: The Relationship between Procedural Justice, Legitimacy and Tax Non-Compliance' (Working Paper No 71, Centre for Tax System Integrity, June 2005) 28.

⁹⁷ *Ibid.*

⁹⁸ Australian Taxation Office, *ATO Corporate Plan 2015-19* (2015) 3.

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A QUESTION OF THE INTEGRITY OF THE DIVIDEND IMPUTATION SYSTEM WHEN CORPORATE TAX RATE CHANGES:

AN AUSTRALIAN STUDY

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ABSTRACT

This study examines the dividend imputation system adopted in Australia, one of a few OECD countries that still operate a full imputation tax system. The Australian government recently announced corporate tax rate cuts, providing an opportunity to study the potential effects that corporate tax rate changes may bring to an imputation tax system. This paper analyses the proposed changes to the imputation system put forward in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* and suggests that such changes could potentially cause distortions to the existing imputation system in Australia. The potential distortions include the discrepancy between the tax rate used in computing company's tax liability and the tax rate employed as a basis for imputation, the additional tax payment required at domestic shareholder's level upon receiving franked dividends, and the wastage of franking credits arisen from previous corporate tax payments. Furthermore, this paper suggests consideration of an extension period of four or five years, during which companies in Australia can still apply the imputation (franking) rate based on the 30% company tax rate in respect of the dividends paid out of the underlying profits that were previously taxed at the same rate of 30%.

I. INTRODUCTION

The literature in corporate taxation has for a long time been concerned about double taxation of corporate profits, which refers to the after-tax dividends getting taxed a second time in the hands of company's shareholders. Under a classical tax system, shareholders' return from investment in companies in reality is not the return received from companies in the form of dividends, which are already taxed at company level. The fact that shareholders are subject to personal income tax on receipt of dividends has resulted in a much lower realised return for these investors. From one perspective, having a classical tax system provides scope for a country to lower their corporate tax rate in order to be competitive in the global market for investments by multinational companies, because in such tax

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jurisdiction on top of the corporate tax the government also collects additional income tax from individual shareholders who are in receipt of dividends.¹

Parallel to the classical tax system, some countries operate a dividend imputation tax system to address the issue of double taxation. Under a dividend imputation system, shareholders are also taxed on the dividend income distributed out of a company's after-tax retained profits but these shareholders at the same time receive a tax credit for the amount of tax that was already paid by that respective company. Before 2000, a number of countries in the Organisation for Economic Co-operation and Development (OECD) had a dividend imputation system in place; however, many of those either abolished entirely the imputation tax system or changed to a partial imputation system by 2012, such as Finland, France, Germany, Italy and Norway.² Until 2016, only five OECD countries operate a full dividend imputation system and these countries are: Australia, Canada, Chile, New Zealand and Mexico.³

An imputation tax system operates to benefit domestic shareholders in a way that these shareholders are entitled to a tax credit for the company tax already paid at corporate level and that tax credit reduces the total personal income tax a shareholder is required to pay on the dividend income. In other words, the tax being paid at shareholder's level under an imputation system is the top-up tax after taking into account the tax already paid in respect of the same income source, i.e. the income originating from the corporate profits. As a simple explanation, for an amount of profit denoted P , the company deriving that profit needs to pay tax at corporate tax rate R_c (say, 30%). When the after-tax profit gets distributed to a domestic individual shareholder whose marginal tax rate is R_i (45% for example), under a full imputation system that shareholder is only required to pay the differential in tax, which is $P \cdot (R_i - R_c)$ where $R_i - R_c = 15\%$, instead of paying a personal income tax amount of $P \cdot R_i$ in addition to the corporate tax amount of $P \cdot R_c$.

The question arises here is, what will happen when a country changes its statutory company tax rate? In a globalised environment where countries are in competition of lowering corporate tax rates to attract foreign investments, most governments bear the pressure to follow their peers and to be in line with other tax jurisdictions. As a result, in a fiscal year where R_c reduces, say from 30% down to 20%, the tax rate differential ($R_i - R_c$) is increased by 10% (i.e. from 15% to 25%) in this simple demonstration. What it means is that, if a company paid tax at 30% on its business profit in a prior year but the underlying after-tax profit is later on distributed in the form of franked dividend based on an imputation rate of

¹ See Geoffrey Kingston, 'Dividend Imputation or Low Company Tax?' (2015) 2 *JASSA Finsia Journal of Applied Finance* 12. This paper examines the potential for a company tax cut in Australia should the dividend imputation system be abolished.

² David Richardson, 'The Case against Cutting the Corporate Tax Rate' (Technical Brief No 20, The Australia Institute, December 2012).

³ Andrew Ainsworth, 'Dividend Imputation: The International Experience' (2016) 1 *JASSA Finsia Journal of Applied Finance* 58.

20%, the additional amount of income tax being paid by an individual shareholder is no longer $P \times 15\%$. Later discussion in this paper suggests that the same individual shareholder is worse off by paying extra tax as a result of the dividend not only being grossed up at a lower R_c but also carrying lower franking credits calculated at the same lower R_c .

This issue faced by an imputation tax system is examined in this paper through an analysis of the Australian tax system. Australia is an appropriate setting for this study for two reasons. First, Australia has a long history of continuous operation of a dividend imputation system, commencing from 1987.⁴ Second, Australia recently announced a company tax rate cut from 30% to 27.5% with a timeframe for the rate cut to roll out gradually from smaller-sized to larger-sized corporate entities. The tax rate cut will come into effect from the 2016–17 income year⁵ for companies with turnover less than AU\$10 million, and will apply to all companies including largest firms by the end of the 2023–24 income year.⁶

The remainder of this paper proceeds as follows. Section II of this paper examines the Australian experience with the dividend imputation tax system. After that, Section III discusses the potential distortions to the imputation system when company tax rate changes. Section IV presents one possible option to retain the integrity of the imputation system when corporate tax cuts occur. A conclusion is provided in Section V.

II. AUSTRALIAN EXPERIENCE WITH THE DIVIDEND IMPUTATION TAX SYSTEM

A. *Operation of the Imputation Tax System in Australia*

Australia is one of a few OECD countries that still operate a full dividend imputation system. Australia's history of the imputation tax system spans decades and dated back to 1923.⁷ For the period from 1923 to 1940, companies were taxed on corporate profits and shareholders were taxed on dividends received from companies but could receive a rebate for the tax that had already been paid at corporation level.⁸ However, from 1940, shareholders in Australia no long received a tax rebate in relation to their dividend income and Australia changed from an imputation tax system to a classical tax system. Under the classical tax system, dividends

⁴ Garry Twite, 'Capital Structure Choices and Taxes: Evidence from the Australian Dividend Imputation Tax System' (2001) 2 *International Review of Finance* 217.

⁵ In this paper, the 2016–17 income year is also referred to as 2017 income year, and so on for other income years.

⁶ See Australian Taxation Office, *Reducing the Corporate Tax Rate* (5 September 2016) <<https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Reducing-the-corporate-tax-rate/>>. The *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* was introduced to the Parliament on 1 September 2016.

⁷ Andrew Ainsworth, Graham Partington and Geoff Warren, 'Do Franking Credits Matter? Exploring the Financial Implications of Dividend Imputation' (Working Paper No 058/2015, Centre for International Finance and Regulation, June 2015) 5.

⁸ *Ibid.*

received by shareholders are necessarily taxed twice, first at company level and second at shareholder level. Australia moved back to the imputation tax system in 1987. Effective from 1 July 1987, company taxes paid to the Australian Taxation Office (ATO) are distributed to Australian tax residents as a tax credit attached to a dividend declared by the company.⁹ Under the Australian tax regime, this tax credit is called a 'franking credit'.

Since 1987, Australia has been continuously operating the dividend imputation system for nearly 30 years. The major change in respect of the operation of this system was the rebate provision, under which the allowable rebate of franking credits before 1 July 2000 was capped at the tax liability of a taxpayer and any excess imputation credit was lost.¹⁰ Under the new provision introduced in July 2000, the entire amount of franking credits is refundable to taxpayers even when franking credits exceed tax liabilities.¹¹ As such, the shareholders do not incur wastage of excess franking credits and the imputation retains its value for taxpayers with low income and having marginal personal tax rate lower than statutory company tax rate.

Under the present imputation system in Australia, companies are required to keep records of the franking account, which keeps track of the income tax payments made to the ATO.¹² The maximum franking credits distributable to shareholders is the balance reflected in the franking account of a company. In other words, a firm cannot 'frank' the dividends (i.e. attach the imputation credits to the dividends) more than the amount of company income tax that has been paid.

As an example, when an Australian resident company makes a before-tax profit of \$100, it is required to pay income tax at statutory corporate tax rate of 30%, being \$30.¹³ After a corporate tax of \$30 is paid by that company to the ATO, the company can record a credit of \$30 in its franking account. The retained profit after tax for the company is \$70. Subsequent to that, when that company pays a dividend of \$70 to its shareholder (assuming an individual sole shareholder in this example), a franking credit worth of \$30 is attached to that dividend, which necessarily reduces the balance of the company's franking account to zero.

The individual shareholder, upon receiving a franked dividend of \$70, is required to 'gross up' the cash dividend amount to reflect the before-tax corporate profit of \$100. The tax liability of that individual shareholder (in respect of the dividend received) is calculated on

⁹ Twite, above n 4.

¹⁰ John C Handley and Krishnan Maheswaran, 'A Measure of the Efficacy of the Australian Imputation Tax System' (2008) 84 *Economic Record* 82.

¹¹ Ibid.

¹² Australian Taxation Office, *Simplified Imputation - The Franking Account* (17 December 2015) <<https://www.ato.gov.au/Business/Imputation/In-detail/Simplified-imputation—the-franking-account/>>.

¹³ Corporate tax rate in Australia for companies that are not 'small business entities' is 30% for the 2015–16 Australian income year. A 'small business entity' is one whose aggregated turnover is less than AU\$2 million. See Australian Taxation Office, *Company Tax Rates* (17 October 2016) <<https://www.ato.gov.au/rates/company-tax/>>.

the grossed-up dividend figure of \$100. For an individual taxpayer with marginal personal income tax rate of 49%, their personal tax on the dividend income will be $\$100 \times 49\% = \49 .¹⁴ Under the dividend imputation system, this Australian resident shareholder is entitled to a franking credit of \$30, which is offset against the tax liability of \$49. Hence, the net tax required of the individual shareholder in this case is $\$49 - \$30 = \$19$. In this example, under the imputation system, total income tax paid on the original \$100 of business profit is \$49, consisting of \$30 paid at corporate level and \$19 paid at individual shareholder level. Contrasting with the classical tax system where no tax credit is provided for the company tax previously paid, total income tax payments on the original profit of \$100 would amount to \$79 (assuming no other tax relief given to the individual shareholder), being made up by \$30 paid by the company and \$49 paid by the shareholder.¹⁵

When an Australian resident company pays tax at a lower rate compared to the statutory corporate tax rate, there will be insufficient franking credits in the company franking account to make the dividends fully franked; in that case, the dividend distributed by the company would be partially franked. Likewise, in a situation where a company does not pay any income tax on its profits after applying available tax offsets (e.g. tax offset for research and development activities carried out by the firm), the dividend distributed will have to be unfranked dividend. Therefore, in Australia, the imputation system can be considered as a system of prepayment of tax on corporate profits because domestic shareholders essentially pay income tax on the distributed company profits (in the form of dividends) at their relevant marginal tax rate.¹⁶ This view is however only applicable for companies of which all of the shareholders are Australian residents for tax purposes.

B. *Australian Experience With Dividend Imputation: Findings of Prior Research*

A dividend imputation system is often referred to as a tax system that addresses the issue of double taxation on dividends encountered in a classical tax system.¹⁷ An imputation system is also viewed as an efficient and equitable tax system.¹⁸ Some researchers argue that an efficient imputation system reduces the biases emerging under the classical tax system, including biases towards debt and retention of earnings as well as bias against the corporation form.¹⁹ Dividend imputation is believed to promote equity because it reduces the tax burden on investors who would otherwise be taxed twice on their return from

¹⁴ Highest marginal individual tax rate in Australia for the 2015–16 income year is 49%, including 2% of Medicare levy and 2% of temporary budget repair levy for the year.

¹⁵ For further examples in relation to operations of the Australian tax system, see Twite, above n 4.

¹⁶ Catherine Ikin and Alfred Tran, 'Corporate Tax Strategy in the Australian Dividend Imputation System' (2013) 28 *Australian Tax Forum* 523.

¹⁷ Handley and Maheswaran, above n 10.

¹⁸ Brett Wilkinson and Marcy M Fancher, 'Eliminating 'Double Taxation': The Dividend Imputation Alternative' (2004) 74 *CPA Journal* 15.

¹⁹ *Ibid.*

investment in companies under a classical tax system.²⁰ In order to further understand the dividend imputation system, this section examines Australia's experience after operating an imputation system for a continuous period of nearly 30 years.

Firstly, a study of the efficacy of the Australian dividend imputation system by Handley and Maheswaran reports significant utilisation of imputation as a means to reduce personal tax liabilities for the period from 1990 to 2004.²¹ More specifically, these researchers document that the percentage of distributed franking credits used to bring down personal taxes is 67% during the years 1990–2000 and that percentage increases to 81% for the period 2001–2004.²² Handley and Maheswaran conclude that the policy shift to a dividend imputation system in Australia delivers the intended result of eliminating double taxation of dividends (for domestic shareholders) which was the major equity issue before 1987 when the classical tax system was still in use.²³

In addition, prior research into the Australian imputation tax system also study how dividend imputation may be associated with share prices, company cost of capital and corporate behaviours. Some academics attempt to analyse whether franking credits are priced by the stock market and whether the value of imputation credits should be incorporated into a capital asset pricing model.²⁴ The reported findings in this line of research are inconclusive in respect of the impacts of dividend imputation on share price and cost of capital. For example, studies by Brown and Clarke (1993) and Minney (2010) suggest that imputation credits are priced by the stock market.²⁵ On the contrary, research carried out by Lajbcygier and Wheatley find that dividend imputation in Australia does not result in lower required returns on equity for investors.²⁶ A separate study examining Australian hybrid securities shows franking credits are not capitalised into the cum-dividend day prices of these hybrid securities, attributing this finding to the argument that price setting in the Australian market is from a foreign investor's perspective whereas only domestic investors receive the benefit of imputation credits in Australia.²⁷

²⁰ Handley and Maheswaran, above n 10; Wilkinson and Fancher, above n 18.

²¹ Handley and Maheswaran, above n 10.

²² Ibid.

²³ Ibid.

²⁴ Stephen Gray and Jason Hall, 'The Relation between Franking Credits and the Market Risk Premium' (2006) 46 *Accounting and Finance* 405.

²⁵ Phillip Brown and Alex Clarke, 'The Ex-dividend Day Behaviour of Australian Share Prices before and after Dividend Imputation' (1993) 18 *Australian Journal of Management* 1; Aaron Minney, 'The Valuation of Franking Credits to Investors' (2010) 2 *Journal of Applied Finance* 29.

²⁶ Paul Lajbcygier and Simon M Wheatley, 'Imputation Credits and Equity Returns' (2012) 88 *Economic Record* 476.

²⁷ Clinton Feuerherdt, Stephen Gray and Jason Hall, 'The Value of Imputation Tax Credits on Australian Hybrid Securities' (2010) 10 *International Review of Finance* 365.

Mentioned earlier in this Section is a remark about the view that a dividend imputation system reduces two biases often observed in a classical tax system: (a) bias towards retention of profits within the corporation, and (b) bias towards debt usage. Research conducted on Australian dividend imputation system provides some evidences supporting this remark. Pattenden and Twite analyse the period from 1982 to 1997 to examine the effect of the switch from a classical tax system to an imputation system in Australia effective from July 1987.²⁸ These researchers report a finding that introduction of the dividend imputation leads to an increase in dividend payouts by Australian companies.²⁹ In addition, with regards to the reduction in the bias towards debt financing following the implementation of dividend imputation, an Australian study documents a decreased level of firm leverage and a corresponding increase in financing using external equity after introduction of an imputation system.³⁰ However, other researchers cautioned that there could be other significant factors contributing to the observed reduction in debt use and it is difficult to ascertain the impact of dividend imputation in this regard.³¹

In a review of the reported findings in respect of the effects of the dividend imputation on the Australian equity markets and behaviours of investors and corporations, Ainsworth, Partington and Warren contend that overall the Australian economy is believed to benefit from having an imputation tax system.³² This contention is important in light of the recent debate about the benefits of dividend imputation and whether Australia should continue maintaining this system. Holding similar view, Davis in a recent paper discussing the interaction between the imputation tax system and the Australian financial system believes that the benefits of having dividend imputation are greater than the costs associated with it.³³ Davis' paper argues that there is less distortion to the operation of the financial system under the imputation tax system as opposed to under the former classical tax system.³⁴ The author also puts forward that the imputation system in Australia enhances 'financial stability, market discipline and corporate governance' through decreased debt uses and increased dividend payouts.³⁵

²⁸ Kerry Pattenden and Garry Twite, 'Taxes and Dividend Policy under Alternative Tax Regimes' (2008) 14 *Journal of Corporate Finance* 1.

²⁹ Ibid.

³⁰ Twite, above n 4.

³¹ Andrew Ainsworth, Graham Partington and Geoffrey J Warren, 'The Impact of Dividend Imputation on Share Prices, the Cost of Capital and Corporate Behaviour' (2016) 1 *JASSA Finsia Journal of Applied Finance* 41, 47.

³² Ibid, 47-8.

³³ Kevin Davis, 'Dividend Imputation and the Australian Financial System' (2016) 1 *JASSA Finsia Journal of Applied Finance* 35.

³⁴ Ibid.

³⁵ Ibid.

Finally, Ainsworth puts it in perspective in his discussion of the Australian imputation tax system after reviewing other countries' experiences with dividend imputation.³⁶ Through an examination of the motivations behind the removal of the dividend imputation in nine countries, Ainsworth observes that after abolishing the imputation system, these countries go through a number of changes to their tax systems to provide various types of remedy for double taxation of dividends (e.g. changing tax rates for dividend income or taxing only part of the dividend received).³⁷ The Australian imputation system on the contrary has remained stable for nearly 30 years with the significant revision being the rebate provision effective from July 2000, which allows full refunds of franking credits for Australian resident shareholders.

Summarising the above, the dividend imputation system in Australia has not only brought positive contributions to the Australian financial market but also proved to be a stable and efficient system for Australia. It is therefore important to identify and address any potential adverse impacts that changes in regulations may cause to the imputation system, in order to ensure that a system that has worked reasonably well will continue to work well in the future.

III. POTENTIAL DISTORTIONS TO DIVIDEND IMPUTATION WHEN COMPANY TAX RATE CHANGES

Australian company tax rate for the 2015–16 financial year is 30% for most corporate entities and 28.5% for 'small business entities' with aggregated turnover of less than AU\$2 million.³⁸ In recognition of Australia's higher corporate tax rate compared to the average of the OECD countries,³⁹ the Australian government is currently implementing a company tax rate cut. Starting from the 2016–17 income year, companies having aggregated turnover less than AU\$10 million will be eligible for a lower tax rate of 27.5%. The threshold of AU\$10 million will increase progressively until 2023–24 when all companies irrespective of turnover levels can access the 27.5% tax rate.⁴⁰ The flat company tax rate will then continue to drop in the following years until it reaches 25% in 2026–27, as outlined in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* submitted to the Australia's Parliament on 1 September 2016.⁴¹ Some prior studies examine the potential impacts of corporate tax rate

³⁶ Andrew Ainsworth, 'Dividend Imputation: The International Experience' (2016) 1 *JASSA Finsia Journal of Applied Finance* 58.

³⁷ *Ibid.*

³⁸ Australian Taxation Office, above n 13.

³⁹ Australian Treasury, 'Re:Think Tax Discussion Paper' (Discussion Paper, Parliamentary Library, Australian Government, 2015) 74–5.

⁴⁰ Australian Taxation Office, above n 6.

⁴¹ Explanatory Memorandum, *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* (Cth) 9–33.

cuts in Australia and analyse the interaction between company tax rate reduction and any potential removal of dividend imputation⁴²; however, such discussion is beyond the scope of this paper. Rather, the focus of this paper is at the consequent impacts on dividend imputation in Australia when corporate tax rate changes.

A. *Previous Adjustments in Response to Changes in Corporate Tax Rates 2000–2002*

The latest changes in respect of Australian corporate taxation introduce the first significant tax rate cuts for companies in the last 15 years since the last change in 2000–2002 under John Howard’s government. In order to have an insightful examination of the effects of the latest measures on the imputation system, it is worthwhile to review the Australian dividend imputation story when the country last had a company tax rate change.

Following the *1999 Review of Business Taxation (the Ralph Report)*, the Australian government decided to change corporate tax rate from 36% in 1999–2000 to 34% in 2000–01, and then down to 30% in 2001–02.⁴³ Together with the reductions in company tax rate, there were also changes to the imputation system to: (a) to reflect the tax rate cuts in the franking account, and (b) to simplify the imputation system. Operation of the imputation tax system in Australia prior to July 2002 is different from what Australia currently has, and the main difference lies in the company’s franking account. Before July 2002, the franking account under the former imputation system was not used to record the corporate tax payments made to the ATO; instead, it was used to track the taxed income, i.e. the net income after deducting corporate tax from taxable income.⁴⁴ A conversion of the franking account was required in 2002–03, which is explained further below. However, previous study suggests that despite different methods of recording the franking account, the outcomes between the former and the existing imputation systems are similar, and the nature of the dividend imputation retains the same in terms of giving a tax credit to shareholders for the company income tax already paid.⁴⁵

(a) *Franking accounts in 2000–01 and 2001–02*

Until 1999–2000, Australian corporate entities could have franking accounts of different classes A, B and C reflecting different tax rates.⁴⁶ The entries in these franking accounts previously arose based on company tax rates of 39% (class A account), 33% (class B

⁴² Studies examining this issue include: Geoffrey Kingston, ‘Dividend Imputation or Lower Company Tax?’ (2015) 2 *JASSA Finsia Journal of Applied Finance* 11; J M Dixon and J Nassios, ‘Modelling the Impacts of a Cut to Company Tax in Australia’ (Working Paper No G-260, Centre of Policy Studies, Victoria University, April 2016).

⁴³ Business Council of Australia, ‘Corporate Taxation An International Comparison’ (Research Paper, October 2005) 9.

⁴⁴ Tom O’Sullivan, ‘Australia’s Dividend Imputation System: New Rules but Similar Outcomes’ (2003) 29 *Tax Notes International* 319.

⁴⁵ *Ibid.*

⁴⁶ Explanatory Memorandum, *New Business Tax System (Miscellaneous) Bill 1999* (Cth) 25–35.

account), and 36% and 34% (class C account).⁴⁷ When the tax rate was reduced from 36% in 1999–2000 down to 34% and then 30% in the following two years, the tax rate cuts were accompanied with a requirement to convert the existing franking credits and debits in all class A, class B and class C accounts into one equivalent class C account.⁴⁸

Under the former imputation system in Australia (before July 2002), the franking account operated to keep track of the after-tax income of corporate entities. For example, when a company earned a profit of \$100 in 2000–01 and paid tax at the company tax rate of 34% in that year, a taxed income amount of \$66 (being \$100 less \$34) would be recorded as a credit in the company's class C franking account for the year ending 30 June 2001. As such, the franking account under the old system reflects the after-tax income (as opposed to the tax payments under the new system after July 2002). On 1 July 2001, this entry would be converted into an equivalent class C franking account using the legislated formula: $34/66 \times 70/30$.⁴⁹ After applying this factor, the resulting credit entry in the 2001–02 class C franking account becomes a credit of: $\$66 \times 34/66 \times 70/30 = \79.33 . After being reinstated on 1 July 2001, a credit of \$79.33 in the 2001–02 financial year means that the company could distribute a fully franked dividend of \$79.33 using the 30% franking rate, which was the new tax rate applicable in 2001–02.

(b) *Franking account in 2002–03*

After converting franking entries from the old class A, B and C franking accounts into the equivalent class C franking account which reflects the corporate tax rate of 30% in the 2001–02 tax year, at the end of the 2002 income year there should only be one new class C franking account. The Australian government decided to implement new rules in 2002–03 to change the operation of the company franking account. From tracking after-tax income under the old rules before 1 July 2002, the franking account changed to keep track of corporate tax payments under the simplified imputation system effective from 1 July 2002.⁵⁰

The ATO required companies to close off class C franking account at 30 June 2002 and roll over any surpluses into a new franking account established on 1 July 2002 by applying a factor of $30/70$.⁵¹ For example, if a company started operation in the 2001–02 tax year and paid \$30 of tax on a pre-tax profit of \$100, their class C franking account at 30 June 2002 would have recorded a credit (or surplus) of \$70. This class C franking account, under the simplified imputation rules, would be closed off on 30 June 2002 and a new franking account would be established on 1 July 2002. In this example, the surplus of \$70 in the old class C

⁴⁷ Revised Explanatory Memorandum, *Taxation Laws Amendment Bill (No. 4) 2001* (Cth).

⁴⁸ *Ibid.*

⁴⁹ Revised Explanatory Memorandum, above n 47, [1.16]–[1.18].

⁵⁰ O'Sullivan, above n 44.

⁵¹ Australian Taxation Office, *How Are Franking Surpluses Prior to 1 July 2002 Converted?* (17 December 2015) <<https://www.ato.gov.au/Business/Imputation/In-detail/Simplified-imputation—the-franking-account/?page=7>>.

franking account would be converted into a credit of \$30 in the new franking account using this calculation: $\$70 \times 30/70 = \30 .

The new franking account established from 1 July 2002 operates on a tax-paid basis. As O'Sullivan contends, 'companies do not need to gross-up franking account entries, or maintain multiple franking accounts when the company tax rate changes from year to year'.⁵² The question arises here is, under the new simplified imputation system, what will happen when there is a change in corporate tax rate? Since 2002, there has been no change in statutory tax rate for companies until recently. The latest company tax cuts therefore present challenges to the existing operation of a dividend imputation system in Australia. What should tax policy-makers do in order to implement the transition to lower company tax rates smoothly while still retaining the integrity of the imputation system?

B. *Potential Distortions to the System Resulting from Latest Company Tax Rate Changes*

(a) *Proposed corporate tax rate reduction from 2016–2017 and changes to the dividend imputation rules*

On 1 September 2016, the Australian government introduced the *Treasury Laws Amendment (Enterprise Plan) Bill 2016* (hereon '*2016 Tax Plan Bill*') which includes the proposed reduction in corporate tax rate.⁵³ Under this proposal, the company tax rate will decrease from 30% to 27.5% over an eight-year period with the change coming into effect from 1 July 2016 for firms with turnover less than AU\$10 million and rolling out for larger companies at different stages. The corporate tax rate in Australia will then further go down, as a flat rate for companies of all sizes, from 27.5% (in 2023–24) to 27% (in 2024–25), 26% (in 2025–26) and then 25% (in 2026–27 and later years).⁵⁴ The *2016 Tax Plan Bill* also puts forward an initiative to align the franking rate of 30% for franked dividends with the corporate tax rate being reduced in stages:

1.70 During that period [from 2016–17 income year to 2023–24 income year], a greater number of corporate tax entities will be entitled to the 27.5 per cent corporate tax rate each year, reflecting the increase in the aggregated turnover to qualify as a base rate entity.⁵⁵ Therefore, it is not feasible to continue to operate the imputation system at the headline corporate tax rate of 30 per cent for all corporate tax entities.⁵⁶

Recognising the potential discrepancy between the current imputation rate of 30% for dividends paid and the reduced statutory tax rate for companies, the *2016 Tax Plan Bill* introduces a new concept of 'corporate tax rate for imputation purposes', suggesting that it

⁵² O'Sullivan, above n 44.

⁵³ Explanatory Memorandum, above n 41.

⁵⁴ Explanatory Memorandum, above n 41, [1.11]–[1.16].

⁵⁵ Definition of 'base rate entity' is provided in para 1.13 of the *2016 Tax Plan Bill*. See Explanatory Memorandum, above n 41, [1.13].

⁵⁶ Explanatory Memorandum, above n 41, [1.70].

can be different from the corporate tax rate applied in income tax calculation.⁵⁷ Although the definition of ‘corporate tax rate for imputation purposes’ is not clearly set out in the *2016 Tax Plan Bill*, para 1.73 of the Bill provides an example to demonstrate how this new concept applies from 2016–17. My interpretation of the proposal is that application of the new concept relies on a comparison between the prior year’s aggregated turnover and the current year’s threshold to be eligible for the lower company tax rate (also the ‘base rate entity’ threshold). If the prior year’s aggregated turnover is less than the current year’s threshold, the corporate tax rate for imputation purposes will be the lower rate of 27.5% (if the year falls in the 2017–2024 period), i.e. franking rate of 27.5% will apply to franked dividends paid. Vice versa, if the prior year’s aggregated turnover is greater than the current year’s threshold, the franked dividends will have the imputation rate of 30%.

(b) *Complexity of the proposed changes*

A detailed reading of the proposed changes outlined in the *2016 Tax Plan Bill* suggests this proposal may add more complexity to the existing corporate taxation and dividend imputation system in Australia. As part of the proposal, new definitions of ‘base rate entity’ and ‘corporate tax rate for imputation purposes’ are introduced in the *2016 Tax Plan Bill*. The way how these new definitions are incorporated into the present imputation tax system is quite complex.

Firstly, while the ‘small business entity’ test is still in use in determining the applicable corporate tax rate for a company for the 2016–17 year (with aggregated turnover threshold set to be AU\$10 million), the relevant test from the 2017–18 year to the 2022–23 year will change to the ‘base rate entity’ test.⁵⁸ A company qualifying to be a ‘base rate entity’ can access the lower corporate tax rate of 27.5% in those relevant income years from 2017–18 to 2022–23. Paras 1.42 and 1.46 of the Bill jointly define ‘base rate entity’ as a corporate tax entity that satisfies two requirements: (a) carrying on a business, and (b) having aggregated turnover below the relevant ‘aggregated turnover threshold’.⁵⁹ While the second limb is straightforward with the annual aggregated turnover thresholds set out in Table 1.1 of the Bill⁶⁰, the first requirement of ‘carrying on a business’ may cause some uncertainty in respect of companies with only passive investments.⁶¹ The proposal however envisages removal of

⁵⁷ Explanatory Memorandum, above n 41, [1.73].

⁵⁸ Explanatory Memorandum, above n 41, [1.11]–[1.13].

⁵⁹ Explanatory Memorandum, above n 41, [1.42], [1.46].

⁶⁰ Explanatory Memorandum, above n 41, 11.

⁶¹ Subsection 995-1(1) of the *Income Tax Assessment Act 1997* defines ‘business’ as follows: ‘includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee’. Detailed analysis of conditions to for a company to be considered ‘carrying on a business’ is beyond the scope of this paper. The attention of this paper is at the complexity of the proposed changes in the *2016 Tax Plan Bill*.

the 'base rate entity' test from the 2023–24 income year since all corporate tax entities will be taxed at a flat rate regardless of their turnovers effective from 1 July 2023.⁶²

Furthermore, the concept of 'base rate entity' is also integrated into determination of a company's 'corporate tax rate for imputation purposes', another new definition proposed in the *2016 Tax Plan Bill*. Para 1.73 of the Bill states:

1.73 As a result of this change, for the purposes of applying provisions in the imputation system, corporate tax entities will use the corporate tax rate for imputation purposes. This is generally defined to mean the entity's corporate tax rate for the income year (the current income year), worked out on the assumption that the entity's aggregated turnover for the income year is equal to its aggregated turnover for the previous income year. [...]

Operation based on this definition may cause confusion. My reading of the Bill suggests that while the aggregated turnover of a company in the current year is relevant in determining the 'corporate tax rate for income tax calculation', assessment of the 'corporate tax rate for imputation purposes' requires reference back to the company's aggregated turnover in the prior year.

Table 1 summarises my interpretation of *Example 1.1* provided in the *2016 Tax Plan Bill*.⁶³ As demonstrated in the table, in this example, company A pays franked dividends carrying imputation credits based on the 27.5% tax rate because company A's aggregated turnover in 2016–17 (AU\$20 million) is less than the 2017–18 'base rate entity' threshold of AU\$25 million. It is important to recognise that the dividends in 2017–18 are most likely distributed from retained earnings accumulated from prior years, which were previously taxed at 30%.

Table 1: Example of operation of the proposed change to imputation rate from 2016–17⁶⁴

Company A	2015–16	2016–17	2017–18
Aggregated turnover	\$18mil	\$20mil	Note (b)
Small business entity (SBE) or base rate entity (BRE) threshold	\$2mil	\$10mil	\$25mil
Current year's aggregated turnover less than current year's SBE/BRE threshold?	No	No	Note (b)
Corporate tax rate for income tax	30%	30%	Note (b)
Prior year's aggregated turnover less than current year's SBE/BRE threshold?	N/A – Note (a)	No	Yes
Corporate tax rate for imputation purposes	30%	30%	27.5%

Note (a): Imputation rate of 27.5% only starts from 2016–17 income year.

Note (b): *Example 1.1* in the *2016 Tax Plan Bill* does not provide this information.

The complexity of this proposal as discussed above could possibly result in various mistakes inadvertently made by taxpayers and tax agents. Moreover, apart from its complexity issue,

⁶² Explanatory Memorandum, above n 41, [1.14]-[1.15], [1.51].

⁶³ Ibid.

⁶⁴ Ibid.

the proposal in the *2016 Tax Plan Bill* may potentially lead to potential distortions to the existing dividend imputation system, which are discussed in detail below.

(c) *Potential distortions*

The recent changes to corporate tax rates and imputation rules in Australia as proposed in the *2016 Tax Plan Bill* present challenges to retaining the integrity of the imputation tax system. Firstly, the major distortion to the dividend imputation is that from 2016–17 franked dividends paid by several companies will be franked based on the new tax rate of 27.5% while the underlying profits for such dividends were previously taxed at a higher rate of 30%.

Under the latest proposal, a large number of companies eligible for the lower corporate tax rate of 27.5% will be caught under the new imputation rules and have to pay franked dividends with an imputation rate equal to the reduced company tax rate of 27.5%. In that situation, the franked dividends received by domestic shareholders will be grossed up at the imputation rate of 27.5%; at the same time, the respective shareholders also receive franking credits calculated based on the tax rate of 27.5%. *Table 2* provides a comparison between the old imputation rules (before 2016–17) and the proposed new imputation rules (in effect from 2016–17 if legislated), and highlights the difference in the overall taxes paid on the same amount of corporate profit under the old and new provisions. As illustrated in *Table 2*, starting from a company profit of \$100 being taxed at 30% in 2015–16, this after-tax underlying profit when distributed to a domestic individual shareholder in 2016–17 will result in different net tax payable amounts required from that individual shareholder under the old and new imputation rules.

Under the old rules where dividend is franked based on a tax rate of 30%, the domestic individual shareholder who is already subject to a top marginal personal income tax rate of 49% will have a personal tax liability of \$19. In this situation, total company tax and shareholder's tax amount to \$49, or 49% of the original company profit of \$100. This example shows that the old rules effectively lead to the intended result for an imputation system where the full amount of company tax paid is passed on to the shareholder in the form of a tax rebate.⁶⁵

In contrast, under the new rules where companies satisfying the 'small business entity' (SBE)/ 'base rate entity' (BRE) threshold can access a lower corporate income tax rate of 27.5%, a large number of those corporations will have a corporate tax rate for imputation purposes of 27.5% while some others may be lucky enough to still be able to frank dividends based on the old tax rate of 30%. The example in *Table 2* assesses the tax liability at the individual shareholder's level if the imputation rate is 27.5%. Calculations in *Table 2* show that the amount of total taxes paid on the original company profit of \$100 is \$50.76,

⁶⁵ This is in line with the argument that the dividend imputation tax system acts as a prepayment of personal income tax on corporate profits through taxing at corporate level. See Ikin and Tran, above n 16.

comprising of \$30 of tax paid at corporate level and \$20.76 of tax paid at domestic shareholder's level. The domestic shareholder in this situation only receives a franking credit worth \$26.55 even though the company tax already paid is \$30. Due to the shortfall of franking credit distributed to the shareholder, under the new imputation rules, the effective rate of total taxes paid on the original company profit for individual domestic shareholders (who are subject to the 49% top marginal personal tax rate) is 50.76%, which is 1.76% higher than the effective rate under the old set of rules.

Para 1.72 of the *2016 Tax Plan Bill* argues:

1.72 This change [referring to the new rules for dividend imputation] does not alter basic operation of the imputation system. Distributions to members who are domestic shareholders will continue to be ultimately taxed at the member's marginal tax rate.⁶⁶

However, the example illustrated in *Table 2* has highlighted the distortion in the imputation system under the proposed new rules in the *2016 Tax Plan Bill* where the imputation system does not deliver the initially intended result because an individual domestic shareholder is now effectively paying tax on fully franked dividend income at a rate that is higher than their own top marginal personal tax rate. Thus, a small portion of double taxation once again comes back to the tax system, as a result of the recent company tax rate cut.

In addition, a new issue arises in respect of the undistributed franking credits remaining in the company franking account. As demonstrated in the example in *Table 2*, under the new imputation rules, while \$30 of company tax paid in 2015–16 is credited in the company franking account, this balance is only reduced by an amount of \$26.55 being franking credits distributed to the domestic shareholder. As a result of this distribution, there is a credit of \$3.45 remained in the franking account. The proposed changes to the imputation system do not address this wastage of undistributed franking credits.

The remaining franking credits can potentially get trapped in the franking account and may only be used in the future when the company engages in some tax aggressive planning to pay company tax at a rate lower than the statutory tax rate. This can happen when the unused franking credits arising from the 'old' profits are attached to the dividends paid out of the 'new' profits, upon which the company pays little tax (owing to tax aggressive strategies) and as such creates little 'new' franking credits. Hence, unconsciously the proposed new imputation rules create an incentive for companies to look for tax aggressive strategies to lower their effective tax rates in future years in order to utilise the 'trapped' franking credits arisen from the changes associated with company tax rate cuts.

⁶⁶ Explanatory Memorandum, above n 41, [1.72].

Table 2: Comparison of taxes paid on corporate profit under the old rules (before 2016–17) and new rules (from 2016–17) of the Australian dividend imputation system

	Old rules: Underlying profit taxed at 30% & dividend with imputation at 30%	New rules: Underlying profit taxed at 30% & dividend with imputation at 27.5%
FY2015–16		
Company before-tax profit (A)	\$100.00	\$100.00
Corporate tax rate (B)	30.0%	30.0%
Company income tax (C = A*B)	\$30.00	\$30.00
Company after-tax profit (D = A - C)	\$70.00	\$70.00
FY2016–17		
Franked dividend paid to shareholder (E = D)	\$70.00	\$70.00
Corporate tax rate (F)	30.0%	27.5% (assuming meeting SBE threshold)
Corporate tax rate for imputation purposes (G)	30.0%	27.50%
Franking credits attached to dividend paid (H = $E*G/(1-G)$)	\$30.00	\$26.55
Grossed-up dividend (I = E + H)	\$100.00	\$96.55
Individual domestic shareholder's marginal tax rate (J) ⁶⁷	49.0%	49.0%
Tax on dividend income at individual shareholder's level (K = I*J)	\$49.00	\$47.31
Franking credits received by individual shareholder (L = H)	\$30.00	\$26.55
Net tax payable on dividend income by individual shareholder (M = K - L)	\$19.00	\$20.76
Summary		
Total taxes paid on the original company profit of \$100 (N = C + M)	\$49.00	\$50.76
Effective tax rate on the original company profit of \$100 (combined corporate and individual shareholder levels) (P = N/A)	49.0%	50.76%

The wastage of franking credits currently available in companies' franking accounts and the potential of corporations' involvement in tax aggressive planning to utilise all the trapped franking credits can be remarkable issues due to the large balance of franking accounts of Australian firms. According to the *ATO Taxation statistics 2013–14*, the total franking credits available for distribution in all companies' franking accounts amount to over AU\$296 billion.⁶⁸ Using the latest data provided in the *ATO Taxation statistics 2013–14*, the average

⁶⁷ Top marginal individual tax rate in Australia for the 2016–17 year is 49%, including Medicare levy of 2% and Temporary budget repair levy of 2%. See Australian Taxation Office, *Individual Income Tax Rates* (31 October 2016) <<https://www.ato.gov.au/rates/individual-income-tax-rates/>>.

⁶⁸ Australian Taxation Office, *Taxation Statistics 2013–14: Company - Table 1* (February 2016) <<https://data.gov.au/dataset/taxation-statistics-2013-14/resource/6217e594-1c2e-4b3e-be66-1c7c502fa28c>>.

growth rate of the companies' franking account balance over a ten-year period from 2004 to 2014 is calculated to be 10.66%. Applying this average growth rate to the 2015 and 2016 tax years, it is estimated that the total franking account balance would reach approximately AU\$363 billion, which is equivalent to total distributable franked dividends of AU\$846 billion (by applying a factor of 70/30, based on current company tax rate of 30%). *Table 3* provides a summary of franking account balances from 2004 to 2014 extracted from *ATO Taxation statistics 2013–14* and estimated franking account balances and equivalent distributable franked dividends in 2015 and 2016.

Since the proposed company tax rate cuts to 27.5% in Australia are to occur in different stages, from smaller to larger companies, over the 2017–2024 period, the more relevant figures are the franking account balances for companies with turnover less than AU\$10 million because these are the ones qualifying for the lower tax rate of 27.5% in 2016–17 and hence most likely subject to the 27.5% franking rate. Firms with turnover less than AU\$10 million do not have much time to plan for dividend distributions whereas larger firms have more time to review their dividend policies to make the most use of the existing undistributed franking credits. The franking account balance figures for these smaller firms are not available; however, the total franking account balances of all companies reported in *Table 3* suggest Australian companies overall tend to have large undistributed franking credits in their franking accounts.

Moreover, another distortion to the existing dividend imputation system created by the new proposal is in respect of the meaningfulness of the proposed method to determine the 'corporate tax rate for imputation purposes'. As discussed above, pursuant to the *2016 Tax Plan Bill*, a company will be required to frank dividends paid in the current year at the 27.5% rate (any year from 2017 to 2024) if its prior year's aggregated turnover is less than the current year's SBE/BRE threshold; otherwise, an imputation rate of 30% will apply. Explaining for this approach, para 1.71 of the *2016 Tax Plan Bill* contends that 'a corporate tax entity will not know its aggregated turnover for a particular income year (and therefore its corporate tax rate for that income year) until after the end of the income year.'⁶⁹ Nevertheless, this paper argues that the proposed operation of the changes to imputation rates delivers little benefit in respect of segregating the underlying profits for which the corporate tax rate equals to the imputation rate.

⁶⁹ Explanatory Memorandum, above n 41, [1.71].

Table 3: Summary of franking account balances from 2004 to 2014 extracted from ATO Taxation statistics 2013–14 and estimated franking account balances in 2015 and 2016

Financial year	ATO statistic / Estimate	Franking account balance (AU\$)	% Increase in franking account balance (compared to previous year)	Distributable franked dividends at 30% tax rate (AU\$)
2003–04	ATO statistic	108,108,909,226		
2004–05	ATO statistic	120,785,640,859	11.73%	
2005–06	ATO statistic	135,127,268,330	11.87%	
2006–07	ATO statistic	153,921,868,636	13.91%	
2007–08	ATO statistic	179,509,795,063	16.62%	
2008–09	ATO statistic	201,380,531,173	12.18%	
2009–10	ATO statistic	217,691,212,752	8.10%	
2010–11	ATO statistic	228,795,702,114	5.10%	
2011–12	ATO statistic	251,971,425,419	10.13%	
2012–13	ATO statistic	276,810,391,705	9.86%	
2013–14	ATO statistic	296,351,149,193	7.06%	
Average % increase in franking account balance over 10 years (2004–2014)			10.66%	
2014–15	Estimate	327,942,181,697	10.66%	765,198,423,960
2015–16	Estimate	362,900,818,266	10.66%	846,768,575,954

As a practical example, let us revisit *Example 1.1* used in the *2016 Tax Plan Bill* to illustrate para 1.73 (with a summary provided in *Table 1* of this paper).⁷⁰ In *Table 4*, the original *Example 1.1* is modified by assuming Company A's aggregated turnover for 2017–18 is AU\$26 million. Since the BRE threshold in 2017–18 is AU\$25 million, company A cannot qualify for lower corporate tax rate of 27.5%. Under the new imputation rules, the 'corporate tax rate for imputation purposes' in 2017–18 is determined by reference to the aggregated turnover in the previous income year, which is 2016–17. Because the previous year's aggregated turnover of AU\$20 million is below the BRE threshold of AU\$25 million for 2017–18, the applicable imputation rate on dividends paid in 2017–18 becomes 27.5%.

⁷⁰ Explanatory Memorandum, above n 41, [1.73].

Table 4: Further example of operation of the proposed change to imputation rate from 2016–17

Company A	2015–16	2016–17	2017–18
Aggregated turnover	\$18mil	\$20mil	\$26mil
Small business entity (SBE) or base rate entity (BRE) threshold	\$2mil	\$10mil	\$25mil
Current year's aggregated turnover less than current year's SBE/BRE threshold?	No	No	No
Corporate tax rate for income tax	30.0%	30.0%	30.0%
Prior year's aggregated turnover less than current year's SBE/BRE threshold?	N/A – Note (a)	No	Yes
Corporate tax rate for imputation purposes	30.0%	30.0%	27.5%

Note (a): Imputation rate of 27.5% only starts from 2016–17 income year.

In this new example, a company pays income tax at 30% on the 'old' profits (2016 and 2017 income years) and still pays income tax at 30% on the 'new' profits in the current year (2018 income year). However, the franked dividends in the 2018 income year, which are necessarily paid out of the 'old' underlying profits, carry imputation credits based on the lower tax rate of 27.5%. Essentially, the franking credits distributed to shareholders are reduced to the lower imputation rate while the company has never been eligible to access the lower corporate tax rate, past and present. This example illustrates a situation where the new imputation rules result in unnecessary mismatch between corporate tax rate for income tax calculation and corporate tax rate for imputation purposes, and therefore further distort the existing imputation regime.

Nevertheless, it should also be noted that one potential consequence of the reduction in imputation rate (from 30% to 27.5% and further reduced after 2023–24) is that companies are pushed to distribute the 'old' profits carrying franking credits at 30% tax rate. As a result, we may expect to see a spike in dividend payout trends. A sudden increase in dividend payouts may reduce retained earnings originally planned for business reinvestment and growth, and require capital to fund dividend payments. It is interesting to see what impact this might have on corporate leverage. Besides, for companies with substantial undistributed franking credits, it is possible that domestic investors may demand distribution of the remaining franking credits in the franking account in order to avoid the disadvantage caused by the lower imputation rate of 27.5% imposed on the underlying corporate profits previously taxed at 30%. In that situation, these firms might be expected to pay special franked dividends to reduce (if not fully exhaust) the undistributed franking credits. Another question arises here as to whether this may have any (potentially favourable) effect on share

price. However, examination of the effects on the financial market is beyond the scope of this paper.

IV. RETAIN THE INTEGRITY OF THE DIVIDEND IMPUTATION SYSTEM?

New Zealand, one of a few OECD countries that still operate a full dividend imputation system, recently also experienced a company tax cut. Following the introduction of the *Taxation (Budget Measures) Act 2010*, corporate tax rate in New Zealand was reduced from 30% to 28%, effective from the 2011–12 income year.⁷¹ The New Zealand government recognised that the reduction in imputation rate to be aligned with company tax rate would create a disadvantage to shareholders upon receiving franked dividend arising from company profit source which had already been taxed at the higher rate of 30%.⁷² Acknowledging that potential disadvantage to shareholders, the New Zealand government provided companies with a transitional period, starting from the first day of 2011–12 income year until 31 March 2013, during which imputation rate of 30% was still applied on dividends paid out of company's underlying profits which were previously taxed at 30%.⁷³ Australia can consider the experience of New Zealand in tailoring its regulations around changes to the Australian imputation system when corporate tax rate changes.

This paper suggests one approach to minimise the potential distortions to the dividend imputation system when the Australian government implements company tax rate cuts. The ultimate outcome targeted by the alternative recommended here is to achieve the intended result of a full imputation system, which is also restated in para 1.72 of the *2016 Tax Plan Bill*: 'distributions to members who are domestic shareholders will continue to be ultimately taxed at the member's marginal tax rate'.⁷⁴ This paper suggests policy-makers consider an extension period, spanning four to five years, for companies to still apply the imputation rate based on the 'old' company tax rate on the corporate profits previously taxed at the same rate. In other words, in the transition from a corporate tax rate from 30% to 27.5%, companies are still allowed to frank dividends at an imputation rate of 30% on the underlying profits that were previously taxed at 30%, for a period of up to four or five years.

This paper puts forward an extension period of four or five years, which is longer than the transitional period adopted by the New Zealand when cutting company tax rate from 30% down to 28%. There are two main reasons for proposing an extension period of this length. Firstly, a period of four to five years would be long enough for companies to plan for dividend

⁷¹ Inland Revenue Department, *New Tax Rates for Companies and Savings* (13 August 2010) <<http://www.ird.govt.nz/technical-tax/legislation/2010/2010-27/leg-2010-27-companies-and-savings/>>.

⁷² Chartered Accountants Australia and New Zealand, 'Submission Lodged on Enterprise Tax Plan Bill' (Submission to Senate Economics Legislation Committee, 27 September 2016).

⁷³ *Ibid.*

⁷⁴ Explanatory Memorandum, above n 41, [1.72].

payments, including arrangement for capital required for cash payments to shareholders. Since Australia has a rather large franking account balance, which stands at AU\$296 billion at the end of the 2013–14 income year,⁷⁵ one or two years of extension might not provide sufficient time for companies to exhaust all the undistributed franking credits. A very short extension period can be particularly difficult for firms that previously retained profits to invest in firm's growth and research and development activities; such firms might have to struggle to finance the payments of special dividends if they choose to distribute all of the 'old' franking credits (based on imputation rate of 30%). Secondly, a longer extension period avoids extraordinary surge in dividend payouts. If the extension period is only for one year, distribution of all of the 'old' franking credits means that there will be unusually high special dividends in that extension year, which essentially push individual shareholders to the next income tax bracket if they are not already at the highest marginal individual tax rate. On the other hand, if this extension time is spread over four or five years, the increase in dividend payments can be spread over the length of the extension period.

In order to segregate the underlying profits for which the tax rate for company income tax calculation and the corporate tax rate for imputation purposes are to be the same, companies may be required to report franking credits available for distribution at each applicable franking rate. The 'applicable franking rate' should be understood as the company tax rate based on which the tax payments, i.e. the franking credits, were originally computed. An example is provided in *Appendix 1* to illustrate how this recommended approach can operate in reality.

Under the approach suggested in this paper, corporations have an extension period to pay out the undistributed ('old') franking credits originally arisen from tax payments at the 30% tax rate. At the same time, companies can start having 'new' franking credits from paying corporate tax at 27.5% recorded in the same company franking account. After all the 'old' franking credits are exhausted through dividends (with imputation rate of 30%) paid within the extension period, a company can start distributing the 'new' franking credits which are attached to dividends franked at the new imputation rate of 27.5%. In order to keep track of the 'old' and 'new' franking credits, companies will be required to clarify the imputation rate for each franking entry (either debit or credit). *Appendix 1* presents one possible way this segregation can be incorporated into the existing company franking account. In essence, this is not much different from operating multiple franking accounts during the extension period; however, the suggestion here makes consolidation into one franking account as simple as possible.

Once the extension period of four or five years lapses, if a company has not used up all the 'old' franking credits (imputation rate of 30%), these will be converted to 'new' franking credits (imputation rate of 27.5%) by applying a factor of: $70/30 \times 27.5/72.5$. This method

⁷⁵ Australian Taxation Office, above n 68.

is similar to the conversion to class C franking account back in 2001–02,⁷⁶ except that back in 2002 the franking account tracks taxed profits while the franking account post-2002 tracks tax payments made to the ATO. The consequence of this conversion is that domestic shareholders will pay higher top-up tax on dividend income compared to that top-up tax required of the same shareholders before conversion of the ‘old’ franking credits. This consequence is shown in *Table 5*.

In *Table 5*, it is demonstrated that for a corporate profit of \$100 on which \$30 of tax is paid to the ATO, if a company distributes \$30 of franking credits within the extension period, an individual domestic shareholder subject to the highest marginal tax rate (of 49%) upon receiving a dividend of \$70 is required to pay an additional tax (or top-up tax) amount of \$19. In contrast, if for some reason this same company does not distribute \$30 of franking credits before the end of the extension period, the ‘old’ surplus of \$30 will be converted into a ‘new’ credit of \$26.55 in the company franking account, i.e. the maximum amount of franking credits distributable to shareholders but these franking credits are subject an imputation rate of 27.5%. Following the conversion, when the domestic shareholder receives a dividend of \$70, the additional tax in the hands of that shareholder now increases to \$20.76. Hence, the ‘additional’ top-up tax of \$1.76 (being \$20.76 less \$19) can be considered as a penalty to company shareholders when a company does not fully exhaust the undistributed franking credits, which arose from previous tax payments made at 30% tax rate, during the extension period provided by the Australian government.

The above recommendation in respect of the extension period and revision to the franking account in order to keep track of franking credits for corporate profits paid at different tax rates is only one alternative this paper can suggest. There can be other alternatives that should be considered with the overarching aim of retaining the integrity of the dividend imputation system in Australia.

⁷⁶ Revised Explanatory Memorandum, above n 47.

Table 5: Comparison of taxes paid on corporate profit before and after conversion of franking credits when extension period lapses

	Underlying corporate profit taxed at 30%	Before conversion: 'old' franking credits	After conversion: 'new' franking credits
Company before-tax profit (A)	\$100.00		
Corporate tax rate (B)	30.00%		
Company income tax (C = A*B)	\$30.00		
Company after-tax profit (D = A - C)	\$70.00		
Franking credits			
+ Original 'old' franking credits (E = B)		\$30.00	
+ 'Old' franking credits converted to 'new' franking credits after extension period lapses (F = $E*70/30*27.5/72.5$)			\$26.55
Franked dividend paid to shareholder (G = D)		\$70.00	\$70.00
Imputation rate (H)		30.00%	27.50%
Franking credits attached to dividend paid (I = $G*H/(1-H)$)		\$30.00	\$26.55
Grossed-up dividend (J = G + I)		\$100.00	\$96.55
Individual domestic shareholder's marginal tax rate (K)		49.00%	49.00%
Tax on dividend income at individual shareholder's level (L = J*K)		\$49.00	\$47.31
Franking credits received by individual shareholder (M = I)		\$30.00	\$26.55
Net tax payable on dividend income by individual shareholder (N = L - M)		\$19.00	\$20.76

V. CONCLUSION

This article raises a question of the integrity of the dividend imputation tax system when corporate tax rate changes. An analysis of the Australian dividend imputation system is provided in this article since Australia is one of a few OECD countries that still operate a full imputation tax system and the Australian government recently announced corporate tax rate cuts to be more in line with the OECD average company tax rate.

This study starts with an examination of the overall experience that Australia has after operating a dividend imputation system for nearly thirty years, starting from 1987. It is overall suggested that the imputation system in Australia has brought positive contributions to the Australian financial market and the imputation system is generally considered to be stable and efficient. The paper proceeds to examine the potential distortions that the proposed changes in the *2016 Tax Plan Bill* may cause to the existing imputation system.

These potential distortions include: (a) the discrepancy between the tax rate of 30% applied on the underlying corporate profits and the lower tax rate of 27.5% used for imputation purposes; (b) the consequently higher tax payable at domestic shareholders' level on the same underlying corporate profit; (c) the wastage of franking credits which may be trapped in the company franking account; and (d) the induced corporate tax aggressive planning strategies to utilise the trapped franking credits. Besides, it is noted that the new imputation rules put forward by the *2016 Tax Plan Bill* may also lead to an increase in dividend payouts, which may consequently have certain interactions with company borrowings to pay special dividends as well as with company's share price.

This paper suggests one alternative for consideration with a view to achieve the intended outcome of a full dividend imputation system. This article recommends providing companies with an extension period of four or five years during which the corporate tax entities can still apply the imputation rate based on the 30% company tax rate in respect of the dividends paid out of underlying profits that were previously taxed at 30%. The suggestion package also includes a revision to the franking account, which allows companies to keep track of franking credits that arise from tax payments at different tax rates (30% or 27.5%). Under the proposed alternative, any undistributed franking surplus previously subject to the imputation rate of 30% will be converted to 'new' franking credits subject to imputation rate of 27.5% once the extension period lapses.

Furthermore, the recommended alternative in this paper also caters for any further company tax rate changes in the future. As part of the proposal in the *2016 Tax Plan Bill*, after corporate tax rate for companies of all sizes reaches a flat rate of 27.5% in 2023–24, further tax cuts will occur to bring the corporate tax rate down to 27% (in 2024–25), 26% (in 2025–26) and then 25% (in 2026–27 and later years).⁷⁷ Therefore, it is now a timely opportunity to consider thoroughly all the alternatives and tailor the changes required in order to retain the integrity of the imputation system in Australia; these changes can set a stepping stone for further variation of corporate tax rate in the future.

⁷⁷ Explanatory Memorandum, above n 41, [1.14]-[1.15].

APPENDIX 1

This appendix presents two examples to illustrate how the suggested approach in Section IV of this paper operates in reality and how adoption of this tracking method for the company franking account may address the issues surrounding company tax rate cuts for Australian companies.

In this appendix, it is assumed that a four-year extension period applies and that during the extension period, companies can still apply the imputation rate (or franking rate) based on the 'old' company tax rate on the underlying corporate profits previously taxed at the same rate. Simply put, companies are still allowed to frank dividends at a franking rate (FR) of 30% on the underlying corporate profits previously subject to tax at 30% for the first four years since the companies start becoming eligible for the lower corporate tax rate.

This paper recommends the existing company franking account be revised to allow recording debit and credit entries at relevant FR. Practically the debit column will be split into two categories, being FR of 30% and FR of 27.5%; likewise for the credit column. Consequently, the running balance column in the franking account would reflect: (a) the franking credits available to be distributed based on 30% tax rate; and (b) the franking credits available to be distributed based on 27.5% tax rate.

In both examples, company A and company B are Australian corporate tax entities and are assumed to be eligible for the lower company tax rate of 27.5% from the 2017 financial year (i.e. the year ending on 30 June 2017). These two companies are allowed a four-year extension period. In the first example, company A could exhaust the undistributed franking credits subject to FR of 30% within the four-year extension period. In contrast, company B does not have sufficient cash to pay enough dividends to utilise all the 'old' franking credits. After the extension period lapses, company B is required to convert the 'old' franking credits into 'new' franking credits, which are subject to 27.5% FR.

Company A:

'Old' franking credits subject to FR of 30% are utilised within the four-year extension period

Assuming company A has an opening surplus of \$50,000 at FR of 30% in its company franking account at the beginning of the 2017 financial year. During the 2017 year, company A receives franked dividends carrying \$10,000 in franking credits at FR of 30%. Company A also pays income tax of \$8,000 to the Australian Taxation Office (ATO) in respect of its 2016 income tax return (which is lodged and assessed after 30 June 2016) and its 2016 income tax is calculated based on tax rate of 30%. The two amounts of \$10,000 and \$8,000 are recorded as credit entries in the FR 30% column. Besides, in the 2017 year, company A pays the ATO income tax instalments totalling \$25,000 in relation to the 2017 financial year. Because company A is eligible for the lower tax rate of 27.5% starting from 2017, the instalments worth of \$25,000 are recorded as a credit entry for the FR 27.5% column. Under

the suggested four-year extension period, company A is allowed to pay dividends franked based on the old tax rate of 30% in the 2017 year. As such, a debit entry of \$35,000 is entered in the FR 30% column to reflect the 'old' franking credits distributed by company A in 2017.

Table A: Franking Account of Company A – 'old' franking credits subject to franking rate of 30% exhausted within the four-year extension period

Franking rate (FR)	Debit		Credit		Balance	
	30.0%	27.5%	30.0%	27.5%	30.0%	27.5%
2017 Financial year: First year						
Opening franking credits					50,000	
Dividend received – FR of 30%			10,000		60,000	–
Income tax paid – 2016 tax return			8,000		68,000	–
Income tax instalments in respect of FY2017				25,000	68,000	25,000
Dividend paid – FR of 30%	35,000				33,000	25,000
Closing franking credits					33,000	25,000
2018 Financial year: Second year						
Opening franking credits					33,000	25,000
Dividend received – FR of 30%			10,000		43,000	25,000
Dividend received – FR of 27.5%				5,000	43,000	30,000
Income tax refund – 2017 tax return		3,000			43,000	27,000
Income tax instalments in respect of FY2018				22,000	43,000	49,000
Dividend paid – FR of 30%	35,000				8,000	49,000
Closing franking credits					8,000	49,000
2019 Financial year: Third year						
Opening franking credits					8,000	49,000
Dividend received – FR of 30%			7,000		15,000	49,000
Dividend received – FR of 27.5%				8,000	15,000	57,000
Income tax paid – 2018 tax return				5,000	15,000	62,000
Income tax instalments in respect of FY2019				27,000	15,000	89,000
Dividend paid – FR of 30%	15,000				–	89,000
Dividend paid – FR of 27.5%		20,000			–	69,000
Closing franking credits					–	69,000

An illustration of how the credit and debit entries are recorded for the 2017 financial year is provided in *Table A*. At the end of 2017, company A has closing surpluses of \$33,000 (at 30% FR) and \$25,000 (at 27.5% FR).

Transactions of similar nature occur for company A in the 2018 and 2019 financial years. In the 2019 year, company A exhausted the franking credits available at FR of 30%. As such, in 2019, company A is considered to have paid dividends in two tranches: the first with

attached franking credits of \$15,000 subject to imputation rate of 30%, and the second with attached franking credits of \$20,000 subject to imputation rate of 27.5%.

Company B:

‘Old’ franking credits subject to FR of 30% are not utilised within the four-year extension period and the remaining balance is converted to ‘new’ franking credits

In the second example, company B is assumed to have the same tax payment and dividend payment history as company A in the 2017, 2018 and 2019 financial years, except that in 2019 the cash available in company B only allows it to pay dividends with attached franking credits of \$5,000 subject to 30% FR rate (because 2019 is only the third year of the four-year extension period). After crediting \$5,000 in the FR 30% column in 2019, the closing balances in company B’s franking account for 2019 become \$10,000 (at 30% FR) and \$89,000 (at 27.5% FR). The calculations are demonstrated in *Table B* of this appendix.

In the 2020 financial year, company B pays the same amount of dividend as that paid in 2019. As such, company B distributes \$5,000 in franking credits at the imputation rate of 30% in 2020, leaving a closing franking surplus of \$5,000 in the FR 30% column. The closing balance of franking credits subject to FR of 27.5% is \$127,000 for 2020. In this example, an assumption is made that the four-year extension period applies, commencing in 2017 and ending in 2020. Hence, the undistributed ‘old’ franking credits subject to franking based on the 30% tax rate are required to be converted to ‘new’ franking credits (i.e. subject to an imputation rate of 27.5%) in the beginning of the 2021 income year.

In *Table B*, the first entry for the 2021 year is the conversion entry, in which the opening franking surplus of \$5,000 in the FR 30% column is converted to \$4,425 franking credits being added to the surplus recorded in the FR 27.5% column by applying this factor: $70/30 \times 27.5/72.5$. As a result of this entry, the only franking surplus in company B’s franking account as at 1 July 2020 (i.e. beginning of 2021 income year) is \$131,425.

Starting from 1 July 2020, after the extension period is over, all franking entries – both debits and credits – for the 2021 financial year are recorded in the FR 27.5% column. In this example, as at 30 June 2021, the franking balance of company B shows a zero balance in the FR 30% column and a closing franking surplus of \$159,425.

This example has demonstrated how the suggested revision to company franking account can be practically carried out when a company does not exhaust its ‘old’ franking credits, which are based on company tax rate of 30%, in the four-year extension period.

The examples provided in this appendix only illustrate one of the possible methods to manage company franking account when corporate tax rate changes with minimal distortions to the current imputation system.

Table B: Franking Account of Company A – ‘old’ franking credits subject to franking rate of 30% not exhausted within the four-year extension period

Franking rate (FR)	Debit		Credit		Balance	
	30.0%	27.5%	30.0%	27.5%	30.0%	27.5%
2017 Financial year: First year						
Opening franking credits					50,000	
Dividend received – FR of 30%			10,000		60,000	–
Income tax paid – 2016 tax return			8,000		68,000	–
Income tax instalments in respect of FY2017				25,000	68,000	25,000
Dividend paid – FR of 30%	35,000				33,000	25,000
Closing franking credits					33,000	25,000
2018 Financial year: Second year						
Opening franking credits					33,000	25,000
Dividend received – FR of 30%			10,000		43,000	25,000
Dividend received – FR of 27.5%				5,000	43,000	30,000
Income tax refund – 2017 tax return		3,000			43,000	27,000
Income tax instalments in respect of FY2018				22,000	43,000	49,000
Dividend paid – FR of 30%	35,000				8,000	49,000
Closing franking credits					8,000	49,000
2019 Financial year: Third year						
Opening franking credits					8,000	49,000
Dividend received – FR of 30%			7,000		15,000	49,000
Dividend received – FR of 27.5%				8,000	15,000	57,000
Income tax paid – 2018 tax return				5,000	15,000	62,000
Income tax instalments in respect of FY2019				27,000	15,000	89,000
Dividend paid – FR of 30%	5,000				10,000	89,000
Dividend paid – FR of 27.5%		–			10,000	89,000
Closing franking credits					10,000	89,000
2020 Financial year: Fourth year						
Opening franking credits					10,000	89,000
Dividend received – FR of 30%			–		10,000	89,000
Dividend received – FR of 27.5%				15,000	10,000	104,000
Income tax refund – 2019 tax return		2,000			10,000	102,000
Income tax instalments in respect of FY2020				25,000	10,000	127,000
Dividend paid – FR of 30%	5,000				5,000	127,000
Closing franking credits					5,000	127,000
2021 Financial year: Fifth year						
Opening franking credits					5,000	127,000
Conversion of opening balance after 4-year extension (factor of 70/30 x 27.5/72.5)	5,000			4,425	–	131,425
Dividend received – subject to 27.5% FR				15,000	–	146,425
Income tax paid – 2020 tax return				4,000	–	150,425
Income tax paid in respect of FY2021				29,000	–	179,425
Dividend paid – FR of 27.5%		20,000			–	159,425
Closing franking credits					–	159,425

WHEN IS THE COMMISSIONER EMPOWERED OR REQUIRED TO NEGATE A GST BENEFIT?

CYRUS THISTLETON*

I. INTRODUCTION

Competently structured tax legislation tends to minimise tax avoidance by putting in place provisions, which may include specific anti-avoidance provisions, to stop the abuse of the intent of each provision in the tax legislation, even when a scheme is devised to enable avoidance. Even though the policy intent of the legislation may be reflected in the wording of the legislation to a greater or lesser degree, it can be open to different interpretations or can be manipulated to suit the taxpayer's preferred outcome. It is impossible for the legislature to foresee all possible tax avoidance arrangements and to enact a tax provision which has no loopholes for an indefinite period. Despite the existence of some specific anti-avoidance provisions¹ to address particular schemes, general anti-avoidance provisions are put in place to prevent artificial schemes which are designed, solely or principally, for the purpose of obtaining tax benefits by using these loopholes in a manner which is inconsistent with the intent of the legislature.

The leading and the most influential High Court decisions on the general anti-avoidance rules in *FCT v Unit Trend Services Pty Ltd*² (Unit Trend), *FCT v Spotless*³ (Spotless), *FCT v Consolidated Press Holdings*⁴ (Consolidated Press), *FCT v Peabody*⁵ (Peabody) and *FCT v*

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¹ Specific anti-avoidance provisions of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA) such as s 9-75(1)(b) (the value of taxable supplies not expressed in money), s 29-25 (Commissioner may determine particular attribution rule for particular taxable supplies and creditable acquisitions), s 66-10 (amounts of input tax credit for creditable acquisitions of second-hand goods) and s 72-70 (the value of taxable supplies for inadequate consideration between associated persons).

² *FCT v Unit Trend Services Pty Ltd* (2013) 250 CLR 523.

³ *FCT v Spotless Services Ltd* (1996) 186 CLR 404.

⁴ *FCT v Consolidated Press Holdings Ltd* (2001) 207 CLR 235.

⁵ *FCT v Peabody* (1994) 181 CLR 359.

Hart⁶ (Hart) have acknowledged the importance of the general anti-avoidance provisions. In this regard, Sackville J stated that 'it is becoming increasingly apparent that the general anti-avoidance provisions are central to the operation of the Australian tax system'.⁷

Division 165 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA) contains the general anti-avoidance rules for the GST, the wine equalisation tax and the luxury car tax. The general anti-avoidance provisions in the GSTA give the Commissioner the power under s 165-40 of the GSTA to negate the GST benefit obtained from an artificial or contrived scheme when the GST provisions fail to achieve the result intended by the legislature. Division 165 can be applied to an arrangement when an entity, being the avoider, got or gets a GST benefit from a scheme which has the sole or dominant purpose of getting a GST benefit or, alternatively, the principal effect of the scheme is that the avoider gets the GST benefit from the scheme, directly or indirectly. However, the third element (determining the purpose and the principal effect) is controversial and subject to different interpretations. The principal effect test is an extension of the test in Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). Once these requirements are satisfied, the Commissioner is empowered to make a declaration negating the GST benefit.

Although the focus of this article is on Division 165, the author refers, in particular, to Pt IVA court decisions because: (1) Division 165 is based on Pt IVA in many aspects, such as structure and purpose;⁸ (2) there is a paucity of judicial guidance on Division 165; and (3) there are many more income tax avoidance court cases than there are GST avoidance cases.

Despite being a derivative of Pt IVA, Division 165 was written to address the transactional nature of GST, as well as rectifying Pt IVA deficiencies. In this respect, Gyles J in *McDonald's Australia Ltd v FCT*⁹ stated that, Division 165 is 'broadly similar to Pt IVA of the *Income Tax Assessment Act 1936* (Cth), the subject of much litigation, but there are important differences ... both from the different terms of the provisions themselves and from the differences between GST and income tax'.

It should be noted that Division 165 should be considered after specific anti-avoidance provisions fail to prevent the GST benefit as the result of the scheme. Accordingly, in this paper, an example is provided which shows how the specific anti-avoidance provisions are considered prior to application of Division 165.

Since Division 165 does not deal with tax evasion, it is important to distinguish between tax avoidance and tax evasion. In this regard, the author explains, in passing, what constitutes tax evasion and what constitutes tax avoidance.

⁶ *FCT v Hart* (2004) 217 CLR 216.

⁷ Justice R Sackville, 'Avoiding tax avoidance: the primacy of Part IVA' (FCA) [2004] *FedJSchol* 11.

⁸ See Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*, [6.313]

⁹ *McDonald's Australia Ltd v Commissioner of Taxation* [2008] FCA 37 at [16].

The author then provides a detailed examination of the application of Division 165 and takes into consideration the policy intent of the GSTA to examine the circumstances in which the Commissioner should negate the GST benefit. The author writes this article from both a legal and a tax administrator's perspective.

II. SPECIFIC ANTI-AVOIDANCE PROVISIONS

Specific anti-avoidance provisions are to address possible tax avoidance schemes. However, it is impossible for the legislature to foresee all possible tax avoidance arrangements and to enact a tax provision which has no loopholes for an indefinite period. When considering application of Division 165, it is always considered necessary to consider the specific anti-avoidance provisions prior to considering general anti-avoidance provisions.

The following example describes an arrangement, entered into by an entity, which attempts to increase its entitlement to input tax credit (ITC), however, it triggers the specific provisions that stop the rise of the GST benefit. In the absence of such specific provisions, it is considered appropriate to apply Division 165 to negate the GST benefit.

When looking at the GST chain, some businesses are end users where the GST is, in part, an expense to the business, such as acquisitions that attract reduced input tax credit (RITC) under s 70-5 of the GSTA. This may include entities which provide input taxed supplies, such as authorised deposit-taking institutions like banks. The financial supplies are input taxed and therefore, the bank cannot claim ITC for acquisitions it makes in making those supplies. However, there is provision for a special 75 percent ITC entitlement for certain types of services acquired by financial supply providers such as banks. These are called 'reduced credit acquisitions'.

The example is a hypothetical scenario for the purposes of demonstrating how specific anti-avoidance provisions work, as follows:

- 1 Ultimate Head Entity (UHE) is a bank which is a financial supply provider.
- 2 Company A is a member of the broader economic group; however, it is not a member of UHE GST group at the initial stage of the arrangement.
- 3 Company A is a service provider which is not carrying on an enterprise for the purposes of making financial supplies. This entitles the company to 100 percent of the input tax credit for its acquisitions.
- 4 Company A, while sitting outside the GST group, buys a business which has the necessary requirements for providing services to UHE, by utilising going concerns provisions and treating the acquisitions as GST free. These acquisitions are intended to be used exclusively by UHE.
- 5 Immediately afterwards (or some time later), the UHE's GST group representative groups Company A for GST purposes. Subsequently, Company A provides goods and/or services to UHE which is an intra-group transaction. Under the grouping provisions of

GSTA, the supplies and acquisitions made wholly within the group are effectively ignored and not treated as taxable supplies or creditable acquisitions.

- 6 While UHE attempted to increase its entitlement to ITC from 75 percent to 100 percent by entering into this arrangement, it triggers GST specific anti-avoidance provisions to prevent the bank from getting the GST benefit.

In the above scenario, the GST benefit is the loss of revenue resulting from the intra-group transaction. Had the Company A been outside of the GST group when it supplied UHE with the services, then the GST liability of the UHE Group representative would exceed the RITC entitlement of the UHE such that the Commissioner would be in a revenue positive position.

Prior to considering the application of Division 165, it is important to consider specific anti-avoidance provisions to see if the GST benefit resulting from this arrangement could result in an increasing adjustment.

This arrangement gives rise to an increasing adjustment under s 48-55, Division 135 and 129 of the GSTA. An increasing adjustment, for purposes of GSTA, means that the GST liability of UHE GST group is increased due to the fact that the bank acquired a business GST-free as a going concern but intends to use it wholly or partly in making input taxed supplies. These provisions are specific anti-avoidance provisions.

Section 48-55 of the GSTA requires that GST groups be treated as a single entity for the purposes of working out whether the representative member has any adjustments, in particular:

(1A) If:

- (a) while you were not a * member of any * GST group, you acquired or imported a thing; and
- (b) you become a member of a GST group at a time when you still hold the thing;

Then, when the * representative member of the GST group applies section 129-40 for the first time after you became a member of the GST group, the * intended or former application of the thing is the extent of * creditable purpose last used to work out: (c) the amount of the input tax credit to which you were entitled for the acquisition or importation; or (d) the amount of any * adjustment you had under Division 129 in relation to the thing.

Division 129 of the GSTA requires an increasing adjustment because of changes in the extent of creditable purpose.

Division 135 of the GSTA applies in relation to any supply of a going concern. Division 135 states that you have an increasing adjustment if you are the recipient of a sale of a going concern and intend that some or all of the supplies, made through the enterprise to which the supply of the going concern relates, will be input taxed supplies. The GST group representative may have an increasing adjustment when the going concern becomes part of the GST group if its use was to make supplies that were neither taxable nor GST free, on the basis that the GST group is now a single entity.

Therefore, the UHE GST group, as the recipient of a supply of a going concern, has an increasing adjustment to take into account the proportion (if any) of supplies that will be

made in running the concern and that will not be taxable supplies or GST-free supplies. Later adjustments are needed if this proportion changes over time. The amount of the increasing adjustment is as follows:

$$\frac{1}{10} \times \text{Supply price} \times \text{Proportion of noncreditable use}$$

The above specific anti-avoidance provisions are in place to address such schemes. However, when such provisions fail, the general anti-avoidance provisions are available to prevent artificial schemes which are designed, solely or principally, for the purpose of obtaining tax benefits by using such loopholes in a manner which is inconsistent with the intent of the legislature.

III. EVASION AND AVOIDANCE

General anti-avoidance provisions of Division 165 are not generally directed at tax evasion. The distinction between evasion and avoidance can sometimes be a little unclear and may be difficult to recognise in practice. While both result in tax revenue leakage, one, avoidance, is done lawfully through artificial but legitimate activity and the other, evasion, classically carries a factor of clear illegality or fraud. As they say ‘the difference between avoidance and evasion is the thickness of a prison wall’.¹⁰ Although fraud can mean different things in branches of the law, for the purposes of Australian taxation law as a whole, it is common law fraud and not criminal law fraud or equitable fraud. The court in *Kajewski v FCT*¹¹ held that:

Fraud within s 170(2)(a) involves something in the nature of fraud at common law, ie, the making of a statement to the Commissioner relevant to the taxpayer’s liability to tax which the maker believes to be false or is recklessly careless whether it be true or false.

It can therefore be extrapolated that this concept also applies equally to GST law. A good description of fraud in taxation matters was given by Enderby J in *Masterman v FCT; MacFarlane v FCT*.¹² In this case, the taxpayer lodged income tax returns, for a few income years, claiming deductions in respect of employees that did not exist. Enderby J stated that the statements made in these tax returns ‘can only be described as frauds on the Commissioner of Taxation’. Taking this approach, in the context of GST, producing invoices for goods which do not exist or claiming GST that was never paid, in order to maximise GST refunds, constitutes fraud and thus evasion.

¹⁰ Former British Chancellor Denis Healey.

¹¹ *Kajewski v FCT* [2003] FCA 258 at [111].

¹² *Masterman v FCT; MacFarlane v FCT* (1984) 16 ATR 77.

Evasion also includes conduct which is more than avoidance but less than fraud. In this respect, Lord Hobhouse in *Simms v Registrar of Probate*¹³ described evasion as ‘nothing more than intentional avoidance of something disagreeable but less than fraud’.

Evasion is best explained by reference to the judgment of Dixon J in *Denver Chemical Manufacturing v FCT*¹⁴ in which his Honour described evasion as a ‘blameworthy act or omission on the part of the taxpayer’.

Williams J in *Barrripp v FCT (NSW)*¹⁵ explained tax evasion in the following way:

Where a taxpayer makes a profit which he knows to be taxable income and wilfully omits this profit from his income tax return, he would be guilty of evasion in the absence of some satisfactory explanation for the omission.

Accordingly, tax evasion requires the presence of two elements: (1) the act itself such as a false statement or deliberate omission; and (2) the ‘guilty’ mind of the taxpayer who knows he is doing something wrong and recklessly ignores the true position.

Gleeson CJ in *R v Meares*¹⁶ distinguished between ‘avoidance’ and ‘evasion’, in the following way:

‘Tax avoidance involves using, or attempting to use, lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful ... It is sometimes said that the difference may be difficult to recognise in practice. I would suggest that in most cases there is a simple and practical test that can be applied. If the parties to a scheme believe that its possibility of success is entirely dependent upon the revenue authorities never finding out the true facts, it is likely to be a scheme of tax evasion, not tax avoidance.’

Tax avoidance was defined by the *Review of Business Taxation*:¹⁷

Tax avoidance may be characterised as a misuse or abuse of the law rather than a disregard for it. It is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by the Parliament but also includes manipulation of the law and a focus on form and legal effect rather than substance. The way things are done in order to take advantage of structural loopholes, or to dress up something to satisfy form but not substance can also stamp an arrangement as avoidance.

Characteristics of a tax avoidance scheme would be qualities such as ‘artificiality’, ‘undue complexity’ and ‘circularity’, or ‘lack of business reality’.¹⁸

¹³ *Simms v Registrar of Probate* (1900) AC 332 at [334].

¹⁴ *Denver Chemical Manufacturing v FCT* (1949) 79 CLR 296 at [313].

¹⁵ *Barrripp v FCT (NSW)* (1941) 6 ATD 69 at [72].

¹⁶ *R v Meares* (1997) 37 ATR 321 at [323].

¹⁷ *Review of Business Taxation*, A tax system redesigned, July 1999, at [243].

¹⁸ *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2005] STC 1 at [24], citing Park J in the High Court.

It should be noted that tax avoidance is different from legitimate tax planning or tax mitigation. Legitimate tax planning is a way in which a taxpayer structures his or her business and taxation affairs, in compliance with taxation laws, to arrive at the lowest possible tax cost. This is not against the intent of the legislature. Lord Templeman, in *CIR (NZ) v Challenge Corporation*, stated that there is a difference between acceptable tax mitigation to which the general anti-avoidance rules do not apply and unacceptable tax avoidance to which the general anti-avoidance rules applies.¹⁹

There is also a situation where taxpayers avoid paying GST liability or other tax liabilities to the Commissioner by phoenixing where the tax liability becomes no longer accessible by means of the systematic liquidation of related entities. The aim of phoenixing is simply to avoid payment of a tax liability, employee entitlements and creditors.

In phoenixing, the directors of the company leave the debts with the old company and place the company into liquidation, leaving no assets to pay creditors. In the meantime, another company is registered and operated by the same 'controlling mind' and continues the same business under a new structure.

For tax purposes, a phoenixing arrangement is concerned with the stripping of assets of companies and trusts before tax liability is due or collected; and schemes under which a tax liability falls on a company or trust that is never intended to have sufficient assets to meet its tax liability. This is neither avoidance nor evasion. It is not avoidance because the GST liability already exists. It is not fraud or evasion as the liquidation is not illegal and it would be difficult to establish the fraudulent intention of the directors to lift the corporate veil. However, director's penalty notices and *Crimes (Taxation Offences) Act 1980* (Cth) could restrict phoenixing. There are cases where the Commissioner has sought to apply the provisions of this Act such as in *R v Ditford*.²⁰

GST avoidance could also be in the way of altering the timing of payments of GST or refunds as was decided in *VCE v FCT*.²¹ *VCE* concerned an arbitrage opportunity through a transaction exploiting differences in the timing for payment and accounting for GST differently, one on cash and the other on accrual. *VCE* claimed an input tax credit when it entered into an agreement to purchase a medical centre payable over an approximately 15-year period, while the vendor was only paying GST when consideration was received. The Commissioner disallowed *VCE*'s claim under Division 165. The Administrative Appeals Tribunal (AAT) found that the taxpayer got a GST benefit and Division 165 was applied to negate the benefit.

In the absence of fraud or evasion, GST anti-avoidance provisions, unlike Pt IVA, have a time limit in which they may be applied. The effective time limit for the Commissioner to make a

¹⁹ *Commissioner of Inland Revenue v Challenge Corporation Ltd* [1987] AC 155 at [167]-[168]. See also the decision of the New Zealand Court of Appeal in *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450 at [39], where the majority drew the line between legitimate tax planning and improper tax avoidance.

²⁰ *R v Ditford* 87 ATC 4678 and 91 ATC 4423.

²¹ *VCE and FCT* [2006] AATA 821.

declaration under s 165-40 is within four years after the time GST became payable by an entity.²²

GST is highly susceptible to evasion and not quite so easily susceptible to avoidance. The obvious situation is where a transaction is a sham with fraudulent GST refund claims or where GST is simply not paid, in respect of a taxable supply, by deliberate underreporting of taxable supplies. Legislation can deal with evasion by criminalising it. It can impose penalties on those who are caught in the act. However, detection and prosecution are the problems.

Since the general anti-avoidance provisions are not generally directed at tax evasion, the act of GST minimisation, for the purposes of Division 165, should fall within the scope of tax avoidance.

IV. APPLICATION OF DIVISION 165

Division 165 is aimed at artificial and contrived transactions that are, in themselves, real and lawful but which nonetheless breach the normal or expected operation of the GSTA. Its object is to deter schemes that would produce GST benefits, such as reducing GST, increasing refunds, or altering the timing of payment of GST or refunds where the dominant purpose or principal effect is to get GST benefits.²³ Not all of the GST benefits obtained by taxpayers constitute GST avoidance.²⁴ An outcome of reduction in GST would hardly seem to be GST avoidance if it comes about accidentally as part of ordinary commercial transaction. Although there is no carve-out for commercial transactions, commercial explanation does not negate Division 165. While the legality and commercial reasoning behind the transaction needs to be considered carefully, it should not prevent the application of Division 165 when some provisions are utilised in a manner not intended by the legislature. In this respect, the New Zealand High Court in *Miller v Commissioner of Inland Revenue*²⁵ held that:

It is the very nature of tax avoiders to manoeuvre skilfully around the express rules of the general law and the tax legislation and end with the innocent submission - as I have not infringed them I have succeeded. That is the very reason for generally expressed anti-avoidance provisions which begin their operation when other provisions have had their effect.

The AAT in *Unit Trend* acknowledged that the fact that a transaction is genuinely commercial does not exclude the application of Division 165.²⁶

²² See *Taxation Administration Act 1953* (Cth), ss 105-5 and 105-50 in Schedule 1.

²³ Explanatory Statement to GSTA, s 165-1. The explanatory statement is quite important. Although they do not have operative force in themselves, they may be considered in determining the purpose or object underlying the legislation (s 182-10 of the GSTA).

²⁴ GSTA, 165-5(1)(b).

²⁵ *Miller v Commissioner of Inland Revenue* (1996) 17 NZTC 13,001.

²⁶ *The Taxpayer and FCT* [2010] AATA 497 at [114].

... even if the ultimate objective of the transaction is genuinely commercial or the transaction producing the GST benefit also delivers a desired non tax commercial outcome, Division 165 may still operate. Division 165 might apply if there is enough in the way in which a transaction is entered into or carried out, viewed through the prism of the matters listed in s 165-15(1) of the GSTA, that the purpose of obtaining the GST tax benefit outweighs the commercial objectives. The greater the degree of artificiality or contrivance in the transaction directed to obtaining the GST benefit the greater the prospect that the commercial pursuits of the transaction will not be dominant.

V. UNIT TREND

Unit Trend, a property developer, was the representative member of a GST group of companies which, at the relevant time, included Simnat Pty Ltd, Blesford Pty Ltd and Mooreville Investments Pty Ltd. Different members of the Unit Trend GST group were allocated different roles in the property development. In this case, when construction of the project was at an advanced stage, Simnat sold the project as going concern to Blesford and Mooreville, which completed the project and sold the completed individual residential units to buyers.

The group members used grouping and going concerns provisions and applied margin scheme which resulted in reducing the amount of GST payable by GST group on the ultimate sales of individual residential apartments. The choices and elections that the GST group made which were specifically allowed under GSTA are:

- The choice to form the GST group;
- The choice of intra-group transactions;
- The choice to treat the sales as a supply of a going concern; and
- The choice to apply margin scheme to final sales of the individual residential apartments which means the GST was payable on the difference between the purchase and sale price, rather than on the sale price alone).

The Commissioner issued a declaration to Unit Trend under the anti-avoidance provisions in Division 165 negating the GST benefit. This declaration was contested by Unit Trend in the AAT which found in favour of the Commissioner. The AAT's decision was subsequently overruled by the Full Court in favour of Unit Trend. The Full Court held that the GST benefit obtained by Unit Trend was attributable to the making of a choice, election, application or agreement expressly provided for by the GSTA and, therefore, Division 165 did not apply. On appeal by special leave to the High Court, the issue before the Court was whether the GST benefit obtained by Unit Trend was not attributable to the making of a choice, election, application or agreement that was expressly provided for by the GST Act.

The High Court in *Unit Trend* considered the purpose of Division 165, and took into account the legislative intent of the supplementary explanatory memorandum to *A New Tax System*

(*Goods and Services Tax*) Bill 1998.²⁷ Further, the High Court in *Unit Trend* considered the ‘election exclusion’ contained in s 165-5(1)(b) GSTA. This saving provision can only be applied to protect the taxpayer where the arrangement is not artificial. The High Court confirmed that Division 165 can still be applied when an entity is taking advantage of an election, which was found in the GSTA, in a way that is not consistent with the policy and object of the provision that grants the choice.

The High Court decision in *Unit Trend* also supports the view that Division 165 is focused on the objective purpose or effect of the arrangement and not the motive or subjective purpose of the taxpayer.²⁸

The decision of High Court in *Unit Trend* is important in the application of Division 165 because the High Court acknowledged that the High Court cases such as *Spotless*, *Consolidated Press*, *Hart* and *Peabody* that dealt with Pt IVA are important authorities in dealing with Division 165 in relation to identifying the scheme, the tax benefit as well as the dominant purpose of the scheme and should also be applied in the context of Division 165. Moreover the importance of *Unit Trend* is the clarification of the exclusion in 165-5(1)(b). This is the first time that the application of the exclusion has been tested in the High Court.

A. *The elements of Division 165*

(a) *GST benefit*

A ‘GST benefit’ is defined in s 165-10(1) of the GSTA. An entity gets a GST benefit by (Any of these effects are a GST benefit):

- reducing GST liability, either by not paying or by paying less;²⁹
- obtaining or increasing GST refunds;³⁰ or
- timing benefits, such as altering the timing of GST payment (eg pays GST later) or GST refunds (e.g. gets a refund earlier).³¹

A taxpayer may obtain a variety of tax benefits from the same scheme. However, for the purposes of Division 165, the dominant target of the scheme should be a GST benefit. The definition of ‘GST benefit’ for the purposes of Division 165 is different from the definition of ‘tax benefits’ in Pt IVA. This is because the nature of GST and income tax are different as they have different bases.

²⁷ *FCT v Unit Trend Services Pty Ltd* (2013) 250 CLR 523 at [53].

²⁸ Michael Evans, ‘GST – It’s Not a Matter of Choice: *Commissioner of Taxation v Unit Trend Services Pty Ltd*’ on Opinions on High (5 July 2013) <http://blogs.unimelb.edu.au/opinionsonhigh/2013/07/05/evans-unittrend/>.

²⁹ GSTA, s 165-10(1)(a).

³⁰ GSTA, s 165-10(1)(b).

³¹ GSTA, ss 165-10(1)(c) and (d).

An obvious example of what constitutes a GST benefit is an inordinate deferred settlement arrangement while claiming an input tax credit today for the expected future value of the property to be paid in future.³²

There may be situations where the GST benefit obtained does not attract anti-avoidance provisions:

- offering delivery-inclusive prices rather than charging delivery separately for GST-free goods. In this case, delivery is incidental to the supply of those GST-free goods and, thus, there is no GST payable on the value of the portion attributed to delivery costs as the delivery is not contractually separate from the sale of the GST-free goods. This is a common commercial arrangement and accepted internationally;
- formulating a product to bring the supply of that product within the GST-free category, such as increasing the fruit juice content of a beverage from 85 percent (subject to GST) to 90 percent (GST-free) in order to achieve GST-free status;
- an exporter electing to have monthly tax periods in order to bring forward the entitlement to input tax credits; or
- a supplier of child care applying to register under the *Childcare Rebate Act 1993* (Cth), which makes the supplies of child care GST-free.

Identifying the GST benefit requires an examination of what could reasonably have been expected to be the position when viewed independently from the scheme; a reasonable counterfactual which involves a reasonable expectation test.

(b) *What is a 'reasonable expectation'?*

The enquiry directed by Division 165 requires comparison between the scheme in question and an alternative hypothesis based on the reasonable expectation test in the context of the definition of tax benefit.

The High Court in *Peabody* explained reasonable expectation as follows:³³

A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.

When identifying the GST benefit raised from a scheme, ss 165-10(1)(a), (b), (c) and (d) of the GSTA refers to 'could reasonably be expected'. In other words, what could reasonably be expected to have happened if the scheme had not been entered into or carried out? The use of the word 'could' rather than 'would' appears to set a lower degree of satisfaction.

There are many factors to consider when applying the reasonable expectation test, but a few of them are more reasonable and, in the author's opinion, give more weight to a reasonable counterfactual scenario:

³² See cases such as *VCE and FCT* [2006] AATA 821 and *Ch'elle Properties (NZ) Ltd v Commissioner of Inland Revenue* [2007] NZCA 256.

³³ *FCT v Peabody* (1994) 181 CLR 359 at [42].

- the most straightforward and usual way of achieving the commercial and practical outcome of the scheme (disregarding the tax benefit);
- commercial norms, for example, standard industry behaviour; and
- the behaviour of relevant parties before/after the scheme compared with during the period of operation of the scheme.

If the scheme includes some significant commercial effect (ignoring the GST benefit), then it is important to see if another counterfactual scenario can achieve the same result but without the GST benefit. When comparing different counterfactuals, it is possible for different conclusions to be reached as to what could reasonably be expected to have happened if the particular scheme had not been entered into or carried out. According to the explanatory memorandum,³⁴ ‘enquiry will be in relation to the most economically equivalent transaction to the scheme or part of the scheme actually entered into or carried out’.

While it may be difficult to find the most reasonable transaction, the one that creates the most economically equivalent transaction to the scheme and which generates the same commercial result and practical outcome without the GST benefit would be the most reasonable one to choose. Interestingly, unlike Pt IVA, even where there is no other alternative scenario, s 165-10(3) provides that a GST benefit can still arise ‘even if there is no economic alternative’. In this respect, the explanatory memorandum states that:³⁵

‘An entity that gets a GST benefit from a scheme, even if the entity claims it would not have entered into any type of transaction had the actual scheme not been entered into can still have that GST benefit negated.’

Accordingly, s 165-10(3) empowers the Commissioner to apply Division 165 in circumstances where the taxpayer claims that no GST benefit arises from the scheme because in its absence, nothing would have happened.

In the author’s opinion, it is reasonable to conclude that it only needs to be found that there is a GST benefit, as the result of the scheme, when the scheme was artificial and had no commercial benefit or outcome other than the obtaining of the GST benefit or perhaps other tax benefits.

(c) *What constitutes ‘an amount’?*

Section 165-10(1)(a), (b), (c) and (d) refers to ‘an amount’ or ‘part of an amount’ which is a particular quantum of money, whether cash or equivalent, either payable to or payable by the entity. Amount includes a nil amount.³⁶

³⁴ Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*, [6.334].

³⁵ *Ibid* [6.335].

³⁶ GSTA, s 195-1.

(d) Which amount constitutes the GST benefit?

Section 165-10(1)(a) deals with that part of the GST benefit involving the actual amount payable by the entity to the Commissioner (including nil amount) being reduced from the amount that should have been paid.³⁷ An obvious scenario is where the taxable supply is converted to GST-free supplies, as the result of the scheme, so the liability of the entity to the Commissioner in respect of that transaction is reduced to nil amount. The amount equal to the reduction in GST for that transaction is the GST benefit. It is irrelevant to say that the GST is paid by one entity (third party) and claimed back as a creditable acquisition and therefore there is no GST benefit since it is revenue neutral. But, in fact, when applying s 165-10(1)(a) to calculate the GST benefit, you consider the liability of the avoider, rather than trading it off against the third party input tax credit to the transaction if the acquisition is a creditable acquisition.

Section 165-10(1)(b) deals with that part of the GST benefit involving the actual amount payable by the Commissioner to the entity being increased from the amount that should have been paid.³⁸ An obvious scenario is where input taxed supplies are converted to GST-free supplies as the result of the scheme so the entity can have a full refund for the GST paid on the acquisitions. The GST benefit in this situation is the increase in the claim for input tax credit.

Section 165-10(1)(c) and (d) deals with the timing benefit which arises from the payment of GST, either in delaying the payment or in claiming it. The GST benefit in these situations will be the time value of the money irrespective of how small it is.

(e) What is the 'net amount'?

According to the explanatory memorandum, the net amount refers to the combined effect of s 165-10(1)(a) and (b) where a net amount payable by an entity to the Commissioner is reduced to nil or converted into a refund payable by the Commissioner to the entity.³⁸

(f) Is it important for the GST benefit not to be attributable to the taxpayer making an election that is expressly provided for by the GSTA?

When an entity obtains a GST benefit, following the choices and elections that the entity makes, which is specifically allowed under the GSTA, the question is, can the anti-avoidance provisions apply in this situation? This issue concerns s 165-5(1)(b) and (3) GSTA. The election exclusion rule in s 165-5(1)(b) sets the following conditions, for the Commissioner, in negating a GST benefit:³⁹

³⁷ Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*, [6.331]

³⁸ *Ibid.*

³⁹ GSTA, s 165-5(1)(b).

(b) the GST benefit is not attributable to the making, by any entity, of a choice, election, application or agreement that is expressly provided for by the GST law, the wine tax law or the luxury car tax law.

This section was included in the GSTA, when the GSTA was introduced, to ensure that the exercise of an express choice, allowed under the GSTA, would not trigger Division 165.

The High Court in *Unit Trend* examined the election exclusion contained in s 165-5(1)(b). In this case, the High Court emphasised that the real test in s 165-5(1)(b) is not whether a GST benefit is attributable to a statutory choice but, rather, whether the GST benefit was not attributable to a statutory choice. Their Honours took the view that the Federal Court mistakenly focused on the word 'attributable' rather than the phrase 'not attributable to'.⁴⁰

However, this created problems in regard to arrangements which were specifically allowed under the GSTA but where the abuse of these provisions created a situation where the taxpayer may argue that the benefit was received and is attributable to the choice which is specifically allowed under the GST law. The language in s 165-5(1)(b) contrasts with the language in the income tax anti-avoidance rule: s 177C(2)(a)(i) of the ITAA36. This rule provides that a tax benefit that 'is attributable' to the making of the choice is not a tax benefit obtained by a taxpayer in connection with a scheme.

Greenwood J in *Walters v FCT* stated that:⁴¹

The phrase in s 177C(2)(a)(i) 'attributable to' the particular election, choice or event means that there must be a direct relationship between the non-inclusion of the relevant amount and the choice or election made by the taxpayer.

Despite the 'not attributable to' issue, s 165-5(3) (creating circumstances or states of affairs) was inserted by the *Tax Laws Amendment (2008 Measures No. 5) Act 2008* (Cth) with effect to choices and elections made after 9 December 2008. The insertion of s 165-5(3) was intended to overcome the problems faced by the Commissioner when considering artificial schemes, even though the explanatory memorandum accompanying the amending legislation stated that this is to confirm the existing law. Section 165-5(3) states that:⁴²

- (3) A GST benefit that the avoider gets or got from a scheme is not taken, for the purposes of paragraph (1)(b), to be attributable to a choice, election, application or agreement of a kind referred to in that paragraph if:
- (a) the scheme, or part of the scheme, was entered into or carried out for the sole or dominant purpose of creating a circumstance or state of affairs; and
 - (b) the existence of the circumstance or state of affairs is necessary to enable the choice, election, application or agreement to be made.

⁴⁰ *FCT v Unit Trend Services Pty Ltd* (2013) 250 CLR 523 at [33].

⁴¹ *Walters v FCT* (2007) 67 ATR 156 at [83].

⁴² GSTA, s 165-5(3).

Therefore, if the taxpayer creates circumstances and a state of artificial affairs, which ultimately provides the GST benefit, then the scheme is not taken, for the purposes of Division 165, to be attributable to a choice, election, application or agreement of a kind referred to in that provision. The High Court in *Unit Trend* acknowledged that when applying the election exclusion in s 165-5(1)(b), you do not need to find a causal link between the relevant choice or election and the GST benefit.

It is considered by some GST pundits that Division 165 will not apply to a situation where GST benefit is obtained through grouping provisions in Division 48. It should be noted that certain choices such as the choice to group may be necessary for a scheme to work. Where the grouping is artificial, and mainly for the purposes of tax benefits, it is irrelevant to say that the non-payment of GST is attributable to the making of a choice expressly provided for under the GSTA. In the author's opinion, Division 165 should apply in cases where grouping provisions are used in a scheme to get the GST benefit directly or which enable the entity to also get other GST-related benefits indirectly.

B. *GST wash transactions*

A GST 'wash' transaction is one where a supplier who is registered for GST fails to include GST in the price of a taxable supply and remit it to the ATO; the supply in question is then made to a recipient who is registered for GST, and would have been a creditable acquisition with the entitlement to claim back, from the ATO, a full input tax credit if the transaction had been correctly treated as taxable by the supplier. The term 'wash' refers to the fact that the effect is revenue neutral.

This could, however, be achieved as a result of a scheme in which a supply made by a GST-registered entity, that would otherwise be a taxable supply, is treated as either a GST-free supply or not a taxable supply.⁴³ The GST-free supply is made to another GST-registered entity. Based on the classification of the transaction, there is no GST liability for the supplier and no ITC entitlement for the recipient. From an ATO perspective, this is a wash transaction as it is revenue neutral. The question arises as to whether the general anti-avoidance rule can be applied in this situation.

It is important to note that Division 165 can still be applied to a GST wash transaction, described above, as you consider the liability of the avoider rather than trading it off against the potential ITCs claimable by the acquirer. That means the GST position of each entity is considered separately to the transaction. It is irrelevant to say that there is no net GST loss to the ATO on the overall net GST position of both entities. However, if this interpretation is

⁴³ For example, under Division 48 of the GSTA (grouping provisions), the supplies and acquisitions made wholly within the group are effectively ignored and not treated as taxable supplies or creditable acquisitions.

taken, then there will be compensating adjustments under 165-45 on the 'losers' net amount.⁴⁴

The application of a wash transaction only has an impact when considering the application of, or remission to, shortfall penalties and/or general interest charges.

C. *The GST benefit must arise 'from' a 'scheme'*

(a) *What is a 'scheme'?*

'Scheme' is defined broadly in s 165-10(2) to include any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise. In establishing whether there is a scheme, the purpose of the scheme is irrelevant. "The focus of the enquiry is on the purpose of the persons who entered into or carried out the scheme. It is not an enquiry into any purpose of the scheme."⁴⁵ The term 'from' in Division 165 suggests that the benefits must flow from the scheme, that is, the scheme must result in the tax benefit.

Due to the wide definition of scheme in the context of GST, it would be easy to establish, under any circumstances, that a scheme exists. Obviously, the scheme cannot be a mere proposal. It should include both actions and courses of conduct. Scheme is an essential part of Division 165, as any GST benefit identified must be related to the scheme and flow from the scheme, as must any conclusion of sole, dominant purpose or the principal effect.⁴⁶

(b) *What is 'part of a scheme'?*

Unlike the Pt IVA provisions, the GST benefit can arise from a single transaction which is part of the scheme. This reflects the nature of GST as being a transaction-based tax.⁴⁷ This does not mean that part of the scheme is a scheme itself, but it appears that Division 165 can be applied to part of a scheme and not necessarily to the full scheme. The scheme can be found in individual steps or, more often, in a combination of steps. In *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*,⁴⁸ the New Zealand Supreme Court held that:

Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise be a permissible arrangement into a tax avoidance arrangement ... Thus tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps of an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement ... [The GAAR's] function is to prevent uses of the specific provisions which fall outside their

⁴⁴ Section 165-45 of the GSTA provides that where an entity gets a GST disadvantage due to another entity getting a GST benefit, the Commissioner may make an adjustment to compensate the disadvantaged entity.

⁴⁵ *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at [423]; Hart (2004) 217 CLR 216 at [63] per Gummow and Hayne JJ.

⁴⁶ *FCT v Unit Trend Services Pty Ltd* (2004) 217 CLR 216 at [41] per Hill J.

⁴⁷ Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*, [6.336].

⁴⁸ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115 at [104].

intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract.

(c) *Territorial application*

A scheme may involve international dealings. This does not preclude the operation of Division 165. Section 165-5(2) provides that ‘it does not matter whether the scheme, or any part of the scheme, was entered into or carried out inside or outside Australia’.

D. *Sole or dominant purpose, principal effect*

Section 165-5(1)(c) requires the existence of one of the following:

- (i) an entity that (whether alone or with others) entered into or carried out the scheme, or part of the scheme, did so with the sole or dominant purpose of that entity or another entity getting a GST benefit from the scheme; or
- (ii) *the principal effect of the scheme, or of part of the scheme, is that the avoider gets the GST benefit from the scheme directly or indirectly; (emphasis added)*

The way in which the sole or dominant purpose is pinpointed has similarities to the way in which the principal effect is pinpointed, albeit with some slight differences.

The inquiry under s 165-5(1)(c) is as to the purpose of the person or persons who entered into or carried out the scheme and it is not to the purpose of the scheme itself.⁴⁹ The AAT in *VCE* confirmed this and stated that it is not the purpose of the scheme that should be the focus of the enquiry, but rather the purpose of those who entered into or carried out the scheme. The person or persons may be, but need not be, the taxpayer.⁵⁰

Sole purpose is too narrow in scope and can be hard to quantify. But this is what the law says. If there is more than one purpose, the sole purpose test cannot, by definition, apply. If the scheme has a number of purposes, then all purposes are examined and decide which one is dominant. Each purpose must be tested by reference to the specified factors. But what is important to consider is the fact that what is planned and done should be for the purpose of getting GST tax benefits, providing the GST benefit can be identified and the purpose/effect tested against it. It should be noted that some schemes which may produce a GST benefit may also produce other tax benefits. The taxpayer usually takes actions that have advantageous tax consequences and which are entered into deliberately with a view to gaining those advantages. This can be tested against what is dominant. When the scheme is found to have two or more purposes, or effects, the effect or purpose can be considered in relativity to other purposes or effects, or to a purpose with more than 50 percent dominance. Dominant purpose or principal effect indicates the purpose or effect which is the ‘ruling,

⁴⁹ *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at [417]; *FCT v Hart* (2004) 217 CLR 216 at [63]; *FCT v Sleight* [2004] FCAFC 94 at [67] per Hill J (with whom Hely J agreed).

⁵⁰ *FCT v Hart* (2004) 217 CLR 216 at [35].

prevailing or most influential purpose', as was held in *Spotless*⁵¹ by the High Court. If the scheme results in multiple tax benefits and if the GST benefit obtained by the scheme is not the dominant purpose or the principal effect of the scheme, then Division 165 cannot not be applied.

In respect of sole or dominant purpose, where the taxpayer argues that the purpose of the scheme is commercial, a question arises as to what extent the scheme actually achieved the desired commercial outcomes.

The difference between purpose and the effect of a scheme is at times lacking in clarity. The purpose of a scheme can be described as 'the effect which it is sought to achieve'.⁵² The ATO in Practice Statement PS LA 2005/24 stated that the effect test focuses on the results of the scheme, rather than the purpose of the participants.⁵³ The net result is that the focus is on the scheme itself, rather than on the participants.

The Explanatory Memorandum to s 165-5(1)(c) clarifies this state of affairs by saying that 'it applies specifically to the avoider and the GST benefit obtained by the avoider'⁵⁴ and it is necessary for the effect to be 'an important effect, as opposed to merely an incidental effect'.⁵⁵ The revised explanatory memorandum provides further clarification:⁵⁶

The principle [sic] effect test only applies to the entity and does not look at the effect on other entities. For this test, principal effect means an important effect, as opposed to merely an incidental effect. This is in contrast to the dominant purpose which is concerned about the prevailing or most influential purpose of the scheme.

Therefore, the purpose test focuses on the participants in the scheme, while the effects test focuses on the result of the scheme.

Where the scheme has a number of purposes or effects, the question will be which appears to be the dominant one or the principal one, that is, to say the one that is most significant. Many schemes which may produce a GST benefit may also produce a tax benefit for income tax purposes.

⁵¹ *FCT v Spotless Services Ltd* [1996] 186 CLR 404 at [416].

⁵² *Newton v FCT* (1958) 98 CLR 1 at [2]; see also *Insomnia (No. 2) Pty Ltd and Insomnia (No. 3) Pty Ltd v FCT* (1986) 84 FLR 278 at [290] per Murphy J; and Justice G Hill, 'Scheme New Zealand or an example of the operation of Div 165' (2003) 1 *eJournal of Tax Research* 147 at [156].

⁵³ Practice Statement PS LA 2005/24: Application of General Anti-Avoidance Rules, [215]. This Practice Statement provides instruction and practical guidance to the ATO officers on the application of General Anti-Avoidance Rules (GAARs). Officers proposing to make a determination under section 165-40 GSTA should follow this practice statement. This practice statement also outlines the role and operation of the GAAR Panel of the ATO.

⁵⁴ Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*, [6.344]; see *The Taxpayer and FCT* [2010] AATA 497.

⁵⁵ Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1998*, [6.345].

⁵⁶ Explanatory Memorandum to the *A New Tax System (Tax Administration) Bill (No. 2) 2000*, [1.95].

Multiple purpose schemes are usually aimed at a few types of tax and there are usually no rational commercial grounds to enter into such a scheme. A good example of a multiple purpose scheme can be seen in transactions involving property. Transfer of property attracts three types of tax, these being stamp duty, GST and income tax. In a property transaction, taxes such as stamp duty would be applicable to the GST-inclusive value of the property transaction making the application of GST more important. To the best of the author's knowledge, there has not yet been an anti-avoidance case that considers this scenario.

Section 165-15(1) GSTA lists a range of matters which are to be taken into account in determining the entity's purpose in entering into or carrying out the scheme. The factors listed in s 165-15(1) need to be considered objectively. The inquiry into the purpose is not the actual purpose of the relevant person. It is an objective one having regard to, and only to, the 12 matters identified in s 165-15(1).⁵⁷

There are 12 factors that must be objectively considered by the Commissioner. The objective enquiry is not about the purpose of entering into the transaction, but a conclusion based on the application of objective facts into the 12 factors.

Some of the matters may point one way, others may point in the opposite direction and some may be neutral. Each of the 12 factors must be taken into account to make a conclusion concerning dominant purpose.⁵⁸

(a) *The manner in which the scheme was entered into or carried out (s 165-15(1)(a))*

In *Spotless*, the joint judgment of six of the Justices of the High Court stated that:⁵⁹

'Manner' includes consideration of the way in which and method or procedure by which the particular scheme in question was established.'

The manner in which the scheme is carried out, for avoidance purposes, usually demonstrates some level of unnecessary complexity which is unusual in the ordinary commercial sense.

The transactions may be carried out for commercial purposes; however, the structured way that the scheme is entered into and carried out usually suggests careful planning and should be justifiable mainly for taxation consequences. Where a simple transaction is carried out with a high level of complexity, it is little wonder that questions should be asked regarding why it should be so.

In *Hart*, the High Court held that consideration of the manner in which the scheme was entered into or carried out is important; this involves unusual features designed to confer a tax benefit not otherwise available.

In *Consolidated Press*, the court concluded that the interposed company lacked any reason for being, other

⁵⁷ *FCT v Hart* (2004) 217 CLR 216 at [65]; *FCT v Sleight* [2004] FCAFC 94 at [67]; *FCT v Zoffanies Pty Ltd* (2003) 132 FCR 523 at [53]-[54].

⁵⁸ *FCT v Consolidated Press Holdings Ltd* (2001) 207 CLR 235 at [94].

⁵⁹ *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at [420].

than to create a tax benefit.

The arrangement is usually structured by some tax experts or based on the advice of tax advisers promoting the arrangements.

While this factor in isolation would not be determinative, the Commissioner will give this factor a great weight.

(b) *The form and substance of the scheme (s 165-15(1)(b))*

Form and substance are probably the most usual indicia of tax avoidance and can include:

- the legal rights and obligations involved in the scheme; and
- the economic and commercial substance of the scheme.

The desired effect of tax planning is to manipulate the form of business transactions in order to maximise the taxpayer's profit. A difference between the commercial and practical effect of a scheme, on the one hand, and its legal form on the other may indicate the scheme has been implemented in a particular form to obtain the GST benefit.

The Full Federal Court's decision in *FCT v Sleight*⁶⁰ and *Pridecraft Pty Ltd v FCT*⁶¹ shows the importance of looking at the substance of arrangements, in particular the commercial and financial substance of arrangements, when making a conclusion concerning dominant purpose.

The period over which the scheme was carried out also impacts on form. Generally, the more short-lived the scheme, the more likely it is to lead to the conclusion of avoidance. It can be presupposed that the form of any tax avoidance transaction will be that which results in the desired GST effect.

(c) *The purpose or object of the GSTA and any relevant provision of the GSTA whether expressly stated or not (s 165-15(1)(c))*

It is necessary to assess the purpose and intent of the relevant legislative provisions in the GSTA which were used by the scheme. It is, therefore, important to consider the legislative purpose of any act. Division 165 is aimed at artificial and contrived schemes that are, in themselves, real and lawful but which nonetheless breach the normal or expected operation of the GSTA and, therefore, that purpose of the Act is, to some extent, frustrated. The policy intent of the Act and the provisions can be manipulated to suit the taxpayer's preferred outcome by entering into an artificial and contrived scheme. In arriving at an appropriate conclusion, the overall intent of the GSTA policy objectives should be considered. This is where the Commissioner should look at the policy intent of the relevant provision to see whether it has been defeated.

⁶⁰ *FCT v Sleight* [2004] FCAFC 94 at [33]-[36].

⁶¹ *Pridecraft Pty Ltd v FCT* [2004] FCAFC 339.

It is contrary to the legislative purposes of the GSTA for an entity to obtain a GST benefit where GST on the transaction is avoided or reduced.

(d) *The timing of the scheme (s 165-15(1)(d))*

The reference to timing is directed at the question of when the particular scheme is entered into or carried out, as well as considering the GST law at the time.⁶²

Consideration of the timing of the occurrence of key steps in the scheme (e.g. immediately or shortly after one another) is also important.

The fact that a scheme is entered into shortly before the end of a tax sensitive date such as the date of a change in the rate of GST (e.g. a future change from 10 percent to 15 percent) and carried out for a brief period may point to the purpose of obtaining a tax benefit.

(e) *The period over which the scheme was entered into and carried out (s 165-15(1)(e))*

The period over which the scheme is entered into and carried out is an important factor. The more short-lived the scheme, the more likely it is to give rise to the conclusion of avoidance.⁶³ In *Futuris*, the court considers whether the steps were carried out in a 'flurry of activity'.⁶⁴ In this case, the transactions were carried out and completed within minutes of each other leading to a conclusion of a dominant tax purpose.

In *Sleight and Vincent v FCT*,⁶⁵ the courts considered whether there was a connection between the timing and the flow of funds by the scheme. It was recognised that if the timing and flow of funds of the scheme are needed for a tax benefit to be produced, then the conclusion of a dominant purpose is more likely to be ascertained.

It should be noted that some schemes are carried out over a long period and not a short period. In this situation, this factor has less weight in the anti-avoidance conclusion.

(f) *The effect that the GSTA would have in relation to the scheme apart from Division 165 (s 165-15(1)(f))*

This factor deals with the effect of the scheme without considering Division 165; whether a GST benefit exists. The GST liability under the arrangement is almost inevitably reduced or nullified.

⁶² *The Taxpayer and FCT* [2010] AATA 497 at [115], with reference to *FCT v Mochkin* (2003) 52 ATR 198 at [45]; *Vincent v FCT* (2002) 193 ALR 686 at [93]; *CPH Property Pty Ltd v FCT* (1998) 40 ATR 151 at [42].

⁶³ *FCT v Sleight* [2004] FCAFC 94 at [83].

⁶⁴ *Futuris Corporation Ltd v FCT* (2010) 80 ATR 330 at [156], and *FCT v Sleight* [2004] FCAFC 94 at [83].

⁶⁵ *Vincent v FCT* (2002) 193 ALR 686 at [91]-[95].

(g) *Any change in the avoider's financial position that has resulted, or may reasonably be expected to result, from the scheme (s 165-15(1)(g))*

There is usually no rational commercial benefit, such as any effect on the market value of company's shares or any movement in the net financial position of the company, in a scheme which is structured mainly for GST benefit and, perhaps, for income tax and stamp duty benefits as well. A scheme with no commercial benefit, merely a tax benefit, will often produce no real change in the financial position of the entity except for the tax benefit component. For the purposes of Division 165, the main measurable financial benefit is the saving of GST. In this case, it is more likely that a finding of tax avoidance will be concluded.⁶⁶ In *Hart*, the High Court established that the beneficial change in the taxpayer's financial position was wholly dependent on the tax benefit that was obtained.

(h) *Any change that has resulted, or may reasonably be expected to result, from the scheme in the financial position of the entity (or a connected entity) that has or had a connection or dealing with the avoider, whether the connection or dealing is or was of a family, business or other nature (s 165-15(1)(h))*

The GST benefits, obtained from the scheme, by the related parties, also point to the scheme being entered into for the dominant purpose or principal effect of getting a GST benefit.

The GST benefit, as the result of the scheme, can impact other persons and this falls within the form and substance factor. There are occasions where the scheme may be financially neutral but, in general, a change in the financial position of the entity, or of a connected entity such as an economic group or family, as a result of tax benefits will be sufficient indication of avoidance.

When considering this factor, *The Taxpayer and FCT*⁶⁷ identified that there is an overlap with the considerations and conclusions reached in relation to the change in the taxpayer's financial position.

(i) *Any other consequences for the avoider or connected entity of the scheme having been entered into or carried out (s 165-15(1)(i))*

This is not always relevant and should be considered in each case separately as was held in *The Taxpayer and FCT*.⁶⁸ Each case is capable of a broad meaning and can include the subjective purposes, motives and intentions of the participating entities. It is important to check whether the entity has skipped commercial profits by entering into the scheme.

⁶⁶ See also *The Taxpayer and FCT* [2010] AATA 497 at [115] and [143]; *Futuris Corporation Ltd v FCT* (2010) 80 ATR 330 at [165]-[169].

⁶⁷ *The Taxpayer and FCT* [2010] AATA 497 at [159].

⁶⁸ *Ibid* at [145].

It seems that the fiscal awareness of the taxpayer was of no account when the legislature considered GST anti-avoidance provisions.⁶⁹

(j) *The nature of the connection between the avoider and a connected entity, including the question whether the dealing is or was at arm's length (s 165-15(1)(j))*

Arm's length dealing has, over time, been discussed in depth in relation to income tax and, more particularly, in relation to capital gains tax. It should be noted that an arm's length dealing between entities which may, or may not, be connected, should be considered and not an arm's length relationship.

In the concept of income tax, Davies J in *Barnsdall v FCT*⁷⁰ stated that 'term should not be read as if the words 'dealing with' were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion'.

In *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT*,⁷¹ Hill J said:

What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.

It is important to note that unrelated parties may interact in a non-arm's length manner. Even so, this may lead to the conclusion that their motivation is to avoid GST.

(k) *The circumstances surrounding the scheme (s 165-15(1)(k)) and any other relevant circumstances (s 165-15(1)(l))*

When considering these two factors, a broad range of enquiries can be considered including, but not restricted to, the prevailing economic conditions, industry practices that are relevant to the scheme,⁷² or the nature of the tax advice received by the taxpayer in relation to the scheme.

Deputy President Forgie in *VCE* stated that these two factors may potentially include the subjective purposes, motives and intentions of the participating entities.⁷³ The same observation was expressed by the court in *FCT v News Australia Holdings Pty Ltd*.⁷⁴

⁶⁹ *VCE v FCT* (2006) 63 ATR 1249 at [86]-[90] per Deputy President Forgie.

⁷⁰ *Barnsdall v FCT* (1988) 81 ALR 173 at [176].

⁷¹ *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT* 21 ATR 1123 at [1133].

⁷² PS LA 2005/24, above n 53, [225].

⁷³ *VCE v FCT* (2006) 63 ATR 1249 at [137] per Deputy President Forgie.

⁷⁴ *FCT v News Australia Holdings Pty Ltd* (2010) 79 ATR 461, at [472].

E. Reasonable conclusion after considering the above 12 matters

Having considered these 12 factors, the application of Division 165 requires a reasonable conclusion as to whether the purpose of an entity in entering into or carrying out the scheme, or the principal effect of the scheme, is to obtain a GST benefit.

In *Peabody*⁷⁵, in a passage, Hill J stated that:

In arriving at his conclusion, the Commissioner must have regard to each and every one of the matters referred to in s 177D. This does not mean that each of those matters must point to the necessary purpose referred to in s 177D. Some of the matters may point in one direction and others may point in another direction. It is the evaluation of these matters, alone or in combination, some for, some against, that s 177D requires in order to reach the conclusion to which s 177D refers.

The 12 factors in Division 165 are, more or less, similar to s 177D(2) of the ITAA 1936. However, there are also some important differences which reflect the transaction-based nature of the GST including s 165-15(1)(c), s 165-15(1)(d) and s 165-15(1)(f). Some of these factors provide obvious indicia of avoidance, others less so, and there has not been much discussion on the weight or relevance of any of these factors in a GST context. It is the evaluation of these matters in combination which is critical.

F. What is the decision-making process?

Step 1

Once the ATO officer has reached a conclusion of GST avoidance, Aggressive Tax Planning (ATP) and Tax Counsel Network (TCN) are engaged.⁷⁶ If the conclusion is supported, in particular, by TCN, the ATO will issue the taxpayer with a position paper setting out its preliminary view.

Step 2

The ATO considers the taxpayer's response (if any) to the position paper.

Step 3

If the ATO officer still considers that Division 165 applies, the case is referred to TCN. If the officer's view is supported (by a submission signed off by TCN), the case is then referred to the General Anti Avoidance Rules Panel (the GAAR Panel).

Step 4

The GAAR Panel, as an independent internal review body, assesses the proposal to apply Division 165 before the formal declaration is made and served.⁷⁷ The GAAR Panel has a

⁷⁵ *Peabody v FCT* (1993) 25 ATR 32, at [42].

⁷⁶ See PS LA 2005/24, above n 53, [11]. The ATO officer should disclose to the taxpayer that Division 165 may be in contemplation when requesting additional information from the taxpayer to determine whether Division 165 may apply to the arrangement or an associated arrangement.

⁷⁷ See PS LA 2005/24, above n 53, [18]-[41].

consultative role and does not make the relevant decision but its advice is taken into account. The GAAR Panel provides its advice on the basis of contentions of fact which have been put forward by ATO officer and by the taxpayer.

The taxpayer has the opportunity to make submissions to the panel. Once the Panel has assessed the applicability of Division 165, the Commissioner may make a Division 165 declaration. Although this is, ordinarily, the course of events, the proposal to apply Division 165 is not always reviewed by GAAR Panel and there are exceptional circumstances where the Commissioner makes a declaration without having the decision assessed by GAAR Panel. This can be due to time constraints or other reasons. However, the application of the GAAR must still be cleared by a Deputy Chief Tax Counsel.

Step 5

A declaration under s 165-40 is required if the Commissioner decides to apply Division 165. The purpose of the declaration by the Commissioner is to negate the GST benefit which has been obtained from the scheme by the avoider. The Division 165 declaration may specify an amount that becomes the net amount for the relevant business activity period.⁷⁸ One declaration can relate to net amounts for several tax periods and importations. Under s 165-65, the Commissioner must give copy of the declaration to the entity affected. A failure to comply with this does not affect the validity of the declaration.⁷⁹

Step 6

The Commissioner will issue the taxpayer with an amended assessment for the relevant tax period to reflect the negation of the GST benefit and the applicable penalties and interest charges.

G. Penalties

Like Part IVA, the same penalty regime applies to Division 165. The taxpayer is liable to pay an administrative penalty of 50 percent of the scheme shortfall amount.⁸⁰

H. Objection and Review

The Division 165 declaration and the subsequent assessment is a reviewable decision.⁸¹ Formal objection must first be made to the Commissioner requesting that he revisit his original decision. The taxpayer may take the objection decision to the Administrative

⁷⁸ Net amount: the GST liability less the input tax credits attributable to a relevant tax period.

⁷⁹ GSTA, s 165-65(2).

⁸⁰ *Taxation Administration Act 1953* (Cth), s 284-160 of Schedule 1 for *base penalty amount*: scheme. See PS LA 2005/24, above n 53, [179]-[184].

⁸¹ *Taxation Administration Act 1953* (Cth), s 14ZZ. .

Appeals Tribunal or appeal to the Federal Court followed by the Full Federal Court, then, with special leave to the High Court.⁸²

The Tribunal may, standing in the shoes of the Commissioner, make a determination including making a new Division 165 declaration and refer the matter back to the Commissioner if AAT or Court thinks the objection decision wrong on some technical point/s, but justified subject to reconsideration in compliance with Division 165. The Court can set the Division 165 declaration aside and can send it back to the Commissioner to reconsider.⁸³

In a review under Pt IVC, the onus is on the taxpayer to prove, on the balance of probabilities, that the assessment is excessive.⁸⁴ In a Division 165 case, this could be done by establishing that the conclusion to invoke the Division by the Commissioner was not supportable.

A Division 165 case will always be based on a set of facts. However, the taxpayer has to satisfy the Tribunal or court, on a review of an objection decision, that the Commissioner's conclusion that there had been tax avoidance as defined by Division 165 is excessive and the Commissioner's action to negate the GST benefit is objectively wrong.⁸⁵

I. *Taxpayer Alerts, Public Rulings and Tax Determinations on Division 165*

There are 17 Taxpayer Alerts⁸⁶ (some covering multiple arrangements) and 12 ATO view products⁸⁷ (Public Rulings and Tax Determinations) issued to date on the application of Division 165 by the Commissioner, as follows:

(I) *Taxpayer Alerts (TA)*

TA 2013/2 – *Wine equalisation tax (WET) producer rebate schemes*. This Taxpayer Alert describes two contrived arrangements that are designed to create additional Wine Equalisation Tax (WET) rebates through non-commercial dealings between entities.

TA 2012/5 – *GST – Acquisition of intangible right for inflated consideration which is financed by supplier*. This Taxpayer Alert describes an arrangement where an entity claims an input tax credit on a purported acquisition (on non-commercial terms) of an intangible right from

⁸² See *Taxation Administration Act 1953* (Cth), Pt IVC, *Taxation objections, reviews and appeals*.

⁸³ *Fletcher v FCT* [1988] FCA 362.

⁸⁴ *Taxation Administration Act 1953* (Cth), s 14ZZK(b)(i).

⁸⁵ *Bai v FCT* [2015] FCA 973 at [34].

⁸⁶ A Taxpayer Alert is a warning to the community about an emerging aggressive tax planning where the ATO believes taxpayers may not be complying with the law. Practice Statement PS LA 2008/15 provides guidance for initiating and issuing a Taxpayer Alert.

⁸⁷ The ATO makes known its views about the application of relevant provisions in a number of ways. For example, the ATO issues formal rulings, grouped in different series, on the application of relevant provisions at a general level, in the sense that they do not address particular entity's affairs.

a GST-registered supplier, with the provision of vendor finance under which payments are contingent on a future event.

TA 2010/7 – GST – *Retirement Village operators who on-sell services to residents in an attempt to claim greater input tax credits.* This Taxpayer Alert describes an arrangement in which a retirement village operator ('RVO') increases its claims for input tax credits (or for decreasing adjustments) by assuming the role of a service supplier, such as an electricity retailer. By buying services and on-supplying them to retirement village residents living in independent living units ('ILUs'), the RVO contends that it is making a taxable supply, separate from its input taxed supply of residential accommodation.

TA 2010/1 – GST – *Interposing an associated 'financial supply facilitator' to enhance claims for reduced input tax credits for expenses incurred in the course of a company takeover.* This Taxpayer Alert describes an arrangement that attempts to create or increase an entitlement to a reduced input tax credit (RITC) for an entity that makes a financial supply of acquiring shares in a company as part of a takeover.

TA 2009/7 – *Uncommercial contract manufacture arrangements to claim the wine equalisation tax (WET) producer rebate.* This Taxpayer Alert describes uncommercial and collusive arrangements where one or more growers use a contract winemaker, so each such grower can attempt to claim the WET producer rebate by retaining title to their produce, until a pre-arranged sale to the winemaker.

TA 2009/6 – *Use of uncommercial indirect marketing arrangements to reduce wine equalisation tax (WET).* This Taxpayer Alert describes uncommercial and collusive arrangements that seek to reduce WET liability by using an interposed entity and an agency relationship to shift the point where WET liability is determined and to manipulate which methodology is used in determining it.

TA 2009/5 – *Use of an associate to obtain Goods and Services Tax (GST) benefits on construction of residential premises for lease.* This Taxpayer Alert describes an arrangement where an entity uses an associate in an attempt to secure input tax credits on the construction of residential premises for lease and defers the corresponding GST liability, in some cases indefinitely.

TA 2009/4 – *Land owner's use of a registered associate to maximise input tax credit entitlements and reduce Goods and Services Tax (GST) payable under the margin scheme.* This Taxpayer Alert describes an arrangement that purportedly allows a land owner to register for GST as late as possible to minimise its GST payable under the margin scheme, but still claim a full input tax credit on its acquisition of construction services from its associate.

TA 2008/17 – *Claims for GST refunds beyond four years arising from the reclassification of a previously taxable supply as GST free.* This Taxpayer Alert describes a situation where a taxpayer seeks to claim a refund four years or more after the end of a tax period on the basis that they incorrectly classified a supply as a taxable supply and they now contend it is GST free. In this situation the Commissioner may not be able to recover the input tax credits

previously claimed on what are contended to be incorrectly classified supplies. This could lead to a situation where either the supplier or the recipient of the supply obtains a windfall gain.

TA 2007/1 – *Lease by a charitable institution to an associated endorsed charitable institution designed to gain input tax credits.* This Taxpayer Alert describes arrangements designed to gain entitlement to input tax credits by treating otherwise input taxed supplies of residential accommodation as GST-free. These arrangements involve charitable institutions leasing land and buildings to associated endorsed charitable institutions in an attempt to increase the cost of making supplies of accommodation to residents and thereby satisfying a concessional GST provision.

TA 2005/4 – *Creation of Goods and Service Tax (GST) input tax credits by barter exchanges.* This Taxpayer Alert describes arrangements where a barter exchange buys and sells in its own right, effectively acting as a member with its own trading account. The barter exchange has access to unlimited trade dollars to spend on the acquisition of goods and services, often at commercially unrealistic prices, from its members. Consequently, large GST refunds are claimed by ensuring that its acquisitions continually exceed its supplies by significant amounts within the barter operation.

TA 2004/9 – *Exploitation of the second-hand goods provisions to obtain Goods and Services Tax (GST) input tax credits.* This Taxpayer Alert describes arrangements apparently designed in an attempt to exploit the GST second-hand goods provisions resulting in claims for GST input tax credits in relation to second-hand goods sold to an interposed associated entity. A GST registered entity acquires goods (usually of high value) through a non-taxable supply. The acquiring entity sells the goods to an associated entity, thus creating a claim for an input tax credit on its acquisition of the goods under the second-hand goods provisions.

TA 2004/8 – *Use of the Going Concern provisions and the Margin Scheme to avoid or reduce the Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement involving an entity which makes a sale of substantially completed residential units/houses to another entity as a GST-free going concern. The acquiring entity completes the residential units/houses and sells them as a taxable supply to third parties, paying GST only on the margin between this sale price and its acquisition cost, which is designed to set the price to reduce or eliminate the margin for GST.

TA 2004/7 – *Use of the Grouping provisions and the Margin Scheme to avoid or reduce the Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement that uses the grouping provisions and the margin scheme in an attempt to avoid or reduce GST on the sale of new residential premises. Relying on a concession within the grouping provisions, substantially completed residential units/houses are sold within a group and not treated as a taxable supply. The acquiring group member completes the residential units/houses and sells them as a taxable supply to third parties, paying GST only on the margin between this sale price and the intra-group sale

price. The effect of the intra-group sale is to avoid or reduce the margin for GST on the sale to the third party.

TA 2004/6 – *Use of the Grouping provisions of the GST Act to avoid Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement that uses the grouping provisions in an attempt to avoid GST on the sale of new residential premises. The parties to the arrangement use a GST group structure for the purposes of creating an ‘internal sale’ of new home units/houses between GST group members. This is to support a claim that the units/houses are no longer ‘new residential premises’. On this basis, any subsequent sale of the residential units/houses is claimed to be input taxed and not subject to GST.

TA 2004/2 – *Avoidance of Goods and Services Tax (GST) on the sale of new residential premises.* This Taxpayer Alert describes an arrangement using the joint venture provisions to attempt to avoid GST on the sale of new residential premises. The parties to the arrangement purportedly form a joint venture for the purpose of creating an ‘internal sale’ of new home units/houses by the joint venture operator to a participant in the joint venture. This is to support a claim that the units/houses are no longer ‘new residential premises’. On this basis, any subsequent sale of the residential units/houses is claimed to be input taxed and not subject to GST.

TA 2004/1 – *Non-arm’s length arrangements using Goods and Services Tax (GST) cash/non-cash accounting methods to obtain a GST benefit.* This Taxpayer Alert describes non-arm’s length arrangements where an entity makes acquisitions from another entity at commercially unrealistic prices to obtain an inflated input tax credit. The arrangements seek to manipulate a timing advantage between a vendor using a cash basis of accounting and a purchaser using a non-cash basis of accounting.

(m) *Public Rulings*

WETR 2014/1 Wine Equalisation Tax: provides the Commissioner’s views on the arrangements set out in Taxpayer Alert TA 2013/2 Wine Equalisation Tax (WET) producer rebate schemes and whether Division 165 of the A New Tax System (Goods and Services Tax) Act 1999 applies.

GSTR 2010/1 Goods and services tax: application of Division 165 of A New Tax System (Goods and Services Tax) Act 1999 where a land owner engages the services of an associate to arrange construction of residential premises for lease under an arrangement described in Taxpayer Alert TA 2009/5.

GSTR 2005/5 Goods and services tax: arrangements of the kind described in Taxpayer Alert TA 2004/8: use of the Going Concern provisions and the Margin Scheme to avoid or reduce the Goods and Services Tax on the sale of new residential premises.

GSTR 2005/4 Goods and services tax: arrangements of the kind described in Taxpayer Alerts TA 2004/6 and TA 2004/7: use of the Grouping or Margin Scheme provisions of the GST Act to avoid or reduce the Goods and Services Tax on the sale of new residential premises.

GSTR 2005/3 Goods and services tax: arrangements of the kind described in Taxpayer Alert TA 2004/9 - exploitation of the second-hand goods provisions to obtain input tax credits.

GSTR 2004/3 Goods and services tax: arrangements of the kind described in Taxpayer Alert TA 2004/2: Avoidance of GST on the sale of new residential premises.

(n) Tax Determinations

GSTD 2011/3 Goods and services tax: do the acquisitions of the services provided under the arrangement described in Taxpayer Alert TA 2010/1 form part of a reduced credit acquisition made by the financial supply provider under item 9 of the table in subregulation 70-5.02(2) of the A New Tax System (Goods and Services Tax) Regulations 1999?

GSTD 2009/D2 Goods and services tax: are there GST consequences where a land owner engages the services of an associate to arrange construction of residential premises for lease under an arrangement described in Taxpayer Alert TA 2009/5?

GSTD 2007/2 Goods and services tax: what are the results for GST purposes of a charitable institution engaging with an associated endorsed charitable institution in an arrangement described in Taxpayer Alert TA 2007/1?

GSTD 2006/5 Goods and services tax: what are the results for GST purposes of barter exchanges engaging in the arrangement described in Taxpayer Alert TA 2005/4?

WETD 2011/1 Wine equalisation tax: what are the results for entities that engage in an arrangement described in Taxpayer Alert TA 2009/7.

WETD2010/1 Wine equalisation tax: what are the results for Wine Equalisation Tax purposes for entities engaging in an arrangement described in Taxpayer Alert TA 2009/6?

VI. CONCLUSION

The application of GST general anti-avoidance provisions is enhanced by a good understanding of different types of tax, especially income tax, stamp duty and GST, in line with a correct interpretation of the relevant law. It also needs competent experience in business structures and tax administration in order to balance the commercial objectives and particular means adopted by the taxpayer.

In the author's opinion, it is reasonable to conclude that it only needs to be found that there is a GST benefit, as the result of the scheme, when the scheme was artificial and had no or immaterial commercial benefit or outcome other than the obtaining of the GST benefit or perhaps other tax benefits.

A case which involves GST avoidance may involve other taxes too, but this cannot be caught by general anti-avoidance provisions of the GSTA. This is due to the sole, dominant purpose or principal effect test. It usually follows that, if the dominant purpose was to reduce income tax, then GST or even stamp duty shortfalls cannot be considered. In the author's opinion, it would be of benefit if the Commissioner were to take one such case, where income tax avoidance, GST avoidance and also stamp duty avoidance are in equipoise, to the court in order to obtain a definitive view.

The Commissioner, undoubtedly, has the power to make a declaration to negate the GST benefit when the circumstances for its exercise exist. However, whether the Commissioner has discretionary power to act or in fact is required to act when he has reached a reasonable conclusion about dominant purpose, or principal effect after considering the 12 factors, is not clear. Even though, there are suggestions, in some quarters, that the words in s 165-40 that the Commissioner 'may make a declaration' imply a discretionary power.⁸⁸ Such a discretion, if it exists, is not absolute. It must be exercised in compliance with the requirements of Division 165. It is not really clear what the implications of the power being limited discretionary are. It might be argued that if it is a discretionary power that it can only be effectively challenged before the AAT which is in the shoes of the Commissioner. The Court can only supervise the proper exercise of the power, not substitute its own opinion as to how the discretion should have been exercised by the Commissioner. The better view, it is suggested, is that the Commissioner's power is not a true administrative discretion.

⁸⁸ *VCE v Federal Commissioner of Taxation* (2006) ATC 187, 63 ATR 1249 at [135] (SA Forgie); cf GT Pagone, *Tax Avoidance in Australia* (Federation Press, 2010), [158-9]; see PS LA 2005/24, above n 52, at [193]: 'It gives the Commissioner the discretion to negate a 'GST benefit' that an entity gets or got from a scheme to which Division 165 of the GST Act applies. This discretion is contained in section 165-40 of the GST Act.' and at [228]: 'If the foregoing elements are satisfied, the Commissioner may exercise the section 165-40 discretion to negate the GST benefit obtained.'

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OPTIONAL DISTRIBUTIONS UNDER NEW ZEALAND'S IMPUTATION AND RESIDENT WITHHOLDING TAX SYSTEMS

JAMES MURRAY*

ABSTRACT

This paper reviews the taxation of optional distributions in New Zealand. Three types of optional dividend plan have been used: bonus election plans, dividend reinvestment plans and profit distribution plans. This paper also looks at share repurchases which are similar to optional dividends as they also give shareholders a choice between cash and shares. Originally each type of optional dividend was taxed according to its component transactions, but their taxation was subsequently aligned due to their economic similarity and to minimise opportunities for dividend streaming. However, although share repurchases are similar they are taxed differently, potentially allowing dividend streaming. Dividend reinvestment plans are the most common form of optional dividend used in New Zealand, despite profit distribution plans providing much higher levels of reinvestment. This paper identifies issues with calculating resident withholding tax (RWT) on taxable bonus issues and the misalignment of company, RWT and personal tax rates as possible reasons why companies are not using profit distribution plans.

I. INTRODUCTION

For more than thirty years New Zealand's (NZ) listed companies have offered optional distributions to their shareholders.¹ This paper examines the income tax implications of giving shareholders a choice between cash and shares through optional dividend plans or share repurchase programmes. As the basis for taxing optional dividends changed from legal to economic form the range of viable options has been reduced. However, viable options could be increased by removing the misalignment of company and individual tax rates and correcting inconsistencies in the calculation of Resident Withholding Tax (RWT) for different types of non-cash distribution. Without these changes the tax treatments of optional dividends and share repurchases remains inconsistent despite their economic similarities.

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¹ Distributions are broadly defined to include dividends and other financial transfers from companies to shareholders, such as bonus share issues and payments arising from share repurchases.

New Zealand companies have used three types of dividend plan; the Bonus Election Plan (BEP), the Dividend Reinvestment Plan (DRP) and the Profit Distribution Plan (PDP).² BEPs let shareholders choose between cash dividends and bonus shares in lieu of dividends. With DRPs all shareholders are paid a dividend, but shareholders who choose reinvestment receive shares purchased using the dividend funds.³ With PDPs all shareholders are issued bonus shares, but they can choose to receive cash instead through these shares being repurchased by the company.

Originally each plan was taxed differently, according to their component transactions. Their taxation was subsequently aligned to prevent companies and shareholders using them to change whether a dividend is paid and tax credits received. Under current NZ tax law there is no advantage to the shareholder in choosing either cash or shares irrespective of the type of plan used.⁴ Share repurchases are similar in making cash distributions optional but they are taxed differently; off-market repurchases may allow some shareholders to receive a taxable dividend and the associated tax credits.

When first introduced BEPs allowed reinvesting shareholders to avoid receiving dividend income. Later, as part of the move to dividend imputation, bonus shares issued in lieu of dividends became taxable which aligned BEP and DRP taxation. Similarly, when introduced PDPs combined non-taxable bonus issues with optional repurchases structured as taxable dividends so only shareholders receiving cash received a taxable dividend and imputation or RWT credits. PDPs later changed to taxable bonus issue and non-taxable share repurchase, so all shareholders would receive taxable income. This change aligned PDP taxation with BEPs and DRPs. All three plans contain two transactions; with DRPs and PDPs the transactions are sequential and the second transaction is optional, with BEPs the choice is between two simultaneous and mutually exclusive alternatives. Taxing the transactions independently is different to taxing the whole transaction based on its overall economic effect.

There are three main problems with the current taxation of optional dividends. Firstly, due to RWT some cash cannot be reinvested even if the shareholder is in a low tax bracket and will claim a refund of the RWT. Secondly, companies have stopped using PDPs and are missing the higher levels of reinvestment PDPs generate. Thirdly, the taxation of optional dividend plans is inconsistent with the taxation of share repurchases despite their economically similarities. Possible solutions to the first two problems include aligning the

² New Zealand bonus election plans and dividend reinvestment plans are similar to Australian bonus share plans and dividend reinvestment plans respectively, there is no Australian equivalent to the profit distribution plan although one New Zealand company using a PDP was dual listed on the Australian Stock Exchange.

³ The reinvested funds are retained by the company. Shares are either new issues or treasury shares.

⁴ The *Income Tax Act 2007* (NZ) includes rules for the taxation of bonus-issues-in-lieu-of-dividends and profit distribution plans but does not mention dividend reinvestment plans.

RWT rate with the company tax rate and changing the way RWT is calculated for PDPs. Aligning the taxation of dividend plans and repurchases will prove a harder problem to solve.

In evaluating the taxation of optional distributions it is useful to keep in mind that tax law is designed to balance trade-offs between four objectives; raising revenue, being fair and equitable, minimising distortions and minimising compliance costs.⁵ The main purpose of taxation is to raise revenue for the Government, a process which is more efficient when compliance costs are low. It is also desirable for taxation to be fair and equitable so those who are equally able to pay, pay equally, and those more able to pay, pay more. In an open market economy a well-designed tax system will minimise the price distortions that arise when taxpayers have incentives to act differently simply because those acts would lower their tax liability. In real world tax systems trade-offs between these four objectives are sometimes necessary.

Section two reviews the component transactions used in optional dividends. These are dividends, bonus issues and share repurchases. This includes a review of the relevant history of dividend taxation including the pre-imputation environment, imputation and RWT. Section three examines the relationship between tax rates and corporate distribution policy and the main changes since the introduction of RWT to New Zealand in 1989. Section four describes the history and taxation of the different types of optional dividend: BEP, DRP and PDP. Section five summarises the main findings and outlines possible solutions to the problems identified.

II. THE COMPONENT TRANSACTIONS IN OPTIONAL DIVIDENDS

Optional dividends involve either a choice between two transactions or a sequence of transactions where the second is optional. To understand how optional distributions are taxed it will be useful to first consider the taxation of the component transactions; dividends, bonus issues and share repurchases. Here the distinction between income and capital is critical, as New Zealand does not explicitly tax capital gains, income must be broadly defined to minimise opportunities for tax avoidance and ensure revenue accrues to the Government. However, rules distinguishing income from capital distributions should not distort legitimate corporate decisions.

A. *Dividends*

This section reviews the general principles of dividend taxation in New Zealand. Imputation and the classical double-tax system which preceded it provide a historical context for optional dividends' introduction. RWT, which compliments imputation, is also reviewed. The

⁵ This framework is consistent with the objectives outlined in Inland Revenue Department 'Briefing for the Incoming Minister of Revenue', October 2014, <<http://www.ird.govt.nz/aboutir/who-we-are/minister/briefing/>>

taxation of dividends paid to non-residents and non-resident withholding tax is outside the scope of this paper.

Generally dividends occur in transactions between a company and its shareholders when the value transferred from company to shareholder exceeds the value transferred from shareholder to company.⁶ Although dividends are taxable income for shareholders companies are not obliged to pay dividends, therefore it is necessary to tax company profits to ensure tax revenue is raised from company profits. However, in countries like New Zealand and Australia there is a single income tax rate for companies and progressive rates for individuals so a fairer and more equitable approach is to tax corporate income at the shareholders' personal rates. The dividend imputation system is designed to facilitate this by giving shareholders credit for income tax paid by the company.

New Zealand's imputation system is an integrated tax system. However, it is not perfectly integrated as tax credits are only imputed to a shareholder's account when dividends are paid and shareholders on low marginal rates can only apply surplus credits to other income. As the value of imputation and RWT credits depends on a shareholder's tax rate there is an incentive for shareholders to transfer the right to receive dividends and tax credits to those who value them the most. Ideally in an integrated system the effective tax rate on company profits should be the average of its shareholders individual tax rates at the time the profits are made. Instead, in practice, it is the average of its shareholders individual tax rates at the time the dividend is paid. This creates an opportunity for shareholders to trade shares in order to minimise the effective tax rate, which is a type of dividend streaming. Tax laws need to prevent streaming to maintain Government revenue.

(a) *Dividends before Imputation*

In the classical system, in place in NZ at the start of the 1980s, corporate profits were subject to double taxation. Company income was taxed when earned, and taxed again when received by non-corporate shareholders. In contrast interest payments were an expense. Interest reduced a company's taxable income and was only taxed in the hands of lenders. This double taxation system was not equitable as interest income was taxed at investors' marginal rates, retained profits were taxed at the company rate and distributed profits were taxed twice. Double taxation created an incentive for companies to favour debt finance over equity, but excessive debt increased financial risk.

One way to avoid double taxation was to distribute capital profits as tax-free dividends. At the time tax-free dividends from capital profits were legal in New Zealand and easy for companies to offer. High inflation in the 1970s and 1980s made it possible for companies to sell capital assets and realise capital profits, which could then be distributed as a tax-free capital dividend. Clearly this was a poor system as tax revenue was reduced. It was also

⁶ *Income Tax Act 2007* (NZ) s CD4. With share repurchases shareholders who sell receive cash but, when the shares are cancelled by the company the value of the shares surrendered is not considered. The full amount of cash paid by the company in a repurchase is a dividend unless the repurchase is a capital transaction.

inequitable as some companies had better access to capital profits than other companies. Finally, because companies required court approval to return capital the process was not efficient. Tax-free dividends were abolished when dividends paid from capital sources became taxable income from 20 August 1985.⁷

(b) *The imputation system*

New Zealand's dividend imputation system took effect from April 1988. Resident shareholders receive credits for tax paid by the company and their dividend income is increased by the value of tax credits received. The net effect is to make a shareholder's marginal rate the effective tax rate on their share of corporate profits, improving tax equity. The process begins as company's tax payments generate imputation credits, later the imputation credits are attached to dividend payments.⁸ If dividends are fully imputed then shareholders with marginal tax rates equal to the company rate will receive credits exactly offsetting the tax on their dividend income. Shareholders on marginal rates higher than the company rate receive insufficient credits so are liable for additional tax; shareholders on lower marginal rates receive surplus credits which can be used to reduce their tax liability on other income.

The objective behind introducing imputation was to reduce the influence the tax system had on company policy, especially with respect to capital structure, investment and dividends.⁹ By eliminating the double taxation of company profits imputation removed the tax bias in favour of debt financing. However, there is a catch built into the system. For imputation to work companies must pay dividends, but a truly neutral tax system would not encourage dividend payments as a neutral tax system has no effect on corporate policy.

An imputation system is more neutral than the classical system as it removes the strong incentive for companies to use debt finance instead of equity. However, it is not completely neutral as it creates shareholder demand for dividends which may be incompatible with a company's need to retain cash for investment. Optional distributions and taxable bonus issues make the imputation system more neutral by disconnecting the distribution of cash from the distribution of imputation credits, so companies can satisfy shareholder demand for credits while retaining cash.

⁷ See Roger Douglas, Minister of Finance, 'Statement on Taxation and Benefit Reform' presented to Parliament 20 August 1985. Eliminating tax free dividends was part of a wide ranging announcement of proposed changes to the New Zealand tax system; the announcement also included plans to introduce a full imputation system in 1988/89. Implementation of imputation was confirmed in the June 1987 budget.

⁸ *Income Tax Act 2007* (NZ) s OA 18(2). The maximum amount of credits that can be attached to a dividend is $t/(1-t)$ where t is the company tax rate.

⁹ Consultative Committee on Full Imputation and International Tax Reform *Consultative Document on Full Imputation* (Wellington, 1987).

(c) *Resident Withholding Tax*

Resident withholding tax is an additional withholding tax paid when dividends are not imputed to the RWT level, and addresses the problem that some companies may have insufficient imputation credits to pay a fully imputed dividend.¹⁰ As such RWT compliments the imputation system. It was originally announced in the 1988 budget and effective from October 1989.¹¹ The main benefit of RWT is that it ensures a minimum level of tax is withheld by the company, reducing the risk of tax evasion or misreporting that would occur if authorities had to depend on individuals correctly reporting dividend income. RWT also prevents the deferral of income tax payments that would otherwise occur if companies paid dividends without tax credits at the start of the tax year knowing shareholders' income would not need to be reported and tax paid until the end of the year.

(d) *Dividend streaming*

Dividend streaming occurs when dividends are diverted to those who obtain the most value from them instead of being paid to the shareholders who owned the company when the underlying earnings were generated. Streaming reduces revenue by lowering the effective tax rate on company income. For example, taxable income could be diverted to untaxed investors while untaxable capital gains are distributed to taxpaying investors, so no tax is paid. In an imputation system streaming credits to low tax shareholders reduces tax equity. Shares are transferred to low rate shareholders, who receive full value from the imputation credits, but at a price which gives high rate taxpayers more than what they would have received from the dividend after tax.

In the absence of laws preventing it there are two main ways to stream dividends; change a company's ownership prior to paying a dividend, or only pay dividends to selected groups of shareholders. New Zealand's anti-streaming laws mainly address changing ownership. Specifically through the shareholder continuity rule, rules covering share lending and companies joining or leaving a corporate group.¹² These rules are complemented by the imputation credit ratio continuity rule. The continuity rule limits a company's ability to change the proportion of imputation credits attached to successive dividends in a single tax year, even when ownership changes are within allowable limits.¹³

Company law stops companies choosing to only pay dividends to selected shareholders. Otherwise it would be too easy for shareholders' funds to be expropriated by dominant investors. In New Zealand dividends must be paid equally to all shares in the same class

¹⁰ This is a key difference between the New Zealand and Australian imputation systems, as Australia does not have resident withholding tax.

¹¹ The intention to introduce resident withholding tax was announced in the 1988 budget and the tax took effect from October 1989, with *Income Tax amendment Act (No.2) 1989* (NZ) introducing a new Part IX A into the *Income Tax Act 1976* (NZ).

¹² *Income Tax Act 2007* (NZ) ss OA8, OB41, OB71, OB72, GB49.

¹³ *Income Tax Act 2007* (NZ) ss OA18, OB60-3.

unless some shareholders have waived their rights to the dividend.¹⁴ However, dividends can be streamed to selected shareholders provided all shareholders are initially offered the same dividend and the same choice to take something of similar value in lieu of the dividend. This is the principle behind early versions of BEPs and PDPs which provided an opportunity for shareholders to choose between income and capital distributions. However, these particular schemes no longer provide an opportunity to stream dividends or imputation credits.

B. *Bonus Issues*

Bonus issues are pro rata issues of shares to existing shareholders for no consideration.¹⁵ As bonus issues involve restructuring a company's share capital they are traditionally classified as capital distributions, not income. Although bonus issues were not regarded as income for the shareholder they were subject to bonus issues tax paid by the company until April 1982.¹⁶ That tax's objective was to discourage companies from using regular bonus issues as an alternative to dividends. Bonus issues tax was abolished with the proviso that any capital reduction in the ten years following the bonus issue would make the bonus issue a taxable dividend.¹⁷

In October 1988 it became possible for New Zealand companies to declare their bonus issues a distribution of taxable income.¹⁸ This change was designed to support the imputation system by allowing companies to distribute taxable income and imputation credits without paying a cash dividend.¹⁹ The viability of taxable bonus issues depends on the net effect on shareholders' taxable income. As long as sufficient imputation or RWT credits are attached a taxable bonus issue does not increase a shareholder's tax payable.

C. *Share Repurchases*

When companies repurchase shares they make a payment to the shareholder, in some cases this payment may be a legitimate return of capital and exempt from income tax. However, to protect revenue, tax law needs to ensure companies cannot use capital repurchases as an alternative to dividends. In New Zealand the presumption is that a repurchase is income

¹⁴ *Companies Act 1993* (NZ) s53.

¹⁵ Bonus issues are similar to scrip dividends but bonus issues are traditionally capital distributions while scrip dividends are income.

¹⁶ *Income Tax Act 1976* (NZ), Part VI. Bonus issues tax was levied at 17.5 percent.

¹⁷ Before the *Companies Act 1993* (NZ) the law was strongly focused on capital maintenance and capital reductions were limited, so shareholders receiving bonus issues would have a reasonable expectation that there would not be a capital reduction and the bonus issue would not be reclassified as a dividend.

¹⁸ *Income Tax Act 2007* (NZ) ss CD8, CD29. A company may elect to make a bonus issue a taxable dividend, if no declaration is made the default is a non-taxable bonus issue. A non-taxable bonus issue is not a dividend.

¹⁹ Consultative Committee on Full Imputation and International Tax Reform, above n 9.

unless specific criteria are met.²⁰ The bright line test treats a repurchase of fifteen percent or greater as a capital transaction. A repurchase of less than ten percent of capital is income. Repurchases between ten and fifteen percent may be classified as capital following an application to the Commissioner.²¹

Repurchases may be either on-market or off-market.²² On-market repurchases are not dividends.²³ Not taxing on-market repurchases as income to the shareholder is fair as there is no way for the seller to know the buyer's identity and receive imputation or RWT credits. An off-market repurchase and pro rata cancellation is not a dividend if it meets the bright line test and is not in lieu of a dividend. To the extent a repurchase is income taxable it is a dividend and may carry imputation credits.

Irrespective of size, a repurchase is a dividend when it is in lieu of a dividend. This is similar in principle to the taxation of bonus-issues-in-lieu-of-dividends. However, the bonus issue rule applies when shareholders are given an explicit choice between a cash dividend and a bonus issue of shares, determining whether a repurchase is in lieu of a dividend requires evaluation of company policy on a case-by-case basis. Certainly, if a company cancelled its dividends and started making similarly sized repurchases there is a strong argument that the repurchases are in lieu of dividends. It would be much harder to prove that a company that did not previously pay dividends, choosing between commencing dividends and using repurchases, chose to use repurchases in lieu of dividends.

III. TAX RATES AND CORPORATE DISTRIBUTION POLICY

The relative levels of company, personal and RWT tax rates determines the extent to which tax affects personal and corporate distribution decisions. From its introduction the rate of RWT has remained fixed at 33 percent. Since the introduction of imputation, company tax has gradually been reduced from 33 percent to 30 percent then 28 percent. Over the same period the top marginal rate for individuals was increased from 33 to 39 percent, fell slightly to 38 percent then returned to 33 percent.²⁴ Through these changes companies have

²⁰ The taxation of share repurchases became much more important with the *Companies Act 1993* (NZ) making it much easier for a company to redeem or repurchase its shares. Accordingly many of the specific rules for taxing repurchase were introduced in the *Income Tax Act 1994* (NZ).

²¹ *Income Tax Act 2007* (NZ) s CD22

²² On-market repurchases, or buybacks, involve a company purchasing its own shares through the stock exchange. With off-market repurchases the company purchases its shares directly from shareholders, usually through a tender offer or a negotiated deal. A company can purchase up to 5% of any class of its own shares, effectively holding shares in itself, *Companies Act 1993* (NZ) s 67A, shares held in this way are called treasury stock. Alternatively the company may cancel the shares.

²³ *Income Tax Act 2007* (NZ) s CD24

²⁴ See Roger Douglas and Trevor de Cleene, press release 7 October 1988, as reported (December 1988) *New Zealand Current Taxation* 460. When first announced the intended RWT rate was 28 percent which matched the prevailing

continued to pay cash dividends and use DRPs, but alternatives such as taxable bonus issues have fallen from favour, indicative of changing tax rates have affecting distribution policy choices. Table 1 summarises the main tax rates since the introduction of RWT.

Table 1: Tax rate Alignment since the Introduction of RWT

Companies		RWT		Individuals	Time Period
33%	=	33%	=	33%	1/10/1989-31/03/2000
33%	=	33%	<	39%	1/4/2000-31/03/2008
30%	<	33%	<	39% / 38%	1/4/2008-30/09/2010
28%	<	33%	=	33%	1/10/2010 -

Company tax, RWT and the top marginal rate for individuals since October 1989.

A. *Period One: When Rates Were Aligned*

From the introduction of RWT, in October 1989, until April 2000 New Zealand's company tax rate, RWT, and the top marginal rate for individuals were all aligned at 33 percent. Alignment meant companies paying fully imputed dividends did not need to withhold RWT. Alignment between RWT and the top marginal rate meant that resident shareholders would receive sufficient tax credits, either imputation credits or RWT, to cover the tax payable on dividends.

During this period fully imputed taxable bonus issues allowed companies to distribute imputation credits without using cash and to distribute profits without imposing a net tax liability on shareholders. Individuals on the top marginal rate received sufficient credits to cover the tax payable on bonus issue income. Individuals on lower rates received surplus credits they could use to offset tax on other income.²⁵

B. *Periods Two and Three: A Higher Marginal Rate for Individuals*

Between April 2000 and September 2010 the top marginal rate was higher than the RWT and company rates.²⁶ Individuals on the highest rate paid additional tax on dividend income as the imputation credits and RWT could not cover the tax on dividend income. This should cause market distortions as it creates a disincentive for those individuals to invest in dividend paying firms. It also increases compliance costs as individuals need to file tax returns to disclose and pay the additional amount.

company tax rate. When RWT was introduced both company and RWT rates were 33 percent, this change suggests the intention was to link the RWT rate to the company rate but the link was not formalised.

²⁵ See Hamish Anderson, Steven Cahan and Lawrence Rose 'Stock dividend announcement effects in an imputation tax environment' (2001) 28 *Journal of Business Finance and Accounting* 653. Positive share price reactions to the announcement of taxable bonus issues, indicated shareholders valued these distributions.

²⁶ From April 2000 to March 2008 the company and RWT rates were 33 percent and the top rate for individuals 39 percent. From April 2008 to September 2010 the company rate was 30 percent, RWT 33 percent and the top rate for individuals initially 39 percent but later reduced to 38 percent.

Taxable bonus issues are not suitable in this environment as shareholders on the top marginal rate do not receive sufficient tax credits to cover their dividend income. Although this also applies to cash dividends, at least cash provided liquid funds to cover the payment.²⁷ It should be no surprise that taxable bonus issues became very rare for listed companies during this period.²⁸

C. *Periods Three and Four: A Lower Rate for Companies*

Since October 2008 the company tax rate has been lower than the RWT rate, see Table 1. As the imputation credit ratio is based on the company rate all dividends now need to be topped-up with RWT credits unless shareholders are RWT exempt. This increases compliance costs for companies as they need to process RWT exemptions, which they previously could have avoided by paying fully imputed dividends.

In October 2010 the top marginal rate for individuals returned to 33 percent and into alignment with the RWT rate. That removed the problem of high rate individuals receiving insufficient tax credits when paid a dividend or taxable bonus issue. Despite the re-alignment companies have not returned to using taxable bonus issues. It is possible that after many years of disuse financial managers simply have no inclination to start using them again, it is also possible that confusion over RWT is discouraging companies from using taxable bonus issues.

The method for calculating RWT for taxable bonus issues may be causing confusion for companies about their RWT obligations. There are different formulae for calculating RWT on cash and non-cash dividends and taxable bonus issues. However, the formula for taxable bonus issues mirrors the formula for cash dividends despite clearly being a non-cash dividend.²⁹

With cash dividends RWT is simply withheld from the cash amount so the shareholder receives less cash. For non-cash dividends RWT is an additional amount paid by the company, with taxable income grossed up. This is because it is usually impractical to withhold, and convert to cash, a non-cash benefit. Similarly it is impractical to partially withhold a bonus issues to pay RWT so, like other non-cash dividends, a company needs to

²⁷ See Hamish Anderson, Steven Cahan and Lawrence Rose 'Taxable bonus issues: A good way to distribute accumulated imputation credits?' (2001) 3 *University of Auckland Business Review* 48.

²⁸ Taxable bonus issues have rarely been used by New Zealand listed companies since April 2000. While they are no longer suitable for regular use they may be used of one-off transactions when the company needs to distribute imputation credits, for example before a major restructuring, when the credits would otherwise be lost.

²⁹ *Income Tax Act 2007* (NZ) s RE13 for cash dividends, s RE14 for non-cash dividends excluding certain share issues, s RE 15 for bonus-issues-in-lieu and shares issued under a profit distribution plan. The formula for bonus-issues-in-lieu is the same as the formula for cash dividends except the cash dividend amount is replaced by an 'alternative amount' representing the cash that would otherwise be paid if the shareholder did not take the shares.

make a separate payment to cover RWT.³⁰ However, unlike other non-cash dividends this payment does not become part of the shareholder's taxable income. The need to pay RWT and confusion over this inconsistency in the tax law could be discouraging companies from using taxable bonus issues and PDPs incorporating taxable bonus issues.

IV. OPTIONAL DIVIDENDS AND THEIR TAXATION

New Zealand companies have responded to the taxation and corporate law environment through the design and use of optional distributions. Optional dividends and repurchases provide companies with more choices in corporate distribution policy, and let companies cater to a broad range of shareholder clienteles while officially treating all shareholders equally.

There are two approaches to taxing optional distributions. One is to treat each transaction independently, the other is to consider the combined transactions. The former concentrates on the legal form of each transaction, the latter concentrates on the economic substance of the whole. The following sections will show that optional dividends were initially taxed through their component transactions, but later BEPs and PDPs were taxed according to their economic substance due to their similarity with DRPs.

A. Bonus Election Plans

The first optional dividend plan adopted by a listed New Zealand company, Bunting and Company Limited, was a BEP.³¹ This was soon followed by National Insurance Limited and Hallenstein Brothers Limited, which simultaneously offered both BEP and DRP options.³² It is likely that these companies were copying the development of similar bonus share schemes and DRPs in Australia, but it is unlikely they would have introduced BEPs without the abolition of bonus issues tax in 1982.³³

³⁰ It is unlikely that the RWT payment would match the value of a round number of shares, so the company cannot repurchase shares and use the payment for RWT, nor can companies issue or repurchase fractions of a share. The only practical way to pay RWT is through an additional cash payment, in which case the dividend should be grossed up by that amount, but the formula does not allow that. With the RWT rate higher than the current company tax rate all taxable bonus issues require RWT payments unless all shareholders are exempt.

³¹ Michael Shelton 'Dividend reinvestment the money or the shares' (1984) 31 *Management (NZ)* 80. It is not clear whether the Bunting and Company Ltd BEP became operational before the company was taken over and delisted in May 1984.

³² Offering both BEP and DRP makes sense if the company has a limited ability to issue bonus shares. Taxed individual shareholders would use the BEP while untaxed corporate shareholders would choose the DRP, leaving more reserves for future BEP issues.

³³ In Australia FAI Insurances Limited offered a bonus share plan (BSP) with their 1978 final dividend. BSPs were introduced before Australia adopted capital gains tax (CGT) and dividend imputation, allowing companies to offer tax free distributions. After the introduction of CGT the distributions became tax deferred as the gain would be taxed when the shares were sold. Later developments in anti-streaming rules have gradually cut back on BSP tax benefits by

An issue of bonus shares is a capital transaction so companies offering a BEP need suitable accounting reserves to capitalise. As some companies were more likely to have these reserves than others BEPs were not viable for all companies or available to all shareholders, reducing tax equity. Limited access to suitable reserves also means companies would be concerned about the long-term sustainability of a BEP programme as companies traditionally like to maintain a stable dividend policy.³⁴

The tax benefits of using a BEP changed frequently during the 1980s. Early BEPs allowed shareholders to choose between taxable dividends and tax-free shares; BEPs offered a clear tax advantage over normal dividends and DRPs when the dividend was taxable.³⁵ However, when first introduced tax-free capital dividends were common and corporate shareholders were not taxed on dividend income. So, for companies paying capital dividends and corporate shareholders there was no benefit in using a BEPs. Briefly, following the abolition of tax-free dividends, in 1985, BEPs were the only viable way for companies to offer a tax-free distribution and avoid double taxation.³⁶ Shareholders took advantage of this opportunity to receive a tax-free distribution, with around 60 to 90 percent reinvested.³⁷ From October 1988 bonus-issues-in-lieu-of-dividends, including BEP share issues, were classified as taxable income.³⁸ BEPs no longer offered a clear tax advantage but the introduction of imputation reduced the need for schemes designed to avoid double taxation. Subsequently there has been no economic difference between offering optional dividends through a BEP or DRP, although they still differ in their legal structure and accounting treatment.

Classifying bonus-issues-in-lieu as dividends supported the general objectives of the imputation system. Paying taxable dividends, and the transfer of imputation credits from company to shareholder, became harder to avoid after BEPs became taxable dividends.

requiring companies to cancel imputation credits on the dividends foregone, and preventing Australian companies offering BSPs on dividends with less than ten percent imputation credits attached.

³⁴ Similar issues had been identified with Australian bonus share plans and may have contributed to the adoption of DRPs in Australia. See Michael Skully *Dividend Reinvestment Plans: Their Development and Operations in Australia and the United States* (Committee for the Economic Development of Australia, 1982).

³⁵ To ensure that BEP shareholders were not deemed in receipt of dividends it was necessary for the election to receive bonus shares to be made before the next dividend was declared.

³⁶ Warren Head 'In lieu of the taxable dividend' (1985, 28 August) Auckland Star C3. Suggests DRPs will be 'put on ice' until the introduction of imputation as BEPs provided a more tax effective optional dividend following the abolition of tax free capital distributions.

³⁷ See D J Hasseldine *Dividend Reinvestment Schemes: An Examination of their Accounting, Financial and Taxation Implications in New Zealand* (MCom Thesis, University of Canterbury, 1986). Many different labels have been applied to various types of optional dividend, Hasseldine refers to 'dividend reinvestment schemes' based on their description and the timing of the research they are more likely to be BEPs than DRPs.

³⁸ *Income Tax Act 2007* (NZ) CD7. With straight bonus issues companies can elect to make the bonus issue taxable, optional bonus issues such as BEPs are bonus-issues-in-lieu so must be taxable.

B. *Dividend Reinvestment Plans*

DRPs were first used by New Zealand companies shortly after the introduction of BEPs in the early-1980s. As the dividend is deemed to have been paid before any funds are reinvested there is no tax difference between reinvesting and non-reinvesting shareholders. DRPs do not provide shareholders with an opportunity to avoid tax so there is no need for specific DRP tax rules.

A possible catalyst for the introduction of DRPs was foreign firms using similar plans, particularly in the United States and Australia. However, it was the introduction of imputation and the taxation of bonus-issues-in-lieu-of-dividends that provided the main impetus for the growth of DRPs. With straight cash dividends the imputation ratio causes a company's ability to distribute credits to be limited by its ability to distribute cash. A cash dividend with a DRP option means companies can declare larger dividends and distribute more credits knowing the cash distribution will be reduced by reinvestment. The level of reinvestment and cash required, however, is only partially under the company's influence.³⁹

DRPs are compatible with the imputation system in general, but RWT is not fully compatible with DRPs as it limits the amount that can be reinvested. RWT payments are withheld from the dividend's cash component before reinvestment, thereby reducing the maximum amount that can be reinvested.⁴⁰ Imputation credits reduce the need to pay RWT, but as the imputation ratio is based on the company tax rate and the RWT rate is currently above the company rate all dividends will have a component that cannot be reinvested.⁴¹

C. *Profit Distribution Plans*

PDPs combine bonus issues with an offer to repurchase the bonus shares if a shareholder prefers cash. PDPs originally combined a non-taxable bonus issue and a repurchase structured as a taxable distribution, usually with imputation credits.⁴² From November 2012 PDPs became a combination of taxable bonus issue and non-taxable repurchase, so all shareholders would be taxed.⁴³ Seven listed companies used PDPs between their introduction and the changes in November 2012. These companies paid a total of thirty-one

³⁹ See D J Hasseldine 'Dividend reinvestment schemes in New Zealand' (1988) 6 *Asian-Pacific Tax and Investment Bulletin* 515. Factors influencing reinvestment rates may be grouped into four categories; economic, company, plan and investor. Plan design and company performance are subject to management's influence, but economic factors including the tax environment and investor factors are external.

⁴⁰ Shareholders on marginal rates lower than the RWT rate may benefit from surplus RWT credits, but the benefit is in the form of a tax refund, not company shares and there is no benefit for companies needing to raise equity capital.

⁴¹ There is no RWT when all shareholders have filed exemption certificates, which is possible for closely held companies but extremely unlikely for public companies.

⁴² Most, but not all, PDPs attached imputation credits to the dividend.

⁴³ *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012* (NZ).

PDP dividends. As far as can be ascertained no listed company has used a PDP since the 2012 changes.

Table 2: Reinvestment in Listed NZ Companies through PDPs and DRPs, 2006–2012

	Number of PDPs	Average PDP Reinvestment	Number of DRP Dividends	Average DRP Reinvestment
2006	3	82.08%	30	26.94%
2007	4	65.65%	31	31.51%
2008	7	59.58%	44	23.66%
2009	6	75.23%	52	24.99%
2010	6	77.82%	59	27.01%
2011	3	57.97%	54	29.69%
2012	2	77.32%	52	31.69%
Overall	31	70.09%	322	27.86%

Source: Author's calculations. Reinvestment is calculated as the value of shares issued (net of PDP repurchases) divided by the cash dividend that would be paid if no shares were issued, data obtained from company announcements.

PDPs are designed to provide a high level of cash retention. Table 2 shows PDPs generate over twice the rate of reinvestment found with DRPs. As shareholders only receive cash on application companies may anticipate that shareholder indifference or inertia will result in many shareholders keeping the bonus shares rather than applying for the cash distribution.⁴⁴ In the thirty-one PDP dividends the smallest cash payment was around four percent of the total dividend, and the largest payment 75 percent. On average only thirty percent of the total dividend was paid in cash.

The PDP structure was introduced by SkyCity Consolidated Group (hereafter SkyCity). In 2005 they applied for a product ruling on a planned distribution which combined a bonus issue of shares with a simultaneous off-market repurchase of the same quantity of shares. SkyCity's application did not specify whether the bonus issue or repurchase would be taxable or non-taxable. However the size of the share repurchase implied the repurchase should be a taxable dividend as it would not be large enough to qualify as a capital distribution under the bright line tests.⁴⁵ The application stated that the PDP would replace their DRP; with the change aimed at increasing the level of reinvestment and reducing cash outflow, to help keep SkyCity's dividend policy affordable.⁴⁶

⁴⁴ This is a form of behavioural nudge, see Richard Thaler and Cass Sunstein *Nudge: Improving Decisions about Health, Wealth, and Happiness* (Yale University Press, 2008).

⁴⁵ SkyCity stated that the repurchase would be less than 10 percent of the market value of the company's shares, implying the repurchase should be a taxable dividend under the bright line tests.

⁴⁶ As the PDP replaced a DRP, and therefore replaced a dividend, it is not clear why PDPs were not classified as using bonus-issues-in-lieu-of-dividends when first introduced.

The resulting product rulings allowed SkyCity to offer its PDP provided the company did not elect to use taxable bonus issues.⁴⁷ They were also required to ensure the company had sufficient imputation credits to cover whatever proportion of the bonus issue was not repurchased. The rulings also stipulated the maximum size of the repurchase, to ensure the repurchase was below the bright line tests and therefore a taxable dividend.⁴⁸

Whether the PDP was designed to allow shareholders to choose tax effective distributions is unknown. Simply setting up a PDP does not necessarily mean imputation credits will be directed away from high marginal rate shareholders and towards low marginal rate shareholders. For dividend streaming to occur in a PDP shareholders need to make appropriate reinvestment decisions based on their marginal rates. A PDP would, at most, facilitate such activity.⁴⁹

The product rulings expired in March 2009 and, following public consultation, PDP taxation was changed from November 2012. The consultation process, through an issues paper, identified the main problem with the original PDP structure as the potential for streaming imputation credits. It also stated that any solution needed to consider the benefits of higher PDP reinvestment levels for companies.⁵⁰

To prevent dividend streaming PDPs became taxable bonus issues, so all shareholders received taxable income, with non-dividend repurchases so no shareholders received two allocations of tax credits.⁵¹ Repurchases will no longer be dividends despite being below the levels set in the bright line tests. However, the objective of retaining higher PDP reinvestment levels has not been achieved because listed companies have simply stopped using PDPs. While no company using PDPs has provided a clear reason for stopping, the problems with taxable bonus issues and RWT identified earlier could be part of the reason.

V. CONCLUSION

Optional dividends are similar to share repurchases in that shareholders are presented with a choice between cash and shares. In both cases the choice to take cash decreases that shareholder's holding relative to investors who choose shares. However; optional dividends

⁴⁷ This prevented SkyCity from increasing imputation credit distribution by making both the bonus issue and repurchase income taxable.

⁴⁸ See Inland Revenue Department Tax Information Bulletin: Vol.18, No.2 (2006) for product rulings 05/07, 05/08, and 05/09, the rulings were issued 5th December 2005 and were valid until 31 March 2009.

⁴⁹ The product rulings state that SkyCity believed only a very small percentage of their shareholders were likely to be taxable at the 39 percent marginal tax rate, which suggests only limited risk of streaming.

⁵⁰ 'The taxation of distributions from profit distribution plans' An officials' issues paper prepared by the Policy Advice Division of Inland Revenue and The Treasury, June 2009.

⁵¹ *Income Tax Act 2007* (NZ) ss 7B, 23B. The changes have effect from November 2012; references to 'bonus-issues-in-lieu' are now to 'bonus-issues-in-lieu and PDP share issues.' PDPs are defined as schemes involving one or more steps including the issue of shares and an option to have those shares repurchased.

increase shares outstanding while with a repurchase there is a decrease. Repurchases only involve transactions with selling shareholders, whereas dividend plans involve all shareholders in at least one transaction. There is a very fine distinction between arguing that BEPs, PDPs and DRPs are sufficiently similar to necessitate similar tax treatments, and arguing that repurchases are distinctive enough to allow different tax treatment.

Taxing economically equivalent transactions equally helps maintain a fair and equitable tax system, minimising distortion and avoidance. However, this objective alone does not explain why BEP and PDP taxation was brought in line with DRP taxation. For that it is necessary to recognise that BEPs and PDPs aided a form of dividend streaming and therefore were a threat to revenue. Furthermore, aligning the taxation of BEPs and PDPs with DRPs supports the operation of the imputation system.

The aim of reducing dividend streaming in PDPs is easily bypassed as streaming is still possible through off-market repurchases. As the taxation of stand-alone share repurchases was not changed, companies can simply use off-market repurchases without issuing bonus shares. Preventing the streaming that occurs through repurchases is a much harder issue to solve. A possible solution is to only allow off-market repurchases as part of a PDP, which would ensure all shareholders received taxable income in proportion to their holding.⁵²

Although the introduction of DRPs predates the imputation system, the rationale for using optional dividends was strengthened by New Zealand's dividend imputation system. Imputation created an incentive for companies to find efficient means to distribute imputation credits.⁵³ DRPs, PDPs and taxable bonus issues separate the distribution of credits from the distribution of cash, allowing more credits to be distributed. There are problems with calculating RWT on taxable bonus issues, and therefore PDPs which incorporate taxable bonus issues under the new rules. Furthermore, when RWT is paid by the company, there is direct cash cost in offering a PDP which partially offsets the increased reinvestment PDPs provide. Overall these problems mean PDPs are not currently viable instruments in corporate dividend policy. Instead DRPs remain the standard form of optional dividend despite suffering from low and variable reinvestment levels, limiting their usefulness for companies needing equity capital.

Listed companies are required to treat shareholders equally but shareholders are not equal in their wants and needs. Corporate actions that suit some will not satisfy all. Some companies responded to this dilemma by offering their shareholders a choice between different distributions, designing a dividend policy to meet the needs of as many

⁵² An exception to this rule would be needed for small selective repurchases, for example when companies want to buy out small shareholders holding less than a marketable parcel of shares.

⁵³ Conversely the need to maintain tax revenues provides an incentive for Government to keep such schemes within reasonable bounds, particularly by preventing companies from streaming dividends and imputation credits to those shareholders who gain the most value from them. PDPs did not allow companies to direct dividends to specific shareholders but they did facilitate streaming by allowing shareholders to accept or avoid dividends in line with their individual tax position.

shareholders as possible. All shareholders are offered the same choice so they are treated equally, but those who value one alternative over another can choose the distribution that best meets their needs. This, in turn, led tax authorities to modify the rules applying to dividend choices; balancing the aims of maintaining revenue with having a fair and equitable system. However, these changes affected the viability of different optional dividend plans resulting in less choice available to shareholders.

The disappearance of PDPs after the tax changes is unfortunate as PDPs provide companies with much higher levels of reinvestment. PDPs could serve a useful corporate purpose and facilitate the operation of the imputation system by increasing cash retention while allowing companies to distribute imputation credits. However, until they become easier to administer they are unlikely to be used. One solution is to change the RWT calculation for bonus issues to the gross-up approach used for other non-cash dividends. This will resolve confusion about how RWT is calculated and paid, although it is not certain this will be sufficient to bring back PDPs.

The objective behind dividend imputation was to reduce the influence the tax system had on company policy. The neutrality of the tax system would be improved if disincentives for using taxable bonus issues and PDPs were removed. This can be achieved through two policy changes; aligning tax rates and changing the RWT calculation for taxable bonus issues. The viability of PDPs would be improved by re-aligning the top personal, company and RWT rates. That would allow companies to use PDPs with fully imputed dividends without needing to pay RWT or impose taxable bonus issues on high marginal rate individuals with insufficient tax credits attached. Changing the RWT calculation for taxable bonus issues would make it easier for companies to use them, and PDPs, when the distribution is not fully imputed. The underlying purpose of the imputation system is to integrate company and personal taxation, aligning tax rates and providing a wide range of viable optional distributions simply helps the imputation system work.

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DOUBTS ABOUT THE CENTRAL MANAGEMENT AND CONTROL RESIDENCY TEST FOR COMPANIES?

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ABSTRACT

This article critically examines the Australian Taxation Office (ATO) interpretation of the second statutory test for company residence found in the definition of 'resident' in sub-section 6(1) of the Income Tax Assessment Act 1936. The statutory test consists of three components: first, if the company is incorporated in Australia then it is a resident; second, if the company is not incorporated in Australia but the company is carrying on a business in Australia and has its central management and control in Australia then it is a resident; and third, it is not incorporated in Australia but it is carrying on business in Australia and has its voting power controlled by shareholders who are resident in Australia then it is a resident of Australia for taxation purposes. The central management and control test contained in the public Taxation Ruling TR 2004/15 has been the subject of considerable conjecture and confusion for many years. The ruling states that the test of residency for a company not incorporated in Australia consists of two requirements: the company must be carrying on business in Australia and it must have its central management and control located in Australia. A company not incorporated in Australia and thus not satisfying the first test of residency must have its central management and control in Australia or have the majority of shareholders resident in Australia coupled with the carrying on of a business in Australia before it is held to be a resident. The contrary view is that the central management and control test on its own may be sufficient to deem a non-Australian incorporated company to be a resident for taxation purposes. It is contended that there is no need to demonstrate that the company is also carrying on a business in Australia. This article contends that the approach of the Commissioner of Taxation contained in TR 2004/14, is open to serious doubt.

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I. INTRODUCTION

The main objective of this article is to critically examine the central management and control test contained in the definition of a resident company in sub-section 6(1) of the *Income Tax Assessment Act 1936* (ITAA36). Sub-section 6(1) provides the definition of 'resident or resident of Australia' and in terms of a company the following definition is provided:

[A] company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

In particular this article critically assesses the Australian Taxation Office's (ATO) interpretation of the second statutory test for the residence of a company found in the above definition of 'resident' in sub-section 6(1) of the ITAA36. The central management and control test contained in the public ruling TR 2004/15¹ has been the subject of considerable conjecture and confusion for many years. The ruling states that the test of residency for a company not incorporated in Australia consists of two requirements: first, the company must be carrying on business in Australia and second, it must have its central management and control located in Australia. In particular, this article addresses the vexed issue of whether the test of residence contains one requirement or two requirements.

The second part of this article looks at the definition of company residence, in particular the central management and control test and its origins. In Part three the article examines the judicial interpretation of this statutory provision and asks the question, is the test one limb; namely, central management and control is where the business is carried on, or does it contain two separate limbs; namely, requiring both the carrying on of a business in Australia and at the same time having its central management and control in Australia?

Part four examines in detail the approach taken by the Commissioner of Taxation contained in Taxation Ruling TR2004/15. In essence that ruling argues that both requirements, namely the carrying on of a business in Australia and having its central management and control in Australia need to be satisfied before a company is a resident of Australia for taxation purposes. In Part five of the article the risk management issues are examined from the perspective of foreign companies complying with the tax ruling. This analysis will determine the likely risks that may arise for companies relying on the ruling and then later finding that the Australian courts have taken a different approach.

Even if all these issues can be resolved, there are practical problems associated with applying the central management and control test. Part six of the article raises, among other things, the vexed question of where central management and control is actually located. In Part

¹ Australian Tax Office, *TR2004/15 Income tax: residence of companies not incorporated in Australia—carrying on business in Australia and central management and control*
<<http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR200415/NAT/ATO/00001>>.

seven the article poses the question of whether it is time for a change. If so, what would the alternative tests contain given how difficult any change would be in a world of cross-border complexity and tax avoidance, especially with the challenges facing countries with large Multi-National Entities (MNE's) engaged in Base Erosion and Profit Shifting (BEPS). For example, the Apple Corporation was a non-resident of both Ireland and the US because of the definition of residence.² Prior to Ireland amending its definition of corporate residence in 2013, a company that was incorporated in Ireland was not a resident unless it had its central management and control in Ireland.³ A company was not a resident of the US unless it was incorporated in the US. Apple Corporation had its central management and control in the US but the company was not incorporated in the US thus avoiding being neither a resident of the US nor Ireland.⁴ This situation was exploited by many other MNE's such as the caterpillar Corporation.⁵

The article concludes that, on balance, the central management and control test has only one requirement and that corporate residency exists in Australia where some part of the company's central management and control takes place in Australia. There is no requirement to be carrying on a business in Australia. This conclusion is at odds with the Commissioner's approach in TR2004/15. It is also the contention of this article that the ATO's current views on the central management and control test, incorrect in law as it has been interpreted by the courts, neither addresses the changing nature of commerce across the globe nor enables Australia to protect in part its company tax base. While this article raises the problems associated with the central management and control test and its different interpretations, Part eight of this article provides some solutions. However, it is ultimately the responsibility of the Commonwealth Parliament of Australia or the courts to provide a robust answer to this potential problem.

II. THE DEFINITION OF RESIDENT IN SUB-SECTION 6(1) OF THE ITAA 36

Sub-section 995-1(1) of ITAA 1997 says that a person, which includes a company, is an 'Australian resident' if that person is a resident of Australia for the purposes of the ITAA 1936. For companies, sub-section 6(1) of the ITAA36 provides three statutory tests, the fulfilment of any one being sufficient to deem a corporate entity to be a resident or resident of Australia. They are the 'incorporation test', the first statutory test; the 'central

² Antony Ting, 'iTax-Apple's International Tax Structure and the Double Non-Taxation Issue', (2014) *British Tax Review* 40, 46.

³ Antony Ting, 'Current Notes – Old wine in a new bottle: Ireland's revised definition of corporate residence and the war on BEPS', (2014) 3 *British Tax Review* 237, 239.

⁴ Ibid.

⁵ Ibid, 237.

management and control' test; the second statutory test and the 'voting power' test which is the third statutory test.

The first statutory test deems a company to be a resident for Australian income tax purposes if it is incorporated in Australia. This test is unequivocal in its operation. The second statutory test deems a company, not being incorporated in Australia, to be resident if it 'carries on business in Australia, and has ...its central management and control in Australia.' The third test deems a company, not being incorporated in Australia, to be resident if it 'carries on business in Australia... [and] its voting power is controlled by shareholders who are residents of Australia.'

It is with the second test that most controversy arises. By a normal reading, the test appears to have an unambiguous two-element construction. The first element requires a company to be carrying on business in Australia and the second element requires that the company has its central management and control in Australia. On this reading, only satisfaction of both elements would deem a corporate entity to be a resident of Australia. However, this interpretation seems to be at odds with the decision in *Malayan Shipping Company v Federal Commissioner of Taxation*.⁶ Many commentators hold to the view that the general principle emanating from the *Malayan Shipping* case is that where a company has its central management and control in Australia, then, ipso facto, it is also carrying on business in Australia thus satisfying both elements in one.⁷ This outcome raises the question of why the original drafters of the legislation would have intended this interpretation given the construction they employed. If this interpretation was to hold in a general sense then foreign companies would be residents simply by having their central management and control in Australia.

However, Professor Dirkis observes that there are those who believe that to be resident under the second test, central management and control must be accompanied by acts which constitute the carrying on of a business.⁸ This is the general view expressed by the

⁶ (1946) 71 CLR 156. This case is discussed in detail in Part III of this article.

⁷ See for example Kerri Sadiq, 'Double Tax Agreements and International Allocation of Business Income in Australia' (1999) 4 *Int'l Trade & Bus L Ann* 151, 155; Taxation Review Committee, Commonwealth, (1975) (Asprey Report), 255; NE Challoner and JM Greenwood *Income Tax Law and Practice (Commonwealth)* (2nd ed, 1962), 42; Uta Kohl, 'The Horror-Scope for the Taxation Office: The Internet and its Impact on 'Residence'' (1998) 21 *University of New South Wales Law Journal* 436, n 45; Tom Magney, 'Australia-Singapore Taxation Aspects of Carrying on Business in Singapore - Part II' (1975) 4 *Australian Tax Review* 67, 69; Kerrie Sadiq, 'Jurisdiction to tax and the case for threshold reform' (2005) 1 (2) *Journal of the Australasian Tax Teachers Association* 162, 169-170, and Richard Vann and Ross Parsons 'The foreign tax credit and reform of international taxation' (1986) 3 *Australian Tax Forum* 131, 148.

⁸ Michael Dirkis, 'The same old same old: Corporate residency after RITA, (2006) 21 *Australian Tax Forum* 27, 38, footnote 48, where he says: 'See e.g. Roger Hamilton, Robert Deutsch and John Raneri, *Australian International Taxation* (October 2002), para 2.190. Similarly, AJ Baldwin and JAL Gunn, *Income Tax Law in Australia*, (1937) 168, note that 'if the business of the company carried on in Australia consists of or includes its central management and control,' then the company is a resident.'

Commissioner in the Taxation Ruling, TR2004/15.⁹ The doubt about the manner in which the test applies is of concern in government quarters due to the problems associated with the collection of taxation revenue. The Review of International Taxation Arrangements (RITA)¹⁰ consultation article, prepared by the Australian Federal Treasury, expressed significant misgivings about the application of the test. In Option 3.12 for consultation, the RITA article requested consideration of clarification of the test so that ‘exercising central management and control alone does not constitute the carrying on of a business’.¹¹

A. *Origins of the Second Statutory Test*

The origins of the second statutory test are derived from the common law of the United Kingdom. In respect of individuals and companies, resident status was a key determinant of a State’s taxation rights. A resident, enjoying the benefits of the infrastructure and the protection of the state, was required to provide something in return. This something was tax payable on taxable income from all sources, not just the country of residence. In respect of a business enterprise, as Adams says: ‘...[a] large part of the cost of government is traceable to the necessity of maintaining a suitable business environment.... Business is responsible for much which occupies the courts, the police, the army and the navy.’¹² The quid pro quo for maintaining this environment is the payment of income tax. As Justice Oliver Wendell Holmes said: ‘taxes are what we pay for civilized society’¹³

For individuals, the English courts linked a resident to some enduring physical quality of a person’s presence in the United Kingdom. Although a question of fact, prime indicators of whether an individual was a resident included things like maintaining a settled or usual place of abode or being present in a place for a considerable time. In *Levene v Commissioners of Inland Revenue*¹⁴, Viscount Cave found that on most occasions there was no particular difficulty in determining ‘where a man has his settled or usual abode.’¹⁵

However, in the early twentieth century in respect of companies, the English courts had to wrestle with a legislatively created entity in determining where a company was a resident

⁹ Australian Tax Office, above n 1.

¹⁰ The Federal Treasury, Review of International Taxation Arrangements, (Canberra, 2002) <http://www.taxboard.gov.au/content/reviews_and_consultations/international_taxation_arrangements/consultation_paper/downloads/international_taxation_arrangements_consultation_paper.pdf>.

¹¹ Ibid 55.

¹² Adams, T.S., *The Taxation of Business*, 11 National Tax Association Proc. 185, 186 (1917) cited in Sprague et al., *Permanent Establishments and the Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests*, Tax Council Policy Institute, 2003.

¹³ *Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue* (1927) 275 US 87, 100.

¹⁴ [1928] 1 AC 217.

¹⁵ Ibid, 222–223.

for tax purposes. In *De Beers Consolidated Mines Ltd v Howe*,¹⁶ Lord Loreburn found it convenient to draw an analogy with individuals in ascertaining where a company was resident. In that case, he said:

In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business...¹⁷

In *Egyptian Delta Land and Investment Company Ltd v Todd*,¹⁸ Lord Sumner acknowledges the difficulty of applying the natural resident concept to companies and in the end he concludes that it can only be artificially applied. However he said:

The analogy that is really possible between a natural person and a company is that of carrying on business at a place...and in my opinion, for the purposes of income tax, both on the words of the Acts and on the cases, the residence of a foreign company is preponderantly...determined by this kind of fact.¹⁹

The question therefore to be addressed by the courts was where does the company keep house and do business? In *De Beers*, Lord Loreburn answered this question by stating that a company's 'real business is carried on where the central management and control actually abides.'²⁰ He also said that this was a question of fact to be determined on the evidence before the court.²¹ In ascertaining where the central management and control abides, Lord Loreburn focused on where the high-level decisions and functions were made such as the negotiation of contracts, the application of profits and the appointment of directors. Based on the facts before him, he concluded that this took place in London where the majority of directors and life governors lived and where the directors meetings were held.

III. THE CENTRAL MANAGEMENT AND CONTROL TEST: ONE OR TWO ELEMENTS?

The leading authority in Australia on the second statutory test in sub-section 6(1) of ITAA36 is the High Court case of *Malayan Shipping Company v Federal Commissioner of Taxation*.²² *Malayan Shipping* centred on the charter of a Norwegian tanker in London by the taxpayer

¹⁶ [1906] AC 455.

¹⁷ *Ibid*, 458.

¹⁸ [1929] AC 1.

¹⁹ *Ibid*, 12.

²⁰ Above n 16, 458. The formulation of central management and control was adopted with approval from the decisions in *Calcutta Jute Mills v Nicholson* (1876) 1 Ex. D.428 and *Cesena Sulphur Co. v Nicholson* (1876) 1 Ex. D.428.

²¹ *Ibid*.

²² Above n 6. Recent English cases on central management and control do not challenge the judicial dominance of *Malayan Shipping* in Australia. In addition there have been no recent decisions in Australia on the central management and control concept or testing the limits of TR2004/15.

company which was incorporated in Singapore. Instructions were issued on behalf of the company by a Melbourne businessman, Mr Sleigh. He was the managing director and held the majority of shares in the company. It was apparent that Sleigh had all the say in the company's operations. He organised the contracts and charted the course of the business. The evidence showed that he had the power to appoint and remove the other directors. The only business of the taxpayer company in the relevant years was the sub-charter to Mr. Sleigh of the tanker on ten voyage charters with the necessary documents being prepared and executed by him in Melbourne, Australia.

The issue before the High Court was whether the taxpayer company was a resident of Australia within the meaning of the second test of residence contained in sub-section 6(1) of ITAA 36 during the relevant years of income. His Honour, Justice Williams found that the company was a resident of Australia and was therefore assessable on the income derived by it from the sub-charter operations. This decision and the reasoning behind the decision has been the subject of much conjecture and is addressed by the Commissioner of Taxation in taxation ruling TR2004/15.

Williams J addressed the submission made by the appellant which:

... contended that since the definition [within the second statutory test] required that the company should be carrying on business in Australia and also that the central management and control should be in Australia...the carrying on of business could not refer to the control of the operations of business from which the profits arose but only to the actual operations themselves.²³

Williams J also made reference to the appellant's contention that as the contracts were made by the taxpayer in Singapore it was not carrying on business in Australia within the meaning of the Act. In his deliberations, Williams J referred to *Mitchell v Egyptian Hotels Ltd* where Lord Parker of Waddington said: '[w]here the brain which controls the operations from which the profits and gain arise is in this country the trade or business is, at any rate partly, carried on in this country.'²⁴ His Honour went on to state:

*The purpose of requiring that, in addition to carrying on business in Australia, the central management and control of the business or the controlling shareholders must be situated or resident in Australia is, in my opinion to make it clear that the mere trading in Australia by a company not incorporated in Australia will not of itself be sufficient to cause the company to become a resident of Australia.*²⁵

This opinion goes some way to deciphering the purpose of the second statutory test. A company not incorporated in Australia may be carrying on business in Australia but without its central management and control being in the same country. In this situation the company

²³ Ibid, 159.

²⁴ [1915] A.C. 1022, 1037.

²⁵ Above n 6, 159.

will not be a resident of Australia in accordance with sub-section 6(1). Satisfaction of both elements is required in this context in order to deem a corporate entity as a resident. But is the converse true? If central management and control is found to exist in Australia, does the company, not being incorporated in Australia, have to be carrying on business in Australia to satisfy the test of residency? In this respect, Williams J said:

*But if the business of the company carried on in Australia consists of or includes its central management and control, then the company is carrying on business in Australia, and its central management and control is in Australia.*²⁶

This statement is suggestive of a general principle that if a company's central management and control is in Australia, then that function forms part of its business and hence the company is carrying on business in Australia. It is this general principle that may lead to a view that the first element of the test is essentially superfluous thus leading to an essentially one-element requirement. However, based on the remarks of Williams J, the first element is there as a reminder that mere trading or the conduct of the lower level management functions will not of themselves give rise to a company being a resident. Something additional is needed. Central management and control refers to the functions at the pinnacle of power. It refers to the high-level decision making such as the appointment of directors, the formulation of the company's strategic direction, the activities which are at the heart of the profit-generating capability, namely the brain.²⁷ Williams J refers to the business of the company being the central management and control. So there appears to be a divergence of activity: some activity is mere trading and on the other hand, some activity constitutes central management and control.

The notion of a one-element approach appears to be similarly expressed in *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation*²⁸ where Dixon J said:

In the first place, it is well to remember that the basal principle is that a company resides where its real business is carried on and that it is for the purposes of ascertaining where that is that the subsidiary principle is invoked that the place where the superior direction and control is exercised determines where the real business is carried on.

However, it is important to note that this case was not about the application of the definition of resident in sub-section 6(1) but rather related to the former paragraph 23(m) of ITAA36 which provided an exemption from income tax to Northern Territory residents for income they derived in the Territory. Dixon J was applying the common law to the particular fact situation to ascertain whether or not the taxpayer was resident of the Territory. However, the remarks of Dixon J do emphasise the hierarchy of business activities with a differentiation between 'real' business and the mere operational aspects.

²⁶ Ibid.

²⁷ Lord Parker, *Mitchell v. Egyptian Hotels Ltd*, above n 24, 1037.

²⁸ (1946) 71 CLR 623, 629.

It is useful to note the comments of the Taxation Review Committee Full Report²⁹ on the central management and control issue. The report says:

*A resident of Australia in relation to a company is defined by exclusively statutory tests, though one of these—central management and control—uses the language of judicial decisions that adopts the notion of residence of a company under United Kingdom law.*³⁰

The report goes on to say:

*As the test has been interpreted, the reference to carrying on business in Australia is unnecessary: central management and control, it is said, involves the carrying on of business. In any event, in the Committee's view it should be enough to give a company a residence in Australia that its central management and control is here.*³¹

It is also interesting to note the concern of the Committee that the meaning of central management and control needed clarification. It said that the phrase might be interpreted widely enough in some circumstances so as to '... increase the likelihood of a company being resident both in Australia and in a foreign country to a degree that might be regarded as unacceptable.'³²

As a final note, Professor Dirki refers to the Explanatory Notes in relation to the second statutory test. As he says, the Note on Clause 2 in the Explanatory Notes of the Bill to Amend the Income Tax Assessment Act 1922–1929 (Cth), 11 provides that:

*The definition was intended to apply '...to companies...whose central management and control is in Australia' thereby ensuring that a '...number of companies incorporated outside Australia whose sole or principal business is located in Australia' were taxable as residents.*³³

This Explanatory Note provides further support for the view that central management and control, alone, would be sufficient to deem a company to be a resident of Australia under the statute.

IV. THE COMMISSIONER'S VIEW IN TR2004/15

Prior to the release of TR2004/15, the difficulties with the decision of the High Court in *Malayan Shipping* had been raised in the Federal Treasury's consultation paper called the Review of International Taxation Arrangements.³⁴ That paper detailed particular problems

²⁹ Taxation Review Committee, Commonwealth, *Full Report* (Canberra, AGPS, 1975).

³⁰ *Ibid*, paragraph 17.13.

³¹ *Ibid*, paragraph 17.14.

³² *Ibid*, paragraph 17.15.

³³ Above n 8, 36.

³⁴ The Federal Treasury, above n 10.

with the current tests of resident for companies including confusion over the application of the second statutory test. The consultation paper says:

*The case law is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test...*³⁵

In the following year, the Board of Taxation recommended a simple and certain test for the residence of companies. A company would only be resident of Australia if it was incorporated in Australia.³⁶ Much of the argument from business for a simple test of incorporation hinged on the perceived difficulties with central management and control, both whether that was enough in fact for the carrying on of a business and its practical application. Concerned that the Government may adopt an 'incorporation in Australia' test which the ATO regarded as open to abuse and not reflecting the economic reality, and hence giving rise to residency by choice for tax purposes. The ATO convinced the Government not to accept the recommendation but instead await a review and possible ruling on the issues of central management and control and whether that made life less difficult in practice for companies who were not incorporated in Australia concerned about their residency. One year later, the Australian Taxation Office produced TR2005/14 on 'the residence of companies not incorporated in Australia – carrying on business in Australia and central management and control.'³⁷The ruling was the ATO's attempt to clarify the operation of the second statutory test of company residence and avoid the worst possible outcome from its point of view – an 'incorporation in Australia' test as the sole determinant of residence here.

The ruling makes a number of points in support of a strict two-element construction of the second statutory test. For a company to be resident under the second statutory test, two conditions must be satisfied. First, the company must be carrying on business in Australia and second, it must have its central management and control in Australia.³⁸ The ruling goes on to say:

*If no business is carried on in Australia, the company cannot meet the requirements of the second statutory test. In these situations there is no need to determine the location of the company's central management and control, separate from its consideration of whether the company carries on business in Australia.*³⁹

To further clarify its position, the ruling says that '...if the company carries on business in Australia it also has to have its central management and control in Australia to meet the

³⁵ Ibid, 54.

³⁶ The Board of Taxation, International Taxation: A Report to the Treasurer, (Canberra, 2003), 109 <http://www.taxboard.gov.au/content/reviews_and_consultations/international_taxation_arrangements/report/downloads/international_taxation_arrangements_report_volume_1.pdf>.

³⁷ ATO, above n 1.

³⁸ Ibid, paragraph 5.

³⁹ Ibid, paragraph 6.

second statutory test.⁴⁰ The general thrust of the ruling is that the central management and control function does not constitute part of the business operations being carried on.

Part of the reasoning employed by the Taxation Office in supporting its general interpretation of the test is based on its views about various principles of statutory construction. Citing *Broken Hill*⁴¹ and *Jackson*,⁴² the ruling argues that a basic rule of statutory determination requires that 'the plain words of an Act must be given full meaning and effect.'⁴³ The ruling goes on to say that 'it is arguable that an interpretation giving effect to all the words of the second statutory test is preferable to one making the words 'carries on business in Australia' superfluous and unnecessary.'⁴⁴

The second line of reasoning employed in the ruling refers to the decision in *Malayan Shipping*.⁴⁵ The Commissioner argues that because the two separate requirements of the test were satisfied by the same set of facts so *Malayan Shipping* should be limited to its facts.⁴⁶ The Commissioner then says that '[o]n the question of whether the company was carrying on business in Australia, Williams J acknowledges that the question of where business is carried on is in every case one of fact.'⁴⁷

In response to this view, it could be argued that the Commissioner is taking Williams J's comments out of context. The tenor of Williams J's findings would appear to be unequivocal. He says that '...if the business of the company carried on in Australia consists of or includes its central management and control, then the company is carrying on business in Australia and its central management and control is in Australia.'⁴⁸ What is open to question is whether the central management and control is in Australia. This is the 'question of fact' to which Williams J referred.

The ruling provides a number of examples to illustrate the Commissioner's interpretation of the second statutory test. At paragraph 71, Example 2 refers to a company incorporated in Papua New Guinea but in which the board meetings of its directors are mainly held in Australia.⁴⁹ At those meetings all the major policies and strategic decisions are made. All of the trading activities are conducted in Papua New Guinea. The Commissioner's view in respect of this fact situation is that the company is not a resident of Australia for income tax

⁴⁰ Ibid.

⁴¹ *Broken Hill South Ltd (Public Officer) v Commr of Taxation (NSW)* (1937) 56 CLR 337 at 371 per Dixon J.

⁴² *Jackson v Secretary, Department of Health* (1987) 75 ALR 561, 571.

⁴³ ATO, above n 1, paragraph 28.

⁴⁴ Ibid, paragraph 29.

⁴⁵ Above n 6.

⁴⁶ ATO, above n 1, paragraph 33 and 34.

⁴⁷ Ibid, paragraph 35.

⁴⁸ Above n 6, 159.

⁴⁹ ATO, above n 1, paragraph 71.

purposes. This is because the company is not carrying on business in Australia even though its central management and control is in Australia. However, as Shaflender et al say, '[o]ne may query whether applying the principle outlined in *Malayan Shipping* to the [ruling's] example would produce a different result.'⁵⁰ It is contended in this article that it would.

V. RISK MANAGEMENT AND RELIANCE ON TR2004/15

Can taxpayers take comfort from the general thrust of TR2004/15? It is strongly argued in this article that there is a clear risk where the affairs of companies are structured in reliance on TR2004/15. In accordance with the law, a company may be deemed a resident under the test whereas the Commissioner's view as expressed in TR2004/15 might suggest that the company is not a resident. As Shaflender et al say, 'if *Malayan Shipping* is judicial authority for the proposition that if a taxpayer's central management and control is in Australia then the taxpayer necessarily carries on business in Australia'⁵¹ then the Commissioner's view cannot displace the law. Clearly there is a conflict but from a practical perspective the legal issues raised by the difference between the ATO' ruling and the *Malayan Shipping's* interpretation might be found in the fact that the Commissioner has the responsibility to administer the income tax laws and his officers are bound to apply the Tax Ruling in appropriate circumstances until a Court or the Parliament of Australia clarifies the law.⁵²

It is interesting to note the almost non-binding nature of the language the ruling uses. For example in the preamble to the ruling, the Commissioner says that '...[t]his ruling provides *guidelines* [emphasis added] for determining whether a company, not incorporated in Australia, is a resident of Australia under the second statutory test...'⁵³ It goes on to say that '... while every case turns on its facts, this ruling gives guidance to companies determining their residence under the second statutory test.'⁵⁴ On reflection this is not surprising since taxation rulings are not binding on taxpayers, although taxpayers may open themselves up to increased penalties if they do not follow the ruling and the Commissioner's view is ultimately upheld by the court.⁵⁵

It is not too hard to imagine scenarios in which taxpayers might want to adopt the view of the High Court in *Malayan Shipping* that central management and control is carrying on a business and challenge the Commissioner's approach in the ruling. For example, some companies incorporated overseas may or may not want to be residents of Australia.

⁵⁰ Shaflender L, et el, 'Residence of companies not incorporated in Australia', *Taxation in Australia*, (2004) 39(4), 187.

⁵¹ Ibid.

⁵² Division 358, *Taxation Administration Act 1953* and PS LA 2008/3.

⁵³ ATO, above n 1, paragraph 1.

⁵⁴ Ibid, paragraph 2.

⁵⁵ *Division 358, Taxation Administration Act 1953*.

Depending on their circumstances and leaving aside tax treaty implications, they may want to argue that they have their central management and control in Australia and are residents of Australia even though they may not otherwise be carrying on business in Australia, at least as understood through the prism of the Taxation Ruling. Applying *Malayan Shipping* could produce a different residency result than relying on the ruling. The ruling may give little solace to taxpayers in those circumstances to confidently arrange their affairs in the knowledge that their Australian residency status for tax purposes will be clear.

Other concerns arise in relation to some of the terminology employed in the ruling. For example, at paragraph 9, the Commissioner addresses the ‘carries on business in Australia’ element within the test. The ruling says that the Commissioner ‘... draw[s] a distinction between a company with operational activities... and a company which is *more passive* [emphasis added] in its dealings. It will be appreciated that there will be some overlap in any particular situation.’ This raises concerns because it effectively admits that the particular circumstances and business activities of the taxpayer will be of the essence in determining whether business is carried on in Australia. Where there is overlap there is potential doubt.

Another point is that taxpayers relying on binding public rulings must have their circumstances on all fours with the arrangements which are the subject of a public ruling. In *Bellinz and Others v Commissioner of Taxation*⁵⁶, the taxpayer arranged its affairs in reliance on various rulings, not all of which were binding, so that it could claim substantial depreciation deductions under a ‘lessor partnership’. One of the issues addressed by the Court was whether the lessor partnership was entitled to rely on public rulings under Part IVAAA of the *Taxation Administration Act 1953*.

In response, the Court held that ‘while underlying the ruling a philosophy to permit depreciation in respect of hire purchase arrangements may be gleaned, none of the rulings relates to an arrangement or class or arrangement precisely similar to the present arrangement.’⁵⁷ This result further highlights the fact that TR2004/15 may not be the ‘Holy Grail’ that some tax planners may think it is and that reliance on it may be problematic if the central management and control test comes before the Australian courts in the future.

Even if risk management reasonably leads a company to rely on TR2004/14, or more interestingly, to not rely on it, there are still major practical problems associated with applying the statutory definition.

⁵⁶ 84 FCR 154.

⁵⁷ Ibid 169.

VI. WHERE IS CENTRAL MANAGEMENT AND CONTROL LOCATED?

Irrespective of the interpretation given to the second statutory test, there still remains the sometimes perplexing issue of where the central management and control actually is on a given sets of facts. This invariably becomes a question of who exercises central management and control and where they exercise it.

As Gillies says:

*The logical place to commence the search for central management and control is in the provisions of the company's constituent documents. Typically they will provide that the power to control the company's destiny is vested in the board of directors.*⁵⁸

As a starting point one could therefore look to where the board meets to transact the company's business as being the place where the central management and control is exercised. But as one commentator notes, this does not necessarily go to the root of the answer because an agreement may have been entered into where the directors will vote in accordance with the instructions of another or because independent judgment is not exercised there.⁵⁹

In the *De Beers* case the question arose as to whether a company should pay income tax on the basis that it was a resident of the United Kingdom. The company was incorporated in South Africa and had its head office situated there. The profits of the company were generated solely from the extraction and sale of diamonds in that country. Although general meetings of its directors were held in both Africa and London, the fact that the majority of the directors lived in London and the latter place was where the chief control of the company's affairs took place, was influential in the House of Lords concluding that the company was resident in the United Kingdom. Lord Loreburn, in addressing the issue of where the company's real business is carried on and hence its central management and control, stated that '[t]his is a question of fact to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business and trading.'⁶⁰

The determination of where central management and control is exercised as a question of fact was enunciated in *Unit Constructions Co Ltd v Bullock*⁶¹ where Viscount Simonds held that '[n]othing can be more factual and concrete than the acts of management which enable a court to find as a fact that central management and control is exercised in one country or another.'⁶²

⁵⁸ Gillies P., 'Understanding Company Residence: Central Management and Control', (1989) August/September, *The CCH Journal of Australian Taxation* 54.

⁵⁹ Hamilton et al; *Guidebook to Australian International Taxation*, (Prospect Publishers 2001), 2.

⁶⁰ Above n 16, 458.

⁶¹ [1959] 3 All ER 831.

⁶² *Ibid*, 834–835.

In *Unit Constructions*, the taxpayer, an English company, sought a tax deduction in respect of certain outgoings to African subsidiaries of its English parent. Although the subsidiaries were registered in Africa, the taxpayer argued that they had become resident of the United Kingdom by reason that the directors of the subsidiaries had stood aside and de facto control had been assumed by the directors of the United Kingdom parent. This assumed control in the United Kingdom ran contrary to the subsidiaries' articles of association which stated that directors' meetings could be held anywhere outside the United Kingdom.

Viscount Simmonds held:

*It does not in any way alter ... [the fact that the acts of management] in greater or less degree ... are irregular or unauthorised or unlawful. The business is not the less managed in London because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution however imperative.*⁶³

Lord Radcliffe in *De Beers* set out the de facto principle when he said that '[t]he articles prescribe what ought to be done; but they cannot create an actual state of control and management in Africa which does not exist in fact.'⁶⁴

The decision in the Australian case *Esquire Nominees Ltd v Federal Commissioner of Taxation*⁶⁵ stands in contrast to the findings of the court in *Unit Constructions*. In *Esquire Nominees* the taxpayer was incorporated in Norfolk Island and acted as trustee of a Norfolk Island trust. The taxpayer's directors were all residents of Norfolk Island and all the meetings of the directors were held there. However, the facts showed that the agendas for the Norfolk Island meetings were arranged by a group of Australian accountants who acted on behalf of the taxpayer's beneficial owners. One of the issues before the High Court was whether the taxpayer was a resident of Australia on the basis that its central management and control was located there and accordingly that the income of the trust would be assessable under Australia's jurisdiction to tax.

The Commissioner, relying particularly on the 'de facto' principle expounded in *Unit Constructions* argued that because the real control and influence was exercised in Australia then the taxpayer was resident there. However, the High Court was not persuaded by this contention.

In finding that the taxpayer was not a resident of Australia, Gibbs J said that '[i]t is well settled that, for income tax, a company is resident where its real business is carried on, and its real business is carried on where the central management and control actually abides.'⁶⁶ He then went on to point out a number of indicia in support of the taxpayer not being a resident. They included the fact that all the directors resided in Norfolk Island, all the A class

⁶³ Ibid.

⁶⁴ Above n 16, 458.

⁶⁵ (1973) 129 CLR 177.

⁶⁶ Ibid, 190.

shareholders who were natural persons were resident of Norfolk Island, all the meetings of the company and its directors were held there and the business of the company was to act as trustee on Norfolk Island.

In the final analysis Gibbs J was swayed by the fact that although the firm of accountants had the power to influence, indeed strongly influence, the trustees, central management and control was located in Norfolk Island because the trustees would be sufficiently independent to always act in the best interests of the beneficiaries. Where the directors did comply with the directions of the accountants this was done because taking the directions was considered to be in the best interests of the beneficiaries. However, '[i]f, on the other hand, [the firm of accountants] had instructed the directors to do something which they [the taxpayer] considered improper or inadvisable, I do not believe that they would have acted on the instruction.'⁶⁷

In conclusion, Gibbs J said:

*[The taxpayer] was in my opinion managed and controlled there [Norfolk Island], none the less because the control was exercised in a manner which accorded with the wishes of the interests in Australia. The appellant was, in my opinion, a resident of Norfolk Island.*⁶⁸

Although this case went on appeal to the Full High Court, the issue of whether the taxpayer was resident was not in contention.

The main difference between *Esquire Nominees* and *Unit Constructions* appears to hinge on the fact that in *Unit Constructions* the directors in Africa stood aside from the control emanating from the United Kingdom, whereas this did not occur in respect of the Norfolk Island directors who performed their duties despite the strong influence coming from Australia. This would appear to be a moot point. As Hamilton and others say:

*A more cynical observer might say that the distinction rests on the mere technicality of transmitting 'suggestions' to be formally adopted by the directors' meetings [and] [p]rovided that the communications are simply 'suggestions', management and control seem to be difficult to prove.*⁶⁹

Irrespective of the Court's reasoning, the factual situation surrounding *Esquire Nominees* indicates how easily a company's circumstances could be arranged to achieve a desired taxation outcome under the central management and control test.

A case with similar lineage to *Esquire Nominees* is *Federal Commissioner of Taxation v Commonwealth Aluminium Corporation Ltd.*⁷⁰ This case concerned the control of businesses carried on in Australia principally by non-residents under the former s136, ITAA36. Through a chain of shareholdings, predominant ownership of the shareholder could be traced to non-

⁶⁷ Ibid, 191.

⁶⁸ Ibid.

⁶⁹ Hamilton et al, above n 59, 2-17.

⁷⁰ (1980) 143 CLR 646.

resident interests. During one of the income years in question, the majority of the directors were non-residents.

The majority of the High Court held that for s136 to apply, the control exercised must be de facto control as opposed to capacity to control.⁷¹ As the non-residents had not, in actuality, exercised control over the business during the relevant years, the section had no application. The high-level decision making was exercised, in the main, by directors resident in Australia. The findings of the majority were based essentially on a form over substance approach which was specifically rejected by Murphy J in his dissenting judgment. In that judgment, Murphy J expressed his concern about arrangements which were engineered to gain favourable taxation outcomes. He said:

[s]ection 136 was intended to be an effective instrument for the Commissioner to deal with non-residents controlling businesses in Australia in such a way that they were able to reduce taxable income by shifting available profits elsewhere or by other devices.⁷²

Murphy J did not accept the contention that the company's business activities in Australia were not controlled by non-residents. He based his view on the principle that it is inappropriate to think of transnational business conglomerates in terms of particular business components and subsidiaries. Viewing the business operations in Australia as part of a transnational corporation the taxpayer was controlled by non-residents.

The decisions in cases such as *Esquire Nominees* and *Commonwealth Aluminium Corporation* reveal the potential uncertainty that may exist as to where central management and control is located in given fact situations. This, coupled with the uncertainty about the interpretation of the second statutory test, is a very real source of concern and confusion for foreign entities planning their corporate structures in connection with Australia.

VII. IS IT TIME FOR A CHANGE?

This article has referred to major problems with the application of the second statutory test for company residence and central management and control. These problems include the issues of lack of predictability and the potential for tax planning and avoidance.

By most standards, the test lacks predictability in its application because of its form over substance approach. First, it is not clear whether it has an essentially one-element or two-element formulation. The Commissioner, through TR2004/15, appears to have manufactured an outcome which holds that the test consists of two components both of which must be satisfied if a company is deemed to be a resident of Australia. But given that the courts see the place where central management and control as being a place where the business is carried out, there must be doubts about the efficacy of TR2004/15. In addition,

⁷¹ Ibid, Stephen, Mason and Wilson JJ 656.

⁷² Above n 70, 655.

where central management and control can turn on precise fact situations, so again there must be doubts about the residency of some foreign companies in Australia under the ruling and the existing case law. On the other hand, it could be argued that the case law is responsible for the confusion and not the ruling.

There is also an additional burden the test places on companies in the light of the self-assessment code operating in Australia. Consistent with the self-assessment framework is the obligation of the Commissioner to assist taxpayers to satisfy their statutory requirements by providing them with appropriate information and guidance. Tax rulings are a product of that obligation where the provision of clear pronouncements on how the law operates should be provided. Whether TR2004/15 meets this requirement with any degree of satisfaction is debatable given the length of the document and the difficult areas of the law it traverses and, as contended in this article, the ATO's incorrect application of the settled law on central management and control.

Professor Dirkis supports the view that the central management and control test also fails on anti-avoidance grounds. He explains how this concern goes deep into taxation history when in 1930 '[t]he leader of the Opposition...in the House of Representatives noted that the central management and control test would be avoided by '...encouraging companies to remove their central management and control from Australia and arrange to be controlled by persons abroad.'"⁷³

What also makes the application of such a test more difficult is the move by multinational conglomerates to less hierarchical structures and global decentralisation of their business operations. Collett provides, by way of example, Rio Tinto's claim that it 'has largely autonomous business centres scattered around the world'.⁷⁴ Finding where central management and control exists in such circumstances may be very difficult if not impossible to determine. Another possibility cited by Collett is where firms reorganise themselves into self-standing units which are brought together to achieve particular outcomes but which are adaptable to changing environmental circumstances confronting the corporation.⁷⁵

These evolutions in corporate structures and operations would not have been envisaged at the time the resident rules were first enacted. In those earlier days business operations were more centrally operated and the physical connection with a particular jurisdiction was generally obvious.⁷⁶ Running in tandem with these changes is the impact of electronic commerce. As this mode of commerce builds momentum, fewer transactions will conform to conventional ways of undertaking business. The tendency of electronic commerce to distort

⁷³ Above n 8, 49.

⁷⁴ Collett M., 'Developing a New Test of Fiscal Residence for Companies', (2003) 26(3) *UNSW Law Journal* 629.

⁷⁵ *Ibid*, 630.

⁷⁶ Graetz M.J., 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies', (2000–2001) 26 *Brooklyn Journal of International Law* 1357.

and override geographic and political boundaries will tend to place further pressure on concepts such as residence and permanent establishment of a company.⁷⁷

What is urgently needed is a major change to the existing rules in which corporations are taxed in Australia. Some go further. Graetz says that for corporations in the context of foreign direct investment 'the idea of residence – an idea central to any discussions of principles and policies relating to international taxation...seems both outdated and unstable.'⁷⁸ Alluding to a move away from traditional tests of residence, Graetz argues that '...in the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties.'⁷⁹ This means alternative tests, taking into account the complexities of the modern cross-border world and the drive by big business to reduce tax 'costs' must be mentioned, if only briefly. It is not within the purview of this paper to examine in any detail alternatives.

VIII. ALTERNATIVES TO THE SECOND STATUTORY TEST

This paper has been about highlighting problems with the central management and control test for company residency. It would be remiss however, not to mention various proposed alternatives to the test. All of them have conceptual and practical problems.

One of the popular recommendations for corporate residency is a stand-alone incorporation test. This is the test that is used in the US and allows 'Apple' to avoid paying income tax in their country of residence. Apple is incorporated in the US, a single test of residence but has its central management and control in Ireland, again a single test country. As Antony Ting states, a company incorporated in Ireland with its central management and control in the US is therefore not a resident of either countries.⁸⁰ Prior to 2013, Ireland had a single, central management and control test whereby any company that did not have its central management and control in Ireland was not regarded as a resident for taxation purposes. However, in 2013 the Irish government amended the definition of corporate residency in order to catch companies that were 'stateless'. For companies incorporated in Ireland prior to 24 October 2013 they had until 1 January 2015 to comply with the new test.⁸¹ According

⁷⁷ McLaren, J (ed) *Advanced Taxation Law* (Thomson Reuters, 2015) 1162. The concept of Permanent Establishment is defined in all Australian Double Taxation Agreements as the place through which a business enterprise is wholly or partly conducted. It could be a branch, an office, a factory, a workshop, a mine site or agricultural operation. The internet and E-commerce is challenging this concept of a permanent establishment. For more details see page 1163.

⁷⁸ Graetz, MJ above n 76,1422.

⁷⁹ Ibid.

⁸⁰ Antony Ting, above n 2, 46.

⁸¹ Antony Ting, above n 3, 238.

to Antony Ting, the place of central management and control can be easily manipulated in practice.⁸²

Another option would be to re-engineer the central management and control test so that both a 'carry on business' and a 'central management and control' test would be needed to be satisfied for a foreign company to be deemed to be a resident. This would remove some of the doubt that presently exists in regard to the test as it currently stands. Professor Dirkis says such an option would assist in minimising compliance costs for companies by 'narrowing the range of non-resident companies caught under the current judicial interpretation of the ...test.'⁸³

Yet another option would be a variation on the central management and control test in which the central management and control element is removed thus requiring a carrying on business element alone. This approach may be seen to reflect more fundamentally the economic connection that a company has with a geographic location and with less emphasis on control. This approach has some similarities with the permanent establishment principle: an essentially source-based notion. However if the *Malayan Shipping* analysis is correct, a company having its central management and control in Australia would be carrying on a business in Australia and so would be a resident. Any provision along the lines suggested would have to fully exclude central management and control from the scope of carrying on a business in Australia.

The internet and other modes of electronic technology challenge the determination of where wealth is generated. For a 'carries on business' test, it may be difficult, if not impossible, to determine where servers and other telecommunications devices are located. As Thorpe notes:

*The problem centres around the issue of whether, due to the decentralised and mobile nature of the Internet, the commercial activity taking place in Cyberspace fits within conventional international tax system definitions and rules followed by most countries and taxing jurisdictions.*⁸⁴

Hence, under this model, it would be necessary to show that an enterprise conducting business over the internet has an economic connection with Australia. Clearly the rise of digital communications threatens tax bases and undermines sovereignty. For example the OECD has said:

⁸² Ibid.

⁸³ Dirkis, above n 8, 65.

⁸⁴ Thorpe K.E., 'International Taxation of Electronic Commerce: Is the Internet Age Rendering the concept of Permanent Establishment Obsolete?', (1997) 11 *Emory International Law Review*, 634.

[T]he challenges brought about by the digital economy raise systemic challenges regarding the ability of the current international tax framework to ensure that profits are taxed where economic activities occur and where value is created.’⁸⁵

Fiddling with the central management and control test will not address these wider BEPS issues.

In this article, the primacy of the resident concept for corporations has remained unchallenged. However, given the fundamental difficulties in framing robust corporate tests, is there an alternative proposal that relies less on the resident shibboleth? If the rules of corporate integration currently employed, in one form or another, by most developed countries could be adapted and extended into a fully integrated global system then the current emphasis on the residency approach for corporations could potentially take on less importance. A logical, but radical, extension to global corporate integration would be to remove the impost of taxation entirely at the company level and tax only individual shareholders. This approach would therefore remove the need to establish the associated sets of corporate resident rules. Various vested interests, including national capital in Australia, implementation difficulties and the need for a unified global approach make this an unlikely option in the short term.

Some have suggested that a view founded on more conventional economic thinking would be to tax companies purely on a source basis. The reliance on a source-based jurisdiction to tax wealth creation was endorsed by a group of economists appointed by the League of Nations to investigate the question of double taxation. The Centre for Tax Policy and Administration for the OECD says that although there are strong theoretical arguments for income being taxed exclusively in the state of residence, the League of Nations economists reported that ‘...taxation should be based on a doctrine of *economic allegiance*: ‘whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income.’⁸⁶ They concluded that wealth creation should be taxed at its origin (source) and where the wealth is spent (residence). This approach may challenge capital exporting countries and their tax bases.

Graetz, for example, although referring to international tax in the context of permanent establishments, poses the question:

[W]ould it be worth exploring whether a threshold amount of sales, assets, labor, or research and development within a nation could better serve to establish both the source of business income and as a threshold for the imposition of income taxation?⁸⁷

⁸⁵ OECD, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, Paris, 2014) 4 <<http://dx.doi.org/10.1787/9789264218789-en>>.

⁸⁶ Ibid 11.

⁸⁷ Graetz, above n 76, 1421.

Other approaches argue for variations on what is known as the formulary apportionment model.⁸⁸ Essentially this uses various formulae based on the factors of production such as labour, capital and land (e.g. payroll, sales and property) to apportion income to different jurisdictions. Difficulties in determining an appropriate formula that reflects the real economic activity in a particular jurisdiction and in implementing the approach, especially without some sort of international consensus, make this another cure which may be worse than the disease.

None of the alternatives on offer provide an easy solution.

IX. CONCLUSION

This article has analysed the second statutory company residence test and the difficulties and uncertainties it generates particularly for foreign-based companies having a connection with Australia. The concern is that the uncertainty about how the test applies may act as a deterrent to companies wishing to establish a presence in Australia.

Although the Commissioner, through the publication of TR2004/15, has expressed a general view that the test constitutes two requirements, there is a potential conflict between that view and the law as determined by the High Court in *Malayan Shipping*. Another difficulty is ascertaining where the central management and control is located as a matter of fact, especially in the digital age with instant communications through the ether and with links such as videoconferencing.

If a residency-based company test is to remain in Australia, which is likely, then new thinking is required to address the changing nature of commerce across the globe and to enable Australia to protect in part its company tax base. The ATO's current views on the central management and control test, incorrect in law as it has been interpreted by the courts, does neither.

⁸⁸ For an interesting discussion of this approach, see Kerrie Sadiq, 'Taxation of multinational banks: using formulary apportionment to reflect economic reality (Part 1)' (2011) 22(5) *Journal of International Taxation* 46.

IN WHOSE INTEREST? AN ASSESSMENT OF THE NEW SOUTH WALES GOVERNMENT'S POST-AMALGAMATION RATE PATH FREEZE POLICY

BRIAN DOLLERY* AND JOSEPH DREW†

ABSTRACT

As part of its controversial forced amalgamation program, the Baird Government announced that merged councils would fall under a rate path freeze for a period of four years. During that time, merged municipalities would face the same rate increases they would have experienced had they not been amalgamated. The NSW Government also requested the Independent Pricing and Regulatory Tribunal (IPART) to offer recommendations on how the rate freeze policy should best be implemented and IPART released *Freezing Existing Rate Paths for Newly Merged Councils* in August 2016. This paper examines the rate freeze policy and the IPART report and demonstrates that they would impose serious efficiency, equity and financial sustainability problems on compulsorily consolidated councils.

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I. INTRODUCTION

Despite the ubiquitous use of forced municipal mergers as an instrument of local government reform in all Australian local government systems, except Western Australia, compulsory council consolidation remains controversial and electorally unpopular.¹ Given the ongoing controversy it has generated, as well as the related by-election loss in Orange in October 2016, the current forced amalgamation program in New South Wales (NSW) is no exception and the Baird Government has imposed a freeze on rates in newly merged councils to ameliorate public concern, notwithstanding the inevitable equity and financial sustainability problems associated with the freeze. This paper examines the freeze together with the Independent Pricing and Regulatory Tribunal's (IPART) recommendations for implementing the freeze.²

The controversial *Fit for the Future* NSW local government reform program had its genesis at the *Destination 2036 Workshop* held in Dubbo on 19th August 2011 which *inter alia* led to the establishment of the Independent Local Government Review Panel charged with providing recommendations for reform of the NSW local government system. In April 2013, the Panel released its interim report *Future Directions for NSW Local Government* recommending a radical program of compulsory council consolidation.³ These recommendations were largely replicated in its final report *Revitalising Local Government* published in October 2013.⁴ The NSW Government accepted the Panel's arguments for forced amalgamation and initiated the formal process of municipal mergers in December 2015, though with a significantly modified list of targeted councils.⁵ As part of this process, the Minister for Local Government determined that – for a four-year period after compulsory consolidation – affected councils would function under the rate increase trajectory already decided prior to the forced mergers.⁶

¹ Brian Dollery, Bligh Grant and Michael Kortt, *Councils in Cooperation: Shared Services and Australian Local Government*, (Federation Press, 2012).

² Independent Pricing and Regulatory Tribunal (IPART), *Freezing Existing Rate Paths for Newly Merged Councils* (2016).

³ Independent Local Government Review Panel (ILGRP), *Future Directions for NSW Local Government: Twenty Essential Steps*, (2013).

⁴ Independent Local Government Review Panel (ILGRP), *Revitalizing Local Government* (2013).

⁵ Glenn Fahey, Brian Dollery and Joseph Drew, *When Push Comes to Shove: The Process of Forced Amalgamation in New South Wales Local Government* (2016), unpublished manuscript, Centre for Local Government, University of New England, Table 1. Table 1 provides details of the changing nature of the list of councils recommended for amalgamation over the course of the *Fit for the Future* process.

⁶ Joseph Drew and Brian Dollery, 'Less Haste More Speed: The Fit for Future Reform Program in New South Wales Local Government' (2015) 75(1) *Australian Journal of Public Administration* 78, 88.

In Chapter 6 of its *Revitalising Local Government*, the Independent Panel called for a full inquiry into the long-standing policy of rate-capping in NSW local government.⁷ In particular, it proposed that the NSW IPART be commissioned to review the NSW rating system, especially with respect to 'options to reduce or remove excessive exemptions and concessions that are contrary to sound fiscal policy and jeopardise councils' long term sustainability' (Recommendation 6.2) and whether to 'either replace rate-pegging with a new system of 'rate benchmarking' or streamline current arrangements to remove unwarranted complexity, costs, and constraints to sound financial management' (Recommendation 6.5).⁸

In late 2015, the NSW Government duly instructed IPART to conduct a review of the local government rating system in NSW.⁹ As part of this review, IPART was requested to report on the NSW Government policy of 'freezing' the existing rate paths for four years of new forcibly amalgamated local authorities and to make policy recommendations to effectively implement this 'rate path trajectory freeze' policy.

The NSW Government's rate path freeze policy has two main element ingredients: (a) compulsory council consolidation must not change the existing rate paths already decided for local councils in newly merged entities on grounds that this would provide 'ratepayers with certainty about their rates', and (b) ratepayers in the newly-amalgamated municipalities would have their rates protected against future increases during the rate path freeze period.¹⁰ The intended net effect of (a) and (b) is that ratepayers will pay no more for their rates for the four-year period than they would otherwise have done had their council not been forcibly merged. In addition, the NSW Government indicated that its four-year rate path freeze policy would assist in obliging merged councils to improve operational efficiency through cost savings which would in turn serve to place downward pressure on property taxes in the longer term.

As part of its deliberations, in April 2016 IPART published its *Review of the Local Government Rating System: Issues Paper* which sought community comment.¹¹ In June 2016 it submitted an interim report on the question of implementing the NSW Government's rate path freeze policy to the Minister for Local Government entitled *Freezing Existing Rate Paths for Newly Merged Councils*. This report was subsequently made public on 1st August 2016. This paper seeks to provide a critical assessment of *Freezing Existing Rate Paths for Newly Merged Councils*.

⁷ Independent Local Government Review Panel, above n 4.

⁸ Independent Local Government Review Panel, above n 4, 16.

⁹ Joseph Drew and Brian Dollery, 'A Fair Go? A Response to the Independent Local Government Review Panel's Assessment of Municipal Taxation in New South Wales' (2015) 30 *Australian Tax Forum* 471, 489.

¹⁰ Independent Pricing and Regulatory Tribunal, above n 2.

¹¹ Independent Pricing and Regulatory Tribunal (IPART), *Review of the Local Government Rating System: Issues Paper*, (2016).

A substantial worldwide literature exists on the analysis of local government reform by means of municipal mergers (for surveys of this literature see, for example, Dollery, Garcea and LeSage; Dollery and Robotti; Faulk and Hicks; Lago-Penas and Martinez-Vazquesz¹²). Given the comparatively heavy emphasis placed by Australian local government policy-makers on forced amalgamation as an instrument of structural reform, this literature has a substantial Australian strand.¹³ This body of work has been recently been augmented by research on the current NSW compulsory council consolidation program, which includes an assessment of the Panel's recommendations on rating in NSW local government.¹⁴ The present paper thus seeks to add to this literature.

The paper is divided into three main parts. Section 2 provides a synopsis of the recommendations offered by IPART in its *Freezing Existing Rate Paths for Newly Merged Councils*.¹⁵ Section 3 offers a critical evaluation of the rate freeze policy and recommendations contained in the IPART report. The paper ends with some brief concluding remarks in section 4.

II. IPART RATE PATH FREEZE POLICY IMPLEMENTATION APPROACH

A. *General Principles Guiding Rate Path Freeze Policy Application*

IPART's *Freezing Existing Rate Paths for Newly Merged Councils* begins with an attempt to operationalise the NSW Government's four-year rate path freeze policy.¹⁶ In essence, IPART argues that the policy centres on the rate of increase of 'general income' of each council forcibly merged into a larger entity over a four-year period. General income is defined in accordance with the NSW *Local Government Act 1993* (as amended) as revenue from 'ordinary rates, special rates and specified annual charges', which does not include 'special rates and charges for water and sewerage'.¹⁷ Accordingly, in terms of IPART's interpretation of the rate path freeze policy, the policy means that 'for the four years after a merger, rates

¹² Brian Dollery, Joseph Garcea and Edward LeSage (eds.), *Local Government Reform: A Comparative Analysis of Advanced Anglo-American Countries* (Edward Elgar, 2008); Brian Dollery and Lorenzo Robotti (eds.), *Theory and Practice of Local Government Reform* (Edward Elgar, 2008); Dagney Faulk and Michael Hicks, *Local Government Consolidation in the United States* (Cambria Press, 2011); Santiago Lago-Penas and Jorge Martinez-Vazquesz (eds.), *The Challenge of Local Government Size: Theoretical Perspectives, International Experience and Policy Reform* (Edward Elgar Publishers, 2013).

¹³ See, for example, Dollery, Grant and Kortt, above n 1.

¹⁴ See, for instance, Drew and Dollery, above n 5.

¹⁵ Independent Pricing and Regulatory Tribunal, above n 2.

¹⁶ Independent Pricing and Regulatory Tribunal, above n 2.

¹⁷ *Local Government Act 1993* (NSW), s 505.

for each individual ratepayer would continue to be set so that their rate path follows the same trajectory as if the merger had not occurred'.¹⁸

Since the 'rate path freeze applies to the general income at the pre-merger council level', IPART argues that 'this general income would only be adjusted for external factors'.¹⁹ Moreover, a new compulsorily consolidated council 'should not be allowed to equalise rates across its pre-merger council areas using mechanisms that lead to rate increases' since this would be 'inconsistent with the rate path freeze policy'.²⁰ Rate equalisation in a newly merged municipality thus cannot be sought by (a) 'imposing special variations on only one pre-merger council area' or (b) 'rebalancing' the burden of rates through increasing rates in one pre-merger council area.²¹ In terms of feedback to its *Review of the Local Government Rating System: Issues Paper*, IPART found that 'in general, stakeholders supported our interpretation of the rate path freeze policy' and it thus determined 'to adopt this interpretation'.²² Under this interpretation, 'the general income in a pre-merger council area would only increase by external factors'.²³

Against this background, IPART proposed Recommendation 1:

'That the general income for a pre-merger council area should be adjusted annually by the following external factors:

- the rate peg OR any special variation approved for that pre-merger council area
- the expiry of any temporary special variations during the rate path freeze period, that apply in the pre-merger council area and are not renewed using a permitted special variation (see Recommendation 6), and
- other external factors permitted under the Local Government Act 1993 (i.e., 'above the peg' growth in general income, catch-up or excess income from the previous year and valuation objections).²⁴

IPART stresses that new net increases in rates above the rate path freeze should not be permitted by arguing as follows: 'Allowing a new council to change its existing rate paths, solely in response to the merger and in a way that increases rates for some ratepayers, conflicts with the rate path freeze policy'.²⁵

This leads IPART to Recommendation 2:

¹⁸ Independent Pricing and Regulatory Tribunal, above n 2, 9.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ibid.

²² Ibid.

²³ Ibid.

²⁴ Independent Pricing and Regulatory Tribunal, above n 2, 9, 10.

²⁵ Independent Pricing and Regulatory Tribunal, above n 2, 11.

‘That new councils should not be permitted to equalise rates across their pre-merger council areas by:

- applying for new special variations, or
- rebalancing the allocation of rates between pre-merger council areas by increasing rates in any pre-merger council area.²⁶

However, IPART contends that a new compulsorily consolidated council should be entitled to attempt to equalise rates across pre-merger council areas by setting rates ‘below the peg’ within a given general income path rise. Under this arrangement, a pre-merger council’s rate path represents a ceiling on these rate increases. Put differently, ‘a new council would be free to set rates at lower levels within any pre-merger council area in any rating category, which might have the effect of equalising rates across its pre-merger council areas’.²⁷

This led IPART to its Recommendation 3:

‘That new councils should continue to be allowed discretion to set rates below the rate cap ceiling during the rate path freeze’.²⁸

B. *Exceptions to General Principles on Rate Path Freeze Policy*

Notwithstanding this general policy guideline for implementing the rate path freeze policy of the NSW Government, in Chapter 3 of its Freezing Existing Rate Paths for Newly Merged Councils, IPART nonetheless proposed five defined circumstances under which rates could be set which exceeded the rate path freeze:

- (a) ‘Where there is a critical short-term financial need’;
- (b) ‘To fund new infrastructure by levying a special rate’;
- (c) ‘To renew an expiring temporary special variation that currently funds a service’ and ‘the council demonstrates the service would be discontinued if the special variation was not renewed’;
- (d) ‘For unrecovered development contributions that are ‘above the cap’ under the Environmental Planning and Assessment Act 1979 (NSW)’; and
- (e) ‘Where former Crown Land has been added to a council’s rate base during the rate path freeze period’.²⁹

IPART justifies these exemptions by noting that while ‘our recommendations provide a high degree of rate certainty to ratepayers, which is consistent with the Government’s policy’, they simultaneously enable local authorities to ‘address critical or unexpected financial

²⁶ Independent Pricing and Regulatory Tribunal, above n 2, 12

²⁷ Independent Pricing and Regulatory Tribunal, above n 2, 9.

²⁸ Independent Pricing and Regulatory Tribunal, n 2, 14.

²⁹ Independent Pricing and Regulatory Tribunal, n 2, 15.

sustainability issues', stimulate the 'development of new infrastructure and urban renewal', and allow for the maintenance of 'existing services'³⁰.

We now consider each of these five exceptions to the general rule and the recommendations which stemmed from them.

In the first place, IPART argues that a newly merged municipality should be entitled to a 'temporary special variation' provided it is 'financially unsustainable' as a consequence of (a) 'one or more of its pre-merger councils having an existing rate path that is financially unsustainable, and merger savings and government funding are insufficient for the new council to achieve sustainability' and (b) an 'external factor that occurs during the freeze', such as natural disaster.³¹ IPART specifies four criteria which must be met:

(a) The new council is 'financially unsustainable' because (i) 'at least one of its pre-merger councils is financially unsustainable and the new council is 'forecast to remain so post-merger' or (ii) the newly-amalgamated entity 'becomes financially unsustainable due to an external shock'.

(b) 'Merger savings and government funding are insufficient to rectify the sustainability issue'.

(c) The 'new council is unable to use debt financing to address the financial need'.

(d) The 'special variation relates to an immediate need' which cannot wait for the end of the rate path freeze'.³²

These considerations led IPART to its Recommendation 4:

That a new council be permitted to apply for a new temporary special variation where there is a critical financial need for the special variation, according to the criteria set out in Table 3.1.³³

Secondly, IPART argues that 'new councils should be able to apply for a special variation to fund new infrastructure' on grounds that 'while such special variations may reduce certainty for some ratepayers about the amount of their rates during the rate path freeze period, the alternative may cause councils to reduce their infrastructure development to below efficient levels'.³⁴ However, IPART contends that 'this special variation would be granted only in very limited circumstances' where (a) 'it is used to fund new infrastructure' (b) 'using a special rate' where (c) the special rate would only be levied on parcels of land that benefit from the infrastructure'.³⁵

These considerations led IPART to its Recommendation 5:

³⁰ Ibid.

³¹ Independent Pricing and Regulatory Tribunal, n 2, 16.

³² Independent Pricing and Regulatory Tribunal, n 2, 17.

³³ Independent Pricing and Regulatory Tribunal, n 2, 18.

³⁴ Independent Pricing and Regulatory Tribunal, n 2, 20.

³⁵ Ibid.

*'That a new council be permitted to apply for a new special variation to fund new infrastructure in its area by levying a special rate under section 495 of the Local Government Act 1993 (NSW).'*³⁶

Thirdly, IPART argued newly merged municipalities should be entitled to seek a temporary special variation to renew an expiring special variation but only under circumstances where (a) the expiring levy currently funds a service and (b) the levy will expire during the rate path freeze period resulting in the service in question being discontinued by the new council. IPART contends that 'a special variation for this purpose is consistent with our interpretation of the rate path freeze policy' since it would 'only be levied on ratepayers in the pre-merger council area that benefit from continuing the service.'³⁷ These arguments led IPART to its Recommendation 6:

*That a new council be permitted to apply for a new temporary special variation: to renew an expiring special variation that currently funds a service in a pre-merger council area, and the council demonstrates that the service would be discontinued if the special variation were not renewed.*³⁸

Fourthly, IPART contended that a newly amalgamated municipality should be eligible to seek a special variation to 'levy unrecovered development contributions that are 'above the cap' under the Environmental Planning and Assessment Act 1979 (NSW)', with the caveat that these contributions 'would only be recovered through a special rate on parcels of land that will benefit from the proposed new infrastructure'.³⁹ IPART rationalised this claim on the argument that 'development contributions are payments by developers to councils that are used to fund local infrastructure that meet an increased demand arising from new developments' and under existing regulation 'if a council's development contributions for an area exceed the relevant cap' then the council 'may seek to fund the gap by applying for a special variation'.

These considerations led IPART to its Recommendation 7:

*That a new council be permitted to apply for a new special variation for unrecovered development contributions that are 'above the cap' under the Environmental Planning and Assessment Act 1979 (NSW).*⁴⁰

Finally, IPART argued that a new compulsorily consolidated council should be allowed to raise its general income when 'Crown Land is added to its rate base during the rate path freeze period' since this is currently permitted through a special variation under section 508(2) of the *Local Government Act 1993*.⁴¹ However, IPART noted that this special variation

³⁶ Independent Pricing and Regulatory Tribunal, n 2, 18.

³⁷ Independent Pricing and Regulatory Tribunal, n 2, 22.

³⁸ Independent Pricing and Regulatory Tribunal, n 2, 18.

³⁹ Independent Pricing and Regulatory Tribunal, n 2, 23.

⁴⁰ Independent Pricing and Regulatory Tribunal, n 2, 24.

⁴¹ Ibid.

should only apply to the general income of the council whose pre-merger area now includes the former Crown Land. The justification for this exception was set out by IPART as follows: 'Adding former Crown Land to a new council's rate base may lead to higher demand for its services, an increase in its costs and a loss of ex-gratia payments from governments' and newly merged councils should possess the 'discretion to apply for a special variation to their general income (above the rate peg limit) to take account of this cost increase or revenue loss'.⁴²

These arguments led IPART to its Recommendation 8:

*That a new council be permitted to apply for a new special variation where former Crown Land has been added to its rate base during the rate path freeze period.*⁴³

It is worth stressing that in addition to calling for these exceptions to be made to rate trajectory freeze policy, in Table 3.2 in Chapter 3 of *Freezing Existing Rate Paths for Newly Merged Councils*, IPART explicitly ruled out several other important exemptions to the rate path freeze which stakeholder councils had sought in their submissions to the IPART Review of the *Local Government Rating System: Issues Paper*. In particular, four categories of items were unambiguously excluded from being exempt from the rate path freeze: (a) additional funding to 'equalise services across the pre-merger council areas'; (b) income to 'address a specific need identified by the community or through the IPR (i.e. Integrated Planning Review) Process'; (c) extra remuneration to 'respond to an exceptional circumstance'; and (d) income to 'recoup revenue lost from a boundary change as a result of the merger'.⁴⁴ While (c) has been partly addressed under Recommendation 4, as we shall see in section 3 of this paper, some of these other exclusions are problematic.

C. IPART Approach to Implementing the Rate Path Freeze Policy

Given its approach to determining the general income of each pre-merger council area in the newly amalgamated entity, in Chapter 4 IPART advances its approach to the problem of how rates should be set within each 'old council' area in the merged municipality. To this end, IPART enunciates two general principles: (a) the new amalgamated municipality must not be able to 'redistribute its rating burden between pre-merger council areas' and (b) 'rates within a pre-merger council area are no higher than they would have been under its existing rate path'.⁴⁵ In terms of normative economic analysis, as we shall see, these principles effectively imply that the Pareto Principle should apply in new merged councils for the four-year period.

IPART proposes five main implementation guidelines which reflect these two principles:

⁴² Ibid.

⁴³ Independent Pricing and Regulatory Tribunal, n 2, 18.

⁴⁴ Independent Pricing and Regulatory Tribunal, n 2, 26.

⁴⁵ Independent Pricing and Regulatory Tribunal, n 2, 27.

- (a) *The rate path freeze policy should be applied 'at the rating category level for a pre-merger council area, but not at the subcategory level';*
- (b) *Councils should be permitted to raise the 'base and minimum amounts in a pre-merger council area by the rate peg (adjusted for any permitted special variations)';*
- (c) *The NSW Local Government Act 1993 (s513) fifty percent limit on base amounts should be waived to newly amalgamated councils over the rate path freeze period⁴⁶;*
- (d) *A 'safety valve mechanism' should be included in the NSW Local Government Act 1993 to enable a new municipality to 'rebalance rates between categories in a pre-merger council area if external factors excessively impact on rates within a category'; and*
- (e) *The rating burden from general land revaluations within each pre-merger council area should be calculated using 'a relative change or the fixed share method'.⁴⁷*

We now briefly consider the formal recommendations flowing from the application of the five main implementation guidelines.

In the first place, with respect to guideline (a), IPART proposes two refinements: (i) an amalgamated municipality 'not be permitted to rebalance rates across the rating categories in a pre-merger council area', such as from business to residential properties and (ii) it should be 'permitted to rebalance rates across the subcategories that comprise a rating category in a pre-merger council area', like from one given business subcategory to another business subcategory.⁴⁸

These considerations led IPART to propose Recommendation 9 and Recommendation 10:

Recommendation 9: 'That the rate path freeze policy should apply to the rating categories (i.e. Residential, Business, Farming or Mining) of a pre-merger council area, but not its subcategories'.⁴⁹

Recommendation 10:

'That a new council would only increase the general income of each rating category of a pre-merger council area annually by the rate peg (subject to any adjustments to general income permitted under Recommendation 1, or special variations permitted under Recommendations 4 to 8), unless: the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the new council could (subject to IPART approval) set rates for these categories in accordance with the plan, or there is a general land revaluation, and the pre-merger council area does not have a pre-existing rate plan, in which case the new council should set rates in accordance with Recommendation 14.'⁵⁰

⁴⁶ The NSW Local Government Act 1993 (s513) imposes restrictions on increases in categories of rates, such as on the rate base in specific rating categories, such as 'farmland' and 'residential', in order to prevent councils from unreasonably imposing big increases on a specific category to the exclusion of other categories.

⁴⁷ Ibid.

⁴⁸ Independent Pricing and Regulatory Tribunal, n 2, 28.

⁴⁹ Independent Pricing and Regulatory Tribunal, n 2, 29.

⁵⁰ Ibid, 39. See below for definition of Regulation 14.

Secondly, the application of guideline (b) by IPART whereby councils be allowed to raise the 'base and minimum amounts in a pre-merger council area by the rate peg (adjusted for any permitted special variations)' led to its Recommendation 11:

That a new council should increase the minimum and base amounts for a pre-merger council area annually: by the rate peg (subject to any adjustments for special variations under Recommendations 1 and 4 to 8) during the rate path freeze, unless the pre-merger council had approved and implemented a pre-existing rate plan for minimum or base amount increases, in which case the new council could (subject to IPART approval) set minimum and base amounts in accordance with the plan.⁵¹

Thirdly, guideline (c) (i.e. 'the NSW Local Government Act 1993 fifty percent limit on base amounts should be waived to newly amalgamated councils over the rate path freeze period') led IPART to its relatively straightforward Recommendation 12:

That new councils be exempt from the 50% maximum limit for revenue collected from base amounts for the duration of the rate path freeze period.⁵²

Fourthly, in regard to the proposed 'safety valve mechanism' in the NSW *Local Government Act 1993* to permit the rebalancing of rates between categories, IPART advanced Recommendation 13:

That if, as a result of external factors (such as a significant change in the number of rateable properties in a category), the average rating burden within a pre-merger council area's rating category will change by more than 5% plus the rate peg (or any applicable special variations), the new council can apply to IPART to rebalance the rating burden across all categories in the pre-merger council area.⁵³

Finally, with respect to implementing guideline (e), IPART proposed Recommendation 14:

That when allocating the rating burden from land revaluations: the new council should allocate it to different rating categories in each pre-merger council area using either the relative change method or the fixed share method, unless the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the new council could (subject to IPART approval) set rates for these categories in accordance with the plan.⁵⁴

D. Regulatory Change Necessary to Implement the Rate Path Freeze Policy

In contrast to Chapter 4, Chapter 5 of *Freezing Existing Rate Paths for Newly Merged Councils* focused on how best to adjust existing regulations to facilitate the implementation of the rate path freeze policy. In its *Review of the Local Government Rating System: Issues Paper*, IPART had earlier canvassed three broad 'options' for regulatory change:

⁵¹ Independent Pricing and Regulatory Tribunal, n 2, 33.

⁵² Independent Pricing and Regulatory Tribunal, n 2, 35.

⁵³ Independent Pricing and Regulatory Tribunal, n 2, 37.

⁵⁴ Independent Pricing and Regulatory Tribunal, n 2, 39.

(a) An amendment to the NSW Local Government Act 1993 to provide 'instrument making power' for the Minister for Local Government.

(b) An amendment to the NSW Local Government Act 1993 in order to expand the proclamation power of the NSW Governor.

(c) Make amendments to Chapter 15 of NSW Local Government Act 1993.⁵⁵

In *Freezing Existing Rate Paths for Newly Merged Councils* IPART simply endorsed its earlier 'preferred option' (a) in proposing Recommendation 15:

*That the Local Government Act 1993 be amended to provide the Minister for Local Government with an instrument-making power that enables the Minister to implement the rate path freeze policy for new councils. This power should be subject to a sunset clause and expire at the end of the rate path freeze period on 30 June 2020.*⁵⁶

III. CRITICAL EVALUATION OF RATE FREEZE APPROACH

While IPART should be commended for tackling a thorny policy challenge in a thorough manner, this cannot in any way disguise the fact that it has been handed a poisoned chalice by way of a rate path trajectory freeze policy which is almost entirely politically motivated in its intent. We now consider some of the numerous efficiency and equity problems associated with the rate path freeze policy and its proposed application to compulsorily consolidated councils.

A. Political Basis for Rate Path Freeze Policy

Given the fact that IPART is a public sector agency and thus bound by the long-standing Westminster tradition of an apolitical civil service, it is hardly surprising that neither the IPART (2016) *Review of the Local Government Rating System: Issues Paper* nor *Freezing Existing Rate Paths for Newly Merged Councils* considers why the NSW Government has enunciated its four-year rate freeze policy in the first place. This policy became effective in April 2016 when the NSW Premier announced the constellations of councils selected for compulsory consolidation. It will thus expire well after the next NSW general election.

Even the most gullible political observer can hardly fail to notice that April 2020 is a most politically opportune time for the governing Liberal National Party Coalition since it must face a general election in March 2019, almost a full year before the four-year rate freeze policy expires. This means *inter alia* that all the pent-up financial problems accumulated by

⁵⁵ Independent Pricing and Regulatory Tribunal, n 8. These three amendment options would allow for the imposition of a rate freeze on merged councils. IPART recommended option (a) since it offered the maximum flexibility to policymakers.

⁵⁶ Independent Pricing and Regulatory Tribunal, n 2, 42.

forcibly merged municipalities will not yet be evident to ratepayers and in any event cannot be translated into substantial rates and fees and charges increases until April 2020.⁵⁷

Given these facts, all the carefully contrived rhetoric surrounding the purported need to 'protect' ratepayers in merged councils from rate increases above those agreed prior to April 2016, as well as sharp fees and charges rises, should be viewed through the prism of the forthcoming general election in March 2019. Put differently, the Liberal National Party Coalition is primarily 'protecting' its own chances of re-election rather than advancing any public interest.

In sum, the four-year rate freeze policy offers the Baird Government three substantial political advantages:

- It made the process of 'selling' the controversial forced amalgamation program to a reluctant and unconvinced electorate easier than it otherwise would have been since at least the prospect of extraordinary rate increases was postponed until 2020.
- It meant that the inevitable financial pressures and other stresses on compulsorily consolidated councils would not be visible to the public in terms of inordinate rate, fee and charge increases until 2020. These financial pressures and stresses derive not only from the substantial costs of amalgamation, but also from the forgone rates income as well as standard increases in the operational costs of running councils.
- It at least partly neutralises the controversial and unpopular forced amalgamation question until after the 2019 election thereby boosting the Baird Government's re-election prospects.⁵⁸

B. *Cost Savings and Efficiency Gains from Forced Mergers*

Notwithstanding the strong political motivation for the four-year rate freeze policy, in its *Freezing Existing Rate Paths for Newly Merged Councils* IPART nonetheless observed that the rate freeze rested on three main planks: to 'provide ratepayers with certainty about their rates', to 'protect ratepayers against future rate increases' and to 'allow merger savings to place downward pressure on rates'.⁵⁹ Furthermore, IPART makes frequent references to the

⁵⁷ Empirical evidence from the aftermath of the post-amalgamation rate freeze in Victorian local government in the 1990s demonstrated starkly that the net effect of the freeze was simply to postpone (and not avoid) longer run increases in rates to compensate for the freeze. See, for example, Joseph Drew and Brian Dallery, 'Breaking Up is Hard to Do: The Costs of the De-amalgamation of the Delatite Shire Council' 2015 15(1) *Public Finance and Management*. Much the same was observed after the 2008 Queensland mergers. It is thus reasonable to expect that NSW councils will also be obliged to increase rates after the lifting of the freeze in order to pay for the costs of the mergers as well as meet normal increases in operational costs. Since the freeze also applies to fees and charges, which are in any event largely regulated by IPART, councils cannot increase fees and charges to compensate for the rate freeze.

⁵⁸ The political unpopularity of the NSW amalgamation program was starkly revealed when the National Party lost the seat of Orange in an October 2016 by-election. Orange had been comfortably held by the Nationals since World War Two.

⁵⁹ Independent Pricing and Regulatory Tribunal, n 2, 1.

likelihood of cost savings flowing from mergers and their attendant efficiency gains.⁶⁰ For instance, IPART noted that the ‘rate path freeze policy allows new councils more time to achieve merger savings, which will reduce the need for any future rate increases’.⁶¹ Similarly, IPART contended that ‘nearly all new councils may have positive OPRs [Operating Performance Ratio] over the long term, once merger savings are factored into the analysis.’⁶² Furthermore, IPART makes various extravagant claims on the extent of ‘merger savings’, such as observing that ‘mergers are forecast to lead to improvements in councils’ expenditure and financial sustainability’, which was ‘evident during the *Fit for the Future* process, where business cases submitted by councils suggested that merger savings from Sydney Metropolitan mergers could be at least \$1.8 billion over a 20-year period’⁶³!

Apart from contentious estimates of future savings in politically charged council submissions, no independent evidence was presented by IPART to substantiate these claims over merger savings, except to point to the KPMG *Local Government Reform: Merger Impacts and Analysis* report⁶⁴ – prepared on behalf of the NSW Government – which claimed the proposed mergers would generate a net financial benefit to councils of around \$2.0 billion across over the next 20 years.⁶⁵ However, KPMG is awash with error, not least KPMG’s mistaken assumption that local government general staff in NSW are covered by the federal award and not the *Local Government (State) Award*.⁶⁶

Had *Freezing Existing Rate Paths for Newly Merged Councils* bothered to consult the wealth of empirical evidence available on forced amalgamation, IPART would have been much less sanguine about making exaggerated claims on cost savings. We now briefly summarise recent empirical work on cost savings and efficiency in developed countries, including Australia.

Most empirical work on amalgamation has occurred in American local government.⁶⁷ In general, American researchers found that mergers have not met expectations in terms of

⁶⁰ Independent Pricing and Regulatory Tribunal, n 2, 13.

⁶¹ Ibid.

⁶² Ibid.

⁶³ Independent Pricing and Regulatory Tribunal, n 2, 51. Under the *Fit for the Future* process councils were obliged to submit estimates of cost savings under merger and ‘stand alone’ scenarios.

⁶⁴ KPMG, *Local Government Reform: Merger Impacts and Analysis* (2015).

⁶⁵ See, Independent Pricing and Regulatory Tribunal, n 2, 51.

⁶⁶ New England Education and Research (NEE&R), *Review of KPMG (2016) Outline of Financial Modelling Assumptions for Local Government Merger Proposals Technical Paper* (2016). NEE&R showed that KPMG (2016) had made serious errors in its calculations, especially with respect to redundancy costs, in the order of tens of millions of dollars.

⁶⁷ See, Suzanne Leland and Kurt Thurmaier, ‘Lessons from 35 years of City-County Consolidation Attempts’, in *The Municipal Yearbook 2006* (International City/ County Management Association, 2006); Suzanne Leland and Kurt Thurmaier (eds.), *City-County Consolidation: Promises Made, Promises Kept?* (Georgetown University Press, 2010); Faulk and Hicks, n 9; Dagny Faulk and Georg Grassmueck, ‘City-county Consolidation and Local Government Expenditures’ (2012) 44 *State and Local Government Review* 196, 205.

efficiency gains and cost savings. For example, in an assessment of empirical work on whether consolidation produced greater efficiency, Feiock concluded that mergers had not generated savings but rather had led to increased expenditures.⁶⁸ Similarly, in their review of the impact of city-county consolidation programs, Martin and Schiff found little evidence that municipal consolidation enhanced performance, including through reduced costs.⁶⁹ Leland and Thurmaier examined nine case studies of amalgamated and comparable unmerged local authorities and they concluded that cost savings and other efficiency gains were not generally observed.⁷⁰

These findings have been echoed in the Canadian literature. For instance, Reese established that remuneration levels in merged Ottawa councils increased in post-amalgamation, with a rise in overall expenditure.⁷¹ Similarly, Vojnovic studied the effects of consolidation on five councils and found that aggregate costs typically increased.⁷² European scholars have arrived at analogous conclusions. For example, contributors to Dollery and Robotti considered amalgamation in France, Germany, Italy and Spain and they found that it had not achieved its intended effects in economic terms.⁷³

A small but growing Australian empirical literature has investigated the impact of municipal mergers on council performance.⁷⁴ With some exceptions, the Australian literature is uniformly pessimistic of municipal mergers as a means of improving local government performance. For example, in the case of NSW local government, Bell, Drew and Dollery empirically investigated the outcomes of the 2000/2004 NSW council amalgamation program by comparing merged and unmerged peer councils: They found no difference in performance.⁷⁵

Similarly, work by Drew, Kortt and Dollery has demonstrated that the projected efficiencies attendant upon the 2008 Queensland amalgamations largely failed to materialize.⁷⁶ Indeed, the net effect of the Queensland mergers was to increase the level of diseconomies of scale

⁶⁸ Richard Feiock 'Do Consolidation Entrepreneurs Make a Deal with the Devil?', in Jered Carr and Richard Feiock (eds.) *City-County Consolidation and its Alternatives Reshaping the Local Government Landscape* (M. E. Sharpe, 2004).

⁶⁹ Lawrence Martin and Jeannie Schiff, 'City-county Consolidations: Promise versus Performance' (2011) 43 *State and Local Government Review* 167, 177.

⁷⁰ Leland and Thurmaier, above n61.

⁷¹ Laura Reese, 'Same Governance, Different Day: Does Metropolitan Reorganization Make a Difference?' (2004) 21 *Review of Policy Research* 595, 611.

⁷² Igor Vojnovic, 'The Transitional Impacts of Municipal Consolidations' (2000) 22 *Journal of Urban Affairs* 385, 417.

⁷³ Dollery and Robotti, above n 9.

⁷⁴ See, Dollery, Grant and Kortt, above n 1.

⁷⁵ Brian Bell, Joseph Drew and Brian Dollery, 'Learning From Experience? An Empirical Evaluation of the 2000–2004 Municipal Mergers in New South Wales' (2016) *Economic Papers*, DOI: 10.1111/1759-3441.12136.

⁷⁶ Joseph Drew, Michael Kortt and Brian Dollery, 'Did the Big Stick Work? An Empirical Assessment of Scale Economies and the Queensland Forced Amalgamation Program' (2016) 42 *Local Government Studies* 1, 15.

in local government service provision. It should be added that the inefficiency resulting from over-scale forcibly merged councils was a significant factor in motivating the large number of bids for de-amalgamation in Queensland.

A further example of the improbable 'efficiency claims' by proponents of the NSW forced mergers derives from the operating results from the Sunshine Coast Regional Council (SCRC) in Queensland which was formed by the compulsory consolidation of Caloundra, Noosa and Maroochy in 2008. In this regard, Drew and Dollery observed that 'the combined operating results of the three councils prior to amalgamation were: surplus of A\$152.8 million in 2007, A\$159.05 million surplus in 2006 and A\$160.78 million surplus in 2005'. By way of contrast, 'operating results for the SCRC in 2010, 2011 and 2012 were A\$126 million surplus (2010 financial year), A\$372 million deficit (2011 financial year) and A\$80 million surplus (2012 financial year), excluding asset revaluations'.⁷⁷ It is thus hardly surprising that SCRC residents voted 81% in favour of de-amalgamation.⁷⁸

However, the bulk of Australian evidence on the outcomes of amalgamation programs in state and territory local government systems derives largely from public inquiries into local government.⁷⁹ The most relevant of these reports in the contemporary NSW context is the Queensland Treasury Corporation's (QTC) *Review of Local Government Amalgamation Costs Funding Submission: Final Summary Report*.⁸⁰ QTC gathered information from councils forcibly merged in Queensland in August 2007. Reported 'first-round' costs were '\$9.3 million (mean) for metropolitan councils and \$7.994 million (mean) for regional/rural councils'.⁸¹ Ongoing amalgamation costs include expenditure arising from wage parity, increased senior management costs, and a reticence to make existing staff redundant.⁸² The mean of claimed one-off amalgamation costs for the 2007 Queensland amalgamations was \$8.1m and this did not include ongoing costs.⁸³

C. *Economic and Financial Impact of the Rate Path Freeze Policy*

As we have seen, throughout *Freezing Existing Rate Paths for Newly Merged Councils* IPART maintains the fiction that not only will net cost savings emerge across the four-year rate path freeze, but also that these cost savings will exceed the transformation and transactions costs

⁷⁷ Joseph Drew and Brian Dollery, 'Separation Anxiety: An Empirical Evaluation of the Sunshine Coast Regional Council De-amalgamation' (2014) 34 *Public Money & Management* 217.

⁷⁸ *Ibid.*

⁷⁹ Dollery, Grant and Kortt, above n 1.

⁸⁰ Queensland Treasury Corporation (QTC), *Review of Local Government Amalgamation Costs Funding Submission: Final Summary Report* (2009).

⁸¹ Drew and Dollery, above n 5, 3.

⁸² Queensland Treasury Corporation, n 74, 22.

⁸³ Queensland Treasury Corporation, n 74.

attendant upon forced amalgamation.⁸⁴ No empirical evidence was adduced by IPART in support of this assumption, apart from citing various politicised estimates in municipal submissions to *Fit for the Future* and the flawed KPMG report.⁸⁵

Quite apart from the findings in the QTC report on the short-run costs associated with the Queensland amalgamations over 2007/08 and the international experience with municipal mergers, Victorian experience with a rate freeze following its forced amalgamation in the early 1990s is salutary. As part of its draconian forced merger program in October 1994 the Kennett Government imposed a freeze on residential rates as well as fees and charges, which was further compounded by a reduction in council rates by 20 per cent and a peg on future rate increases.⁸⁶ In 1996, the Victorian Government proclaimed savings of some \$323 million in municipal outlays as a consequence.⁸⁷ However, Dollery and Wijeweera examined the relative performance of Victoria rates compared with other Australian local government systems and demonstrated that – once the rate peg was lifted – Victorian rates increased the most rapidly. Table 1 is reproduced from Dollery and Wijeweera⁸⁸:

Table 1: Percentage Rate Increases by Australian State Jurisdiction, 1995/96 to 2003/04

State or Territory	Per cent Council Rate Increase
New South Wales	29.2%
Australian Capital Territory	35.2%
Tasmania	36.3%
South Australia	55.1%
Queensland	55.6%
Western Australia	64.8%
Victoria	66.1%
Gross Domestic Product	61.8%

⁸⁴ Independent Pricing and Regulatory Tribunal, above n 2.

⁸⁵ KPMG, above n 58.

⁸⁶ Brian Dollery and Albert Wijeweera, 'Time for Change? An Assessment of Rate-Pegging in New South Wales Local Government' (2010) 6 *Commonwealth Journal of Local Governance* 56, 76.

⁸⁷ Victorian Government, Performance Reporting in Local Government (2008).

⁸⁸ Dollery and Wijeweera, above n 80, 69.

Table 1 provides a striking demonstration of how the Victorian rate freeze simply delayed inevitable expenditure, especially on the costs of amalgamating. Moreover, it dispels the myth that Victorian municipal mergers generated lower rates in the long term. It follows that if the objective of the NSW Government's rate path freeze policy is to prevent a future rate 'shock', then this demonstrates that – at best – it will simply defer the shock for four years.

Given the heavy transaction and transformation costs imposed on compulsorily consolidated councils by amalgamation, together with the sharp impost related to the need to 'harmonise' local service delivery across newly amalgamated municipalities, it is obvious that the four-year rate path freeze will have a deleterious effect on the financial sustainability of the new councils. In essence, at the same time that they are being asked to incur additional expenditure to harmonise services and pay amalgamation expenses, councils will have around a third (34%) of their revenue frozen through the rate path freeze.⁸⁹

In addition, the timing of the expiration of the rate path freeze in April 2020 could hardly be worse. It coincides with likely sharp reductions in Commonwealth Financial Assistance Grants (FAGs) when the four-year freeze expires.⁹⁰ Thus, in addition to being exposed to rate shock deriving from councils playing 'catch-up' on the four-year rate path freeze, residents will also likely be exposed to increases in rates to cover significant reductions in FAG receipts. However, it should again be stressed that this will occur after the next NSW election which will mitigate its political impact.

D. *Equity Considerations of the Rate Path Freeze Policy*

As we have seen, in its interpretation of the NSW Government's rate path freeze policy, IPART advanced two normative principles to guide rate-setting in the requisite four-year post-merger period:

- The new amalgamated municipality must not be able to 'redistribute its rating burden between pre-merger council areas'.
- 'Rates within a pre-merger council area are no higher than they would have been under its existing rate path'.⁹¹

In the standard normative economic analysis of public policy this is equivalent to invoking the well-known Pareto Principle which holds that no person should be made worse off under a policy change than they would have otherwise have been had no policy change occurred.⁹²

However, if we consider the NSW Government's rate path freeze policy in the context of all NSW local authorities – and not simply those which have been compulsorily consolidated – then it becomes clear that IPART has not thought through the inequitable consequences of

⁸⁹ Australian Bureau of Statistics (ABS), *Government Finance Statistics*, Australia, 2014–15 (2016).

⁹⁰ *Local Government (Financial Assistance) Act 1995* (Cth), proclamation under subsection 6(4), 2006.

⁹¹ Independent Pricing and Regulatory Tribunal, above n 2, 27.

⁹² Edward Mishan, *Introduction to Normative Economics* (Oxford University Press, 1981).

the rate path freeze policy. In the first place, if we compare forcibly merged councils with their unmerged counterparts, then it is clear that the equity consequences of the rate path freeze policy are problematic. For example, why do some ratepayers in NSW get their rates frozen as at the trajectory determined in April 2016 whereas other ratepayers in unmerged councils remain exposed to very large increases? In what sense is this equitable from a system-wide perspective? Secondly, in what respect is the rate path freeze policy equitable when local authorities which had applied for - and been granted - Special Rate Variations (SRVs) prior to forced amalgamation remain stuck with the increases, whereas residents in councils which had only planned (but not yet applied) for SRVs will not face increases until at least April 2020?

A universal feature of both voluntary and forced municipal mergers resides in the need to modify the characteristics of local service delivery of the pre-merger councils so that local residents across the new local authority enjoy comparable levels of services.⁹³ While in some cases where rural shires are forcibly combined with regional centres differentiated services persist, in general equity considerations demand that all residents of amalgamated councils receive an equal level and quality of local services. This obviously requires the 'harmonisation' of services.

However, under the IPART stipulation that (a) the new amalgamated municipality must not be able to 'redistribute its rating burden between pre-merger council areas', the equity consequences of service harmonisation generate glaring inequities.⁹⁴ For example, in the case of a newly merged council comprised of, say, council A and council B, if council A had an SRV accepted prior to the amalgamation of ten per cent per annum, whereas council B had no SRV, it is obvious that service harmonisation will place council A residents in invidious and worsening inequitable circumstances. By contrast, inhabitants of council B will enjoy a 'free lunch' for the four-year rate path freeze. It is thus apparent that the IPART approach to the rate freeze policy can lead to sharp inequities which are bound to generate bitterness and division in the new councils.

IV. CONCLUSION

In this paper we have carefully considered both the interpretation of the NSW Government's rate path freeze policy by IPART in its *Freezing Existing Rate Paths for Newly Merged Councils* and IPART's approach to the implementation of the policy over its proposed four-year life to April 2020.⁹⁵ We have been at pains to stress the overtly political nature of the rate path freeze policy and the political advantages which it confers on the NSW Government. In

⁹³ Dollery, Grant and Kortt, above n 1.

⁹⁴ Independent Pricing and Regulatory Tribunal, n 2, 27.

⁹⁵ Independent Pricing and Regulatory Tribunal, n 2.

essence, the rate freeze policy is designed to enhance the political fortunes of the Baird Government rather than advance the public good by improving NSW local government.

The analysis of IPART's *Freezing Existing Rate Paths for Newly Merged Councils* conducted in this paper has demonstrated that its approach to the NSW Government's rate path freeze policy is severely flawed in at least four major respects.⁹⁶

Firstly, as we showed in section 3.1 of the paper, IPART has perforce ignored the political foundations of the NSW Government's rate path freeze policy. This means that it has misinterpreted the underlying motivation for the policy. Secondly, in section 3.2 we have marshalled available empirical evidence to show that the purported cost savings flowing from the forced merger program are illusory and will in any event be swamped by the cost of amalgamation. Thirdly, in section 3.3 we have evaluated the economic and financial impact of the rate path freeze policy on the future financial sustainability of local authorities. In so doing, we have demonstrated that the onerous transaction and transformation costs of compulsory council consolidation imposed on compulsorily consolidated councils by amalgamation, in combination with the expenses associated with local service harmonisation across new councils, will have an adverse impact on the financial sustainability of the new councils. Finally, in section 3.4 we showed that the application of the rate path freeze policy advocated by IPART will have inequitable consequences not only for residents of the amalgamated councils, but also for people living in unmerged municipalities.

⁹⁶ Independent Pricing and Regulatory Tribunal, n 2.

