THE NEW "OPTION 2"? THE HENRY REVIEW'S BROAD BASED CASH FLOW TAX

By Michael Walpole[*1]

This article critiques the cash flow tax proposed in the Australia's Future Tax System Review (the Henry Review)(the proposed tax on financial services is covered elsewhere). The author recognises several attractions of the cash flow tax, principally the lower compliance costs associated with 'automation' of processes and the removal of the need to identify actual transactions. But concerns are expressed about the cash flow tax such as the risk of underreporting, the risk to Australian Double Tax Agreements by removing income tax on business and adopting a system that is not well recognised internationally.

1. INTRODUCTION

1.1 Introduction

One of the reforms that was proposed in the 1998-2003 era in Australian tax policy formulation was the so-called Option 2 of the Review of Business Tax.[2] It was ultimately abandoned. It proposed a cash flow/tax value method of determining tax liability in such a way as to follow an accounting approach. The

---

[*] Professor, School of Taxation and Business Law (Atax), Australian School of Business, UNSW; Research Fellow, Monash University Taxation Law and Policy Research Institute. The assistance of Atax's Edmond Wong in researching material for this article is acknowledged with thanks.

[1] The support of the University of Canberra and of the Monash University Taxation Law and Policy Research Institute in the development of this article is gratefully acknowledged. It has benefitted from comments by attendees at conferences hosted by both institutions.

[2] Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (AGPS, 1999) 155-63; Review of Business Taxation, *A Platform for Consultation: Building on a Strong Foundation* (AGPS, 1999) 43-4.

proposal offered many advantages, not least the reduced compliance costs associated with aligning tax and accounting processes. It was nonetheless abandoned.

Not the same as the Review of Business Tax Option 2, the 'Henry Report'[3] suggests the introduction of a cash flow tax applicable to business. It also promises, apparently, reduced compliance costs and ease of compliance for business. It is noticeable that once again there does not seem to have been resounding support for the idea.

The Henry Report model is a cash flow tax that affects all business and was intended to replace the goods and services tax ("GST"). This is a different model to others in the literature that propose a cash flow tax to replace the company tax. This article considers some of the strengths and weaknesses of such a cash flow tax and identifies the things that would need to be addressed to make it workable.

1.2 The Cash Flow Tax Proposal

In a presentation to the Australian Tax Institute[4] a member of the *Australia's Future Tax System Review* ("the Review"), Professor Greg Smith, pointed out the nation's revenue needs and the inability of the current tax collection methods to meet them. He pointed to a cash flow tax as a possible way of addressing the revenue needs.[5] Smith's presentation suggested that Australia will reach a modest fiscal surplus of only AUD 5 billion in 2014-15 (with deficits right up to 2011-12 and extremely modest surpluses after that until 2014-15) and this will occur in a context where there will be very heavy reliance

---

[3] Australia's Future Tax System Review Panel, The Treasury Canberra, *Australia's Future Tax System: Report to the Treasurer* (2010) ('*Australia's Future Tax System Report*')

[4] Greg Smith, 'Tax Reform: Priorities and prospects' (Paper presented at The Tax Institute's Great Tax Debate, KPMG Sydney, 31 August 2011).

[5] Ibid.

on personal income tax.[6] He has argued for another strong source of revenue that is an alternative to income tax and that will be efficient. In a post Global Financial Crisis (or as some would have it, a continuing one) world, does such a tax offer a source of revenue to assist with rebuilding reserves and strengthening the economies of the world?

It will be recalled that the Review's terms of reference excluded changes to the GST. This was presumably in anticipation of any political mileage that might be made by the Parliamentary Opposition. The terms of reference were laughable in the frequency and emphatic tone used – see the text highlighted by this author below.

Term of reference 3 required:

> The comprehensive review of Australia's tax system will examine and make recommendations to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes. The review will consider:
>
> > 3.1. the appropriate balance between taxation of the returns from work, investment and savings, consumption **(excluding the GST)** and the role to be played by environmental taxes;...

For the purposes of reinforcement Term of reference 5 reminded us that:

> 5. The review will reflect the **Government's policy not to increase the rate or broaden the base of the GST**; preserve tax-free superannuation payments for the over 60s; and the announced aspirational personal income tax goals.

And just in case people had not got the message, item 16 of the Terms of reference explained that:

[6] Ibid 89-92.

> 16. The review process will be conducted in several stages. These will follow the release of an initial discussion paper by Treasury on the architecture of the tax system and an examination of the existing tax rates and bases **(excluding the GST)**.....

Such an emphatic exclusion of discussion of GST from the Review was a considerable limitation on the various proposals open to the Review.

In the absence of being able to discuss the GST at length, the Review had to come up with an alternative consumption tax. Its suggestion was a cash flow tax and much of the discussion of the cash flow tax was critical of the GST (and the state indirect taxes) in comparison.

> It would be possible to replace … [inefficient state based taxes] … with a low-rate broad-based cash flow tax that more effectively utilised the consumption base. Exports would be exempt and imports subject to the tax, to ensure that it taxes consumption in Australia. The tax could be designed so that returns from labour would be taxed, making an additional payroll tax unnecessary. It would be highly efficient, because it would cover most of the consumption tax base. It would also be a relatively simple tax if it could be added to the existing tax reporting obligations of businesses.[7]

1.3 What is a Cash Flow Tax?

What then is the cash flow tax that holds such promise? Also known as "The Brown Tax",[8] and sometimes as a "business activity tax",[9] a cash flow tax can take various forms.

---

[7] *Australia's Future Tax System Report*, above n 4, 72.

[8] Parthasarathi Shome and Christian Schutte, 'Cash-flow Tax' (1993) 40 *IMF Staff Papers* 638, 638.

[9] Office of Tax Policy, US Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (2007) ('*Competitiveness of the US Business Tax System Report*').

Shome and Schutte refer back to Meade[10] to explain that a corporate cash flow tax uses net real (thus termed an "R-based" corporate cash flow tax) transactions as the tax base, thus taxing the difference between sales and purchases of real goods and services. They explain that the features of this are the expensing of capital outlays, but neither deduction of interest payments nor taxation of interest as income.[11] In another form, the "Real plus Financial" ("RF based") corporate cash flow tax extends to the inclusion of financial transactions so as to pick up the difference between borrowing and lending unrelated to equity transactions. Interest is deductible under this tax but both monies borrowed and interest received are taxed.[12] The third form of the cash flow tax explained by Shome and Schutte, and the one preferred by Meade for reasons of administrative simplicity is the "S based" corporate cash flow tax which taxes the net flow of cash to the shareholders of the company. This is represented by the formula: "dividends paid + purchases of shares – issues of new shares".[13]

Which of these, or what other hybrid, is suggested in the Henry Report? The Henry Report recognises the considerable merit of the Real plus Financial ("R+F") type of cash flow tax. It says that the "…broadest possible consumption tax would include all cash flows, including ... interest payments and receipts".[14]

Although this would extend across all sectors of the economy including the financial sector and would be more neutral through not affording a price advantage to "...products

---

[10] Virtually the same explanation is in Peter Wilson, 'An Analysis of a Cash Flow Tax for Small Business' (Working Paper No 02/27, New Zealand Treasury (2002).
[11] Shome and Schutte, above n 9, 641.
[12] Ibid. As they describe it 'RF base= (sales + borrowing + interest received) - (purchases + interest paid + debt repaid).'
[13] Ibid 641-2.
[14] *Australia's Future Tax System Report*, above n 4, 281.

that rely more on the value add from financial services”[15] such an R+F cash flow tax, this “...would [in relation to existing businesses] affect assets that have already been financed by debt”.[16] For lenders, interest payments and re-payments of the principal of the loan would be taxable without having previously been allowed as deductions on the cash flow outside of the transactions and this would create the need for complex transitional rules affecting a huge proportion of the business sector.[17]

For this and other reasons such as the inefficiency with which GST currently impacts the consumption of financial services (over taxing financial service providers and, much more significantly, under taxing domestic consumption of financial services) the Henry Report finds that:

> To remove the adverse efficiency costs of input taxation on business and exports, financial services could be removed from the GST (effectively, made GST-free). However, this would have a large revenue cost and inappropriately exempt private consumption of financial services. The Australian government, in consultation with the financial sector, could further develop an alternative method of taxing domestic consumption of financial services to replace input taxation under the GST, or to complement a cash flow tax, to ensure that consumption of financial services is treated equivalently to other forms of consumption.[18]

Thus the Henry Report advocates the separate taxation of financial services using a targeted form of consumption tax specifically for that sector and the for the rest of the consumption tax base the use of “... a ‘real’ or ‘R base’ cash flow tax, which involves removing cash flows associated with

[15] Ibid.
[16] Ibid.
[17] Ibid.
[18] Ibid 313.

financial services from the taxable base."[19] "The sale and purchase of most goods and services would be included, but payments of principal or interest would not." [20] The financial services sector would be dealt with separately.

Accordingly, the Review's cash flow tax would impose tax at a set rate on the difference between nearly all flows in and nearly all flows out of the business. What might seem surprising about the cash flow tax proposed by the Review is that it would not only involve a collection of revenue by the public purse, it would also involve the public purse paying out. This is because under a cash flow tax "...outlays on capital expenditure would be immediately deductible in full, [and] new or growing businesses would likely be in a tax loss position in the early years, with tax liabilities arising in later years (when the business becomes profitable)."[21] The government would in those circumstances refund the negative cash flow on the expectation that, when they are in positive cash flow, a liability to tax will arise. The Henry Report sees this as "...similar in effect to the government sharing the risks in the business by taking a position equivalent to a silent equity partner."[22]

Not only would start up businesses have negative cash flow, but export businesses would also have negative cash flow. The Henry Report cheerfully balances this against the fact that "...this revenue loss would be balanced by taxing imports (foreign goods or services consumed inside Australia)".[23]

And the refund group would not end there, for "...businesses that provide predominantly financial services, but purchase real goods and services, would be in a net refund position...".[24] This

---

[19] Ibid 281.
[20] Ibid.
[21] Ibid 282-3.
[22] Ibid 283.
[23] Ibid.
[24] Ibid.

situation the Henry Report sees as balanced by the fact that, as explained above, there would be "...coverage of the financial sector through a financial services tax...[which] would ensure that the domestic consumption of financial services would still be taxed on an equivalent basis."[25]

Below some of the positive and negative aspects of the cash flow tax idea are discussed, but it is worth recording at this point that not everyone will be as sanguine about these aspects of the proposal as the Review members appear to be. Firstly, anyone who has had technical dealings with the GST will be aware of the difficulties that have been experienced in relation to the administration of the refunds system.[26] At the time of writing the case of *FCT v Multiflex Pty Ltd*[27] serves to highlight the tensions associated with taxpayers' understandable enthusiasm for a prompt refund of surplus input tax credits compared with the Australian Taxation Office's understandable reluctance to refund amounts that taxpayers may not be entitled to receive. The Review is obviously aware of the revenue risk, stating "[t]his introduces a potential revenue risk, as the government would be required to make cash payments to businesses that claim to be in a net refund position."[28]

Other aspects of its discussion of this point seem glib. It explains that "[t]he GST already operates on this basis, as input tax credits are refundable."[29] Its focus seems to be on only part of the compliance aspects of this rather than the administrative difficulty that GST has encountered in this area. It explains simply that "… unlike the GST, a claim for a refund under the

[25] Ibid.
[26] See for example the discussion in Michael Walpole, 'Light in the GST Refund Tunnel: Is that an Exit or is that a Train?' in Christine Peacock (ed), *GST in Australia: Looking Forward from the First Decade* (Thomson Reuters, 2011) 409.
[27] (2011) 197 FCR 580.
[28] *Australia's Future Tax System Report*, above n 4, 282.
[29] Ibid.

CFT need not be supported by a tax invoice issued by a third party (although evidence of payments would still be needed)."[30]

The second brief criticism that might be made in relation to financial services, is that this has been a vexed aspect of our and many other tax systems[31] and has led to a diversity of responses in other jurisdictions.[32] A separate tax on financial services will be likely to create its own complexities and anomalies.

The Henry Report emphasizes the cash flow tax as a form of consumption tax with no suggestion of confining it to companies – as other versions of a cash flow tax have. It would apply to businesses whatever legal form they may take. The application to businesses generally is one of its attractions and because it is the only example mentioned in the relevant discussion, the Review seems to contemplate that only micro businesses might be removed from the tax base, although it would be open to the designers to create other exemptions. Even if they are created, it is thought the exemptions should not materially increase complexity:

> Because net cash flows, rather than individual goods and services, would be taxed, there would be no need for the GST's system of invoices to enforce different tax treatments for different goods or services. The direct subtraction method would allow specific entities — such as very small businesses — to be removed from the system entirely, without making the system more complicated for those entities that remain (given

[30] Ibid.

[31] There is some discussion of this in Michael Walpole, 'The Miraculous Reduced Input Tax Credit for Financial Supplies in Australia' (2011) 22 *International VAT Monitor* 316 and Rita de la Feria and Michael Walpole, 'Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared' (2009) 58 *International and Comparative Law Quarterly* 897.

[32] See the examples of Singapore and New Zealand in *Australia's Future Tax System Report*, above n 4, 308.

> that the tax makes no distinction between cash flows to or from 'registered' or 'unregistered' entities).[33]

Under the model suggested by the Review the cash flow tax would be as simple as possible and would be pretty well blind as to the underlying nature of the transactions giving rise to the cash flow. It would be "…based on accounts."[34] Differentiation between transactions, commodities supplied and the like would be kept to a minimum:

> There would be no compliance need to show CFT on invoices, as this would not be needed to support a deduction (or an input tax credit under GST) for other businesses. Rather than adding up tax payable or refundable for each individual sale or acquisition (as necessary for an invoice-credit GST), a taxpayer would apply a single rate of tax to their net cash flow position (see Chart D1–1). The broader the cash flows included in the base, the simpler the tax is for those in the system.[35]

But simplicity can be taken only so far if unwanted consequences are to be avoided. There would be some differentiation to avoid taxing exports so "… taxable cash inflows would include inflows such as sales but not revenue from exports, as goods and services consumed outside Australia should not be taxed under an Australian consumption tax. Likewise, imports of goods would be taxed at the border."[36]

The Review suggests that overall simplicity would have advantages aside from compliance and compliance costs – it would be more sustainable in Australia's federal political context because there would be fewer exemptions and refinements that have to be agreed upon:

---

[33] *Australia's Future Tax System Report*, above n 4, 284.
[34] Ibid 280.
[35] Ibid.
[36] Ibid.

> The current GST system achieves stability of the tax base by requiring unanimous agreement between the Australian government and the States before any changes can be made to the base or rate of GST. …[T]his administrative arrangement … makes it difficult to make improvements to the GST, as any government has an effective veto.
>
> A direct subtraction method tax would not require the same institutional arrangement as a GST. Because net cash flows, rather than individual goods and services, would be taxed, there would be no need for the GST's system of invoices to enforce different tax treatments for different goods or services.[37]

It should be noted that the two statements quoted, although made together in the Henry Report, do not quite relate to each other, the simplicity of net cash flow over invoice credit is not directly linked to the federal arrangements regarding state consent to changes in the rate of GST so not all the points being made in this extract are clear. Furthermore, it is unclear to this author how much the need for State agreement is a constraint on developments to the GST. One would think that any amendment that is sensible and results in increased revenue or efficiency ought to be agreed to readily by the states.

These points aside, there is strong attraction in the cash flow tax's simplicity. Despite overall simplicity of treatment, distortions would need to be avoided so as, for example, to reduce the self-supply bias evident in value added tax ("VAT") systems like GST and so labour would need to be distinguished for special treatment. Imports too would need appropriate treatment. As the Henry Report explains:

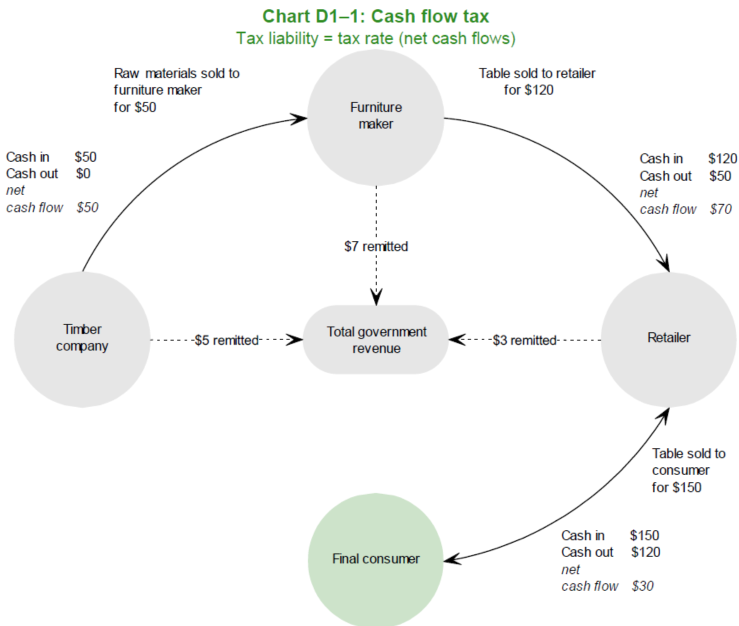
> Deductible cash outflows would make no distinction between capital and non-capital expenses, but would exclude cash payments related to labour remuneration (as the value of labour, unlike the value of most other inputs, would not have been subject to the tax, ensuring that there would be no bias between

[37] Ibid 284.

> in-sourcing and out-sourcing labour). Similarly, no deduction would be available for imports of services (which cannot be taxed at a border).[38]

This cleaner, lower compliance model led the Review to conclude that a “cash flow tax — using the direct subtraction method — can be a simple way of taxing consumption.”[39]

The Henry Report includes a diagrammatic representation of a cash flow tax as follows:[40]



The point made by the Review about the treatment of labour seems slightly confusing because rather than it not being deductible, the Henry Report may mean that it *should* be

---

[38] Ibid 280-1.
[39] Ibid 281.
[40] Ibid 280.

deductible thus making the difference between inflows and the outflow cost of labour taxable. It depends on how one explains the operation of the cash flow tax. However expressed, the separate treatment of labour poses a challenge because to remove the bias between in sourcing and outsourcing would require the labour component of outsourced services to be separately identified.

1.4 The Cash Flow Tax and Regressivity

The Review recognizes that one of the problems with broad and efficient consumption taxes is that they can be regressive as they apply to all income groups irrespective of ability to pay. The Henry Report goes to some length, however, to explain firstly that it is difficult and inefficient to deal with income distribution problems within a cash flow tax, and secondly that the Australian way of dealing with regressivity of GST has not been successful.

The Henry Report asserts that income tax and the tax transfer systems are the means by which to make "Australia fairer".[41] If this approach is adopted "…other taxes and charges can be used in the most efficient way, reducing the overall complexity of the system. It is very difficult to target GST exemptions on some products to certain groups."[42]

The latter point is illustrated by means of the information available about the GST-free treatment of food under the GST we have now. It is accepted that the higher the income the lower the proportion of expenditure accounted for by food, but this is only part of the picture and "…actual expenditure on GST-free food is almost six times greater for the highest than the lowest income groups."[43] The result is that wealthy Australians apparently derive disproportionate benefit from the food

---

[41] Ibid 286.
[42] Ibid.
[43] Ibid.

exemption and "… more than one-third of the AUD 5 billion exemption for GST-free food (Australian Government 2009, p. 205) benefits households in the highest 20 per cent of the income distribution."[44] The economic cost of this misplaced benefit is that it introduces complexity and compliance costs to the GST system.[45]

Another aspect related to the regressivity/progressivity debate that was considered by the Review arises from the actual incidence of a cash flow tax when compared with a payroll tax such as we currently have in Australia. The Henry Report goes to some lengths to explain the complexity and inefficiency of the payroll tax, especially in light of the state variations to be found. This discussion[46] shows how payroll tax is mainly borne by workers, not the businesses that employ them. This is because payroll tax is a typical indirect tax – it is paid by the employers but is borne by the workers in the form of lower wages. Thus, to argue that a cash flow tax would raise costs for workers would need to also take into account a saving from the removal of payroll tax which should result in increased remuneration to workers. A broader consumption tax than we currently have in the GST, if it also swept away payroll tax, may not leave workers less well off to the degree that might at first be anticipated.

Furthermore, if a cash flow tax is not to overshoot its revenue target the rate would need to be low and the tax would need to replace other taxes:

> Consumption is made up of labour income and any excess returns to other factors of production (such as capital). In particular, a broad-based consumption tax would be applied to all businesses selling goods and services, including the self-employed. As the base is broader than just labour income, the

[44] Ibid.
[45] Ibid.
[46] Ibid 296-7.

> rate of tax would need to be lower for any given revenue target, making it more efficient and arguably more equitable than simply taxing the labour income component only. As the base includes labour income, there is little reason to have both a payroll tax and a broad-based consumption tax operating at the same time.[47]

The overriding attractiveness of the cash flow tax for the Review seems to have been this simplicity. Instead of many taxes there would be just a few – primarily income tax, financial services consumption tax, and cash flow tax. Instead of many exemptions and special cases there would be just a few and instead of several state variations on these taxes there would be just a few. Above all, instead of a large compliance burden associated with the invoice credit GST there could be automation of processes and an alignment with activities already going on within the business:

> By avoiding complex exemptions and special rules, a CFT could be radically simpler than
>
> existing consumption taxes, while also improving the efficiency of the tax system. … a single-rate, broad-based CFT provides the opportunity for many businesses to significantly reduce their compliance costs. A CFT could be reported through a simpler business activity statement using fewer labels than the statement used for the GST.
>
> Relying on the natural systems of businesses, such as financial or payroll systems, can reduce compliance costs …. With the CFT, companies or sole traders with very simple tax affairs might use a bank account to have their CFT liability calculated automatically…[48]

The description is near to a tax Nirvana.

---

[47] Ibid 301-2.
[48] Ibid 283.

1.5 Which Model of Cash Flow Tax?

It was apparent from the Henry Report that it had been influenced in its views on the cash flow tax it advocates by recent consideration of such taxes in the United States. One source referred to in the Henry Report is the United States *President's Advisory Panel on Federal Tax Reform* 2005 which sets out a simplified approach to calculating tax on small business and some medium sized business by means of an automatic tax account which would determine tax liability on "net cash flows (excluding financial flows and payroll costs)."[49]

Another source of ideas about the cash flow tax appears to have been a report by the Office of Tax Policy, US Department of the Treasury entitled *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century.*[50] This is a product of a US Treasury Department conference on *Global Competitiveness and Business Tax Reform* intended to identify ways in which the US business tax system might be reformed. One of the solutions suggested was a business activities tax (BAT) very like the cash flow tax. There are some aspects of the US Treasury paper which are worthy of note in evaluating a cash flow tax. There are of course many differences between the US and Australian economy and important differences in the federal tax systems that the two jurisdictions operate. Of most particular importance is the fact that the US has no federal consumption tax like our GST, the main consumption taxes being state based sales taxes. Nevertheless (quite understandably) the US Treasury paper addresses some of the negatives associated with a BAT in more depth than the Henry Report was able to.

---

[49] Ibid; The President's Advisory Panel on Federal Tax Reform, The Treasury Washington DC, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (2005) 127-8.
[50] *Competitiveness of the US Business Tax System Report*, above n 10.

1.6 Problems Associated with Consumption Taxes – Socially Desirable Activities and Regressivity

At the outset the US Treasury paper (*Approaches to Competiveness*) acknowledges the difficulties associated with trying to tax consumption too broadly such as the difficulty of taxing some goods and services and the equity issues that might arise where it is not desirable to tax merit goods like education, health care, religious activities etc. In addition the unfairness that can be associated with taxation of necessities may require lower rates of consumption on some things. Thus a single flat rate on everything can be difficult to achieve.[51]

In relation to regressivity of a consumption tax it will have been noted that the Henry Report considerably qualified the popular wisdom that consumption taxes are always highly regressive. The *Approaches to Competitiveness* paper considers the distributional issues of consumption tax at considerable length. It suggests that simple rich/poor classifications based on the broad measure of annual income, although convenient, are simplistic and suggests that it is preferable to examine the distributional effect based on life time income "...which gives a comprehensive measure of an individual's ability to pay taxes over his [sic] entire economic life."[52] It explains how a household's income changes from year to year as the individuals enter the work force, acquire assets, establish themselves, and retire. Thus not every household contains "...those that are perennially poor"[53] and "...households tend to smooth consumption between low and high earnings periods."[54] When viewed on this basis the paper claims that "Studies find that VAT remains regressive when households are classified

[51] Ibid 21-22.
[52] Ibid 29.
[53] Ibid 30.
[54] Ibid.

according to lifetime income. But the extent of the regressivity diminishes significantly."[55]

In addition, the *Approaches to Competitiveness* paper argues that if it is accepted that both income tax and VAT levy tax on the return on investment of capital it will be seen that there is more fairness in a consumption tax than one initially realises. The authors of the paper do concede, however, that the research on this is not conclusive.[56]

Australian readers will recall that the perceived regressivity of the Australian GST is what eventually resulted in the rather odd Australian treatment of food under our GST and it remains to be seen how a CFT would be perceived on the same criterion.

1.7 Integrity: Evasion and Avoidance

The *Approaches to Competitiveness* paper acknowledges that some goods and services "...while perhaps easy to value, would raise difficult enforcement problems. For example underreporting of sales by small businesses or casual service providers would be a problem under BAT, as it is under our current tax system".[57]

In the opinion of the writer the risk of this form of evasion would be exacerbated in the case of the proposed cash flow tax for Australia because the removal of income tax on such businesses would remove the parallel record keeping of income tax and thus reduce the opportunities to audit businesses on the basis of discrepancies between what is being reported for income tax and what is reported for cash flow tax. The problem could, it seems be even worse if, as the Henry Report suggests, some small businesses would be able to stay out of the system. I suggest this may introduce the risk that if this were threshold

---

[55] Ibid.
[56] Ibid 34.
[57] Ibid 21.

based, related businesses may be tempted to transfer activities from one to another so as to benefit from a lower threshold and the avoidance of cash flow tax.[58] The *Approaches to Competitiveness* paper recognises this risk also. Given that under the BAT it proposes there would be firms that are exempted on the basis of their turnover threshold being too low and given that the payment of wages would not be deductible for the purposes of the tax whereas payments to third parties for services would be this would lead "to opportunities for tax planning".[59] This is an understatement and this writer concurs with the authors of the *Approaches to Competitiveness* paper that there would need to be "rules to deal with this issue"[60] and limit the attractiveness of outsourcing. In addition there probably would need to be wider and more general integrity measures which aggregate related businesses activities to prevent linked business units operating under the threshold when from an economic point of view they are the same business.

The *Approaches to Competiveness* paper notes too that the rate at which the BAT/Cash flow tax applies will be determinative of some evasion and avoidance activities as the higher the rate the higher the stakes and therefore the greater the benefit to businesses and the more difficult the task of enforcement.[61]

Another area of risk in relation to the proposed cash flow tax and one which has already been commented on relates to the system of refunds. Shome and Schutte suggested that there would be a problem in relation to the claiming of refunds by serial non-economic enterprises such as "hobby farms".[62] There are already non-commercial loss rules in Australian income

[58] This is discussed at length by Shome and Schutte, above n 9, 649-52.
[59] *Competitiveness of the US Business Tax System Report*, above n 10, 28.
[60] Ibid.
[61] Ibid 36.
[62] Shome and Schutte, above n 9, 652.

tax.[63] These would need to be maintained and expanded so as to prevent non-economic businesses surviving on refunds rather than genuine commercial activities. The *Approaches to Competiveness* paper acknowledges this as a concern because "[s]ome countries have encountered significant cases of evasion or fraud....particularly with respect to VAT refunds".[64] The paper identifies that this risk can result in higher administration costs, a topic that will be discussed below.

In the context of the types of refund frauds that many jurisdictions have encountered one of the main areas of enforcement difficulty has been the so-called "carousel" fraud where a payment is made to an entity outside the jurisdiction and a refund is claimed for the VAT on that payment but in circumstances where the foreign entity passes the payment back (albeit indirectly) to the party that made the payment.[65] The Henry Report suggests that

> Applying a BAT on a destination-basis and implementing border tax adjustments ensures that businesses may only claim deductions that are offset by corresponding inclusions. Closing the system in this way helps prevent tax evasion through cross-border transactions structured to generate tax deductions for payments to foreign parties.[66]

Thus something can be done about one aspect of refunds frauds – but possibly more would need to be done to make the system smooth and secure. As the work of Smith[67]

---

[63] See *Income Tax Assessment Act 1997* (Cth) div 35.
[64] *Competitiveness of the US Business Tax System Report*, above n 10, 35.
[65] This may be the fraud itself or only part of a wider set of fraudulent transactions. See, for example, Stephen Smith, 'VAT Fraud and Evasion' in Robert Chote, Carl Emmerson and Andrew Leicester (eds), *The IFS Green Budget* (Institute of Fiscal Studies, 2007) 167, 171.
[66] *Competitiveness of the US Business Tax System Report*, above n 10, 34.
[67] Ibid 35.

demonstrates, this is only one type of refund fraud that can occur.

1.8 Costs of Compliance

A strong argument in favour of a broad based cash flow tax of the sort proposed is that its simplicity through limited exemptions and consistent rates reduces compliance costs for the taxpayer and for the administrator. In addition, because it is cash flow based there is limited need for identification of actual transactions, line ball calls on issues such as capital/revenue distinctions and similar costly complexities associated with self-assessment and decision making in the context of income tax. Similarly the need to track and identify transactions and categories of commodities and other supplies such as is done under a VAT or GST that is invoice and credit based with multiple exemptions would be avoided. The *Approaches to Competiveness* paper stresses the important correlation between design features and the costs of compliance and administration[68] and thus the design of an Australian cash flow tax would be critical. One can go only so far, however, in arguing for the compliance costs savings of the cash flow tax because there is no proposal to entirely remove the income tax on individuals, only the income tax on businesses. Thus the *Approaches to Competitiveness* paper acknowledges that the benefits to compliance simplicity

> ...would be counteracted to some extent because businesses would continue to have to determine income in order to distinguish between dividends and capital gains (which would be taxable at the individual level) from returns of the investor's capital (which would not be taxable).[69]

In Australia this would be the case also, and the situation might be aggravated by the other taxes that businesses in

[68] Ibid.
[69] Ibid 36.

Australia have to deal with, such as the fringe benefits tax. Thus the gains in reduced compliance costs from a cash flow based consumption tax may not be as pronounced as might at first be thought to be the case.

1.9 International Aspects

Australia is part of a world economy and many of the businesses operating in Australia are multinational companies. In addition it is relatively easy for Australian businesses to relocate themselves or parts of their enterprise overseas if necessary. Thus the impact of the proposed cash flow tax on activities of local businesses and on foreign investors is important. In short there are risks that if the cash flow tax were overly unattractive to such businesses they might well choose to relocate. If the cash flow tax impacts too heavily on new businesses that have to borrow in their start up phase the result could be that the borrowing would be included in their cash flow with limited deduction of payments. This may be unattractive and they may choose to operate outside Australia.[70] Another potential problem is that were the cash flow tax introduced without the equivalent safeguards against transfer pricing that are to be found in rules applicable to the income tax regime,[71] (that impose an expectation that dealings with related entities internationally should be undertaken on an arm's length basis including in relation to the charges imposed on one another), there could well be loss of part of the tax base overseas – especially in relation to the claiming of exemption of exports.[72]

[70] This comment is based on responses to a proposed cash flow based Corporate Tax in the US. See Reuven S. Avi-Yonah, 'Deja Vu All Over Again? Reflections on Auerbach's 'Modern Corporate Tax' (Paper No 10-030, U of Michigan Law & Econ, Empirical Legal Studies Center, 1 December 2010).
[71] Such as the *Income Tax Assessment Act 1936* (Cth) div 13.
[72] A similar argument is raised by Avi-Yonah above n 71, 6.

In addition to these integrity issues the cash flow tax would need to align itself with international practices and if it were the main means of taxing businesses without an income tax it could lead to double tax. Applying Avi-Yonah's criticism of the Auerbach Corporate Consumption Tax: "...other countries may consider ...[the tax]...not to be an income tax and therefore not eligible for credit or exemption under domestic law or tax treaties."[73]

The same point is made by Shome in relation to the company cash flow tax.[74]

1.10 Conclusion

In light of these many considerations it might be concluded that the cash flow tax proposed has several attractions. But as with any tax it also comes with disadvantages and challenges and (in the Australian political climate at least) it may be difficult to establish. The hardest battle is likely to be in relation to the perceived regressivity of the cash flow tax. There is a lesson in the history of the introduction of the Australian GST and the result of the perceptions of regressivity in the form of an overly complex regime around food and socially desirable activities such as charitable work. The next most strenuous battle may be ensuring compliance and limiting avoidance, especially if the equity arguments introduce exemptions. And these contests will be accompanied by many arguments highlighting the adventurous nature of the cash flow tax and the manner in which it is out of step with world practice which favours a combination of more traditional VAT style consumption taxes accompanied by income taxes.

---

[73] Ibid.
[74] Shome and Schutte, above n 9, 653.