

# eJournal of Tax Research

Volume 13, Number 2

September 2015

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## **eJournal of Tax Research**

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# **eJournal of Tax Research**

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# Reconceptualising Australia's transfer pricing rules: An approach based on adopting economic presence as a basis for taxation

Nicole Wilson-Rogers<sup>1</sup> and Professor Dale Pinto<sup>2</sup>

## ***Abstract***

Against the background of a global focus on base erosion and profit shifting and well-publicised cases of high profile multinationals minimising their taxable burden in high tax jurisdictions, including the use of transfer pricing as a major tax minimisation strategy, this paper argues for a reconceptualisation of Australia's Transfer Pricing rules by adopting an approach based on using economic presence as a basis for source based taxation.

The approach of the paper is to first discuss and evaluate the evolution of Australia's transfer pricing legislation. In this part, it will be argued that the most current reforms to Australia's transfer pricing regime present several fundamental deficiencies. In response to these deficiencies, the second part of the paper advocates a policy response focused on a reconceptualised version of current source rules applying economic presence as a foundation for taxation.

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<sup>1</sup> Lecturer, Curtin Law School.

<sup>2</sup> Professor of Taxation Law, Curtin Law School and Fellow, Tax Law and Policy Research Institute, Monash University.

\*\*\*This paper was submitted for publication on 28/7/2014 and accepted for publication on 27 November 2014. Materials are current as of the date this article was submitted for publication.

## 1. INTRODUCTION

Transfer pricing occurs when goods and/or services are sold or purchased between entities that are located in different countries, but which are members of the same multinational group.<sup>3</sup> The price allocated to such goods and/or services can materially impact upon the profitability of entities within the group and therefore can ultimately determine the amount of tax they pay.<sup>4</sup>

Tax benefits associated with base erosion and profit shifting (BEPS) have featured prominently worldwide<sup>5</sup> including examples of high profile multinationals, such as Apple, Starbucks, Microsoft, Google and Amazon<sup>6</sup> minimising their taxable burden in high tax jurisdictions through complex international structures,<sup>7</sup> including the use of transfer pricing as a major tax minimisation strategy.<sup>8</sup>

This focus on reforming transfer pricing and targeting BEPS has been occurring internationally, with the Organisation for Economic Co-operation and Development (OECD) releasing its discussion paper, *Addressing Base Erosion and Profit Shifting* and subsequent *Action Plan*, as part of its BEPS project.<sup>9</sup> Furthermore, the G8,<sup>10</sup> G20<sup>11</sup> and the OECD have agreed to undertake substantive action to curtail problems associated with BEPS, including those caused by transfer pricing.

At the same time as these international developments have been unfolding, several countries, including Australia, have taken active steps to reform and revisit their domestic transfer pricing rules.<sup>12</sup>

<sup>3</sup> Department of Parliamentary Services (Cth), *Bills Digest to Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, <[http://parlinfo.aph.gov.au/parlInfo/download/legislation/billsdgs/2299302/upload\\_binary/2299302.pdf;fileType=application/pdf](http://parlinfo.aph.gov.au/parlInfo/download/legislation/billsdgs/2299302/upload_binary/2299302.pdf;fileType=application/pdf)>.

<sup>4</sup> Ibid.

<sup>5</sup> See, for example, Richard Gluyas, 'Call for Law Reform to Close Tax Loopholes', *The Australian*, 10 March 2014, 19.; Michael Bingemann and Andrew Main, 'Billions in Revenue 36 million in tax: It's the Apple Way', *The Weekend Australian*, 1–2 February 2014, 25, Dipesh Gadher and Simon Duke, 'British Hit Google with \$4 Million Tax Bill', *The Australian*, 6 January 2014, 5; Katie Walsh 'Labor Targets Digital Giants for Tax', *Australian Financial Review*, 22 November 2012, 1. Former Assistant Treasurer Hon. David Bradbury MP, 'Towards a Fair Competitive and Sustainable Corporate Tax Base', (Speech delivered at the ICAA National Tax Conference, Hilton Sydney, 22 November 2012) <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2012/013.htm&pageID=005&min=djba&Year=&DocType>>. Note since the date this article was originally submitted and accepted for publication there has been a substantial number of articles dealing with this issue.

<sup>6</sup> See as examples the references provided in n 5.

<sup>7</sup> Ibid.

<sup>8</sup> Richard Vann, "Tax Base Erosion—What is likely to be the Australian Legislative Response Going Forward?" (Paper presented at the Corporate Tax Masterclass NSW Division of Taxation Institute, 23 October 2013) states at p. 3 that, "there has been an increasing crescendo in the press about the tax planning of multinational in the digital economy which has captured attention round the world".

<sup>9</sup> OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, Paris, 2013), (OECD BEPS Report), 10, 52, 53. Action Items 8, 9 and 10 deal with transfer pricing. The deadline for examination of these issues is September 2015. Action Item 13 deals with transfer pricing documentation. The most recent Federal Budget has adopted the recommendations in relation to Action Item 13 (see below).

<sup>10</sup> Group of 8 industrialised countries.

<sup>11</sup> Group of 20 Finance Ministers and Central Bank Governors.

<sup>12</sup> Examples of some countries other than Australia that have revised their transfer pricing rules include most recently Greece, Ukraine, Mexico, Costa Rica and Nigeria.

The catalyst for Australia's reforms in this area has been three-fold.<sup>13</sup>

First, in Australia the significance of transfer pricing arrangements as a percentage of GDP has been increasing and was estimated to be over 20% of Australia's GDP in 2009.<sup>14</sup> This appears to be, at least in part, a direct consequence of growing globalisation<sup>15</sup> which has led to increased mobility of capital and has allowed companies to incorporate in different jurisdictions with increasing ease.<sup>16</sup>

Next, the decisions delivered in *Commissioner of Taxation v SNF (Australia) Pty Ltd*<sup>17</sup> and *Roche Products Pty Ltd v FCT*<sup>18</sup> were contrary to the Australian Taxation Office's (ATO) views in relation to the application of the transfer pricing provisions and were seen as highlighting a perceived deficiency in the rules.

Finally, the worldwide focus on reforming transfer pricing to address BEPS strategies has also given further impetus to countries like Australia to review the efficacy of their domestic transfer pricing rules.

The response to these drivers has resulted in a three-phased reform process in Australia.

Currently, Australia's transfer pricing rules are contained in two sources, namely the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) and the associated enterprise

<sup>13</sup> In July 2010, the OECD updated the report, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*. All the member countries accepted the concept on 1 November 2011 and the Australian Government announced it would modernise the existing transfer pricing rules to further align them with international best practice.

<sup>14</sup> Department of Parliamentary Services (Cth), above n 3. The *Digest* states at p. 7: "Any set of transactions representing over 20 percent of Australia's gross domestic product is a sizeable piece of its economic activity. It would concern any government that the expected revenue arising from such activity was not collected".

<sup>15</sup> OECD, *Glossary of Statistical Terms*, <<http://stats.oecd.org/glossary/detail.asp?ID=1121>>. Notably, former UN secretary Kofi Anan stated that, "It has been said that arguing against globalization is like arguing against the law of gravity". The OECD defines globalisation as:

an increasing internationalisation of markets for goods and services, the means of production, financial systems, competition, corporations, technology and industries. Among other things this gives rise to increased mobility of capital, faster propagation of technological innovations and an increasing interdependency and uniformity of national markets.

<sup>16</sup> Inspector General of Taxation, *Report into the ATO's Management of Transfer Pricing Matters* (IGOT TP Report) (released June 2014), <http://igt.gov.au/files/2014/11/management-of-transfer-pricing-matters.pdf>. In the IGOT TP Report stated at p. 1:

1.4 Most submissions impressed on the IGT that the above issues have been exacerbated by major changes in the global business environment over the past two decades such as:

- ongoing evolution of globalisation leading to the decline of trade barriers and increasing the privatisation of business activity, which is said to have facilitated the expansion of many businesses globally and increased the importance of transfer pricing policies;
- ongoing (re)location of the production of final products and components to various jurisdictions to improve business efficiency with decisions based on production costs, infrastructure, tax incentives and skilled labour force;
- the concentration of service functions and assets, such as research and development, internal finance, production and intangible assets within different business units of a Multi-National Enterprise (MNE) which may be located in different jurisdictions; and
- advances in telecommunications that has allowed, among other things, the advent of electronic commerce and '24/7' trading.

<sup>17</sup> [2011] FCAFC 74.

<sup>18</sup> [2008] AATA 639.

articles of Australia's Double Tax Agreements (DTAs) in the *International Tax Agreements Act 1953* (Cth).<sup>19</sup>

In order to get to the current legislative framework, Australia's domestic transfer pricing regime has undergone a significant three-phase transformation. Phase One consisted of former Division 13 of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). Division 13 applied from 1982 but was repealed on 29 June 2013 and replaced by the current transfer pricing regime.

The second phase involved the enactment of former Division 815-A of the ITA 1997. These rules were introduced from 2012 and were controversially enacted retrospectively to deal with perceived deficiencies in existing Division 13, which applied from 2004 onwards. Division 815-A only applied if there was a DTA in force and was designed to ensure that the DTA functioned as an independent head of power. Where no DTA was in force, Division 13 continued to apply.

The third and current phase involved the termination of Division 13 and Subdivision 815-A for income years on or after 29 June 2013 and the replacement of new transfer pricing rules in Subdivision 815-B, 815-C, 815-D of the ITAA 1997 and 284-E of the *Taxation Administration Act 1953* (Cth) (TAA 1953).<sup>20</sup>

Against this background, the purpose of this paper is twofold. Firstly, the paper discusses the evolution of Australia's transfer pricing legislation and evaluates the regime, over the three phases of its reform.<sup>21</sup> It will be argued that the most current reforms to Australia's transfer pricing regime present several fundamental deficiencies and rather than overcoming the difficulties recently noted by the OECD in its BEPS report, they actually legislatively entrench those difficulties.

In response to these deficiencies the second part of this paper advocates a reconceptualised version of current source rules as a possible policy response. It is contended that current source rules have an established theoretical justification and policy underpinnings to address the limitations of the current transfer pricing regime and also have sufficient flexibility to remain relevant in the modern economy. While it is beyond the scope of this paper to address the logistics of translating this solution into legislation, it will be argued that the strong theoretical justifications for adopting the source rules to allocate jurisdiction to tax in transfer pricing transactions warrants further consideration.

It is recognised that there are other potential legislative solutions, such as a formulary approach or greater reliance on the recently amended general anti-avoidance rule (GAAR) contained in Part IVA of the ITAA 1936. However, the limitations associated with adopting a formulary approach for transfer pricing has been debated in

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<sup>19</sup> Australia has over 40 DTAs with other countries. For a list of countries with which Australia has a DTA see, <http://www.treasury.gov.au/Policy-Topics/Taxation/Tax-Treaties/HTML/Income-Tax-Treaties>.

<sup>20</sup> These rules were enacted by the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (Cth). Enacted as Act 101 of 2013.

<sup>21</sup> Note that in parallel to these transfer pricing reforms other significant reforms have been occurring in the international tax landscape in Australia. These include the proposal to require the Commissioner to publish the tax information of large corporates. The introduction of the International Dealing Schedule and Reportable Tax Position Schedule which requires increased disclosure of reportable tax positions and international dealings.

the literature and currently most jurisdictions do not seem to have a ready appetite to adopt such an approach.<sup>22</sup> Furthermore, the limitations associated with the use of a GAAR to combat tax avoidance activities has also been widely investigated by various commentators and scholars.<sup>23</sup>

By contrast, the idea of a return to relying on source rules as a conceptual basis for allocating the right to tax income in related party transactions has not received significant recent consideration by the literature, especially in the context of transfer pricing, and therefore warrants further consideration.

This paper is based on the assumption that protection of the corporate income tax base is a justifiable policy goal. It is acknowledged that other commentators and reports have suggested that instead of constantly reforming the corporate income tax base there should be greater emphasis on looking for other more robust and efficient taxes such as a consumption taxes.<sup>24</sup> However, a discussion of this issue is beyond the scope of this paper.

The structure of this paper is as follows:

- Part two considers the purpose of transfer pricing regimes;
- Part three traces the three phases of Australia's transfer pricing legislation and outlines areas of future action;
- Part four details some of the major benefits and difficulties associated with the current Australian transfer pricing legislation;
- Part five argues that a reconceptualisation of existing source rules using economic presence as a basis for taxation could provide an alternative response to addressing cross-border profit shifting that warrants further investigation; and
- Part six concludes.

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<sup>22</sup> See, for example, Erik Roder, 'Proposal for an Enhanced CCTB as Alternative to a CCTB with Formulary Apportionment' (Working Paper, Max Planck Institute for Tax Law and Public Finance, 2012). Also see Arthur J Cockfield, 'Formulary Taxation Versus the Arm's Length Principle: The Battle Among Doubting Thomases, Purists and Pragmatists' (2004) 52(1) *Canadian Tax Journal*, 114.

<sup>23</sup> See, for example, Rachel Tooma, *Legislating Against Tax Avoidance* (IBFD, 2008) which considers the advantages and disadvantages of utilising a GAAR to combat tax avoidance. Given the similarity of the GAAR to the current transfer pricing provisions in Australia which also require ascertainment of a counterfactual, this alternative has not been investigated in any detail.

<sup>24</sup> Vann, above n 8, 9 states:

The main objective of the whole BEPS exercise is the protection and restoration of the international corporate income tax base, which is assumed to be such a policy no-brainer that there is little OECD argument for it. Yet the OECD has for over two decades sponsored economic research indicating that the corporate income tax is inefficient (particularly because of the mobility of capital) and should be replaced by more efficient taxes, such as indirect taxes. The Henry Review picked up on this work which is now regularly referred to in Treasury policy documents.

## 2. PURPOSE OF TRANSFER PRICING REGIMES

Transfer pricing rules are integrity measures designed to ensure that a taxing jurisdiction retains taxing rights over an appropriate return for the Australian operations of a business. In the Australian context, the stated objective of the current transfer pricing rules suggests that these measures are designed to ensure that the tax amount imposed in Australia reflects the economic contribution made by Australian operations.<sup>25</sup>

An appropriate return is generally defined by what is considered to be 'arm's length'. This is the accepted basis for regulation by Australia and other OECD members.<sup>26</sup>

Transfer pricing rules are pivotal in Australia, with related party transactions being valued at \$270 billion in 2009.<sup>27</sup> Likewise, the 2012/2013 ATO Compliance Program suggests that international related party transactions now comprise approximately 50% of all cross-border trade.<sup>28</sup> Furthermore, Treasury reports that intra-firm trade was equivalent to greater than 20% of gross domestic product (GDP) in Australia in 2009.<sup>29</sup>

It is expected that the scope and effect of transfer pricing will intensify as the world continues to be increasingly globalised and also as a greater trade occurs in services and in intangibles through the agency of related developments in e-commerce and advances in information and communication technologies.<sup>30</sup>

### 2.1 Transfer pricing strategies

While transfer pricing strategies can take various forms, at their most basic level they represent an attempt to shift profits from high tax to low tax jurisdictions by artificially inflating the costs of goods or services between related entities. This shifting can provide the group of companies with a tax benefit or advantage. In this respect, the ATO *2012/2013 Compliance Program* suggests:

Multinational groups may attempt to structure their global operations to minimise tax costs by, for example, maximising the proportion of their profits recorded in low-tax jurisdictions such as Singapore and Hong Kong. Our concern is with related-party dealings that are contrived to avoid paying a fair share of tax on profits earned in Australia.<sup>31</sup>

Two very basic transfer pricing strategies are described below.

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<sup>25</sup> See the Objects sections in Subdivision 815-B in the form of section 815-105. Also see paragraph 3.1 to the Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013.

<sup>26</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, Paris, 2010).

<sup>27</sup> See paragraph 1.8 of the Explanatory Memorandum, Tax Laws Amendment (Cross Border Transfer Pricing) Bill (No 1) 2012.

<sup>28</sup> Australian Tax Office (ATO), *Compliance Program 2012/2013*.

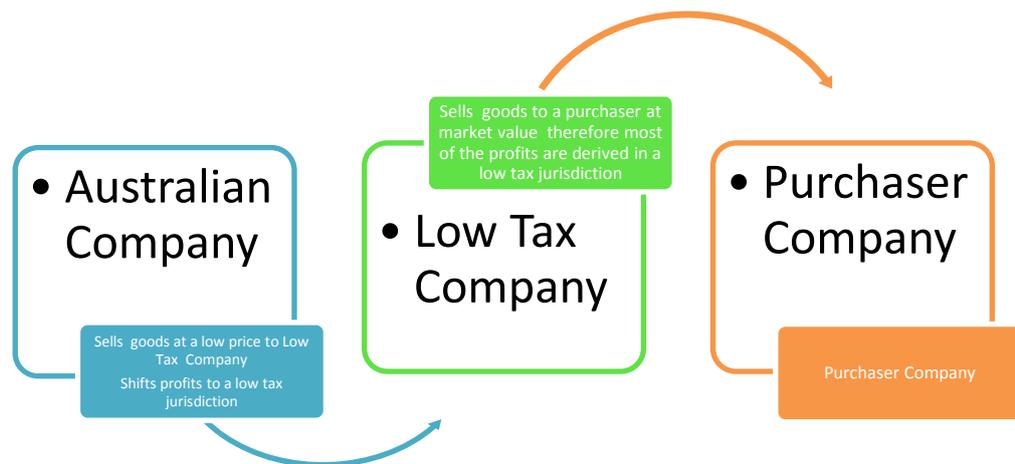
<sup>29</sup> Commonwealth Treasury, *Income tax: Cross border Profit Allocation: Review of Transfer Pricing Rules* (Consultation Paper, November 2011).

<sup>30</sup> IGOT TP Report, above n 16.

<sup>31</sup> ATO, *Compliance Program 2012/2013*.

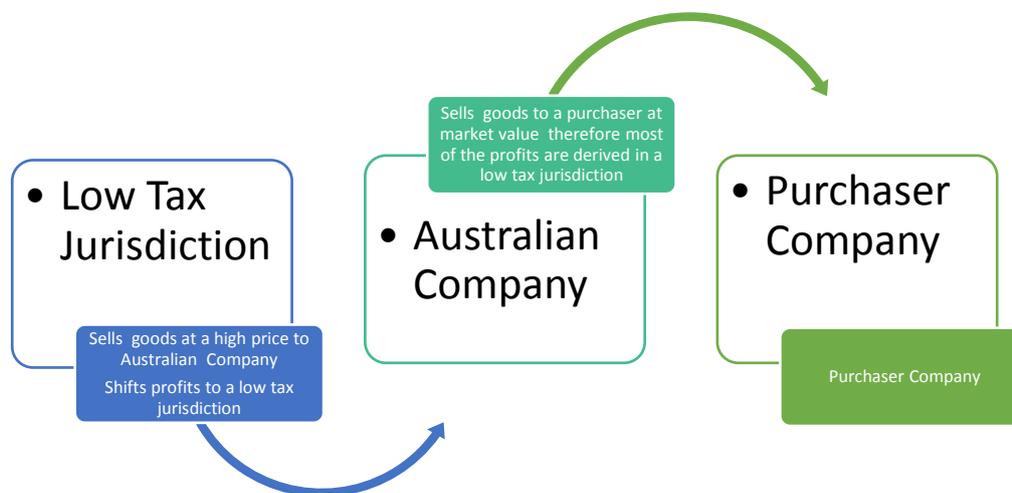
The first strategy involves a company selling goods or services in a high tax jurisdiction (for example, Australia) at a low price to a related company in a low tax jurisdiction and the company in the low tax jurisdiction on-selling them to a third party purchaser. This enables the profits to be shifted to the low tax jurisdiction and the profits booked in the high tax jurisdiction (for example, Australia) to be minimised. This is depicted in the diagram below.

**Figure 1: Basic transfer pricing strategy 1**



Selling goods at a low price to a low tax jurisdiction that on-sells those goods at market value.

The second strategy involves a company in a low tax jurisdiction selling goods or services to a company in a high tax jurisdiction at a high price, thereby shifting profits to the low tax jurisdiction, as the low tax company's profits will be maximised thereby minimising the company's overall tax liability. The company can then on-sell those goods at market value to the ultimate purchaser. A common example of this arrangement is depicted in the diagram below.

**Figure 2: Basic transfer pricing strategy 2**

Low tax jurisdiction sells goods at a high price to a high tax jurisdiction that on-sells those goods at market value, thereby shifting profits to the low tax jurisdiction.

The well-publicised activities of Starbucks are a good example of the way transfer pricing strategies can be utilised. Despite appearing to be a very commercially successful company Starbucks reported losses for a sustained period (a substantial proportion of the history of its operations) in the UK.<sup>32</sup> Thus, there was a significant disconnect between this position for taxation purposes and the reports presented to shareholders that the business was successful. To a large degree these losses were due to a substantial payment made to a Netherlands subsidiary for intellectual property and for payments relating to its coffee making activities.<sup>33</sup> In relation to Starbucks and the low quantum of company tax collected, the House of Commons, Public Accounts Committee, HM Revenue and Customs Annual Report and Accounts made the following observation:

Starbucks told us that it has made a loss for 14 of the 15 years it has been operating in the UK, but in 2006 it made a small profit. We found it difficult to believe that a commercial company with a 31% market share by turnover, with a responsibility to its shareholders and investors to make a decent return, was trading with apparent losses for nearly every year of its operation in the UK. This was inconsistent with claims the company was making in briefings to its shareholders that the UK business was successful and it was making 15% profits in the UK. Starbucks was not prepared to breakdown the 4.7% payment for intellectual property (which was 6% until recently) that the UK company pays to the Netherlands based company. The Committee was sceptical that the 20% mark-up that the Netherlands based company pays to the Swiss based company on its coffee buying operations,

<sup>32</sup> This was for 14 out of the 15 years Starbucks was in the UK.

<sup>33</sup> Public Accounts Committee, HM Revenue and Customs: Annual Report and Accounts, *Tax Avoidance by Multinational Companies*, House of Commons, United Kingdom, 3 December 2012.

with a further mark up before it sells to the UK, is reasonable. Starbucks agreed that it had a special tax arrangement with the Netherlands that made it attractive to locate business there, which the Dutch authorities asked Starbucks to hold in confidence, and that Switzerland offers a very competitive tax rate. In addition, there is an inter-company loan between the US Starbucks business and the UK Starbucks business over a period of time with the interest rate set at higher rate than any similar loan we have seen. We suspect that all these arrangements are devices to remove profits from the UK to these areas with lower tax.<sup>34</sup>

In order to combat activities like this, governments worldwide have enacted and reviewed their transfer pricing legislation. Australia's protracted legislative history in this area is described below.

### 3. THREE-PHASED REFORM OF AUSTRALIA'S TRANSFER PRICING REGIME

#### 3.1 Phase One: Former Division 13

Former Division 13 of the ITAA 1936 applied into two situations, where there was:

the supply or acquisition of 'property'<sup>35</sup> or services pursuant to an 'international agreement'<sup>36</sup> between separate legal entities; or

dealings internationally between a multinational head office and branch or permanent establishment (PE).

Once the existence of these circumstances or preconditions was ascertained, the Commissioner could exercise his discretion to determine that the parties were not acting at arm's length and had therefore received a transfer pricing benefit.<sup>37</sup> Where such a determination was made, the Commissioner could notionally substitute arm's length consideration for the supply or acquisition. Hence, this provision focused on the Commissioner ascertaining what the arm's length consideration was for a supply/receipt of property and services under an international agreement.<sup>38</sup>

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<sup>34</sup> Ibid.

<sup>35</sup> Property was defined expansively in former section 136AA to include:

- (a) a chose in action;
- (b) any estate, interest, right or power, whether at law or in equity, in or over property;
- (c) any right to receive income; and
- (d) services.

<sup>36</sup> An international agreement was defined in former section 136AC to be an agreement pursuant to which:

- (a) a non-resident supplied or acquired property under the agreement otherwise than in connection with a business carried on in Australia by the non-resident at or through a permanent establishment of the non-resident in Australia; or
- (b) a resident carrying on a business outside Australia supplied or acquired property under the agreement, being property supplied or acquired in connection with that business.

<sup>37</sup> Former section 136AD(1) to (3) of the ITAA 1936.

<sup>38</sup> Former section 136AD(4) operated where the Commissioner was unable to ascertain arm's length consideration in respect of the transaction and it was deemed to be such amount as the Commissioner determined.

Notably, where the Commissioner couldn't practically ascertain an arm's length consideration he could deem an arm's length amount. Likewise, where adjustments were made to a taxpayer's taxable affairs pursuant to former section 136AD the Commissioner could provide for a compensating adjustment.<sup>39</sup>

Like Part IVA of the ITAA 1936, former Division 13 had overriding operation over the other provisions of the Act, but not the provisions of the *International Agreements Act 1953* (Cth) which continued to have effect. However, it was subsequently made subject to Division 815-A of the ITAA 1997 which is discussed in further detail below.

Under former section 170(9B) of the ITAA 1936,<sup>40</sup> the Commissioner could amend an assessment to give effect to a transfer pricing determination at any time.<sup>41</sup>

Notably, the onus was on the taxpayer to disprove the Commissioner's assessment<sup>42</sup> and therefore the taxpayer had to prove what the arm's length consideration would be.

While the core of former Division 13 was the determination of arm's length price, there was nothing specific in the terms of former Division 13 that specified how to determine an arm's length price.

Australia and other OECD countries have adopted accepted methodologies in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010)* (*OECD Transfer Pricing Guidelines*) to determine what is meant by arm's length in this context. Broadly these methodologies can be categorised into two types: traditional transaction methods and the profits methods. Under these two umbrella terms there are different methods that can be applied. A brief discussion of these methods is provided below.

### 3.1.1 How to determine arm's length price

#### i. Traditional transaction methods

There are three broad traditional transaction methods the comparable uncontrolled price method (CUP), the resale price method (RPM) and the cost plus method (CPM).

The CUP is the most direct comparator. Under this method a comparable transaction between unrelated parties in a comparable market is identified and the price is then set in the controlled transaction by reference to this. Difficulties in utilising this method result where there is no direct comparison or in cases which involve intangibles where such comparators may not be readily available.

The RPM is based on the price that a product purchased from an associated enterprise is sold to an independent enterprise or third party. The resale price is then reduced by the resale price margin and what remains is supposed to

<sup>39</sup> Former section 136AF of the ITAA 1936.

<sup>40</sup> Repealed by Act 101 of 2013.

<sup>41</sup> ATO, *Income tax assessments for the 2003–04 and Earlier Nil Years: Effect of Transfer Pricing Determination on the Period Within Which an Original Assessment Can Be Made*, ID 2012/44, <<http://law.ato.gov.au/atolaw/view.htm?docid=%22AID%2FAID201244%2F00001%22>>.

<sup>42</sup> *WR Carpenter Holdings Pty Ltd v FCT* [2007] FCAFC 103.

represent an arm's length price. This method is most accurate where the party reselling the product does not add substantial value to the good. The difficulty with this method lies in determining what an appropriate mark-up is and finding a comparable arm's length re-seller.

The CPM refers to profit mark up to suppliers cost (the same supplier in a comparable dealing with an independent party). This requires an assessment to be made of what should be added to the suppliers cost to make arm's length consideration (for example, what is the mark up). This can be found by looking at a supplier in a comparable dealing with an independent party. This method is accurate where semi-finished goods are sold between related parties.

ii. The profit methods

There are two types of profit methods: the profit split method (PSM) and the transactional net margin method (TNMM).

The profit split method identifies the combined profit or loss from dealings between associated enterprises and then splits the profit on a basis which represents the division of profits which would flow from an arm's length agreement. Accordingly, the first step is to identify what is the quantum of the profit that should be split and the second is to split these profits on an economic basis.

Under the TNMM, the net profit is examined in light of a base comprising of costs of sales and assets and then profits are attributed on a basis similar to the CPM and RPM.

### 3.1.2 Double tax agreements and the OECD Guidelines

In phase one a further source of transfer pricing/profit allocation rules were found in the associated enterprise articles of Australia's DTAs and the *OECD Transfer Pricing Guidelines*. While the specific articles can differ, broadly such rules allow related-party transactions to be scrutinised and to hypothesise the position if the entities had been dealing on an 'independent basis'.<sup>43</sup>

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<sup>43</sup> For examples of associated enterprise articles see the Australian/Malaysian DTA Article 9 which states:

1. Where—

(a) an enterprise of one of the Contracting States participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the Contracting States and an enterprise of the other Contracting State, and in either case conditions operate between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing at arm's length, then any income or profits which, but for those conditions, might have been expected to accrue to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the income or profits of that enterprise and taxed accordingly.

2. If the information available to the competent authority of a Contracting State is inadequate to determine the income or profits to be attributed to an enterprise, nothing in this Article shall affect the application of any law of that State relating to the determination of the tax liability of a person by the exercise of a discretion or the making of an estimate by the competent authority, provided that that law shall be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

### 3.1.3 The demise of Phase One—the SNF and Roche decisions

There were two major court decisions in Australia that led to the ultimate demise of Division 13, *Roche*<sup>44</sup> and *SNF*.<sup>45</sup>

The *Roche* decision was the first to test the transfer pricing regime in Australia. The ATO audited Roche (a multinational pharmaceutical company) for the years 1993–2003 and issued assessments totalling \$126 million. Ultimately this was reduced to \$45 million.

The taxpayer was a subsidiary of a Swiss holding company and carried on a business selling and supplying prescription and over-the-counter pharmaceuticals and other pharmaceutical products.

The taxpayer had three divisions—pharmaceutical, consumer and diagnostic. The Roche Group would sell through its subsidiaries and Roche agreed these sales were not at arm's length.

As a result of an audit, the ATO increased the taxpayer's assessable income, alleging amounts paid were more than the arm's length price. The ATO made this adjustment on the basis of former section 136AD in Division 13<sup>46</sup> and Article 9 of the Australia/Switzerland DTA. One of the main basis for the adjustment was external reports prepared by American expert witnesses.

Broadly, the ATO used the TNMM method. The Administrative Appeals Tribunal (AAT) substituted its own view on the arm's length consideration, stating that the traditional transactional methods were preferable. The AAT preferred the use of the *OECD Transfer Pricing Guidelines* on transfer pricing and the CUP, RPM and CPM.

The transfer pricing regime was again under the spotlight in *SNF*.<sup>47</sup> SNF was a distributor of chemical products and a wholly-owned distributor of chemical products. The ATO undertook a transfer pricing audit and the ATO adopted the TNMM to estimate the arm's length prices. The basis for making these adjustments were said to be Article 9 of the US/Australian DTA, Article 9 of the Chinese/Australian DTA and Article 8 of the French/Australian DTA. As a result of these articles the ATO increased the assessable income of SNF by approximately \$13 million. Specifically, the ATO stated:

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3. Where profits on which an enterprise of one of the Contracting States has been charged to tax in that State are also included, by virtue of the provisions of paragraph 1 or 2, in the profits of an enterprise of the other Contracting State and charged to tax in that other State, and the profits so included are profits which might reasonably have been expected to have accrued to that enterprise of the other State if the conditions operative between the enterprises had been those which might reasonably have been expected to have operated between independent enterprises dealing wholly independently with one another, then the firstmentioned State shall make an appropriate adjustment to the amount of tax charged on those profits in the firstmentioned State. In determining such an adjustment, due regard shall be had to the other provisions of this Agreement and for this purpose the competent authorities of the Contracting States shall if necessary consult each other.

<sup>44</sup> 2008 AATA 639.

<sup>45</sup> [2011] FCAFC 74.

<sup>46</sup> Repealed by Act 101 of 2013.

<sup>47</sup> [2011] FCAFC 74.

when a business is faced with persistent losses it would not have continued to purchase products from an arm's length supplier at a price that led to the perpetuation of those losses.<sup>48</sup>

The ATO lost this case on appeal to the Full Federal Court where it was held that prices paid by the taxpayer were on an arm's length basis and the CUP method was an acceptable estimation of arm's length price and therefore, the Commissioner's adjustment on the basis of TNMM were not valid. The Court held that the fact that there were sustained losses did not invalidate the taxpayer's case and significantly the Court stated that the *OECD Transfer Pricing Guidelines* were of limited assistance in interpreting Division 13.

Following this case, commentators argued that there was uncertainty in relation to the following:

- Whether Australia's DTAs could indeed act as a sword and not a shield, that is, could DTAs be a repository of taxing powers?;
- What role profit-based calculations of arm's length could play in reallocating transfer prices; and
- The Commissioner's power to reconstruct or annihilate the transaction that satisfied other specific anti-avoidance rules such as the thin capitalisation provisions.<sup>49</sup>

### 3.2 Phase Two—former Subdivision 815-A

Former Subdivision 815-A of the ITAA 1997 was enacted in September 2012 and applied retrospectively from 1 July 2004.<sup>50</sup> It was designed to boost the efficacy of Australia's DTA rules and was specifically created to ensure that the domestic rules in Australia were interpreted consistently with 'international transfer pricing standards' as enunciated in the *OECD Transfer Pricing Guidelines*.<sup>51</sup>

More specifically it was enacted in response to the *Roche* and *SNF*<sup>52</sup> decisions (discussed above) as the government perceived these cases highlighted issues with the existing Australian transfer pricing provisions.<sup>53</sup>

The stated purpose of Subdivision 815-A was to limit taxable profits being redirected outside Australia and one way the government sought to achieve this was by providing

<sup>48</sup> Ibid.

<sup>49</sup> Significant literature exists discussing these points as examples see comments made in the following papers: Bob Deutsch, 'International Tax Hot Topics' (Paper presented at 28th National Convention, Tax Institute, Perth Convention and Exhibition Centre, 13-15 March 2013); Janelle Sadri, 'Responding to Australia's Transfer Pricing Reforms' (Paper presented on International Day, Tax Institute City West, West Perth, 10 May 2013); Soulla McFall, Marc Simpson and Leesan McLeish, 'Transfer Pricing Reforms in Australia' (2012) 46(8) *Taxation in Australia*, 357.

<sup>50</sup> *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012* (Cth).

<sup>51</sup> Explanatory Memorandum, Tax Laws Amendment (Cross Border Transfer Pricing) Bill (No 1) 2012.

<sup>52</sup> [2011] FCAFC 74.

<sup>53</sup> The Hon Bill Shorten MP (then Assistant Treasurer), 'Robust Transfer Pricing Rules for Multinationals', (Media Release, No 145, 1 November 2011)

<<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F1197735%22>>.

reference to the OECD guidance material, to enable interpretation of the rules.<sup>54</sup> It further provided clarification of how this worked in conjunction with Division 820 of the ITAA 1997 in relation to the thin capitalisation rules. As discussed, these guidelines were held not to be a legitimate aid to the construction of the DTAs or Division 13 in *SNF* and *Roche* and this change was directed at seeking to overcome these difficulties by allowing a transfer pricing adjustment to be made under Subdivision 815-A, relevant provisions of a DTA or Division 13. Specifically, the Explanatory Memorandum to the Act stated that:

The decision of SNF highlighted that Division 13 may not adequately reflect the contributions of the Australian operations to multinational groups and as such in some cases treaty transfer pricing rules may produce a more robust outcome.<sup>55</sup>

Subdivision 815-A allowed the Commissioner to determine a liability under the domestic law rather than the DTA to negate a transfer pricing benefit. The Commissioner could negate the transfer pricing benefit and increase the taxable income or reduce the loss or net capital loss of the entity. No tax avoidance purpose was required and the associated enterprise or business profits articles of the DTA could apply. However, overall this Division operated to allow the ATO to maintain the position that DTAs indeed did provide a separate power to make transfer pricing adjustments.

Thus, Division 815-A ultimately created a situation where a DTA could act as a sword rather than a shield and it is arguable that this leads to a situation where DTAs are exceeding their intended purposes as the commonly understood purpose of a DTA is to allocate taxing rights in cases of possible double tax rather than to create taxing powers per se. For example, in the case of *Undershaft (No 1) Ltd v FCT*<sup>56</sup> the Court stated that a 'DTA does not give a Contracting State power to tax' but rather allocates the right to tax between Contracting States in case of possible double taxation.

Finally, there was an unlimited amendment period for determination by the Commissioner under Subdivision 815-A.<sup>57</sup>

One of the major difficulties with Subdivision 815-A was that it applied only to cross-border dealings with treaty countries and therefore this created a patchwork of inconsistent rules discriminating on the basis of whether a treaty was in place with the country where the related part was resident.

### 3.3 The Final Phase - Subdivision 815-B to D of the ITAA 1997, Subdivision 284-E of Schedule 1 of the TAA

Australia's current transfer pricing regime is contained in Subdivision 815-B to D of the ITAA 1997 and Subdivision 284-E Schedule 1 of the TAA 1953.

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<sup>54</sup> Section 815-20(2) ITAA1997.

<sup>55</sup> Above n 51, paragraph 1.12.

<sup>56</sup> [2009] FCA 41.

<sup>57</sup> The transitional provisions apply to penalty imposition 2004/5–2011/12 income years.

This new regime replaces the former two regimes and applies to income years commencing on or after 29 June 2013 and unlike previous section 815-A, it only operates prospectively.

The regime as a whole is designed to create alignment between the application of the arm's length principle in Australia's domestic law and the *OECD Transfer Pricing Guidelines*. The stated aim of these provisions is to ensure that the taxable amount imposed reflects the economic contribution made by Australian operations.<sup>58</sup> Furthermore, the operation and drafting of these provisions are designed to put beyond any doubt that the Commissioner can have reference to the *OECD Transfer Pricing Guidelines* and also to look at the "totality of the arrangements where taxpayer takes place instead of the particular circumstances of a specific set of transactions".<sup>59</sup>

Section 815-B requires amounts brought to tax in Australia where there are cross border transactions to be worked out by applying arm's length conditions.<sup>60</sup>

Section 815-120 states that a transfer pricing benefit can include an increase in taxable income or withholding tax amount, reduction in losses or tax offsets.

Where this type of benefit is obtained, section 815-115 requires that arm's length conditions are substituted in place of financial relations it may have with another entity. Arm's length conditions are those that would be expected to operate between independent entities in comparable circumstances.

Section 815-125(2) provides significantly more flexibility in relation to the calculation of an arm's length price by requiring the use of the 'most appropriate and reliable method' to calculate arm's length conditions. This is ascertained by having regard to a defined set of circumstances including the:

- strengths and weaknesses of the method is in their application to the actual conditions;
- circumstances such as the functions performed, assets used and risks that are taken by each of the entities;
- availability of reliable information required to enable the use of a particular valuation method;
- degree of comparability between the actual circumstances and the comparable circumstances.

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<sup>58</sup> Above n 25.

<sup>59</sup> Department of Parliamentary Services (Cth), above n 3, 10.

<sup>60</sup> Section 815-105(1) ITAA 1997.

Section 815-135 allows the use of documentation to identify arm's length conditions including the *OECD Transfer Pricing Guidelines*.

The new rules specify an amendment period of seven years.<sup>61</sup>

Subdivision 815-C also applies to transfer pricing benefits that arise for entities PE and is designed to ensure that the attribution of income and expenses between parts of an entity reflects the allocation that may be expected had the parts been separate entities dealing with each other on a 'wholly independent' basis. The new rules are triggered where an entity that is a PE gets a tax advantage that it would not have obtained where the PE had been a separate entity dealing with the entity on an arm's length basis.<sup>62</sup>

Section 815-215 requires that if a PE gets a transfer pricing benefit it should disregard amounts of profit attributed to it and calculate the amounts on an arm's length basis.

Section 815-220 defines a tax benefit arising when the profit calculated on an arm's length basis is different to the actual profit.

Section 815-235 specifies that the arm's length profits will be worked out in accordance with the *OECD Model Tax Convention* and commentaries as amended on 22 July 2010.

Subdivision 815-D sets out special rules that apply to trusts and partnerships attempting to ensure transfer pricing rules will apply to these entities.

A significant feature of the new rules in relation to the new provision is that they are self-executing and are therefore no longer dependent on the discretion of the Commissioner making a determination arguably this approach brings the rules more into line with the self-assessment basis of Australia's tax system.

These rules operate in conjunction with Subdivision 284-E Schedule 1 of the TAA 1953 which notes the documentation that an entity should retain in -assessing the tax position under Subdivision 815-B or 815-C.

A *de minimis* threshold applies, and below that threshold penalties will not be incurred. To comply with the new rules, documentation must be prepared before lodgement of the relevant taxpayer's return. While the documentation requirements are not mandatory they are relevant for the taxpayer being able to establish that a reasonably arguable position was maintained in the context of penalties, which effectively makes the rules mandatory.<sup>63</sup>

One notable aspect is that this Subdivision will apply to *all* dealings between related and unrelated parties to ensure that the dealings are arm's length and recreates the transactions so that they will be what they would have been if the entities were dealing on a 'wholly independent basis'. The reason for this broader casting of the net is to ensure that:

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<sup>61</sup> Section 815-150 ITAA 1997.

<sup>62</sup> Section 815-225 ITAA 1997.

<sup>63</sup> See also section 4.3.2 of this paper where this point is dealt with in detail.

Independent parties engaging in, for example, collusive behaviour or other practices where they are not dealing exclusively in their own economic interests will not circumvent the rules by reason of their non-association.<sup>64</sup>

### 3.4 Future reforms

Despite the consolidation of Australia's transfer pricing provisions described above, there are still substantial future reforms and activities taking place in this area. The OECD has released a draft booklet on moderating transfer pricing,<sup>65</sup> a draft white paper on transfer pricing documentation<sup>66</sup> and a Discussion Paper on the issues associated with intangibles in the transfer pricing context.<sup>67</sup> The Commonwealth Treasury has released an Issues Paper in relation to dealing with multinational profits shifting.<sup>68</sup> The ATO has established an anti-profit shifting taskforce. The two key functions of the taskforce are to work with offshore tax authorities to investigate the substance of the operations of Australian multinational entities, offshore entities or associates and investigate profitable multinational companies (MNCs) doing business in Australia.

In the 2015–16 Federal Budget, the Australian Government announced various measures to combat BEPS including:

- The implementation of new transfer pricing documentation standards based on the OECDs recommendations. These documentation requirements will provide information being provided on the global operations of large corporates, including the location of its global income and the taxes paid on a global basis;<sup>69</sup>
- A master file that contains a complete overview of the corporations global business, organisational structure and overarching transfer pricing policies;<sup>70</sup>
- A file that provides information on the local taxpayers related intercompany transactions;<sup>71</sup> and
- Developing a 'targeted anti-avoidance law' within Part IVA *Income Tax Assessment Act 1936* (Cth) to address multinationals that seek to 'artificially

<sup>64</sup> Above n 25.

<sup>65</sup> OECD BEPS Report, above n 9.

<sup>66</sup> OECD, *White Paper on Transfer Pricing Documentation* (OECD Publishing, Paris, 30 July 2013), <http://www.oecd.org/ctp/transfer-pricing/white-paper-transfer-pricing-documentation.pdf>. This was developed in response to Action 13 in the OECD's Action Plan which stated that there should be rules surrounding transfer pricing documentation. It is stated that MNEs should provide governments with information on their global allocation of income, economic activity and taxes paid.

<sup>67</sup> This is a Revised Discussion Draft on the transfer pricing aspects of intangibles.

<sup>68</sup> The Commonwealth Treasury released a Scoping Paper *Risks to the Sustainability of Australia's Corporate Tax Base* to look at the integrity issues associated with BEPS. The Scoping Paper acknowledged the risk to Australia's and the international community's corporate tax bases and endorsed the OECD's BEPS Report.

<sup>69</sup> See Commonwealth Treasury, 'Budget Paper Number 2—2015 Budget', p 15, available at <[http://www.budget.gov.au/2015-16/content/bp2/html/bp2\\_revenue-07.htm](http://www.budget.gov.au/2015-16/content/bp2/html/bp2_revenue-07.htm)>.

<sup>70</sup> Ibid.

<sup>71</sup> Ibid.

avoid' a taxable presence in Australia. An associated measure will be doubling the penalties the Commissioner can apply to such corporates.<sup>72</sup>

It is expected that the OECD's BEPS project will make further recommendations in this area and continued focus on the efficacy of these rules is likely to persist and intensify.

#### **4. EVALUATION**

This section firstly sets out some base comparisons between the regimes detailed previously. Utilising these comparisons, it then analyses the advantages and deficiencies of these changes.

##### **4.1 Comparisons**

The table below summarises the different outcomes for each of the three phases of Australia's transfer pricing rules.

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<sup>72</sup> Ibid.

**Table 1: Different outcomes for each of the three phases of Australia's transfer pricing rules.**

	<b>Phase One</b>	<b>Phase Two</b>	<b>Phase Three</b>
	<b>Division 13 of the ITAA 1936</b>  <b>Relevant articles of Australia's DTAs</b>	<b>815-A of the ITAA 1997</b> <b>Division 13 of the ITAA 1936</b>	<b>815-B, C, D and E of the ITAA 1997</b>  <b>Subdivision 284-E</b> <b>Schedule 1 of the TAA 1953</b>
<b>Feature of the transaction under scrutiny</b>	Pricing of transactions  Arm's length consideration	Looking at economic activity and profitability of the transaction	Looking at profits—arm's length conditions
<b>Self-assessment or assessed by the Commissioner</b>	Assessed by the Commissioner but onus on the taxpayer to disprove the Commissioner's assessment	Assessed by the Commissioner but onus on the taxpayer to disprove the Commissioner's assessment	Self-assessed by the taxpayer
<b>Documentation requirements</b>	No	No	Documentation 284-E of Schedule 1 to the TAA 1953
<b>Amendment period</b>	Unlimited  (former section 170(9B) of the ITAA 1936)	Unlimited	7 years  (section 815-150 of the ITAA 1997)

## 4.2 Advantages of the new regime

### 4.2.1 *Enhancing certainty, consistency and equity*

The policy goals of the new legislation as noted above appear to be robust and highly justifiable: to align Australia's domestic measures with the OECD *Transfer Pricing Guidelines* and to bolster the efficacy of Australia's transfer pricing rules. The importance of having effective integrity measures are well documented and the overall advantage is every multinational pays their 'fair share' of tax in the jurisdictions in which they have an economic presence. This in turn creates greater equity for all Australian taxpayers. As the former Assistant Treasurer David Bradbury stated these types of integrity measures ensure multinationals are unable to gain:

an unfair competitive advantage over domestic companies and disadvantage Australian taxpayers who must make up the tax shortfall or accept fewer Government services.<sup>73</sup>

Rather than representing a patchwork of legislative measures, the consolidation of the rules into a single regime appears to provide more coherence and certainty which is also desirable. The integration of the *OECD Transfer Pricing Guidelines* into the domestic tax rules also appears to create a more certain pathway for applying and incorporating these rules.

The Taxation Institute stated in their submission on the (then) proposed transfer pricing amendments:

cohesive and co-ordinated approach to transfer pricing between Australia and our major trading partners is essential to ensure that multi-national enterprises (MNEs) are broadly taxed in line with mutually agreed principles as encapsulated in the OECD Guidelines. MNEs also stand to benefit via lower compliance costs stemming from consistency across the many compliance frameworks to which each enterprise is likely to be subject.<sup>74</sup>

### 4.3 Deficiencies of the new regime

#### 4.3.1 *Uncertain application and administration*

However, while the policy goals noted above are highly justifiable, the practical ramifications for users are unclear and could in fact potentially significantly increase the compliance burden for taxpayers. This increase in compliance costs may negatively impact upon Australia's competitiveness. Under the new rules the ATO appears to have much broader reconstruction powers and as it is not yet clear how these will be exercised, thus creating much uncertainty.

In April 2014 the ATO released draft ruling TR 2014/D3 on the Commissioner's view of the application of s 815-130 of the ITAA 1997 which includes the new power to reconstruct the actual transaction. However despite this draft guidance many uncertainties in the practical application of this power remain and some of these uncertainties are discussed in the ensuing sections of the paper.

Interestingly in June 2014 the Inspector General of Taxation released a report, *Review into the Australian Taxation Office's management of transfer pricing matters*.<sup>75</sup> The catalyst for this was concerns raised by various stakeholders including taxpayers, practitioners and professional bodies that there were unnecessary costs, protracted timeframes and insufficient communication by the ATO regarding areas of concern, consultation, guidelines and advice. Also, a key underpinning was that the ATO lacked capability to deal with these complex matters.

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<sup>73</sup> The Hon. David Bradbury MP 'Reforms to Crack Down on Tax Avoidance and Profit Shifting', (Media Release, 010, 13 February 2013), <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/010.htm&pageID=003&min=djba&Year=&DocType=>>>.

<sup>74</sup> Taxation Institute of Australia, *Exposure Draft—Modernising Australia's Transfer Pricing Rules* (21 December 2012).

<sup>75</sup> The Review was announced on 25 October 2012.

#### 4.3.2 *Increased documentation requirements*

As noted above, the documentation requirements are significantly increased under the new rules, which coincide with the self-executing nature of these provisions. While preparation of such documentation or maintaining these standards is not mandatory, failure to do so will impact on the availability for entities to advocate they have a reasonably arguable position (RAP). Public officers have to sign off on the appropriateness of the transfer pricing position adopted. This is particularly onerous given the notorious difficulties and divergent opinions that arise in determining comparability especially where specialised transactions or intangible assets are involved. In certain circumstances a public officer may be subject to penalties for inaccuracies and to ensure certainty taxpayers may need to seek several opinions. This leads to questions of how much detail and substantiation will be sufficient to reduce penalties.

Williamson and Lam<sup>76</sup> argue that some of the questions arising include: will documentation that is prepared and stored overseas be sufficient and what degree of contemporaneity does the documentation need to have? For example, does it need to be prepared before the return is lodged?

The Bills Digest<sup>77</sup> also notes that one of the reactions to the introduction of the amending Bill which introduced these changes was the onerous record-keeping requirements with no carve out for small and medium enterprises (SMEs). This issue was again raised in the Inspector General's Report<sup>78</sup> where it was noted that taxpayer's compliance costs were increased by responding to ATO queries regarding transfer pricing. It was noted this particularly impacts small medium entities. As a result of these findings the ATO had agreed to a number of recommendations aimed at decreasing compliance burdens for SME taxpayers included the increased use of safe harbours for lower value and more common transactions, decreasing the overall documentation requirements.<sup>79</sup>

#### 4.3.3 *A multi-faceted hypothetical inquiry*

The new rules create a much more onerous burden on public officers as they necessitate looking at the overall commerciality and pricing of a particular transaction. Taxpayers need to determine if a transfer pricing benefit has arisen as a result of the transaction being subject to non-arm's length circumstances. This is different to the former inquiry that looked at arm's length consideration. In this context, Cain argues that:

The most controversial aspect of the new legislation is the requirement to hypothesise arm's length conditions, which may involve speculation about the broader terms and conditions independent parties may have agreed. This potentially empowers the ATO to 'reconstruct' related party transactions, in

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<sup>76</sup> Sue Williamson, Ada Lam, Keir Cornish, Amita Pradhan and Zong Aw, "New Tax Avoidance and Profit Shifting Laws—Uncertainty for Taxpayers" *Taxchat*, (9 July 2013), <<http://www.taxchat.com.au/?p=1722>>).

<sup>77</sup> Department of Parliamentary Services (Cth), above n 3, 13.

<sup>78</sup> IGOT TP Report, above n 16.

<sup>79</sup> *Ibid.*

certain circumstances, replacing the actual conditions with the 'arm's length conditions'.<sup>80</sup>

Cain also notes that this further aligns these provisions with the GAAR and may be indicative of why the new transfer pricing provisions were introduced in the same Bill as the GAAR:

The approach to transfer pricing is now very much aligned with an anti-avoidance mindset and language. Taxpayers must now be able to demonstrate they have considered and documented the overall commercial context of their cross border arrangements and concluded their behaviour is consistent with the way independent parties would have behaved. This process can be complex.

Entities need to ensure that the new provisions have been applied accurately in calculating their taxable income, which includes making adjustments for transfer pricing benefits. The *quid pro quo* is that where penalties are levied as a result of transfer pricing the public officer may be personally liable for this and prosecuted where a false or misleading statement has been made.<sup>81</sup>

Arguably, this may be too great a burden to impose on many public officers who may not be in a position to ascertain the level of detail needed. It may necessitate asking such questions as: what conditions actually operate between this entity and another entity? Do these differ from an arm's length condition? This difficulty is consolidated by the amorphous nature of an arm's length condition or price.

Given the conditions in the legislation in order to satisfy their obligations public officers will have to enter into an inquiry regarding the alternative postulate, similar to the inquiry that is necessary under Part IVA of the ITAA 1936. For example, they will need to satisfy themselves with the commercial conditions between independent parties in the same or similar circumstances. It is unclear what needs to be done if they would have structured things differently. Does this mean that the entire transaction must be notionally treated as if it was supplanted with these new requirements? What if there is a range of transactions that the arm's length parties may have entered into or if they simply chose to do nothing? A multitude of factors could influence what an arm's length dealing would look like. As Williamson and Lam state:

This means that intercompany pricing might need to be based on hypothetical transactions that did not exist. This may include alternative terms that could significantly impact the appropriate pricing of such transactions. These provisions give the Commissioner wide ranging powers to effectively 'second guess' transactions that taxpayers have entered into, rather than pricing the actual transactions that took place.<sup>82</sup>

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<sup>80</sup> Alexander Cain, 'Australia Tightens Transfer Pricing Regulations', *In the Black* (CPA Australia) (December 2013), <<http://www.itbdigital.com/tools-of-the-trade/2013/12/11/australia-tightens-transfer-pricing-regulations/>>.

<sup>81</sup> Williamson et al., above n 76.

<sup>82</sup> *Ibid.*

The necessity to prepare for the counterfactual appears to be incredibly onerous and difficult and would require considerable time and resources to be spent by public officers, which would add to compliance costs and the complexity of the current rules.

#### 4.3.4 *Retrospective v prospective application*

One particularly contentious aspect of Division 815-A of the ITAA 1997 is that it applied retrospectively from 1 July 2004. However, transitional rules provided that penalties for schemes in income years before 1 July 2012 were limited to the amount that could be substantiated under the existing provisions prior to Subdivision 815-A. The reasons cited for the fact that these rules were enacted retrospectively was that the amendments merely represented a clarification of the longstanding legislative intent that the law operated in this way.

The retrospective nature of the interim measures was highly controversial. However, the High Court has confirmed that the parliament can pass retrospective legislation, but should justify the need to do so and ensure that it does not impede a person's rights.<sup>83</sup>

Despite there being a basis in law for retrospective legislation, are obvious issues with retrospectivity in terms of challenges to the rule of law, certainty and overall stability in the tax system which can impact upon business confidence.<sup>84</sup>

By contrast, the current transfer pricing rules in Australia are prospective. While prospective application has an obvious attraction in terms of the rule of law and certainty, it also means that these new and arguably more effective provisions cannot apply to previous aggressive tax planning structures that may be identified. This may be contrary to the public interest and protection of the revenue base. In this regard, the Bills Digest states:

There is a significant public interest reason for allowing the Commissioner to re-examine past transfer pricing transactions under the proposed arrangements. The above example of Starbuck's conduct in the UK is an alleged example of the unacceptable abuse of that countries corporate tax arrangement, together with the provisions applying in other countries. It is safe to argue that these provisions were used in a manner far beyond the intention of the United Kingdom (UK) Parliament. Should such examples exist in Australia then it would be in the public interest for the Commissioner for Taxation to re-examine such cases using the proposed provisions. For where such cases exist Australia's tax laws at the time were similarly abused, though their legal form may have been adhered to.<sup>85</sup>

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<sup>83</sup> The constitutional validity to pass retrospective legislation was affirmed in the High Court in *Polyukhovich v Commonwealth* (1991) 172 CLR 501.

<sup>84</sup> For the issues associated with retrospective legislation, see the Hon. David Bradbury MP, –'Tax Reform for an Economy in Transition' (Speech delivered at the Tax Institute NSW 5<sup>th</sup> Annual Tax Forum, 18 May 2012), <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2012/003.htm&pageID=005&min=djba&Year=&DocType=>>.

<sup>85</sup> Department of Parliamentary Services (Cth), above n 3, 6ff.

Overall, the authors believe that in the absence of some egregious abuse of an existing tax law, remedial legislation should, as far as possible, be prospective.

#### 4.3.5 *Time limits*

Another interesting aspect of the current legislation is that time limits that have now been imposed on the Commissioner's ability to amend assessments as per the transfer pricing provisions. Under the new law the amendment period is seven years whereas by contrast under former Division 815-A there was an unlimited period. Whether or not this is a welcome development depends on the perspective adopted.

On the one hand it does create significant further certainty for taxpayers, however, it is still not aligned with the general amendment period of four years for the Commissioner to amend an assessment.<sup>86</sup> On the other hand it limits the Commissioner's ability to amend assessments that may be subject to this type of aggressive tax planning. As identified in the *Discussion Paper on the Review of Unlimited Amendment Periods*,<sup>87</sup> the imposition of a time limit involves a very fine balancing act between two competing policy objectives. Taxpayers need certainty in relation to their taxation affairs particularly in the self-assessment context however the ATO needs sufficient time to complete its verification procedures, audits and investigations. As the Discussion Paper states:

So, while short amendment periods provide greater certainty for taxpayers, setting periods too short may jeopardise the capacity of the Commissioner to detect non-compliance. A balance needs to be reached between the two competing objectives.<sup>88</sup>

The Report specifically recommended an eight year amendment period in transfer pricing case. However, a seven year time period was ultimately adopted.

The Bills Digest states that one of the main submissions made the objection that seven years was too long and a four year period was preferable.<sup>89</sup> It was noted that an extension of time is available to the Commissioner under section 170(7) of the ITAA 1936, although this is only achievable through a Federal Court order which is expensive and onerous to obtain.

#### 4.3.6 *Self-assessment v Commissioner's assessment*

Whereas former Divisions 13 and 815-A required an assessment by the Commissioner to trigger the operation of the transfer pricing provisions, the new provisions are self-executing. This means taxpayers must undertake a review of their transfer pricing position before completing their income tax return.

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<sup>86</sup> The Tax Institute, Submission to Standing Committee on Economics, *Inquiry into Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, 22 February 2013, 11.

<sup>87</sup> Commonwealth Treasury, 'Review of Unlimited Amendment Period in the Income Tax Laws', (Discussion Paper, August 2007), <<http://archive.treasury.gov.au/documents/1298/PDF/Review%20of%20unlimited%20amendment%20periods%20DP.pdf>>.

<sup>88</sup> *Ibid.*

<sup>89</sup> Department of Parliamentary Services (Cth), above n 3, 15.

One of the issues associated with the provisions being self-executing is that they may catch many arrangements that are not within the scope of the mischief. The advantage of the alternative method where the Commissioner had to exercise discretion was that this allowed him to weigh up all relevant facts to decide whether to ultimately pursue a matter.

This considerable onus now being placed on the taxpayer may see a greater move by multinational entities to secure advanced consent (before entering into the transaction) from the revenue authority in the form of a vehicle such as an Advance Pricing Agreement<sup>90</sup> with the Commissioner.

#### 4.3.7 *Pricing-based v Profits-based assessments*

Australia's current transfer pricing legislation has shifted focus from looking at the pricing of the transactions to an overall allocation of profits. The implications of this subtle change are likely to be profound.

In this regard, Hearder states that profits based approach may result in the Commissioner second guessing business decisions rather than focusing on factors influencing pricing. Specifically Hearder states:

The line might be blurred as a matter of practice, meaning that the Commissioner could be second-guessing business decisions, even if that was not the intention, rather than focusing solely on those factors influencing pricing. It might also mean that the Commissioner could too readily reconstruct a transaction and ignore the actual transaction, based on his conclusions about what independent parties would have done.<sup>91</sup>

This apparent intervention in the business dealings of multinational entities is a considerable departure from *Tooheys v DCT; Sydney Ferries*<sup>92</sup> where it was reinforced that is not for the tax office to say how a taxpayer should run their business:

The question is what he **did in fact** spend on his business. If he chooses to employ a hundred men where 20 would have been ample that is his own affair. (emphasis added)

#### 4.3.8 *Multilateral v unilateral action*

A bigger question that arises from the reform of Australia's transfer pricing system is whether this type of unilateral action can be effective in combatting what is a multilateral issue. In this regard, former Assistant Treasurer David Bradbury states:

It will be crucial that efforts to address BEPS occur on a multilateral basis. While there has been considerable rhetorical support for this cause by many key global leaders, the proof of the pudding will be in the eating.

<sup>90</sup> For details regarding the history and use of Advanced Pricing Agreements, see Dr Michelle Markham, 'Are Advanced Pricing Agreements the Transfer Pricing Controversy Management Tool of the Future?' (2011) 40(4) *Australian Tax Review* 222.

<sup>91</sup> Dixon Hearder, 'New Transfer Pricing Legislation—Phase Two', (March/April 2013) *Asia-Pacific Tax Bulletin*, 136, 137.

<sup>92</sup> (1922) 22 NSW SR (NSW) 432.

It is perfectly understandable for governments to focus on making their tax systems internationally competitive. What is not sustainable is for national governments to ignore the global implications of turning a blind eye to their own harmful preferential regimes, especially where the interactions between their laws and the laws of the other nations are facilitating the rise of stateless income or worse still, stateless entities.<sup>93</sup>

Likewise, Vann states:

It is not enough to tackle international problems individually or sequentially, rather BEPS requires that the issues be tackled holistically.<sup>94</sup>

With the continued onset of globalisation and rapid and continued advances in information communication technology, accompanied by the growth in the international trade in intangibles and services, it is increasingly likely that problems which previously could have been viewed through the lens of the Nation State now need a different theoretical construct, requiring the problems to be analysed on a global and multilateral basis.

#### 4.3.9 *A flawed premise based on a concept that is difficult to ascertain*

A common theme of all three phases of Australia's transfer pricing reforms is that they are based on a hypothecation which attempts to attribute arm's length prices to dealings between different parts of (in most cases) the same entity. Such a policy is arguably not grounded in sound economics. As the Head of the Revenue Section of Treasury, Rob Heferan, states, attributing arm's length pricing to a transaction ignores the synergistic reasons why a firm enters into such transactions:

While the arm's length method, if able to be applied, can highlight some cases of profit shifting, the economics underlying it are not strong. For an economist, a firm can never be reduced to a series of arm's length transactions. As Ronald Coase argued so compellingly in 'The Theory of the Firm' in 1937, firms exist precisely because they create and capture value beyond what is obtainable through market based external contracts.<sup>95</sup>

Similarly, Sadiq argues that as a theoretical basis the arm's length model "fails to take into account the synergies arguably inherent in a multinational enterprise".<sup>96</sup> Likewise, not only is this theory flawed, it is also notoriously difficult to ascertain an arm's length price. Again Heferan states:

The difficulties in applying the arm's length price is nothing new, but the nature of intangibles in the digital age makes it even harder and where the

<sup>93</sup> Matthew Gilleard, 'BEPS—The Australian Perspective' *International Tax Review*, (10 December 2013), <<http://www.internationaltaxreview.com/Article/3288298/Latest-News/BEPS-The-Australian-perspective.html>>.

<sup>94</sup> Vann, above n 8, 4.

<sup>95</sup> Rob Heferan Executive Director of Revenue Group in a speech delivered at the 2014 Economic and Social Outlook Conference, Melbourne Institute, 4 July 2014, <<http://www.treasury.gov.au/PublicationsAndMedia/Speeches/>>.

<sup>96</sup> Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach and Transfer-pricing. Should the Separate Accounting Model be Maintained for Multinational Entities?' (2004) 7(2) *Journal of Australian Taxation*, 196, 241.

intangible in question is unique, it simply does not exist in the market. And by its very nature, intellectual property is always unique in some way.<sup>97</sup>

Similarly Vann argues that:

... the theory of the firm—that firms generate additional profits to those available in the market as otherwise they would not exist and hence the application of a market paradigm to allocate profits is likely to miscarry. The outcome may be allocation of profits to countries where activities occur (value is added) rather than where capital and asset ownership (particularly of intangibles) is located.<sup>98</sup>

## 5. RELYING ON A RECONCEPTUALISED VERSION OF THE EXISTING SOURCE RULES

The preceding analysis has argued that the current regime, while exhibiting some desirable aspects, also continues to present several practical difficulties for taxpayers and administrators and is arguably based on a flawed premise.

Thus, while the amendments to the transfer pricing regime have taken Australia on a long and complex journey, it appears that if Australia continues to rely on the current conceptual basis for allocating transfer prices, these amendments will be far from the last chapter. In fact, the amendments to Australia's transfer pricing regime appear to entrench (rather than overcome) the issues associated with the 2010 *OECD Transfer Pricing Guidelines* which are currently under review. As Vann states:

Although the Australian government linked its revision of the legislation on transfer pricing on BEPS, in fact that legislation adopts the 2010 version of the OECD Transfer Pricing Guidelines which have been much of the cause of the activity that the recent OECD draft is trying to shut down.<sup>99</sup>

Given transfer pricing practices and BEPS are driven by the ingenuity and creativity of taxpayers and their advisers when combined with globalisation and constantly evolving technologies, a fundamental attribute of any potential solution must be flexibility and responsiveness to change to ensure rules remain robust and relevant in a dynamic business environment. However, this adds to compliance costs and creates business uncertainty.

Trying to put in place static rules to address an evolving problem will inevitably result in frequent amendment and a need to constantly revise the rules.

While it is beyond the scope of this paper to suggest a definitive solution to the mischief associated with transfer pricing, the authors advocate that greater reliance upon a reconceptualised version of existing source rules that uses economic presence as a basis for taxation warrants further research. Furthermore, this provides a sound conceptual basis on which to ground the transfer pricing rules.<sup>100</sup>

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<sup>97</sup> Heferan, above n 95.

<sup>98</sup> Vann, above n 6.

<sup>99</sup> Ibid 18.

<sup>100</sup> In the article by Gluyas, above n 5, there was a discussion of Dr Antony Ting's two recommended reform methods—recognition that multinationals are single enterprises that are not capable of dealing

Ascertaining the source of the income from an overall cross-border related party transaction could result in a more correct allocation of the profits than the current arm's length basis addressed by the transfer pricing rules. However, it is suggested that the existing common law sources rules may need to be modified or reconceptualised to take into account economic and related developments consequent upon globalisation and related challenges presented by developments in information technology.

The approach advocated by the authors involves two steps which draws from the thesis of Pinto and related literature on source-based taxation.<sup>101</sup>

First, the source of the income from the related party transaction would need to be ascertained. In this regard, the idea of an economic presence instead of relying on formalistic rules like physical presence which are easily manipulated in an economic environment) or economic footprint could be used to identify the true source of such profits, rather than concepts like a permanent establishment or fixed base which are easily manipulated. Notably, the new transfer pricing reporting standards that are to be implemented in Australia would assist in ascertaining the economic footprint of a multinational by providing an overall picture of the global operations of the entity.

It is argued that tracing or establishing the economic presence of a company in a particular jurisdiction would allow a more accurate identification of the place of where the value is created or the profits should be allocated.

This approach takes a substance over form approach to determining the source of income. Pinto<sup>102</sup> notes that economic presence could be determined by reference to a 'regular and systematic direction of activities in a country'. Pinto's work refers in turn to Harris where he states:

Did the taxpayer 'purposefully avail' itself of the benefits of a taxing state? Did the taxpayers conduct and operations in the taxing State rise to a level where it should have reasonably anticipated being hauled into court? Were the taxpayers in-state activities a continuous and systematic part of its general business in the state.<sup>103</sup>

Once the source of the income is ascertained, on the basis of economic presence the second step would be looking at the overall profits of the jurisdiction and attributing them to that particular jurisdiction based on the source.

This type of approach would achieve greater flexibility and durability to truly consider the place where the source of profits is derived and would be more adaptable to changing economic circumstances. Interestingly, in the G20 Declaration in September the Heads of Government stated: 'Profits should be taxed where economic activities

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with one another and the utilisation of subject to tax conditions as have appeared in German tax treaties, where parties can only claim benefits on offer where they are subject to reasonable tax levels. As noted earlier in the paper, the authors concede other solutions may also be possible including formulary apportionment methods for transfer pricing but an evaluation of this is well covered in the literature and is therefore beyond the scope of this paper.

<sup>101</sup> Dale Pinto, 'The continued application of source-based taxation in an electronic commerce environment', (PhD Thesis, The University of Melbourne, 2002), 44–45.

<sup>101</sup> *Ibid.*, 44–45 and 242.

<sup>102</sup> *Ibid.*

<sup>103</sup> Pinto, above n 101, 44–45, 242.

deriving the profits are performed and where value is created.<sup>104</sup> This supports the proposition advocated in this paper that it is the source of the profits which one should endeavour to locate rather than an artificial allocation based on arm's length prices.

The authors concede that utilisation of the source rules may lead to less certain or predictable results than a more mechanistic specific anti-avoidance rule like the arm's length rules adopted by the current transfer pricing regime but would better reflect the economic creation of profits to determine taxing rights.

As a related point it could also be argued that the need to refer to alternative postulates and difficult concepts to ascertain such as an arm's length price is already entrenching significant legislative uncertainty that is based on a flawed premise. Conversely, the source rules are based on the correct premise that taxing rights should be attributed based on the source of the profits, which in the case of digitised industries, e-commerce or related party dealings may most accurately be reflected by where the entities' economic presence lies.

In this way, source rules that are based on economic presence have the advantage of being more readily adaptable to the business model or method of transaction that is under scrutiny. For example, where a cross-border transaction involves e-commerce the most important variable to consider may be where the customers are located rather than searching for a fixed place of business.

In terms of re-conceptualising how this might operate, the starting point in relation to ascertaining source is the seminal statement of Isaacs J in *Nathan v FCT*<sup>105</sup> that the source of a transaction is 'a practical hard matter of fact' and involves looking at what a "practical man would regard as a real source of income". Notably, the term source is not defined in the ITAA 1936 and is defined in a very circular manner in the ITAA 1997 to refer to the fact that income will have an Australian source if it is 'derived from an Australian' source.

By looking for the source of the transaction between related parties rather than trying to attribute an arm's length price between related entities, it will allow a more 'in substance approach' to help to circumvent any artificial measures that seek to artificially shift profits, by ascertaining the location of the actual source of the transaction or income. For example, returning to the transfer pricing strategies, where a company sells goods or services in a high tax jurisdiction (for example, Australia) at a low price to a related company in a low tax jurisdiction and the company in the low tax jurisdiction on-selling them to a third party purchaser, a source-based approach would focus on the overall profits of the enterprise and then locate the true source of the transaction. The source would depend upon the nature of the goods. If it were tangible goods, the rule would look at the types of functions performed on the asset and if all the production occurred in Australia. If little was done to the goods in the low tax jurisdiction before it was on-sold to the ultimate consumer then the source rules would allow Australia to tax the majority of the income in the transaction.

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<sup>104</sup> Jerin Matthew, 'Sydney G20 Meeting Communiqué: Full Text' *International Business Times*, (24 February 2014), <<http://www.ibtimes.co.uk/sydney-g20-meeting-communication-full-text-1437618>>.

<sup>105</sup> (1918) 25 CLR 183.

In support of adopting such an approach, cases such as *Cliffs International Inc v FCT*<sup>106</sup> and *Thorpe Nominees Pty Ltd v FCT*<sup>107</sup> illustrate a propensity by the judiciary in Australia to focus on a substance over form approach, with the Court inquiring where the economic activity that gives rise to the income has occurred. Likewise, this is consistent with the ATO's approach in *Taxation Ruling TR 2013/1*<sup>108</sup> where it is stated that a substance over form approach will be adopted, and in circumstances where there is a disconformity between the two the actual behaviour of the parties rather than the formal terms of the contract will be given precedence.<sup>109</sup>

Pinto argues<sup>110</sup> elsewhere that source rules have continued theoretical justification for allocating income that arises from international transactions, even in the case of e-commerce transactions.

The submissions made by Pinto and others in relation to e-commerce specifically have broader application to related-party transfer pricing transactions. Specifically, Pinto's thesis addresses a situation where income should be said to be generated if all the value of what is sold is created in the country of residence (for example, where the intellectual property is located in a low tax jurisdiction) but the customers that determine this value are in the source country (where the goods are ultimately sold in a high tax jurisdiction).<sup>111</sup>

Pinto maintains that in those cases the only contribution of the source country is the customers it could be argued that source countries provide marginal benefits relevant to the production of the income that would justify the right to tax that income in the first place. However, he concedes that such an argument can be challenged on several policy grounds.<sup>112</sup> Pinto opines that even if a business doesn't have a physical presence in the source country it nevertheless *benefits substantially* from the infrastructure in the source country. Therefore, consistent with the benefit theory, it should contribute to the government of the source country via taxation. Similarly, another work by Pinto<sup>113</sup> concerns the broad nature of what can be construed as a 'benefit'. He states:

Benefits that may be provided by source countries can either be general or specific. In terms of general benefits, education (which relates to the availability and level of labour), policy, fire and defence protection represent obvious examples. However, apart from these general benefits, there are more specific benefits that source countries may provide, including a conducive and operational legal infrastructure for the proper functioning of business. Allied with this may be specific government policies, such as

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<sup>106</sup> 85 ATC 4374.

<sup>107</sup> 88 ATC 4886.

<sup>108</sup> ATO, *Income Tax: The Identification of 'Employees' for the Purposes of the Short Term Visit Exception Under the Income from Employment Article or its Equivalent, of Australia's Tax Treaties*, TR 2013/1.

<sup>109</sup> *Ibid.*

<sup>110</sup> Pinto, above n 101, 44–45 and 242, Chapter 2.

<sup>111</sup> *Ibid.*

<sup>112</sup> *Ibid.*

<sup>113</sup> Dale Pinto, 'The Theoretical Foundations and Continued Rationale for Source-based Taxation in an Electronic Commerce Environment', (2012) 27 *Australian Tax Forum* 443.

keeping exchange rates stable and interest rates low, thereby providing economic stability and business and consumer confidence.<sup>114</sup>

Likewise, businesses that do not maintain a physical presence derive benefits from a country's legal system in 'as much as they rely upon it to enforce payments, uphold intellectual property rights and maintain a pro-competitive and conducive business environment'.<sup>115</sup> Other benefits provided from the country where the consumers are located include 'waste disposal for packaging materials, consumer protection laws and an infrastructure upon which delivery vehicles can travel'.<sup>116</sup> Pinto's thesis refers to this as 'entitlement theory' and supports the fact that there can be taxation in source countries even where a business lacks a physical presence in those countries. In fact Pinto states:

Given that physical presence can be largely insignificant for an electronic commerce transaction, economic presence may be a better indicator upon which source-country tax nexus may be based.<sup>117</sup>

Thus, in e-commerce related party transactions, it may be necessary to reconceptualise the source concept to focus on the economic presence of the transaction.

It is acknowledged that ascertaining the source of each transaction could potentially be a difficult task and seen as practically and administratively onerous. Furthermore, there may be difficulties in determining when a series of distinct transactions should be aggregated.

However, these reasons for not adopting a source-based approach are as stated by Pinto elsewhere 'based on practical and administrative considerations and therefore based on expedience rather than being founded on theoretical grounds ...'.<sup>118</sup> Likewise, in the same work Pinto acknowledges that the logistics and practicalities of administering a particular methodology should be a secondary condition to if it should be done to begin with 'how something can be done (which involves practical and administrative considerations should be a secondary considerations to whether it should be done in the first place'.<sup>119</sup>

Arguably, an approach that looks to the true source of a transaction rather than utilising hypothecations based on arm's length price is much more grounded in reality and would be a more stable basis to allocate taxing rights. Furthermore, the use of such a conceptual framework reflects to a greater extent the overall goal of the taxpaying regime, which is to truly allocate a fair share of tax based on the Australian entity's 'economic contribution'.<sup>120</sup>

A reconceptualised source rule would not be based on a fiction, trying to artificially segregate a multinational into a series of different arm's length transactions, so therefore does not exhibit the same conceptual flaw as an arm's length price. In this

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<sup>114</sup> Ibid, 445.

<sup>115</sup> Ibid.

<sup>116</sup> Ibid

<sup>117</sup> Pinto, above n 101.

<sup>118</sup> Ibid.

<sup>119</sup> Ibid.

<sup>120</sup> Above n 25.

regard, Sadiq argues<sup>121</sup> that the application of arm's length rules incorporates a 'legal fiction of imagining transactions between unrelated parties'.<sup>122</sup> Sadiq further states that this fiction fails to accord with the reality of the situation, that multinational entities exist to operate in a way independent entities would transact.<sup>123</sup>

## 6. CONCLUSION

Given the evolving nature of technology, the increasing mobility of labour and individuals consequent upon globalisation, along with the growing trade in services and intangibles, it is inevitable cross-border transactions will continue to rise. Therefore, Australia's response to transfer pricing strategies must be flexible and adaptable in order to remain relevant and robust to adapt to constant change. It will no longer be sufficient to use a static 'old world approach' to a dynamic 'new world problem'.

If sufficient flexibility can be entrenched into the transfer pricing legislation, the story of Australia's legislative transfer pricing provisions may come to an end and a new chapter of flexible and responsive legislation may supersede it.

Accordingly, in light of these unprecedented changes to the world economy, this paper has suggested a paradigm shift in approach to the allocation of taxing rights in transfer pricing transactions. This shift is from ascertaining a fiction in the form of arm's length price between related entities under current transfer pricing rules to adopting an approach grounded in reality by ascertaining the source of such profits using a reconceptualised notion of source-based taxation on the adoption of economic presence to ground a jurisdiction's right to tax.

While the rules may need to be reconceptualised, the ascertainment of source continues to have a strong theoretical underpinning and significant flexibility to deal with the mischief of transfer pricing in the current globalised world economy. It is acknowledged that this represents a substantial change from the currently utilised approach. Nevertheless, it is argued that this change in approach is necessary to deal with the unprecedented globalisation and continued digitisation of the world economy.

As recently stated by Heferan these conditions have presented policy makers with the chance to reconsider what is an appropriate tax system and to challenge the status quo:

**... where successful thinkers are those who embrace change and challenge the state of play.** Globalisation and digitisation have presented policy advisers and policy makers with opportunities to consider what constitutes an appropriate tax system in this ever changing world.<sup>124</sup> (emphasis added)

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<sup>121</sup> Sadiq, above n 96.

<sup>122</sup> Ibid.

<sup>123</sup> Ibid.

<sup>124</sup> Heferan, above n 95.

# South East Asian tax administration issues in the drive to attract foreign direct investment: Is a regional tax authority the way forward?

Timothy Brand<sup>1</sup>, Alistair Hodson<sup>2</sup> and Adrian Sawyer<sup>3</sup>

## ***Abstract***

The Association of South East Asian Nations (ASEAN) region is of growing importance to foreign investing New Zealand businesses. Under the umbrella of a case study focusing on Vietnam, this paper utilises interviews and phenomenology observations to ascertain the particular tax administration issues that are of concern to foreign investors. The research then explores the possibility of establishing an ASEAN-based Regional Tax Authority (RTA) as a way of alleviating such tax administration issues and, ultimately, increasing foreign investment into the ASEAN region. It is suggested that the establishment of an ASEAN RTA is the 'best way forward'.

**Keywords:** *ASEAN, foreign investment, interviews, New Zealand, regional tax authority, tax*

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1 Timothy Brand, Former Bachelor of Commerce Honours Student, Tax Consultant at KPMG.

2 Alistair Hodson, Lecturer in Taxation, University of Canterbury.

3 Adrian Sawyer, Professor of Taxation, University of Canterbury (Contact Author)  
(adrian.sawyer@canterbury.ac.nz).

## 1. INTRODUCTION

### 1.1 Overview

Over recent decades, developing South East (SE) Asian nations have been the subject of monumental political, cultural and economic change. Association of South East Asian Nations (ASEAN) members such as the Philippines, Vietnam, Laos, Cambodia and Myanmar, are at varying points on the journey to development, yet the combined economic significance of the region is undisputable.<sup>4</sup> In relation to Vietnam, Tran-Nam considers economic growth to be the most important determinant of economic development, with good tax policy a cause rather than a result of such progress.<sup>5</sup>

It has been argued that promoting economic growth is almost synonymous with attracting inbound foreign direct investment (FDI).<sup>6</sup> The United Nations Conference on Trade and Development (UNCTAD) recognised that deciding whether to invest in a nation is a vexed decision, with a nation's 'policy framework' being one factor considered by potential investors, along with economic considerations (market size, infrastructure etc.) and the ease of doing business in the chosen nation.<sup>7</sup> There is a plethora of research pertaining to the inverse relationship between corporate income taxes (CIT) and Gross Domestic Product (GDP), including Hartman's quantitative study.<sup>8</sup> However, the majority of this literature is United States (US) centric in nature with a focus on inbound US investment, and thus fails to consider the tax administration challenges unique to developing countries. Despite this limitation, Hines' survey of multiple quantitative studies found an elasticity of  $-0.5$  to  $-0.6$  between CIT rates and FDI, which, due to being less than perfect, supports the view of the UNCTAD that the decision to invest in a nation is multifaceted and not solely dependent on corporate tax rates.<sup>9</sup> Instead, an effective tax administration is one of many important considerations.<sup>10</sup> Therefore, it is clear that an effective, legitimate tax administration is a key determinant of attracting FDI and stimulating economic development.

The tax literature pertaining to FDI focuses almost exclusively on the relationship between tax rates and investment levels. Administrative factors, such as 'red tape' and compliance costs, can also weigh significantly on investment decisions. However, somewhat alarmingly, it is observed that 'empirical studies have practically ignored these important considerations'.<sup>11</sup> Tax administration issues not only fall within the ambit of the UNCTAD's 'policy framework' category but also under the 'business

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<sup>4</sup> Nolan C Sharkey, "Greater China and South East Asia" in Nolan Sharkey (ed) *Taxation in ASEAN and China: Local Institutions, Regionalism, Global Systems and Economic Development*, (Routledge, 2012), 1–13.

<sup>5</sup> Binh Tran-Nam, "Tax Reform and Economic Development in Vietnam" in Nolan Sharkey (ed.) *Taxation in ASEAN and China: Local Institutions, Regionalism, Global Systems and Economic Development*, (Routledge, 2012), 126–147.

<sup>6</sup> Tran-Nam, n 5 above.

<sup>7</sup> United Nations Conference on Trade and Development (2003), *World Investment Report, 85, 1-322* <[http://unctad.org/en/Docs/wir2003\\_en.pdf](http://unctad.org/en/Docs/wir2003_en.pdf)>.

<sup>8</sup> David Hartman, 'Tax Policy and Foreign Direct Investment in the United States' (1984) 37 *National Tax Journal*, 475–488.

<sup>9</sup> James R Hines, 'Lessons from Behavioral Responses to International Taxation' (1999) 52 *National Tax Journal* 305–322.

<sup>10</sup> United Nations Conference on Trade and Development, n 7 above.

<sup>11</sup> Tran-Nam, above n 5, 137.

facilitation' head due to the intrinsic link between tax administration and the ease of doing business. It is thus conceivable that tax administration issues can play a significant role in attracting FDI, giving a basis for the present study to test this relationship in addition to identifying current SE Asian tax administration issues relevant to foreign investors, and also investigating whether a Regional Tax Authority (RTA) may be an appropriate solution.

While some researchers have argued that 'externally imposed initiatives in tax administration are likely to be resisted, if not rejected, by local interests', they fail to explore the potential acceptability of a less radical proposal aimed at 'foreign interests' as opposed to 'local interests'.<sup>12</sup> Vehorn appositely observes that administrative reform should aim for simplification of the law and taxpaying processes and ideally be implemented by a government with a strong political will for modernisation under a structured plan, preferably incrementally.<sup>13</sup> This is in accordance with Bird's suggestion that administrative reforms are most effective when simple and well sequenced.<sup>14</sup> It is in agreement with these remarks that the present research explores the feasibility and perceptions from a range of businesses, academics and tax practitioners of an RTA which would conceivably act as an intermediary between foreign investors and SE Asian governments/tax authorities to pragmatically address current problems prohibiting the ease of foreign investment.

## 1.2 Importance of South East Asia as a trading partner for New Zealand

Due to SE Asia's rapid development and emergence as a global economic powerhouse, there is substantial demand for reform proposals from SE Asian nations wishing to maintain such high growth rates (due in part to FDI capital injections), and also from foreign enterprises which require certainty and transparency in a tax administration as a prerequisite to making foreign investments. From a New Zealand (NZ) perspective, SE Asia is of immense importance to future economic growth, with China recently having overtaken Australia as NZ's largest trading partner and the wider Asian region constituting a significant 40 percent of total merchandise imports and exports with NZ.<sup>15</sup> With the Trans-Pacific Partnership (TPP) negotiations on-going, NZ trade and investment in SE Asia is set to markedly increase from an already substantial 29 NZ companies investing \$2.37 billion as of 2011.<sup>16</sup> While NZ's network of Free Trade Agreements (FTAs), which lay the legal 'groundwork' for investment in Asia continues to grow, such investment opportunities may be neglected if the tax administration in that country is uncertain or problematic.

This study aims to side-step the current tax administration challenges faced by foreign investors by exploring the possibility of establishing an RTA at the international

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<sup>12</sup> David Chaikin and Maria Dyball, 'Tax Compliance and Administrative Challenges: Lessons from the Philippine experience' in Nolan Sharkey (ed.) *Taxation in ASEAN and China: Local Institutions, Regionalism, Global Systems and Economic Development* (Routledge, 2012) 73–97, 91.

<sup>13</sup> Charles L. Vehorn, 'Fiscal Adjustment in Developing Countries through Tax Administration Reform', (2011) 45(1) *The Journal of Developing Areas* 323–338.

<sup>14</sup> Richard Bird, 'Administrative Dimensions of Tax Reform', *Asia-Pacific Tax Bulletin* (2004) March, 134–150.

<sup>15</sup> Hugh Dixon and Jason Leung-Wai (2012), *Foreign Direct Investment: New Zealand and Asia*, Asia: New Zealand

Foundation <[http://asianz.org.nz/files/Foreign\\_Direct\\_Investment\\_New\\_Zealand\\_and\\_Asia.pdf](http://asianz.org.nz/files/Foreign_Direct_Investment_New_Zealand_and_Asia.pdf)>.

<sup>16</sup> Dixon and Leung-Wai, n 15 above.

(regional) level. This is achieved through use of qualitative research techniques, namely interviews and direct author observations.

After spending three months living and working in Vietnam, from late 2012 though to early 2013, one of the authors was able to witness the ‘hunger’ for FDI from state authorities whilst also sensing the hesitation and concerns held by potential investors with regard to issues including uncertainty in the tax administration. The identification of tax administration issues that curtail the alignment of foreign investor and SE Asian state interests has motivated the current research’s normative, forward-looking orientation. Increased FDI will accelerate SE Asian growth rates, whilst also benefiting foreign investing enterprises and their ‘home’ nations, which ultimately receive the after-tax profits from off shore operations and investments. Such research is also motivated by the notable lack in the literature of such studies and reform proposals as is discussed in the following sections.

The tax literature is arguably lacking a recent study of SE Asian tax administration issues specific to foreign investors. It is also notably lacking any normative consideration of an RTA which would ostensibly administer taxes exclusively for foreign investors. Whilst Sharkey has proposed a SE Asian Regional Tax Organisation (RTO), the following discussion shows that Sharkey’s proposal is more extreme in its functionality, with few features in common with the proposed RTA.<sup>17</sup> Despite these conceptual differences, the present study seeks to comment on the feasibility and attractiveness of the Sharkey proposal to determine whether it may be an ‘end point’ that could be reached after the initial establishment of an RTA through a process of gradualism. Therefore, the interrelated research questions are:

RQ1 What are the tax administration issues faced by foreign investors in SE Asia nations and to what extent do such tax administration issues influence FDI decisions?

RQ2 What is the feasibility/perception of an RTA as a means of countering such issues?

RQ3 Pragmatically, is it feasible to view the RTO proposed by Sharkey as an ‘end point’ subsequent to the establishment of an RTA?

## **2. REVIEW OF PRIOR RESEARCH ON SOUTH EAST ASIA TAX ADMINISTRATIONS AND REGIONAL/GLOBAL TAX ORGANISATION PROPOSALS**

This review first examines recent studies of SE Asian tax administrations and notes a number of thematic administration issues. Secondly, previously proposed solutions to deficient tax administrations of large taxpayer units (LTUs) and autonomous or semi-autonomous revenue authorities (SARAs) will be critiqued. Finally, recent calls for a global or SE Asian RTO will be noted and distinguished from the present, less radicalised proposal for reform.

### **2.1 Prior studies on South East Asian tax administration issues**

With foreign investment being critical to the region’s economic growth, it is curious to note that literature on tax administration in SE Asia tends to focus on issues related to

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<sup>17</sup> Sharkey, n 4 above.

domestic compliance problems rather than the subcategory of administration issues which are of relevance to foreign investors. Despite this general trend, several papers contain analysis of issues relevant to the present study, including Chaikin and Dyball's study<sup>18</sup> of the Philippines tax compliance and administration issues. Chaikin and Dyball's study surveys various compliance and administrative challenges in the Philippines, seemingly on the basis of pre-existing literature and empirical data. It is noted that corruption is rampant and so deeply entrenched in the Bureau of Internal Revenue (BIR) that the Philippines Congress has considered the BIR's complete disestablishment 'in favour of starting out fresh'.<sup>19</sup>

Additionally, Chaikin and Dyball refer to a 2008 Social Weather Station (SWS) survey gauging the extent that businesses encountered corruption in the revenue authorities. An alarming 71 percent of respondents reported having been asked for a bribe, 31 percent when paying import duties and 46 percent when paying income taxes. More telling, 79 percent of respondents did not report the solicitation accompanying these bribes as they believed that 'nothing would be done'.<sup>20</sup>

Perhaps of greater relevance to potential investors, the corruption perceptions index (Transparency International) shows markedly high levels of perceived corruption in the Philippines.<sup>21</sup> This index is calculated by country analysts through extensive surveying of business people, with unbiased hard data being inherently difficult to obtain on such a politically 'sensitive' issue.<sup>22</sup>

As with Chaikin and Dyball, Tran-Nam's case study of Vietnam does not focus directly on tax administration issues relevant to foreign investors, yet it still notes several systematic administration issues relevant to the present study.<sup>23</sup> After critiquing the gradual lowering of CIT rates, Tran-Nam claims that 'administrative reform is needed', yet refrains from detailing 'how' or 'what' the reform should be.<sup>24</sup> It is observed by Heij that issues in the Vietnamese tax administration include taxpayer compliance costs stemming from legal problems, the time taken to deal with bureaucracy, hidden fees and the objection and appeal process.<sup>25</sup> Other issues identified include high corruption, low education and low compensation of tax officials who are also subject to low political accountability due to the single party political system. Tran-Nam reasons that these issues are contributing factors towards Vietnam's low ranking in the World Banking Group's 'ease of doing business' report series, and suggests that 'commitment and implementation of tax administration measures [by the government] will send a very positive signal to foreign investors'.<sup>26</sup> However, the study did not investigate what reform options may be appropriate.

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<sup>18</sup> Chaikin and Dyball, above n 9.

<sup>19</sup> Ibid 73.

<sup>20</sup> Ibid 75.

<sup>21</sup> Transparency International, (2012), *Corruption Perceptions Index 2012*, <<http://www.transparency.org/cpi2012/results>>.

<sup>22</sup> Chaikin and Dyball, above n 12.

<sup>23</sup> Tran Nam, above n 5.

<sup>24</sup> Ibid 137.

<sup>25</sup> Gitte Heij, 'Costs of Compliance: the Taxpayer's Hidden Tax Burden' (1995) 1(1) *Asia-Pacific Tax Bulletin*, 22–24.

<sup>26</sup> Tran Nam, above n 5, 142.

A quantitative study by Ajaz and Ahmad was the first to test the relationship between corruption, good governance and total tax revenues collected.<sup>27</sup> Through the use of an econometric model, it was found that high corruption levels in a tax administration result in lower revenue collections, while a positive relationship was observed between tax collection and good governance (including strategic planning) of such authorities. A more recent study by Mansor and Tayib is the first to look at the existence of strategic planning (a feature of good governance) in a SE Asian tax administration, finding disparities between the practices observed and international norms.<sup>28</sup> Ajaz and Ahmad's study is particularly significant for the present study as it was found that tax administration issues relevant to foreign investors, which have been identified by prior studies, have an adverse impact on revenue collection.<sup>29</sup> This enables the inference to be drawn that both SE Asian revenue authorities and foreign investors are experiencing sub-optimal investment outcomes due to tax administration issues.

## 2.2 Large Taxpayer Units (LTUs) and Semi-Autonomous Revenue Authorities (SARA)

A survey of the literature reveals a plethora of 'solutions' to tax administration problems, although few have proved to be successful or adaptable to the unique circumstances of developing nations. Vehorn reviewed proposals arguing for and against the establishment of large taxpayer units (LTUs) in developing countries, finding that such bodies are fundamentally flawed in their conception.<sup>30</sup> LTUs have been propagated by the International Monetary Fund (IMF) as a way of enhancing revenue flows by way of creating a specialised unit within a nation's revenue authority tasked with collecting taxes from large taxpayers.<sup>31</sup> Proponents for such units observe that less than 10 percent of enterprises in developing countries typically contribute between 50 percent and 90 percent of tax revenue, with a highly trained 'one stop shop' LTU creating fewer opportunities for corruption, thus increasing tax collection.<sup>32</sup>

Through statistical analysis of economic data collected before and after the implementation of LTUs by 40 developing countries, Vehorn found that while tax revenue rose in 32 of the 40 countries, tax share (collections/GDP) increased in only 10 of 40 countries, with a decline witnessed in 43 percent of the nations studied. Pertinently, it was found that the implementation of an LTU in developing nations suffering tax administration issues such as corruption is 'not systematically associated with higher economic growth'.<sup>33</sup> However, Vehorn reaches these conclusions based on the experience of developing nations outside SE Asia, and fails to take into account external events such as wartime conflicts and the global financial crisis (GFC). Regardless, this study indicates that the establishment of LTUs guarantees neither economic growth nor (significantly) enhanced revenue flows.<sup>34</sup>

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<sup>27</sup> Tahseen Ajaz and Eatnaz Ahmad, 'The Effect of Corruption and Governance on Tax Revenues' (2010) 49(4) *The Pakistan Development Review*, 405–417.

<sup>28</sup> Mansor Muzainah and Mahamad Tayib, 'Strategic Planning in Public Organisations: The Case of a Tax Administration in a Developing Country' (2012) 1(8) *Business Management Dynamics* 20–33.

<sup>29</sup> Chaikin and Dyball, above n 12.; Tran-Nam, above n 2; Mansor and Tayib, above n 28.

<sup>30</sup> Vehorn, above n 13.

<sup>31</sup> International Monetary Fund (IMF), *Improving Large Taxpayers' Compliance: A Review of Country Experience* (2002), <<http://www.imf.org/external/pubs/nft/op/215/index.htm>>.

<sup>32</sup> Vehorn, above n 13.

<sup>33</sup> Ibid 334.

<sup>34</sup> Ibid.

Another solution to many of the unique challenges faced by developing countries is the establishment of an autonomous or Semi-Autonomous Revenue Authority (SARA) operating under an organisational structure with many features in common with private sector organisations.<sup>35</sup> Devas, Delay and Hubbard, for example, note in this regard that the role of the government is to ‘steer, not to row’.<sup>36</sup> The authors state that the rationale behind a SARA is that independence from the government can yield greater efficiencies as a result of lower levels of corruption than is found in the public sector and being able to invest in sophisticated staff training. Mann adds that SARAs are typically introduced as a measure to remedy the lack of transparency in revenue authorities which can be indicative of corruption.<sup>37</sup>

A more recent IMF survey of various SARAs found that they operate with varying degrees of autonomy, yet they share common features.<sup>38</sup> A later Organisation for Economic Co-operation and Development (OECD) analysis found that indicators of autonomy, or rather, the SARA’s ability to operate independently of government, include its independence in organisational planning and budget management, whether it sets its own performance measurement standards, and whether it has control over its human resource policies.<sup>39</sup> Through comparative analysis of SARAs in existence, Crandall found that 75 percent have empowered management boards, 70 percent operate outside the public service and 30 percent are funded independently by retaining a percentage of their tax collection.<sup>40</sup>

With extensive use of the SARA model in Africa, Devas et al.’s study of the Ugandan experience exposes several weaknesses with this reform option.<sup>41</sup> Uganda introduced a SARA to combat extensive corruption and staff training deficiencies that were thought to be the reason for its poor tax share.<sup>42</sup> Devas et al. observe that ‘while the desired results were initially obtained with dramatic increases in tax share’, problems of corruption have re-emerged highlighting that SARAs ‘do not guarantee isolation from political interference, incompetence or malpractice’.<sup>43</sup> There is no discussion in the literature on whether the effectiveness of the SARA model in developing nations may differ if it were fully autonomous and operating at an international (or regional) level.

### 2.3 Reform proposal: A World Tax Organisation

While SARAs and LTUs are currently in existence, Sawyer proposed the forward looking and normative establishment of a World Tax Organisation (WTO) as a

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<sup>35</sup> William Crandall, ‘Revenue Administration: Autonomy in Tax Administration and the Revenue Authority Model’, *IMF Technical Notes and Manual 10/12* (2010) <<http://www.imf.org/external/pubs/ft/tnm/2010/tnm1012.pdf>>.

<sup>36</sup> Nick Devas, Simon Delay and Michael Hubbard, ‘Revenue Authorities: Are they the Right Vehicle for Improved Tax Administration?’ (2001) 21(3) *Public Administration and Development*, 211–222.

<sup>37</sup> Arthur J Mann (2004), ‘Are Semi-Autonomous Revenue Authorities the Answer to Tax Administration Problems in Developing countries? A Practical Guide’ *Research paper for the project: Fiscal Reform in Support of Trade Liberalization* <[http://pdf.usaid.gov/pdf\\_docs/PNADC978.pdf](http://pdf.usaid.gov/pdf_docs/PNADC978.pdf)>.

<sup>38</sup> International Monetary Fund (2006), *Revenue Authorities: Issues and Problems in Evaluating Their Success* WP/ 06/240 <<http://www.imf.org/external/pubs/ft/wp/2006/wp06240.pdf>>.

<sup>39</sup> Organisation for Economic Co-operation and Development (OECD) (2009), *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series* (2009), (OECD, 2009).

<sup>40</sup> Crandall, above n 35.

<sup>41</sup> Devas et al., above n 36.

<sup>42</sup> Crandall, above n 35.

<sup>43</sup> Devas et al., above n 36, 213 and 221.

solution to certain tax challenges in ‘an increasingly integrated and globalised world with many cross-border transactions and companies operating across many jurisdictions’.<sup>44</sup> Sawyer proposes that the initial jurisdiction of such a body be limited to binding (advance) rulings and advance pricing agreements (APAs) accompanied by a dispute resolution function giving standing to private parties. Sawyer argues that over time, ‘through gradualism, an international organisation should assume ever greater authority for coordinating administrative tax policy and processes for cross-border business transactions’, although Sawyer adds the caveat that he is not a proponent of ‘complete harmonisation’.<sup>45</sup>

Pinto and Sawyer reason that a WTO could have the subsidiary benefit of being a global ‘relationship bridge’ to share research and best practices in tax administration.<sup>46</sup> Usefully, their study examines the limited roles of a wide range of international organisations that may constitute ‘associations of tax organisations’, ultimately concluding that the proposed WTO would be an appropriate body for such a function. Sawyer acknowledges that his research ‘is certainly not the final work on the topic [of a WTO]’ with several aspects unexplored including the potential ‘expansion of its jurisdiction’.<sup>47</sup> The possibility of a regional tax authority with the independence and jurisdiction of the proposed WTO is also not examined by these studies.

## 2.4 Proposed regional tax organisations

It is appropriate to recognise that the OECD plays a limited but significant role in international tax administration, primarily by encouraging double tax agreements (DTAs), Tax Information Exchange Agreements (TIEAs) and by setting guidelines for complex issues such as transfer pricing (TP) and exchange of information standards. It should also be noted that the United Nations (UN) Model Double Taxation Convention between Developed and Developing Countries,<sup>48</sup> is used extensively in the negotiation of DTAs, placing an emphasis on *source* taxation. However, the OECD DTA model is often used where a developing country is negotiating a DTA with an OECD member. The OECD’s limited role in this sphere has been subject to criticism from academics including Bazo who claim that standards set by the OECD are viewed dimly by developing economies, with the perception being that the OECD’s interests are ostensibly for the benefit of developed economies.<sup>49</sup>

Further, Sharkey criticises the OECD as merely entrenching established tax principles of *source* and *residence*, which makes fundamental changes in international tax policy

<sup>44</sup> Adrian Sawyer, *Developing a World Tax Organisation: The Way Forward*, (Birmingham, Fiscal Publications, 2009), ix. This study builds upon the pioneering work of Tanzi; see Vito Tanzi, ‘Is there a Need for a World Tax Organisation?’ in Assaf Razin and Efraim Saka (eds), *The Economics of Globalisation: Policy Perspectives from Public Economics*, (Cambridge University Press, 1999) 173–186.

<sup>45</sup> Sawyer, above n 44, 9. Kerrie Sadiq, ‘The Traditional Rationale of the Arm’s Length Approach and Transfer-pricing. Should the Separate Accounting Model be Maintained for Multinational Entities?’ (2004) 7(2) *Journal of Australian Taxation*, 196, 241.

<sup>46</sup> Dale Pinto and Adrian Sawyer, ‘Building Bridges between Revenue Authorities: Would a World Tax Organisation be a Key Facilitator?’ (2011) *Journal of Applied Law and Policy*, 25–38.

<sup>47</sup> Sawyer, above n 44, 208.

<sup>48</sup> United Nations (5 April 2012), *Model Double Taxation Convention between Developed and Developing Countries* <<http://www.un.org/en/development/desa/publications/double-taxation-convention.html>>.

<sup>49</sup> Andres E Bazo, (2008), *The International Tax Organization, a Proposal Destined for Failure?* Working Paper <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1319929](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319929)>.

increasingly difficult.<sup>50</sup> Sharkey and Bain argue that the ‘jurisdictional nexus rules of *source* and *residence*’ are incompatible with the current era of international business and economic transnationalism. Thus organisations such as the OECD, which are perceived as serving the interests of developed countries over developing countries, and which have a conservative approach to international taxation reform, may not be appropriate bodies to further an agenda of radical tax administration reform in the SE Asian region.<sup>51</sup>

As previously noted, ASEAN is a geo-political and economic organisation with membership comprising Singapore, the Philippines, Malaysia, Indonesia, Thailand, Brunei, Vietnam, Laos, Cambodia and Myanmar, and it operates with social, economic, defence and cultural mandates. An ASEAN policy document stipulates that economic integration is one of the aims of ASEAN, with the end goal being a single unified market comparable to the European Union (EU).<sup>52</sup>

Sharkey uses this mandate as the foundation for a proposed SE Asian RTO which would contribute towards economic integration of ASEAN countries whilst refraining from political harmonisation as seen in the EU.<sup>53</sup> The motivation for such a change is the interconnected nature of the regional economies, with globalisation and the elimination of harmful regional tax competition argued to be better served by the establishment of an RTO. In support of Sharkey and Bain, Sharkey proposed the establishment of a ‘regional’ concept of *source* and *residence*, not restricted by national or geographical borders.<sup>54</sup> Sharkey then proposed that a regional common tax rate be set, with the administration and collection of SE Asian taxes being undertaken by the RTO before being distributed to the various nations.<sup>55</sup>

Significantly, however, it must be noted that the proposal fails to address the issue of how the common tax rate would be set. Any international organisation requiring a state to hand over the sovereign task of setting its tax rates is inherently radical in nature. It should also be recognised that a proposed RTO would encounter numerous complexities if tasked with assessing the hundreds of millions of ‘domestic residents’ within the SE Asian region as opposed to merely concentrating on foreign investors. Regardless, the Sharkey proposal provides a useful reference point for the present study. Its radicalism leaves a notable ‘gap’ between the status quo and the proposed RTO in which a less radical but equally effective RTA can be explored.<sup>56</sup>

## 2.5 Conclusion from the prior research

The preceding examination of the prior research has shown that there are many tax administration issues plaguing the SE Asian region. However, not only is there a lack of research into these issues beyond a relatively small number of isolated studies, but these studies fail to determine which particular issues are faced by foreign investors as opposed to ‘taxpayers’ in general. Research on ‘domestic level’ LTUs and SARAs

<sup>50</sup> Nolan Sharkey, ‘A South East Asian Tax Organisation’, (2013) *British Tax Review*, 2, 175–191.

<sup>51</sup> Nolan Sharkey and Katherine Bain, ‘Tax Residence and Regions: Addressing South East Asian Transnationalism through ASEAN’, in Nolan Sharkey (ed.) *Taxation in ASEAN and China: Local Institutions, Regionalism, Global Systems and Economic Development*, (Routledge, 2012), 236–258, 236.

<sup>52</sup> ASEAN (1997), *Vision 2020*, ASEAN <<http://www.asean.org/news/item/asean-vision-2020>>.

<sup>53</sup> Sharkey, above n 50.

<sup>54</sup> Sharkey and Bain, above n 51.

<sup>55</sup> Sharkey, above n 50.

<sup>56</sup> *Ibid.*

was also examined, indicating that such ‘solutions’ have failed in practice due, primarily, to a failure to prevent the re-emergence of corruption. However, aspects of the LTU and SARA ‘solutions’, such as increased staff training, will be considered in the present study as possible features of the proposed RTA.

Likewise, the proposed WTO is radical in its conception and, although not directly concerned with the SE Asian region, contains several attractive features such as an accessible disputes settlement function and the issuance of binding rulings.<sup>57</sup> Sharkey’s proposed RTO is radical and extreme and could potentially be viewed as an ‘end point’ rather than a ‘starting point’ for reform.<sup>58</sup> Thus, it is clear that there have been no proposals in the literature exploring the feasibility of a less radical RTA acting as an intermediary between foreign investors and SE Asian States.

### 3. RESEARCH APPROACH

This study focuses on Vietnam, although some of the data collected relates to the wider ASEAN region as opposed to being Vietnam specific. This case study utilises mixed research methods, which primarily consisted of semi-structured interviews, but also includes phenomenological observations. Interviewees were asked questions pertaining to their perceptions of a potential RTA, both in relation to the identified administration issues, and whether it would likely prove attractive to foreign investors in their capital investment decisions.

#### 3.1 Interviews

The interview subjects included three academics with knowledge of ASEAN tax administration, senior executives or tax managers of NZ companies that have invested or are considering investing in Vietnam, one who has worked for New Zealand Trade and Enterprise (NZTE) in SE Asia, and a NZ tax adviser, who provides advice to NZ companies on SE Asia market entry. For practical and ethical reasons, individuals currently residing in Vietnam were not interviewed. While this may appear to be a limitation, it was largely to improve the validity of the study, as individuals living in Vietnam may not feel that they are in a position to be ‘open’ to discussing challenges in the tax administration, and may subsequently provide opaque, misleading or false information.

With this study being explorative, there is no intention to seek to generalise the findings from the interviews. Nevertheless, it was our intention to interview a sufficient number of subjects so as to ensure any emerging themes had qualified support. Eight interviews were undertaken with the subjects selected on the basis of their expertise and experience concerning FDI and Vietnam. In the case of the academic subjects, these were selected from a very small pool of established Australasian researchers examining SEA tax administration issues. The senior executives, tax managers, and advisors were either key personnel in businesses that one of the authors had established prior contact with or were known to be actively involved in undertaking or advising on FDI in Vietnam.

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<sup>57</sup> Sawyer, above n 44.

<sup>58</sup> Sharkey, above n 50.

The literature suggests that a defensible absolute minimum number of interviewees is six, with typical interview samples involving twelve or more subjects (or ceasing at the point of saturation when no new information is gleaned from the last interviewee).<sup>59</sup> As Morse observes, it is not the quality of data that is theoretically important but the richness of the data derived from the detailed description.<sup>60</sup> In this study, given its exploratory nature and the relatively small number of experts and NZ businesses known to be actively involved in FDI in Vietnam, the number of potential interviewees was small. The resulting findings give us no reason to believe that had a wider pool of subjects been included, the emerging themes and issues would be significantly different.

The interviews were semi-structured enabling the 'what' and 'why' questions to be asked with regard to administrative issues before delving into the exploratory aspects of the case study, which sought to gauge the interviewee's perceptions of the proposed RTA as a solution to the tax administration issues raised in the earlier phase of the interview. Issues raised by interviewees in early interviews formed the basis of questions in later interviews. Although this means that the interview findings could not be directly compared, the 'evolving' nature of some of the interview questions benefited the research findings.

Each interview subject was provided with a non-exhaustive overview of the questions to be discussed approximately 24 hours prior to the interview, along with an information sheet which outlined the scope of the research. Prior human ethics approval was sought and granted. All interview subjects were presented with a consent form prior to the interview with all but one subject consenting to their names being included in the results section. One interview was conducted via telephone, with the remainder being conducted in person. With the consent of all interviewees, the interviews were electronically recorded to allow for accurate transcription of relevant quotes. The transcripts were then analysed to ascertain common themes and concerns among interviewees. Interviewee's companies and names have been anonymised.

### 3.2 Author observations

Phenomenological research unsurprisingly is a study of a phenomenon, which could be a relationship or activity. It differs from ethnographic research in that it is not constrained to studies of culture and the phenomenological researcher tends to experience the phenomenon being researched as opposed to merely observing other participants.<sup>61</sup>

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<sup>59</sup> With research involving phenomenology (as in the current study), Creswell suggests five to 25; see John Creswell, *Qualitative Inquiry and Research Design: Choosing Among Five Traditions*, (Thousand Oaks, Sage, 1998), 64. Morse suggests the minimum should be at least 6; see Janice M Morse (1994), 'Designing funded qualitative research' in Norman K Denzin and Yvonna S Lincoln (eds), *Handbook of Qualitative Research* (Thousand Oaks, Sage, 2<sup>nd</sup> ed, 1994), 220–35, 225. See also Glenn A Bowen, 'Naturalistic Inquiry and the Saturation Concept: A Research Note (2008) 8(1) *Qualitative Research*, 137–152. Further useful guidance is provided by Greg Guest, Arwen Bunce and Laura Johnson, 'How Many Interviews Are Enough? An Experiment with Data Saturation and Variability', (2006) 18(1) *Field Methods*, 59–82.

<sup>60</sup> Janice M Morse, 'The Significance of Saturation' (1995) 5(2) *Qualitative Health Research*, 147–149, 148.

<sup>61</sup> Margaret McKerchar, *Design and Conduct of Research in Tax, Law and Accounting*, (Thomson Reuters, 2010).

The phenomenological observations were collected by one of the authors while living and working in Vietnam for three months from late 2012 through to early 2013. Unlike ethnography, the observations do not pertain to internal phenomena within the observer's 'employer' organisation, but rather, to what was observed during interactions with the Vietnamese tax authorities when one of the present authors was effectively an 'agent' of foreign investors. As such, the observations are largely between one of the authors and the Vietnamese tax administration (a public authority). The observations pertain to the problems faced by foreign investors in the administration of their taxes. The observations, recorded in diary form, are limited in their scope and are intended to supplement the empirical data gained through the interviews discussed above.

#### **4. THEMES AND ANALYSIS EMERGING FROM THE INTERVIEWS AND OBSERVATIONS**

The present section identifies common themes that have been drawn from an analysis of the interview and phenomenology data. Illustrative quotes collected from the interviews are included to support the thematic observations. The findings are analysed in relation to the preceding research questions and literature review, before being discussed in a more general sense in the following discussion section.

##### **4.1 The importance of South East Asia for New Zealand businesses**

All interviewees perceived the SE Asia region to be an area of high growth, with exponentially increasing consumer demand levels presenting opportunities for NZ businesses that are unmatched by the relatively stagnant domestic NZ market. While all interviewees noted that China has historically been the Asian investment destination of choice for NZ businesses looking to break into the Asian market since the 1998 Asian financial crisis, there was a common theme of caution against over-investing in a single market. This is illustrated by the following interview extract from 'Company A':

Companies like to diversify, so companies will not put all their 'eggs' in one market, so we will see growth in both SE Asia and China. If you're concentrating on only one [market], you will lose opportunities in the others.

It is also apparent from the interviews that it is not only Vietnam which is regarded by investors as an attractive investment destination, but also a range of other SE Asian markets, as indicated by 'Company B':

We see it [SE Asia] as a growth spot and have looked around Singapore, Malaysia and Indonesia. However, we see a lot more interest from NZ clients looking to go into Vietnam ... a three hour circle [flight time] around NZ includes a [much] smaller range of customers than three hours from Hanoi and HCMC [Ho Chi Minh City] ... so we see growth across the SE Asia region, but would be looking to hub it through Vietnam.

Also of note, 'Adviser A' observed that intra ASEAN trade is relatively low when compared to other global regions due to the poor surface infrastructure plaguing developing ASEAN nations. As a result, it was reasoned by 'Adviser A' that FDI is in high demand from developing SE Asian nations to either directly assist with infrastructure development, or provide tax revenues to fund such projects stating:

NZ companies can get involved with infrastructure development in the region. The time is now. We will see more in the next 10 years in the way of demand for investment than the 5 years after that.

As such, it is clear that there is a strong desire from NZ companies to invest in SE Asia in addition to there being a correlating demand for such investment from SE Asian countries.

#### **4.2 Factors considered in foreign direct investment decisions and the role of the tax administration**

An important aspect of the present research is to determine whether a potential investment destination's tax administration is a factor considered by foreign investors when making investment decisions. If not, then the rationale underpinning the establishment of an RTA aimed at increasing FDI flows through improved tax administration would be undermined. Fortunately, the interviews found that tax administration is one factor considered by investors.

However, a common theme expressed by all interviewees was that it is one of many considerations, and is usually not the predominant factor driving investment decisions. The prevalent considerations for businesses tended to be either the region's low manufacturing costs as a result of affordable labour rates or, alternatively, SE Asia's rapidly rising wealth and resulting consumer demand for western products and services. 'Company B' invested primarily because of the former consideration, which has given its services a competitive advantage when sold in the NZ market. 'Company A' invests primarily on the latter consideration, with the region's low manufacturing costs largely irrelevant to its FDI decisions by virtue of its product being produced in NZ. 'Academic B' commented that tax considerations are ever-present, yet secondary considerations when deciding whether to invest in Vietnam:

Investment into Vietnam is very dependent on international macro-economic conditions ... as is evidenced by the fact that FDI [into Vietnam] fell dramatically during the [1997] Asian financial crisis.

This theme was supported by other interviewees:

Investment decisions are largely commercially driven, with tax considerations becoming important at the 'how' stage as opposed to the 'if' stage.

'Company A'

While tax [administration] is an important consideration, it cannot lead the discussion. However, there is no question that you want to make sure [that you are] paying the correct amount. It [tax administration] has to be considered.

'Adviser B'

'Company B' expressed similar views, noting that its investment into Vietnam was primarily motivated by increasing domestic NZ demand for software products coupled with the desire to reduce labour costs, to allow the business model to employ idle staff

so it can be in a position to bid for projects with immediate start dates. However, Vietnam's political stability, relative to neighbouring ASEAN nations (which is inextricably linked to many tax administration functions), was also a fundamental investment consideration.

'Adviser A' agreed that tax administration tends to be a secondary consideration, although he reasoned that transparency and consistency in the law is a crucial prerequisite for any potential host State. As such, tax administration can be relevant when deciding whether to invest in one SE Asian State over another. 'Academic A' supported this view, arguing that tax administration is relevant when deciding between the likes of Singapore or Malaysia, but not so relevant when deciding between Singapore and Vietnam.

The thematic finding that the tax administration is not the primary investment determinant is perhaps best encapsulated by the following observation by 'Company C':

We don't let the tail wag the dog, which you can do with tax if you're not careful.

Group tax manager of 'Company A' added:

... and people have let the tail wag the dog and they've got themselves in [trouble] because of it.

These results confirm the findings of UNCTAD that the decision to invest in a foreign country is vexed, with tax administration being one of many considerations.<sup>62</sup> However, the finding that it is not the most important consideration should not undermine its nominal importance, as by virtue of being a consideration, it is capable of influencing FDI flows.

### 4.3 The role of double tax agreements in foreign direct investment decisions

The interviewees were asked about the importance they placed on the existence of DTAs when making investment decisions. In particular, the interviews sought to gauge perceptions of the recently signed DTA between NZ and Vietnam.<sup>63</sup> Overwhelmingly, the common theme was that while DTAs can be attractive 'in theory' as a way of achieving greater predictability in both tax law and administration, their effectiveness differs markedly in 'practice'. As noted by 'Company A':

DTAs are one factor, but they do not determine why we invest, but more, how we invest. DTAs can create predictability, but like FTAs, we often have to actually tell the [tax] officials that they exist. Also, if Vietnam does not like the [outcome from] a DTA, they will ignore it. We have found this all across Asia, with half the problem being that many of these countries aren't even members of the OECD, so have never bought into OECD rules, and [they] don't understand them. So in practice, they don't work so well.

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<sup>62</sup> United Nations Conference on Trade and Development, above n 7.

<sup>63</sup> See *Agreement between the Government of New Zealand and the Government of the Socialist Republic of Viet Nam for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income* (5 August 2013) <<http://taxpolicy.ird.govt.nz/tax-treaties/viet-nam>>.

#### 4.4 Vietnam/ASEAN tax administration issues

The present section of this paper identifies the tax administration issues that are currently of concern to foreign investors. Most of the findings were made in relation to Vietnam; however, several interviewees commented on issues encountered in other developing ASEAN members. These findings are included and presumed to be generalisable on the assumption that many such issues are common across developing countries in the region.

It was found that the native written language of tax laws is not a significant tax administration issue for foreign investors. Vietnamese tax laws are published by Vietnamese tax authorities in both Vietnamese and English. However, where a conflict arises, it is the Vietnamese version that takes precedence. Despite this potential conflict, 'Company A', 'Company B' and 'Adviser B' found the English versions of tax statutes to be readable, accessible and not an issue in themselves.

A common tax administration concern among interviewees was the uncertainty of tax laws arising from the seemingly arbitrary application of the law as opposed to any concern over the substance of the law. 'Company A' commented:

Often, in the interpretation of tax laws there are three answers. One, technical, being what the rule says. Two, policy based, which may differ from the technical answer and three, what happens in practice. So depending on how you approach things, you can come up with three different answers. Vietnam is right up there with practice differing from rules ... so understanding tax laws is not [only] technical, but tactical.

The interviewees were willing to pay whatever taxes are applicable according to the letter of the law, as a result of favouring a risk averse approach for their SE Asian investments. However, they found it difficult and frustrating to ascertain precisely what laws were applicable, and how they apply to complex tax situations. Such difficulty is partially due to the ad-hoc passing of tax law through decrees as opposed to statute, and partially due to a cultural misunderstanding by the tax department and local advisers of the desire for foreign investing entities to pay tax according to the letter of the law, even if such an amount exceeds what is paid 'in practice'. The difficulty in ascertaining what laws are applicable due to their ad-hoc enactment was noted by 'Adviser B':

Vietnam and Indonesia are problematic as they change the law by regulation and not by statute. Regulation can be contrary to statute and statute contrary to statute.

Similarly, 'Company C' commented:

[Constant reform of tax laws] can cause a bit of a kerfuffle before things settle down and people [taxpayers and tax authorities] understand them. How they [laws] read and how they work [in practice] can be two quite separate things.

The desire to pay the legally correct amount of taxes as per the letter of the law is evidenced by the following remark by 'Company B':

I'm very risk averse. I don't want to be escorted off to a small room next time I land in Vietnam. I like to pay per the letter of the law, so I need to know what the law says I must pay or what I must do ... Also, to me, if you want to do long term business in a country, you need to do what is right, not what is perceived to be right.

The difficulty of ascertaining the correct legal position is also symptomatic of the broader administration issue of the difficulty of attaining binding rulings from tax authorities, as noted by 'Adviser B':

Vietnam and Indonesia are the most difficult [countries] in the region to get binding rulings from. It can be difficult to get a decision let alone a binding ruling. Even getting consistent views from two independent advisers can be difficult. I can go to two different legal firms in Vietnam and get two different opinions. This is why we have to structure investments through Hong Kong, but you shouldn't have to do that to get certainty of profit.

'Academic B' hypothesised that the cause of such inconsistent tax interpretations is twofold. First, this is due to a lack of competently trained staff in the tax department, and second, it is a result of corruption stemming from poor remuneration of tax officials:

There is an inability to attract quality staff with expertise who can get paid much more working for a private firm ... [which is] expounded by the fact that you cannot get a tax degree in Vietnam, so graduates don't have the technical expertise. They [tax departments] are trying to train staff internally, but the results are slow. More digitalisation is needed to reduce face-to-face contact which leads to corruption. The lack of staff rotation is also a problem.

This was supported by 'Academic A':

There are few people employed by each ASEAN tax authority who have the required expertise to deal with complex situations. This is often due to the small size of the authorities, which are not large organisations like the Australian Tax Office. You may have one person who has tax treaties as one tenth of their job.

A further tax administration issue linked to the uncertainty of law and inconsistent interpretations of tax laws is a culture of corruption in the tax administration with an (incorrect) assumption by tax officials that international investors are willing to participate in such practices. While in Vietnam during 2013, one of the authors observed the following practice:

Several trips had been made to the HCMC tax department (HCMCTD) over the previous months. The normal procedure is to walk into the waiting area, take a ticket number from the automatic dispenser and wait for your number to be called over the loud speaker, at which time you would meet with an official. However, the procedure was somewhat different in late January, following the recent end of financial year and immediately before the festive Chinese New Year holiday period known locally as 'tet'. As the only 'foreigner' in the vicinity, I was immediately struck by the sight of everyone else walking into the HCMCTD carrying enormous gifts, typically hampers

filled with the likes of champagne, French cheese and high quality spirits. Instead of waiting for their assigned number to be called, those with the largest gifts would proceed almost immediately to a waiting tax officer to have their tax issue ‘addressed’.

‘Academic C’ also recognised the existence of corruption, noting that:

Some [foreign investing] companies like this, as it can be efficient to just go to the tax office and find out the outcome and that’s that. On the other hand, when it turns against you, you don’t have much of a leg to stand on.

Other interviewees, emphasising that their risk averse approaches demand that they do not engage in any corrupt practices, confirmed the latter:

We do what’s right, not just what’s perceived to be right. This can be a point of [cultural] confusion in getting Vietnamese tax advice. You have to say, ‘I don’t care what you just told me, I will actually pay four times as much, I don’t care’.

‘Company B’

We have a zero tolerance corporate policy towards corruption, and any ‘in practice’ approach [to tax administration] is dangerous.

‘Company A’

Another common theme was the difficulty faced by investors if they decide to challenge a tax ruling or assessment made by a SE Asian tax authority. It was found that dispute settlement functions did not allow for the timely resolution of disputes, as is desirable in a commercial context. There is also a significant imbalance of power in the dispute settlement process which is expounded by a lack of transparency in judicial systems, and the fact that breaches of tax law are subject to criminal penalties if an offence is established. As a result, investors and their agents are reluctant to challenge tax assessments directly, even when there may appear to be significant legal merit supporting their argument. Ultimately, this creates a greater level of commercial uncertainty for foreign investors. This is supported by the following comments:

Our employees are very reluctant to engage with the local tax authorities because they are scared of them. Tax advisers will often pay the disputed amounts themselves, as they don’t want to deal with the tax authorities- even [they are] scared of them.

‘Company A’

It [challenging determinations] takes time, probably as NZ is not big enough to demand the time [of tax officials] that big countries such as the USA can. Also, New Zealanders and Australians are too honest to pay ‘assistance’ which is not a bad thing. It is not uncommon to wait 3 to 4 months for a reply, but business moves faster than that.

‘Adviser B’

A further tax administration issue experienced by investors in Vietnam was the significant cost and time required to collect accurate transfer pricing (TP) benchmarking data. The complexity of the process often necessitates the involvement of a highly competent locally based tax adviser.

As noted by 'Company B':

TP is an issue. We have spent a lot on TP benchmarking every two years. It costs a lot of money, but having [a big four's] name on the document gives credibility in the case of a potential audit.

The lack of readily available TP data is not only a problem for investors, but also for the tax departments which often do not have the expertise or resources to know what a fair TP price is, and when tax avoidance may be taking place. As observed by 'Academic B':

A lack of TP expertise is a major issue (for the Vietnamese tax authority), with some companies having taken advantage of Vietnam ... causing a loss of tax revenue. The government has stated that TP is one of their main priorities, and they have been sending staff overseas to try and foster expertise. Still, their staff are at a knowledge disadvantage in such negotiations.

A further issue identified by 'Company B' was the difficulty of getting profits out of Vietnam and back to NZ due to anti money-laundering (AML) laws. Under such regulations, letters confirming that the investor has paid all outstanding taxes must be shown to the bank prior to the international transfer. However, the Vietnam tax department (HCMC) can be very slow to issue such letters, as observed by 'Company B':

It can be very difficult to get money out of Vietnam. I waited 5 years to make my first dollar and then another 7 months to bring it back. Many documents need to be verified and sealed, including TP and CIT confirmations.

#### **4.5 A Regional Tax Authority (RTA)**

The latter part of the interviews sought to collect perceptions on a range of aspects regarding the proposed establishment of an RTA. Prior to the interviews, the interviewees were given an advance question outline, which listed several possible features of an RTA (see Appendix). The interviewees were told that the prospective RTA would be established at the international level and used by foreign investors to pay their SE Asian region taxes. It was suggested that the RTA would be fluent in the investor's native language(s), and that the staff would be highly trained. The interviewees were informed that a dispute settlement function and the ability to issue binding rulings could also be included. It was made clear to the interviewees that this list of features is not exhaustive.

##### *4.5.1 Desirability of a Regional Tax Authority*

All interviewees supported the establishment of an RTA, with greater commercial certainty and predictability of the law seen as the major benefits for investors. Multiple interviewees emphasised that an RTA could prove to be particularly valuable

for NZ companies considering SE Asia market entry, as they will be able to clearly identify the tax ramifications flowing from the commercial decision of entering an Asian market. These themes are evident in the following comment by ‘Company A’:

If you got all [ASEAN] countries to buy into it, it would be attractive, it would be fantastic. It would add a lot of value. While we invest on the basis of commercial reasons, it would create certainty and predictability which is key [for such investments].

#### 4.5.2 *Desirable features*

The interviewees commonly agreed that the establishment of an RTA could alleviate many of the tax administration issues identified in the preceding section. Overarching attributes of timeliness, predictability and accountability were identified as necessary traits by the interviewees. An effective dispute settlement function capable of resolving tax disputes in a timely and decisive manner without recourse to the national level courts of RTA member states was recognised to be highly desirable, as was the ability to issue binding rulings upon request. In addition to the establishment of a quasi-judicial dispute settlement organ, several interviewees emphasised the need for an arbitration and/or mediation function. ‘Company A’ stated:

It’s attractive to have some sort of arbitration or mediation. Court processes should be avoided as there is nothing to be won from a court case, anything can happen. From a commercial and business point of view there is often some sort of middle ground, so arbitration is preferred.

‘Academic B’ added:

I think that a body that can give binding determinations is a wonderful idea; it would give much greater certainty and consistency among [RTA member] countries.

Before further remarking:

It [the dispute settlement function] has to be seen as the ultimate authority. The countries will have to put significant faith in the ruling to be judged in accordance with [their] national laws and conventions, so any vetoing of the ruling will undermine it. So it must be binding to both parties. I expect the RTA to be quite effective, quite powerful, because otherwise it is just wasting time.

When commenting on the practical workings of a dispute settlement organisation, ‘Academic B’ suggested:

There should be multiple levels of dispute resolution. Parties should try to come to an agreement before going to mediation or before judges [of a quasi-judicial function]. The appointment of judges can also be problematic as judges tend to have a bias towards their own countries’ viewpoint. Judges should not be involved in cases pertaining to their home country. So if the dispute was between Vietnam and the US, a Singapore or Thai judge should preside.

#### 4.5.3 *Transfer pricing*

There was overwhelming support among the interviewees for the RTA to establish a function tasked with producing TP data for the benefit of both investors and RTA member states. As noted by ‘Adviser B’:

TP is particularly difficult in the region as there is a lack of publicly available data and it [any available data] is extraordinarily expensive and not necessarily accurate. If the RTA could provide data, this would be very helpful.

The attractiveness of such a function not only to foreign investors, but also to RTA member states, was emphasised by ‘Academic B’:

I think it would be a key role to be played by the organisation. The Vietnamese government would be happy to use TP data provided from independent research as they [themselves] currently lack benchmarking data.

Further support came from ‘Academic C’:

It sounds like something sensible [to include]. TP is something that the countries would be interested in getting right if you are going to preserve the independent tax systems, as TP is going to affect their tax take.

#### 4.5.4 *Impact on tax adviser use*

An additional theme to emerge was an expectation that the establishment of an RTA would decrease a foreign investor’s reliance on tax advisers. Primarily, this was due to the greater predictability, certainty and transparency of tax administration that would be achieved by an English speaking RTA. As observed by ‘Company C’:

We would still use a tax adviser, but we would decrease our reliance on them. It would be more of a review use rather than a preparation use. We would be attracted to the potential cost savings.

Similarly for ‘Company B’:

‘Company B’ is in ‘maintenance’ mode post set up, but if you were to ask me as a company about to embark on an investment, I would love it. If ‘Company B’ does expand our SE Asian investment beyond Vietnam, we would use it [the RTA] instead of advisers.

#### 4.5.5 *Challenges/feasibility*

The interviewees identified a number of challenges that would have to be overcome prior to establishing a functional, politically ‘palatable’ RTA. The issues of cost, political attractiveness, the physical location of the RTA’s headquarters and the seemingly arbitrary differential treatment for foreign and domestic businesses were the major concerns thematically identified across interviewees.

#### 4.5.6 *Cost*

The funding of an RTA was seen as a significant issue that would have to be addressed. ‘Academic B’ argued that the cost should be borne by both the investors and RTA member nations:

There needs to be a cost sharing agreement between countries and users. The formula for cost sharing would have to take into account that some countries receive more FDI than others.

Moreover, 'Company C' warned:

Cost would be an issue, how much we would use it depends on how much it would cost.

'Adviser A' suggested:

Cost wise, it may be best to sit under ASEAN so that all countries can help pay for it, perhaps as a proportion of its tax take. Myanmar and other developing countries may go to the World Bank to pay for their share of it- this fits within their [the World Bank's] objectives.

#### 4.5.7 *Political acceptability*

Interviewees were sceptical of whether culturally, politically and economically diverse ASEAN States would be willing to cede certain sovereign rights of taxing and cooperate as members of an RTA. 'Company A' observed:

Inter ASEAN rivalries are potentially a massive barrier. The underlying general hate of countries in Asia [pause] ... you'd be amazed, and it goes back hundreds of years. These countries are incredibly nationalistic and don't easily cede sovereignty.

Similarly, 'Adviser B' commented:

Resistance would come from member states. I can just see the discussion in member parliaments 'we are giving away our taxing rights' – wow!

'Adviser A' emphasised that there will likely be differences between modern nations such as Singapore and Malaysia, and undeveloped nations like Vietnam, Cambodia and Myanmar:

Resistance will be two ways; from developed countries saying 'what's in it for me' through to undeveloped countries looking at it from a legal standpoint, worried about whose laws would be applied.

'Academic A' added:

ASEAN nations can be divided into three levels of economic development. This can be problematic when working together as I don't think they have a common economic goal, or common economic history. Singapore could resist it as Singapore and Malaysia currently have an administrative advantage.

This was emphasised by 'Academic C':

There will always be resistance from those who already have their houses together, just like people; States don't like to put their hands in their pockets unless there is something coming back.

Before further reasoning:

However, they have committed to the joint ASEAN vision of closer integration, and the AEC (ASEAN Economic Community) 2015.

As a result of these findings, it is clear that the bounds of the taxing rights signed over to the RTA by members would have to be well defined and narrowly drafted to cover only tax administration. Additionally, the RTA stands a greater chance of attracting developed nations such as Singapore if it is established under the ASEAN umbrella.

#### 4.5.8 *Location of headquarters*

Interrelated to the aforementioned issue of the inter-ASEAN tensions and rivalries is the issue of where to domicile the RTA. It was suggested by 'Company A' that Indonesia's nationalism as a potential barrier can only be overcome with it being located in Jakarta:

Indonesia is problematic as they have announced that they wish to be self-sufficient by 2022. ... In saying that, the ASEAN secretariat is in Jakarta, so locating it there could be quite strategic.

However, the majority of interviewees thought that Singapore was the best location, both for investors and as an inducement to encourage Singapore to join the RTA. 'Academic B' stated:

With Singapore it would have to be 'tit for tat', you would have to give them some benefit such as locating it in Singapore. I think this would be acceptable to Vietnam as Vietnam has a good relationship with Singapore, and the ministers would enjoy visiting Singapore. Singapore hosting the RTA ... would be the most practical way forward ...

#### 4.5.9 *Differential treatment*

A further concern was raised by 'Academic C' over the potential for differential treatment between foreign investors and domestic ASEAN businesses:

The downside is that you are offering two different treatments to domestic and foreign businesses. It would be nice to say 'administrative treatment' and not 'legal treatment', but administrative treatment becomes a real substantive economic difference in a weaker rule of law environment.

However, it is equally plausible to argue that any such difference would put pressure on RTA members to improve tax administration for domestic companies, with an RTA thus benefiting both foreign and domestic taxpayers in the long run.

### 4.6 **Comparison to the Organisation for Economic Co-operation and Development Semi-Autonomous Revenue Authority model**

The academic interviewees were asked whether they thought the proposed RTA would be plagued by the same troubles as the OECD recommended SARA model. The predominant theme to emerge was that an RTA would not suffer the same problems of corruption and low quality staff, primarily due to the fact that it would be at the international level as opposed to being a domestic based solution. 'Academic B' stated:

The RTA differs as it is at the international level, so is much more transparent, much more robust. It would be self-policing as each member could check each other.

#### 4.7 Practical considerations

Certain practical considerations are inextricably linked to the feasibility of a potential RTA. A common theme to emerge was that an RTA should be representative of all member nations. In order to achieve this end, multiple interviewees suggested the establishment of a 'rotating' chair or secretariat, whereby each Member State would provide a secretariat to the RTA for a stipulated time period. Likewise, the dispute settlement function would retain judges and mediators from every state, but such personnel would not preside over disputes involving their home states. Therefore, a Vietnamese tax law being disputed by an NZ investor may be heard before a Thai judge. Interviewees thematically noted that certain functions of the RTA would have to be carried out by ASEAN nationals in order to maintain political 'palatability'. However, all academic interviewees identified the importance of employing expatriates for certain functions, such as TP data production, which require a high level of both independence and technical skill.

It became apparent from the interviews that a RTA is only feasible if it includes various accountability mechanisms capable of holding the organisation's leadership to account. Given the vested interests of each state, a high degree of transparency needs to be maintained in order for each member to be confident that they are receiving the correct revenues. 'Academic C' emphasised the importance of auditing:

It would have to be audited, and as a public body everything would have to be publicly available – I don't think it's even an option; you would have to do that.

'Academic B' added that the RTA should produce a comprehensive annual report, with an organisational review taking place every five years to ensure that the RTA is following its constituted aims.

#### 4.8 Relationship with ASEAN

All interviewees argued that the RTA should sit under the ASEAN 'umbrella' in order to gain legitimacy and leverage off the existing shared ASEAN vision. As noted by 'Academic B':

If set up under ASEAN, it will be more attractive to ASEAN leaders. Perception-wise, it will be more attractive to investors.

One problem of basing it under ASEAN is that it would require the common agreement of ASEAN members, including potentially problematic nations such as Singapore before being established. However, 'Academic A' appositely notes that recent amendments to the ASEAN Charter allow for differential treatment of members. Therefore, it would be possible to have several ASEAN members, such as Vietnam, Laos, Myanmar, Indonesia and the Philippines, establish a RTA. If successful, non-member ASEAN States may decide to join the RTA rather than compete against it. Ultimately, it can be concluded that the RTA should be linked to ASEAN.

## 5. A MORE RADICAL APPROACH?

An important aspect of this study was to assess the bounds of a potential RTA, including whether it could, through gradualism, morph into the more radical RTO proposed by Sharkey.<sup>64</sup> A common theme to emerge from those interviewed was that there would be crippling political resistance to Sharkey's RTO proposal. Interviewees viewed it as highly unlikely that nationalistic ASEAN States would be willing to surrender the high degree of sovereignty called for by the RTO. Instead, an RTA was viewed as far more feasible than an RTO.

A commonly identified reason for resistance was the differing levels of economic development and political mandate across ASEAN members. This is manifested in drastically different tax structures, as noted by 'Adviser B':

There are huge differences in the structure of tax systems across Asia. You have socialist regimes through to extremely free market regimes and tax is an important part of how they want to redistribute wealth. Many ASEAN nations have youthful populations; if you don't have a fair distribution of wealth, you would have riots and civil disobedience.

Similarly, 'Adviser A' added:

It would be impossible, but it [a RTO] would be a utopia, as it would make it so much more transparent and simple. It just wouldn't happen as these countries need to use tax as a tool to manage their economies.

'Academic B' emphasised the historical political tensions between ASEAN nations and how this may prohibit a convergence of tax policy:

For countries that have been fighting for independence for so long, I don't think they are ready to hand over such sovereignty. ASEAN countries have surprisingly little in common ... and are not that united. The RTA is just about right [in terms of feasibility] but they [ASEAN members] would never accept a RTO, as the differences are just too great to find a common ground.

All interviewees reasoned that a RTA was far more realistic. For example:

Pipedream! It [a RTO] has merits from an idealistic point of view, but has no chance politically or even practically.

'Company A'

The RTA proposed is much more realistic, each country involved will still want to have their own rights and set their own tax rates ...

'Company C'

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<sup>64</sup> Sharkey, above n 50.

## 5.1 A 'social conscience'

In addition to the theme suggesting that an RTO would be unfeasible due to varying levels of development across ASEAN members and diverse political systems, multiple interviewees also expressed concern that their taxes would not go directly to the state in which they operate. Such a 'social conscience' was first raised by 'Company B', before being confirmed by 'Company A', which is a larger company, suggesting that such a concern is held by investors regardless of size. 'Company B' initially raised the point:

To me, I like that my tax revenue goes back to the Vietnamese government. It feels good that it's going there, whereas if it was going to one big pool, I would be concerned.

This was then confirmed by 'Company A':

The element of social responsibility is a genuine one these days, so socially, we should pay the right amount of tax for what we are doing in a particular country and we have no problem with that.

'Academic A' suggested that such a 'social conscience' can be part of a wider theme of organisations wanting to legitimise their operations and maintain a positive public perception:

It's an ongoing theme. If all else is the same, companies will go to the country where they believe in the government and have faith that the government will do right with their money.

## 5.2 Whether a Regional Tax Organisation should be viewed as an 'End Goal'

On the basis of the above interview findings, it can be concluded that the Sharkey proposal should not be viewed as an end goal as it lacks political feasibility, and would be immensely difficult to implement.<sup>65</sup> However, it is important to note that such a conclusion should not preclude certain aspects of the RTO proposal from being added to an RTA through a process of gradualism. A detailed analysis tasked with categorising each feature of the RTO proposal as either feasible or unfeasible is beyond the scope of the present study.

## 6. DISCUSSION

From the findings, it is apparent that SE Asian investors face a vast array of tax administration issues. Thematically, these include corruption, uncertainty of the law, cumbersome dispute settlement mechanisms and a lack of transfer pricing data. These issues were similar to Chaikin and Dyball's study of the Philippines tax administration.<sup>66</sup> It was found that tax administration issues are creating an environment of greater uncertainty for foreign investors when making foreign investment decisions.

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<sup>65</sup> Sharkey, above n 50.

<sup>66</sup> Chaikin and Dyball, above n 12.

The research also confirmed the findings of the UNCTAD<sup>67</sup> that foreign investment decisions are multifaceted, with investors taking into account a wide range of factors. Nonetheless, it was found that tax administration is a factor in such decisions. Therefore, it is possible to draw the inference that improved tax administration can lead to increased FDI.

There was substantial support from the interviewees for an RTA as a means for addressing the tax administration issues that they identified in the earlier part of the interviews. Particular attributes including a dispute settlement function, the production of transfer pricing benchmarking data and the ability to issue binding rulings were viewed as highly desirable by the investors, the tax adviser and the academics interviewed. Significantly, it was found the Vietnamese government may support the RTA taking over certain functions, as it currently lacks 'in-house' expertise to be able to produce complex transfer pricing data and administer the DTAs. Such a 'win-win' outcome for foreign investors and RTA member states ultimately improves the likelihood of states handing over the degree of sovereignty called for by the RTA.

Despite the overwhelming support for the proposed RTA, the research identified major challenges that such a proposal would have to overcome. Such challenges include cost, political acceptability and the location of headquarters. The interviews suggest that funding may be sourced from the World Bank and that the RTA headquarters may have to be located in Singapore in order to ensure its membership in the RTA. It was found that ASEAN members are highly nationalistic, with limited historical, cultural or current economic links. As such, it is suggested that the RTA have a rotating Chair, and include staff from all members in order to remain 'neutral' as opposed to becoming affiliated with one particular nationality. Ultimately, careful planning of the RTA organisational structure will be critical for determining whether it will be politically 'acceptable' for ASEAN members.

It is suggested that any RTA employ highly trained staff from both RTA member states and other nations as expatriates. Expatriate influence would be valuable for collecting and publishing transfer pricing data, where neutrality between investors and RTA member states is important for all parties. The dispute settlement function could include a pool of mediators and judges from a range of nationalities, to ensure that there is always a perception of judicial independence in the settlement of disputes. Together with the numerous accountability mechanisms of auditing and publicly available data, these features should collectively ensure that the RTA model is far more successful in countering developing country tax administration issues than the domestic level SARA or LTU models. As a result, although beyond the scope of the present research, the RTA model could be attractive to investors and developing countries in other global regions plagued by similar tax administration issues, such as Africa and South America.

The interview findings pertaining to the RTO proposed by Sharkey<sup>68</sup> indicate that an RTO in its current form is not viewed as an 'end point' to be worked towards through a process of gradualism after the establishment of an RTA. Primarily, this is due to the severe political resistance that the proposal would likely face due to the need for members to cede a far greater degree of sovereignty than is called for under the

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<sup>67</sup> United Nations Conference on Trade and Development, above n 7.

<sup>68</sup> Sharkey, above n 50.

proposed RTA. However, this research also found that resistance to an RTO could come from investors who have a 'social conscience' towards the societies in which they operate, and therefore demand that their taxes benefit their investment host nation(s) as opposed to being distributed among RTO members on other grounds as is proposed by Sharkey.<sup>69</sup> Despite these criticisms, there is substantial scope for an RTA to adopt additional features over time. Further, if RTAs are adopted in other global regions such as Africa and South America, it is possible that there could be features shared by such RTAs, and interaction with the WTO as proposed by Sawyer.<sup>70</sup>

## 7. CONCLUSIONS, LIMITATIONS AND FUTURE RESEARCH

### 7.1 Conclusions

Foreign direct investment is immensely important for maintaining the high GDP growth rates in SE Asian nations, which are contributing to increased wealth and ever higher standards of living. The present research confirmed that tax administration is a consideration evaluated by foreign investors when making FDI decisions. Therefore, it is in the interests of both developing ASEAN members and profit maximising foreign investors to resolve the plethora of tax administration issues such as corruption, untimely and inconsistent dispute settlement, lack of transfer pricing data and difficulty of obtaining binding rulings which the present study found to be plaguing the region. While the RTO proposed by Sharkey<sup>71</sup> may have theoretical merit, the present research suggests that its implementation would be highly problematic. In contrast to an RTO, the present research found that an RTA is attractive to foreign investors while remaining within the bounds of what is practical and politically feasible. It is suggested that the establishment of an RTA is the best way forward as a 'first step' that could potentially morph into a more radical organisation over time through a process of gradualism.

This research addresses the lack of literature into the particular tax administration issues faced by foreign investors before proposing an RTA with a pragmatic orientation that has not yet been suggested in the literature. The RTA is intended to be pragmatic, distinguishing itself from the forward looking, yet problematic, proposals that have been put forward by academics as a solution to a much broader range of tax administration issues (not just those faced by foreign investors).

While the proposed RTA at the centre of the research differs from previous reform propositions, it should not necessarily be viewed as contrary to all such proposals. Over time, the relatively less radical, foreign investor-oriented RTA could expand in its functionality towards the larger, multi-faceted World Tax Organisation as developed by Sawyer,<sup>72</sup> although this is not explored by the present study.

Aside from academia, the practical implications, and demands for such research from investors and SE Asian 'host' States is significant. SE Asian States stand to benefit from increased FDI and tax collections through such an organisation, whilst foreign investors will also stand to benefit as they will be able to enter foreign export markets

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<sup>69</sup> Ibid.

<sup>70</sup> Sawyer, above n 44, 208.

<sup>71</sup> Sharkey, above n 50.

<sup>72</sup> Sawyer, above n 44.

with increased ease and certainty. Ultimately, this increased FDI and trade will benefit the economies of investors' 'home' nations which receive the benefits of the after tax profits from the increased offshore capital investments. It is hoped that the RTA proposed by this research will be further developed to contribute towards a 'win-win-win' solution for foreign investors, ASEAN nations and non-ASEAN investor 'home' economies.

## 7.2 Limitations

The present research contains several limitations and assumptions that warrant acknowledgement. First, it may be susceptible to criticism on the basis that it is fundamentally normative in nature. A further limitation of generalizability arises due to the methodology of a single country case study being used as a basis for the proposed RTA which will involve numerous SE Asian nations.

However, many of the interviewees commented not only on their tax administration issues in Vietnam, but also on many issues that they had encountered in other developing ASEAN countries. As discussed in the findings section, similar issues were found to exist in Vietnam, Cambodia, Indonesia and the Philippines. Comments made by interviewees suggested that Singapore, Malaysia and Thailand do not suffer from the same degree of tax administration issues as Vietnam, so certain findings may not be as generalisable to these ASEAN members. However, it should be noted that Vietnam can be viewed as at a 'mid-point' of development relative to other ASEAN members which acts to improve generalisability, illustrating the suitability of using Vietnam as a case study subject.

Additionally, it is arguable that the data collected with regards to Vietnam may not, in itself, be generalisable to the Vietnamese situation due to the small number of interviewees. Given the small potential pool of interview subjects, the interviews undertaken, together with the observations of one of the author's (phenomenology), collectively provide a justifiable means of collecting data pertaining to foreign investor administration issues, and enabling triangulation of the findings.

It is also assumed as a foundation of the present research that FDI leads to economic development, which leads to growth, which in turn, leads to improvements in living standards. This view is 'mainstream' and is not challenged by the present research in its discussion of why SE Asian nations should support the establishment of an RTA. Indeed, the existence of CIT competition in the region indicates that SE Asian nations hold a belief that increased FDI is in their economic interests. The present proposal does not address the issue of tax rate competition, and instead focuses on the significant benefits that can accrue from improving the region's tax administration.

## 7.3 Future research

The present research leaves many 'avenues' open for future research to explore. First, there is scope for the Vietnam case study to be replicated by future studies examining other ASEAN nations. Additionally, there is the need for future research to consider the practical aspects of a potential RTA, including how it should be constituted and how it should overcome the challenges identified in this study. Such research should further consider the Sharkey<sup>73</sup> proposal and how some of its features could be

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<sup>73</sup> Sharkey, above n 50.

included in an RTA despite the present research finding that it is a highly unlikely 'end point' in its entirety.

Further, given the present research findings coupled with a global move towards regionalisation, future research could explore the possibility of establishing organisations akin to the proposed RTA in regions such as Africa and South America, where developing countries suffer from many of the same tax administration challenges as developing SE Asia nations. Future research could also explore the interplay between such regional tax organisations and a WTO as proposed by Sawyer.<sup>74</sup> Ultimately, it is hoped that future research can refine such proposals to a point where they can be practically considered by policy makers and global leaders.

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<sup>74</sup> Sawyer, above n 44.

## 8. APPENDIX

### Interview Question Outline and Guide- (Semi-structured interviews)

*Sections 1, 2 & 4 are intended for all interviewees. Section 3 is directed towards the academic interviewees, although it may also be utilised with the other interviewees.*

#### 1 Current Vietnam tax administration issues faced by foreign investors

- 1.1 What is the extent of your current SE Asian investments (i.e. which nations, percentage of your business, history of operating in the area etc.)?
- 1.2 Do you view the SE Asia region as a 'growth area' for your business warranting future expansion?
- 1.3 Is the recently signed Double Tax Agreement (DTA) with Vietnam likely to be a factor in any future investment decisions?
- 1.4 When/if making a decision whether or not to invest in a foreign country, what are the most important factors to consider? The least important?
- 1.5 To what extent is a potential investment destination's tax administration an important consideration?
- 1.6 What issues with the Vietnamese tax administration or other SE Asian nation tax administrations are you aware of?
  - 1.6.1 Do you find the regions tax laws clear/ easy to understand and interpret? Why/why not?
  - 1.6.2 Is language a complicating factor in understanding your tax obligations and paying your taxes? Why/why not?
  - 1.6.3 Do you find it easy to challenge tax determinations that you may disagree with?
- 1.7 Do you consider any of these issues to impact upon foreign investment decisions, and if so, how?
- 1.8 Do you currently use a tax adviser to advise on your SE Asian tax obligations?

#### 2. A Regional Tax Authority (RTA) as a potential reform avenue.

*(The interviewer reiterates that an RTA would be an organisation established at the international level which may be used by foreign investors to pay national level taxes in addition to other functions such as possibly dispute settlement and the issuance of binding rulings.)*

- 2.1 Do you consider the establishment of some form of RTA to be an attractive proposition for foreign investors? Why/why not?
- 2.2 Do you consider it likely that such reform would be positive in encouraging Foreign Direct Investment (FDI)? Why/Why not?

- 2.3 Do you think that frequency of the tax administration issues discussed earlier in the interview would decrease with the establishment of such a body? Why/why not?
- 2.4 What are the potential challenges of establishing such a RTA?
- 2.5 Do you currently use a tax adviser in SE Asia? If so, would your use of such an adviser decrease or increase with the introduction of such an RTA? Why?
- 2.6 What resistance do you think such a proposal is likely to encounter? From whom? Why?
- 2.7 What features do you think should be included in the formation of such a RTA at the time of formation? Why?
- 2.8 What features do you consider to be the most important in order to maximise FDI? Why?
- 2.9 What features do you consider to be the least important to attaining the goal of maximising FDI? Why?
- 2.10 Do you consider it desirable for the jurisdiction of such an RTA to expand over time beyond the administration of taxes for foreign investors?
- 2.11 What features do you think should be added over time to expand the jurisdiction of the RTA?
- 2.12** *(The interviewer reiterates Nolan Sharkey's recent proposal, as published in the British Tax Review in 2013, for a South East (SE) Asian Regional Tax Organisation (RTO) which includes such features as the setting of a common tax rate among SE Asian nations through the formation of a single SE Asian tax jurisdiction and the introduction of a 'SE Asian resident' for tax purposes.)*
- 2.12.1 What are your thoughts on this more radical approach compared to the less radical RTA proposal outlined above?
- 2.12.2 Would a single SE Asia tax rate administered by such an organisation be attractive to you when looking to increase its investment in the region?
- 3. Additional questions for the interview subjects who are academics:**
- 3.1 Could such an RTA be effective in countering transfer pricing uncertainty? If so, how?
- 3.2 How do you think such an organisation be structured/formed? By treaty? By any other method?
- 3.3 Who do you believe should be employed by the RTA to maximise effectiveness? SE Asian nationals? Expats? Why/why not?
- 3.4 What accountability mechanisms do you consider it important to include in such a body?
- 3.5 What are the advantages/disadvantages of establishing such an organisation as an extension of ASEAN as opposed to under an independent treaty or any other method?

3.6 Do you consider such an RTA to be a better solution than the OECD Semi-Autonomous Revenue Authority (SARA) model (*interviewer explains if required*) in countering the tax administration issues faced by foreign investors? Why/why not?

**4. For all interview subjects:**

4.1 Are there any other comments that you wish to make?

# Judicial dissent in taxation cases: The incidence of dissent and factors contributing to dissent

Rodney Fisher <sup>1</sup>

## ***Abstract***

This paper outlines findings from a research project examining dissent in taxation decisions determined by the High Court of Australia. This paper focuses on the incidence of dissent by individual Justices on the High Court, with the suggestion being that the overall incidence of dissent in tax decisions appears to be higher than may have been expected.

Given this incidence of dissent, the paper examines some factors contributing to the level of dissent in taxation cases more so than in other areas of law, such factors including greater complexity in taxation law, judicial approaches to statutory interpretation, institutional factors of the High Court, and characteristics individual to judges themselves.

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<sup>1</sup> Associate Professor, Faculty of Law, UTS, [rodney.fisher@uts.edu.au](mailto:rodney.fisher@uts.edu.au)

## 1. INTRODUCTION AND SCOPE

The Australian approach to the delivery of judgments by the courts follows the common law tradition, encompassing the delivery of seriatim decisions by individual justices, this tradition carrying with it the right for an individual judge to deliver a dissenting opinion if not in agreement with the majority view of the court. This paper reports on findings from a research project examining the incidence of judicial dissent by individual Justices in taxation decisions heard by the Australian High Court. As outlined later, the project considered taxation decisions as these, by their nature, involve the imposition of a non-voluntary pecuniary burden on members of society. Given the nature of such laws, it was considered that they may have the potential to generate greater tension and disagreement among members of the judiciary, involving, as they do, notions of fairness and equity in relation to the relative contributions to society by different taxpayers. Differing judicial approaches to statutory interpretation or underlying jurisprudential approaches by Justices in relation to such matters may be manifest in a dissenting opinion.

The paper outlines the methodology adopted in determining the incidence of dissent in tax judgments of the High Court for each of the Justices who have served on the High Court since Federation. Classification issues arise in identifying those decisions which may be classed as tax decisions, as a particular case may involve legal issues which are not limited to the incidence of taxation alone, but span a number of different areas of law. Categorisation issues also arise in ascertaining which decisions may be classified as being dissenting opinions, as opposed to decisions where a different reasoning path has resulted in a similar outcome. Approaches used in the research to distinguish those cases treated as tax cases, and those cases identified as expressing a dissenting view are explained, along with the rationale for the approaches adopted.

Given the incidence of judicial dissent identified in tax judgments, which the paper suggests appears to be higher than may have been expected in an area where certainty and stability would assist taxation planning, the paper examines some factors contributing to this higher incidence of dissent. Rationales canvassed in the paper include the greater complexity in the tax system, in particular the complexity surrounding tax legislation and commercial transactions, the related issue of judicial approaches adopted in the process of statutory interpretation, institutional issues in relation to the operation of the High Court and the delivery of judgments, and individual characteristics of judges themselves. While these matters would contribute to dissent in all areas of law, it is suggested that they may have greater significance in the taxation law realm, as explained later.

By way of background, the paper firstly outlines the development and operation of the practice of Justices delivering dissenting judgments, examining in particular the role dissenting judicial opinion may play in the development and evolution of the wider legal system.

## 2. DISSENTING OPINIONS

Unlike a number of European civil law jurisdictions, where the tradition provides for a single judgment of the court, Australia has inherited from England the common law tradition, a feature of which has been that members of the judiciary retain the right to

express an opinion which is in dissent from the majority judgment of the court. Part of this difference may be explained by the civil law tradition of a career judiciary who are seen as part of the voice of the state,<sup>2</sup> while the common law tradition views the judiciary as independent, not only from government, but from each other. The Australian High Court practice of seriatim judgments has arguably also played a role in, if not promoting, then certainly not discouraging, dissenting opinion.

The strong argument in favour of a unanimous judgment from a court, or at least a single composite speech, rests on the perceived certainty that this provides in relation to the application and operation of the law. This appears particularly relevant to taxation law, with tax planners and taxpayers seeking certainty in the interpretation and application of the law. However, as pointed out by Eyre CJ in the 18th Century, such certainty may be more illusory than real, suggesting that ‘... it is impossible that bodies of men should always be brought to think alike ...’.<sup>3</sup> Justice Kirby, speaking extra judicially, has gone further, suggesting that given the frequently ambiguous language in legislation, and the changes in society and societal values, disagreements over the law are inescapable and quite common, and that the ‘... demand by observers for unanimity among judges is often infantile’.<sup>4</sup>

In a similar vein, Judge Brennan of the US Supreme Court saw judicial dissent as an essential democratic safeguard, and uncertainty in the law as a sign of a healthy society.<sup>5</sup> He suggested that dissenting opinion may serve a number of functions, including demonstrating perceived flaws in the majority legal analysis, and offering a corrective for later cases; safeguarding the integrity of the judicial decision-making process by keeping the majority accountable for the rationale and consequences of the decision; and emphasising the limits of the majority decision, and ways to distinguish subsequent cases.<sup>6</sup>

The acceptance of dissenting opinion in the judicial decision-making framework has been seen to depend, not so much on legal tradition and culture as such, but on the acceptance of a number of hypotheses. These hypotheses would propose that dissenting opinions do not jeopardise the coherence of the law, provided that the law is understood to allow for the existence of several possible solutions to a single question, at least in the absence of clear and precise statutory provisions; that institutional legitimacy of the courts is compatible with the individual independence and impartiality of judges; and that majority opinion will be viewed as sufficient to lend authority to judicial decisions.<sup>7</sup>

These views would suggest that where the legal and judicial system is sufficiently robust, the system is able to accommodate differing judicial opinion without placing the system under stress, jeopardising the legitimacy of the system, or threatening the acceptance of the authority of the system.

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<sup>2</sup> Ruth Bader Ginsburg, ‘Remarks on Writing Separately’ (1990) 65 *Washington Law Review*, 133, 134.

<sup>3</sup> (1798) 1 Bos and Pul 229 at 238, quoted in John Alder, ‘Dissents in Courts of Last Resort: Tragic Choices’ (2000) 20 *Oxford Journal of Legal Studies*, 221.

<sup>4</sup> The Hon Justice Michael Kirby, ‘Judicial Dissent’ (2005) 12 *James Cook University Law Review*, 4–5.

<sup>5</sup> William J Brennan Jr, ‘In Defense of Dissents’ (1986) 37 *Hastings Law Journal*, 427.

<sup>6</sup> *Ibid*, 430.

<sup>7</sup> The Honourable Claire L’Heureux-Dube, ‘The Dissenting Opinion: Voice of the Future?’ (2000) 38 *Osgood-Hall Law Journal*, 503.

Justice Brennan recognised, however, that not all dissents are equal. He saw some dissenting voices as recognising the evolving standards that mark a maturing society, these being the ‘... dissents that soar with passion and ring with rhetoric’, being ‘... dissents that, at their best, straddle the world of literature and law’.<sup>8</sup> Such dissents he saw as the most enduring dissents, where the dissent can be both prophetic as well as expressing the judge’s opinion, while at the same time operating as a careful and methodical refutation of the majority’s legal analysis.<sup>9</sup> It is these dissents which may ultimately be transformed into fundamental legal principles that may have never seen the light of day but for the dissenting voice.

This contribution to the law would not be true of all dissenting judgments, however, as there are many dissents which ‘... become obsolete the instant they are published’.<sup>10</sup> The more likely outcome for dissenting opinions may be that they produce no significant or lasting impact, either because the dissenting view may only be different in outcome and not in analysis, or because the dissenting view holds no attraction for new directions in law.

Given that dissent is an intrinsic part of the Australian legal tradition, matters that arise for consideration in relation to dissenting opinions include the incidence of dissent, and the possible rationales which may contribute to this incidence of dissent. This paper considers these two elements in relation to taxation decisions of the High Court of Australia.

The reason for looking at dissent in taxation decisions lies in the nature of taxation statutes, which, along with penal statutes, seek to impose a penalty on members of the community, thus invoking notions of fairness and justice, which may create tension between Justices with alternative views. In the case of taxation statutes this penalty is by way of a non-voluntary pecuniary impost requiring an individual contribution from a broad range of the community, and the appropriate balance between individuals and the state, setting taxation law apart from many other areas of law. Historically, the traditional interpretation to be applied to statutes imposing a penalty on the community, as with penal provisions, and from the 1820s with revenue provisions, suggested that the statute should be interpreted strictly but not so as to defeat the purpose of the legislature, as explained by Isaacs J in *Scott v Cawsey*:<sup>11</sup>

When it is said that penal Acts or fiscal Acts should receive a strict construction, I apprehend that it amounts to nothing more than this. Where Parliament has in the public interest thought fit ... to extract from individuals certain contributions to the general revenue, a Court should be specially careful ... to ascertain and enforce the actual commands of the legislature, not weakening them in favour of private person to the detriment of the public welfare, nor enlarging them as against the individuals towards whom they are directed.<sup>12</sup>

While it may be that statutory interpretation of penal and taxing statutes no longer stands apart from the interpretation of other provisions, the nature of taxation statutes,

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<sup>8</sup> Brennan, above note 5, 431.

<sup>9</sup> Ibid.

<sup>10</sup> L’Heureux-Dube, above note 7, 517.

<sup>11</sup> (1907) 5 CLR 132.

<sup>12</sup> Ibid, 154–155.

and the consequences of the interpretation of the statutes, may have the potential to generate a greater degree of disagreement between members of the judiciary than may be the case for other areas of law.

### 3. IDENTIFYING TAX CASES

The research project from which these findings are reported involves an examination of taxation decisions of the Australian High Court to determine the incidence of dissent in taxation cases decided by the Court, to consider those factors which may have contributed to the dissent, and at a broader level, to examine whether dissenting opinions have played a part in the shaping of the taxation landscape in Australia. The cases in the research project were drawn from the Commonwealth Law Reports (CLR) service, with CLR volumes 1 to 245 being the volumes which had been reported at the time of the research, and were thus included in the research project.

The two significant issues which required initial resolution were firstly distinguishing those criteria to be used in classifying a court decision as being a taxation decision, and within that subset of taxation cases, then identifying whether or not a particular judgment could be categorised as being a dissenting judgment. Each of these issues is of significance, as it is those cases identified as taxation cases, and those cases characterised as involving a dissenting opinion, which would influence the outcome as to the incidence of dissent that can be ascribed to individual Justices.

However, while the identification of taxation cases or dissenting judgments is certainly a significant matter, the aim of this component of the research is more to gain an overall impression as to the relativities of the incidence of dissent between different Justices rather than to definitively identify a particular quantum of dissent. On this basis it was considered that if the criteria applied were transparent, justifiable, and consistently applied in identifying a case as being a taxation case, or identifying a particular judgment as being in dissent, then the resultant outcomes would provide a sufficient reflection of the relativities of dissent between Justices, being the outcome sought by this initial stage of the research.

The first difficulty which arose in categorising relevant cases for the project involved the determination of the scope of the class of cases which would qualify as taxation cases, and therefore be included in the project. The choices available included either taking a narrow view, selecting only those cases which dealt with the imposition of a tax in particular circumstances, or taking a more expansive view, which would involve the inclusion of all cases which had an impact on the development of the taxation landscape in Australia.

This research has adopted the broader more expansive classification in identifying taxation cases, as one purpose of the project is to look to whether dissenting judgments have had a role to play in the transformation and shaping of the overall taxation environment in Australia. On this basis, it was considered that the wider rather than narrower classification of what constituted a taxation decision would provide a better reflection of any influence that judicial dissent may have had on the development of the broader taxation regime.

Accordingly, relevant cases identified included those cases dealing both with the application of individual taxes in particular circumstances, and also included those

cases concerning the validity of taxation laws. Within the first category were cases applying a wide range of taxes to individual circumstances, such taxes including, but not being limited to, income tax, customs and excise tax, stamp duty, sales tax, probate and estate duty, and payroll and land tax, among others.<sup>13</sup>

A further category of cases encompassed by adopting the wider approach involved those cases which dealt with challenges to the constitutional validity of taxes, as the decisions in these cases have been of major significance in the shaping of Australian taxation law, particularly in relation to federal taxation. It is considered that the inclusion of such cases provides a more complete picture of the development of taxation law in Australia, particularly in relation to the subsequent role and influence, if any, of dissenting judgments in this class of cases.

Applying these criteria to the High Court decisions in CLR volumes 1 to 245 resulted in extraction of some 975 cases which were characterised as being cases that would qualify as taxation cases. Taxation decisions featured early on in the history of the High Court, with the first tax decision in *Murray v Collector of Customs*<sup>14</sup> being decided by the Full Bench of Griffith CJ and Barton and O'Connor JJ in 1903, the first year of the operation of the High Court.

While taxation cases being heard by the High Court continued apace, particularly throughout the halcyon era for tax avoidance during the 1960s and 1970s, the proportion of taxation cases reaching the High Court was showing signs of slowing by the 1980s. This trend was hastened during the 1980s by two significant legislative changes. In 1984 the requirement for a grant of special leave to appeal to the High Court was introduced,<sup>15</sup> thus providing the court with a case selection discretion, with the consequence of reducing the number of appeals, while simultaneously increasing the complexity of the cases being heard by the High Court. Following this, in 1987 the enactment of the *Australia Acts*<sup>16</sup> established the High Court as the final court of appeal for Australia, giving the court added responsibility for making final determinations.

#### 4. IDENTIFYING DISSENTING JUDGMENTS

Given that the legal system is able to accommodate differences in judicial opinion on a particular matter, the question arises as to the extent of difference that is required before a decision would be characterised as a dissenting voice. This issue becomes more problematic given the range of the nature and forms which judicial disagreement may take. However, it is suggested that, in broad general terms, a judgment may be classed as being a dissenting view in one of two ways, being either on the basis of the outcome of the decision or the resolution of the matter, or alternatively on the basis of the difference in reasoning underlying that resolution.

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<sup>13</sup> This included some interesting, but long repealed taxes, such as an entertainment tax, and a light dues tax.

<sup>14</sup> *Murray v Collector of Customs* (1903) 1 CLR 25.

<sup>15</sup> Introduced by section 3(1) *Judicial Amendment Act (No 2) 1984* (Cth).

<sup>16</sup> *Australia Act 1986* (Cth), *Australia (Request and Consent) Act 1986* (Cth), *Australia Acts Request Act 1985* (each state), *Australia Act 1986* (UK).

While it may be argued that such an approach oversimplifies the nature and forms of judicial disagreement that may arise, from a practical view there needs to be some method chosen to identify 'dissent'. It is suggested that if the method chosen to characterise 'dissent' is again transparent, sufficiently justifiable, and applied consistently across the range of cases, then whatever particular approach is applied is a valid measure for that research.

Previous research into High Court dissent has sought to clearly delineate judicial dissent from the concepts of majority and minority opinion, proposing a set of rules for identifying a judgment as dissenting.<sup>17</sup> In essence, the rules characterised a judgment as being in dissent when the Justice voted to dispose of the case in a manner that differed from the final orders of the court, with opinions that concurred with the orders of the court, even if not part of the majority, not being characterised as dissenting opinions.<sup>18</sup>

Such an approach effectively overcomes the difficulty associated with plurality decisions, where there is no clear majority but a profusion of differing judgments, with the final orders of the court reflecting varying points of consensus among the judgments. With the High Court approach of seriatim judgments such plurality of decisions can occur, with the final orders of the court not necessarily favoured by any one judge.

Essentially the identification of dissent in this research followed the approach outlined, with dissent characterised on the basis of the outcome or order made, rather than on the basis of the reasoning underlying the decision. Accordingly, a judgment is categorised as dissenting when the Justice would resolve the outcome in a different way to the final orders of the court, including making a contra finding to the orders of the court. A judgment would not be classified as being a dissent when the judgment concurred with the final orders of the court, even if the reasoning underlying the decision was at odds with the reasoning of the majority making those orders.

Similarly, a judgment would not be dissenting if the Justice concurred with the orders made, even if expressing doubt as to the finding.<sup>19</sup> Further, a judgment would not be categorised as dissenting if the Justice made no order on a particular issue, for example, having found that issue did not need to be decided.<sup>20</sup>

This approach to classifying dissent by outcome rather than by reasoning is seen as useful in overcoming difficulties which may arise in all cases, but which can prove particularly problematic in taxation cases. In taxation cases, while there may be a single issue for decision, there may be a number of alternative paths of reasoning to follow in reaching the same conclusion. As an example, in determining the single issue of whether an amount should be included in assessable income, the amount may be found to be income under ordinary concepts, or income from carrying on a business, or income from carrying on a profit making scheme, or statutory income under

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<sup>17</sup> Andrew Lynch, 'Dissent: Towards a Methodology for Measuring Judicial Disagreement in the High Court of Australia' (2002) 24 *Sydney Law Review*, 484.

<sup>18</sup> *Ibid.*

<sup>19</sup> See, for example, *Automatic Totalisators Ltd v FCT* (1920) 27 CLR 523, where Isaacs and Rich JJ essentially concurred with the orders of the majority of Knox CJ, Gavan Duffy and Starke JJ, but doubted the reasoning.

<sup>20</sup> See, for example, *FCT v Thorogood* (1927) 40 CLR 454, where Higgins J declined to give an opinion.

provisions of the legislation, such as income from trading stock, or a capital gain included in assessable income. It is suggested that it would be an unusual outcome if all Justices agreed on the outcome of an amount being assessable income, but the opinions were labelled as dissenting because of the different reasoning employed to reach the decision.<sup>21</sup>

It is recognised that with plurality decisions, this approach to characterising an opinion as being in dissent based on outcome may itself result in circumstances where many of the Justices are identified as being in dissent in a particular case. As noted above, it may be that when a number of issues are to be determined, there is no clear majority but a profusion of differing judgments, with the consensus shaping the final orders of the court.<sup>22</sup> However, while not ideal, it is considered that the method chosen for characterising dissent provides a useful measure, and is better suited to the purpose of identifying whether and how judicial dissent may have contributed to the shaping of the broader Australian taxation landscape.

## 5. DISSENT FOR INDIVIDUAL JUDGES

By applying this characterisation of dissent to some 975 cases which had been extracted as taxation cases, there were in excess of 320 cases initially identified as involving a dissenting judgment by one or more of the Justices. This indicates a dissent rate of around 33 per cent in taxation cases decided by the High Court, which may be seen as a little surprising for a number of reasons.

Such an incidence of dissent may appear to be a higher incidence of dissent than may have been expected in taxation cases, as it may have been thought that Justices would seek to achieve a degree of unity in taxation matters to generate greater certainty in the interpretation of taxation laws as a means to assist taxation planning by taxpayers.<sup>23</sup> Additionally, given the significance of decisions in taxation cases generally in imposing a non-voluntary pecuniary burden on individuals in the community, it may have been thought that a court may have sought to reach agreement and minimise dissent in taxation decisions as a path to providing a degree of certainty in the broader taxation landscape. It would be thought that to lose a taxation case would be disappointment enough for a taxpayer, and it must only add to that angst to know that, in a split decision, a narrow minority of the Justices shared the taxpayer's view as to the operation of the law.

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<sup>21</sup> As an example see *Shelley v FCT* (1929) 43 CLR 208, where the Full Court excluded certain sums from taxable income; by Knox CL and Dixon J on the basis that the entity was not a co-operative company, and by Isaacs J on the basis that the amounts were a diminution of expenditure and not income.

<sup>22</sup> See, for example, *Hooper & Harrison Ltd (in liq) v FCT* (1923) 33 CLR 458, where Isaacs and Rich JJ dissented on one issue, and Knox CJ and Gavan Duffy J dissented on another issue, leaving Higgins J as the only Justice in full agreement with the order of the court.

<sup>23</sup> While there is no broad comparable data to allow comparison with the incidence of dissent across a range of other areas of law, one example of research which has identified a lower rate of dissent in other areas of law over limited timeframes is provided in A Lynch and G Williams, 'The High Court on Constitutional Law: The 2004 Statistics' (2004) 27 *University of NSW Law Journal*, 88, which suggested an average rate of dissent in cases examined in that research in the low 20% range; Kirby J had a rate of dissent of around 33%, making him 'the great dissenter'.

The table in Appendix A shows, for each of the Justices who have decided taxation cases, the incidence of dissent for that particular Justice for the taxation cases heard by that Justice.

Initially, and perhaps not surprisingly, there was little dissent among early members of the court, with a strong consensus among the judiciary for a number of years. Barton and O'Connor JJ dissented in around two per cent of the tax cases on which they sat in judgment, with Griffith CJ dissenting in around five per cent of the tax cases heard, demonstrating the early accord in the court in tax decisions. Indeed, many judgments were handed down by Griffith CJ on behalf of the whole court. After an harmonious honeymoon period of around four years, during which the court was in accord, dissent in tax decisions first appeared in High Court tax cases in 1907.<sup>24</sup>

Despite the accord in the early High Courts, an increased incidence of dissent in taxation matters started to emerge in later Courts, although the incidence of dissent was still not high. Among the early Justices, Isaacs and Higgins JJ were the first Justices to find themselves in dissent in over 10 per cent of taxation cases, while Evatt J, Latham CJ, and Webb J were the first Justices to dissent in more than 15 per cent of taxation cases on which they sat.

It has only been the latter half of the twentieth century which has witnessed a greater incidence of dissent by some of the Justices, with Stephen J being the first Justice to dissent in 20 per cent of taxation matters heard.

At the other extreme to the accord of the early High Courts, the highest incidence of dissent in taxation cases fell to Kirby J, who dissented in around 35 per cent of the taxation cases which his Honour heard. Other Justices with higher rates of dissenting opinions included Murphy J with a dissent rate of some 28 per cent, Aickin J with a dissent rate of 26 per cent, and Stephen J, who dissented in some 20 per cent of taxation cases, these being the only other justices who dissented in 20 per cent or more of the taxation cases which they heard. Of the 48 Justices to have served on the High Court in the period covered by the CLR reports considered, Kirby J was the only justice with a rate of dissent above the average rate of 33 per cent.

During the period covered by the research, the most common incidence of dissent appears to fall in the range of between around 10 per cent to 15 per cent, with a total of nineteen of the Justices having an incidence of dissent in this range. Apart from the four Justices above with incidences of dissent of 20 per cent or more, the only other Justices to exhibit an incidence of dissent above 15 per cent were Evatt, Latham, Webb, Brennan and Bell JJ, and with Bell J the small numbers of taxation cases heard may distort the percentage. Only eight of the Justices exhibited an incidence of dissent at or below the five per cent range, and apart from Griffith CJ and Barton O'Connor JJ on the first High Court, others included French CJ, Gleeson CJ, and Gummow, Hayne and Heydon JJ, all of whom have served on more recent High Courts. With the research covering the cases reported to CLR 245 there are some Justices who remain on the High Court so their incidence of dissent in taxation cases

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<sup>24</sup> See, for example, *Chandler & Co v Collector of Customs* (1907) 4 CLR 1719. The case highlighted the significance of the composition of the court, as Griffith CJ and Barton J were in dissent, with O'Connor, Isaacs and Higgins JJ comprising the majority. If the new appointments had not yet been made and there had still been a three member bench, Griffith CJ and Barton J would have been in the majority and the decision would have been different.

may vary, but the figures provide an early reflection of the relativities of a possible proclivity to dissent.

What is of interest is that the incidence of dissent in taxation cases for some of the more recent Justices has fallen to the same low incidence as was evident in early High Courts. While some of the Justices continue sitting on the High Court, for the cases extracted for the research, Gummow, Hayne, and Heydon JJ, along with Gleeson and French CJ, have exhibited an incidence of dissent in taxation cases not witnessed since the Court of Griffith CJ.

This may appear unexpected, as it may have been thought that with the significantly reduced number of taxation cases reaching the High Court there would be a corresponding increase in the complexity of the taxation cases being heard by the Court, which may have suggested the potential for greater disagreement among Justices. Such would not appear to have been the case, with the Justices almost appearing to be in furious agreement on the outcome of taxation matters.

As noted earlier, there has been a significant diminution in the number of taxation cases being heard by the High Court since the introduction of the requirement for leave to appeal, and this is reflected in the number of cases on which particular Justices have passed judgment. At one extreme, Rich J sat on some 331 taxation cases, with a dissenting opinion in around eight per cent of those cases, and Dixon, as a Justice and Chief Justice, heard some 305 tax cases, delivering a dissenting judgment in around seven per cent of those cases. At the other extreme, in the cases reported up to CLR 245, Bell J had heard some twelve tax cases, dissenting in only two of those, and French CJ had sat on some seventeen tax cases, dissenting in none of those.

## 6. DISSENT IN TAXATION CASES

These initial findings from the research suggest that while the overall average incidence of dissent in taxation cases is around one-third of cases heard, very few of the Justices who have sat on taxation cases have consistently demonstrated a high incidence of dissent during their period on the bench. Rather, it appears that the generally higher incidence of overall average dissent is generated by different Justices dissenting in different cases, leaving individual Justices with lower dissent rates, while the overall proportion of cases with a dissenting opinion appears generally higher. Effectively, the dissent appears to have been dispersed among the Justices, with the figures suggesting that only four of the Justices who have served on the High Court dissented in 20 per cent or more of the taxation cases on which they sat in judgment.<sup>25</sup>

Appendix B illustrates, for each of the Justices, the incidence of dissent in taxation cases during the period for which the Justice was a member of the court, whether or not the particular Justice was in dissent. As an example, for tax cases heard by Aickin J, there was a dissenting judgment delivered in 48 per cent of the cases on which his Honour sat, while Aickin J himself dissented in only 26 per cent of these cases, meaning there was a dissenting view from another member/members of the court in the remaining 22 per cent of cases in which he was involved. This chart appears to lend some support for the view that dissent in taxation cases has been spread among a

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<sup>25</sup> Kirby J at 35%, Murphy J at 28%, Aickin J at 26% and Stephen J at 20%.

number of the Justices, although individual Justices may not have had a high incidence of dissent.

The Justice who witnessed most dissent in taxation cases has been Jacobs J, who dissented in some 14 per cent of the taxation cases heard, but witnessed dissent in more than another 50 per cent of the taxation cases on which his Honour sat. In a similar vein, while Stephen J dissented in around 20 per cent of the taxation cases which his Honour heard, there was dissent by at least one other Justice in around 38 per cent of the cases on which his Honour sat, so almost 60 per cent of cases heard by Stephen J involved a dissenting judgment. Conversely, while Kirby J dissented in around 35 per cent of the tax cases in which his Honour was involved, there was dissent in 46 per cent of tax cases in which he was involved, so there was dissent by another Justice in only another 11 per cent of the taxation cases heard while his Honour was in the majority.

What is of interest from this chart is the degree to which this aggregation of any dissent for cases raises the overall incidence of dissent in taxation judgments, with the majority of Justices sitting on taxation decisions which witnessed dissent in above 30 per cent of the cases, and sixteen of the Justices seeing dissent in more than 40 per cent of the taxation cases heard. Even for Justices who themselves had a low incidence of dissent, dissent by another Justice/Justices in the cases raises the overall incidence of dissent. As examples, while Gummow and Hayne JJ each dissented in less than five per cent of their taxation cases, there was dissent in the taxation cases on which their Honours sat in more than 30 per cent of the cases. Similarly, while Mason as Justice and Chief Justice dissented in around seven per cent of taxation cases, there was a dissenting voice in more than 40 per cent of the taxation cases heard while he was part of the High Court bench.

Also of interest is that the incidence of dissent in taxation cases has been declining in more recent times from the higher levels apparent in earlier Courts, although the figures for the court of French CJ are subject to change as the Court continued to sit at the time the taxation cases were extracted. While the numbers of cases are low, there had been dissent in only 18 per cent of tax cases heard by the court of French CJ, with his Honour not being in dissent on any occasion for the cases reported at the time of the research. These lower incidences of dissent occurring while the particular Justice is serving appear to broadly correspond with the lower incidences of dissent for each Justice, with the incidence of dissent by any Justice in a taxation case falling in the more recent High Courts.

## 7. EXPLAINING DISSENT

The following discussion outlines some contributing factors which may assist in explaining why taxation decisions should cause Justices to dissent from a majority view in taxation cases. It would be expected that no single matter would provide an explanation of the incidence of judicial dissent, with a range of considerations interacting to exert differing influences over a period of time.

Contributing factors outlined in this paper relate to: the complexity of taxation law in Australia, particularly in relation to taxation legislation; changing judicial approaches to statutory interpretation; institution factors relating to the operation of the High

Court and the judicial process; and characteristics of particular Justices. While these factors would also contribute to dissent in other areas of law, it is considered that they have the potential to contribute to dissent in taxation matters to a greater extent than in other areas of law. The suggestion is: that the taxation statutory regime has become more complex than statutes in other areas of law; that the nature of taxation laws, as mentioned above, is such that differences between Justices in terms of statutory interpretation approaches and other factors individual to the Justices are more likely to result in a dissenting view; and the increased use of resources such as unreported cases, and in particular overseas cases, is more likely to result in dissent in tax matters as a Justice may look to questions of fairness or equity in application of the law, and may be more inclined to seek more widely for overseas authority on such matters.

As all of these factors are inter-related and interwoven it is not possible to isolate one factor from the others, with this discussion aimed at highlighting aspects of each of these factors which potentially contribute to the incidence of judicial dissent.

## 8. COMPLEXITY IN TAXATION LAW

While it may appear trite to suggest that complexity of legislation can contribute to alternative judicial interpretations, and thus dissenting judicial voices, the high degree of complexity that permeates the Australian taxation system and taxation legislation has attracted widespread criticism for a considerable period.<sup>26</sup> However, the complexity that may generate judicial disagreement and a dissenting opinion is not limited to the complexity of the legislation, but extends further in taxation matters to the complexity of the factual matrix of commercial transactions and the consequent complexity in matters at issue in taxation cases.

At its very core, Australian taxation legislation is contained in two separate Assessment Acts which have widely divergent drafting methodologies, so it is small wonder that the taxation system edifice with such an ungainly and awkward base has been described as failing abysmally against almost any test of simplicity,<sup>27</sup> being possibly the largest in the world in terms of volume,<sup>28</sup> and while volume alone does not necessarily generate complexity, the legislation is also seen as among the most difficult to read and comprehend.<sup>29</sup>

Much of the criticism of the complexity now inherent in the taxation legislation has come from academics and commentators, with the suggestion being that '(a)lmost certainly, more irrational distinctions based on inappropriate criteria exist in the Australian law than in any other nation's tax legislation ...'.<sup>30</sup> However, commentators have not been alone in their assessment of the tax legislation, with members of the judiciary, charged with determining the interpretation and application

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<sup>26</sup> As examples, see Hon Justice Nye Perram, 'The Perils of Complexity: Why More Law is Bad Law' (2010) 39 *Australian Tax Review*, 179; David Wallis, 'The Tax Complexity Crisis' (2006) 35 *Australian Tax Review*, 274; Richard Krever, 'Taming Complexity on Australian Income Tax' (2003) 25 *Sydney Law Review*, 467.

<sup>27</sup> Krever, above n 26.

<sup>28</sup> *Ibid.*, 468.

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.*

of the legislative provisions, themselves being prepared to voice concerns over the complexity of the legislation which they are interpreting.

In an oft quoted passage from the judgment in *FCT v Cooling*<sup>31</sup> in the Federal Court, concerning the capital gains tax provisions as originally enacted, Hill J referred to one of the sections at issue as having been drafted ‘... with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms’.<sup>32</sup> The case of *Hepples v FCT [No 2]*<sup>33</sup> also involved consideration of the capital gains tax legislation as firstly enacted, with Deane J being led to lament that ‘successive administrations have allowed the Act to become a legislative jungle ...’.<sup>34</sup> In the same case, and in a similar vein, Toohey J was driven to characterise the capital gains tax provisions as ‘... unduly labyrinthine ...’.<sup>35</sup>

While there has been an attempt to reduce complexity by rewriting legislation in plain English language, Sir Harry Gibbs, writing extra-judicially after his term as Chief Justice of the High Court had expired, commented that the legislative

... complexities cannot be removed simply by rewriting the existing provisions in plainer language ... Real reform would require not a rewriting of the present law, but a completely new Act; that is, a new approach is necessary ...<sup>36</sup>

Part of the reason for the complexity of the legislative provisions lies in the drafting method adopted, with taxation legislation exhibiting different drafting styles as amendments have been made to the legislation. As a consequence, the probable and understandable response to the complexity which is now imbued in the Australian tax provisions is to point an accusatory finger at the drafters of the legislative provisions, as illustrated by the comments in the judgment of Hill J in *Consolidated Press Holdings v FCT*,<sup>37</sup> where his Honour expressed his frustration with the provisions, commenting that ‘... it should not be expected that the courts will construe legislation to make up for drafting deficiencies which revel in obscurity’.<sup>38</sup>

However, it has been suggested that drafters should not alone stand accused of increasing legislative complexity, arguing that others, including judges themselves, should bear some of the responsibility for increased legislative complexity,<sup>39</sup> although arguably most of the responsibility should be sheeted home to the legislature.<sup>40</sup> In particular, the suggestion is that inappropriate or piecemeal responses to judicial decisions that did not suit the government, and the government use of taxation laws to achieve other social or political objectives, contribute significantly to legislative complexity.

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<sup>31</sup> *FCT v Cooling* (1990) 22 FCR 42.

<sup>32</sup> *Ibid*, Hill J at 61.

<sup>33</sup> *Hepples v FCT [No 2]* (1991) 65 ALJR 650.

<sup>34</sup> *Ibid*, Deane J at 657.

<sup>35</sup> *Ibid*, Toohey at 662.

<sup>36</sup> Sir Harry Gibbs, ‘The need for taxation reform’ (1993) 10(1) *Australian Tax Forum*, 9.

<sup>37</sup> *Consolidated Press Holdings v FCT* (1998) 98 ATC 5009.

<sup>38</sup> *Ibid*, Hill J at 5018.

<sup>39</sup> Krever, above n 26, 470.

<sup>40</sup> *Ibid*, 486.

A feature of the drafting which has attracted considerable criticism<sup>41</sup> has been the legislative response of enacting detailed and precise provisions, the suggestion being a desire on the part of the legislature to expunge from the law elements of discretion. The theory behind this approach suggests that vague and general provisions increase uncertainty, and allow arbitrary exercises of power by unelected judges. In an attempt to preclude this uncertainty, and forestall judicial decisions which do not suit the legislature, the path taken has been to increasingly extirpate as much vagueness as possible with greater prescription and regulation in the statutes, adding new complexity to the ineffective existing complexity.<sup>42</sup>

However, the danger from this approach of increasing the level of prescription is that it invariably increases the number of legal terms in play, and the suggestion has been that rather than reduce uncertainty, it simply exchanges one form of uncertainty for another, with a consequence of making every step in the judicial reasoning process more problematic.<sup>43</sup> The result of the complexity is a judicial branch burdened by increasingly unreadable provisions, leading to greater uncertainty in interpretation outcomes. The problem is exacerbated further when a judicial decision is unfavourable to the legislature, which then responds with additional prescriptive provisions.

In addition to the complexity of legislation, the complexity of matters at issue and transactions giving rise to these issues has also increased over time. Part of the reason for judicial disagreement, which finds voice in a dissenting judicial opinion, is that the problems to be addressed involve difficult and complex issues.<sup>44</sup> One of the reasons underlying this increase in the complexity of cases before the High Court has been the removal of an automatic right to appeal to the High Court and the need to seek special leave to take a case before the Court. As a consequence, those taxation cases for which special leave is granted would be expected to be the more complex cases raising more difficult questions of law than would be the case with those cases where special leave had not been granted. A further source of complexity in issues before the court has been the increase in complexity of the commercial transactions raising questions of law, particularly in situations where financial engineering has generated detailed and complex transactions which may not be readily understood other than by specialists in the area.

Regardless of the source of the complexity, and where the responsibility for complexity should lie, it is intuitively appealing to suggest that the incidence of complexity in taxation legislation and taxation issues has been a contributory factor to the increasingly difficult task of interpretation of the statutes, as the judicial reasoning process becomes more problematic as complexity generates uncertainty. On this basis, it may be that the uncertainty in interpretation arising from the complexity of the legislative provisions and issues involved may provide, in part, an explanation for a greater incidence of judicial dissent in taxation decisions than is demonstrated in other areas of the law.

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<sup>41</sup> See, for example, Hon Justice Nye Perram 'The Perils of Complexity: Why More Law is Bad Law' (2010) 39 *Australian Tax Review* 179.

<sup>42</sup> *Ibid*, 184.

<sup>43</sup> *Ibid*, 185.

<sup>44</sup> See, for example, the discussion in J D Heydon, 'Threats to Judicial Independence: The Enemy Within' (2013) 129 *Law Quarterly Review*, 205–222.

While this suggestion does have intuitive appeal, as noted earlier, the incidence of dissent by Justices in taxation cases in more recent High Courts appears to have been declining to levels not witnessed since the early High Courts. With the High Court being in a position to select those cases to be heard by the Court, it would be expected that the cases being granted leave to appeal would be the more complex and demanding cases, which would have the potential to generate greater divergence of opinion, and potentially a higher incidence of dissent. However, such would not appear to be the situation, with the Justices of more recent High Courts, with the notable exception of Kirby J, exhibiting a lesser tendency to dissent in taxation matters.

## 9. STATUTORY INTERPRETATION

Another matter inextricably linked with the interpretation of complex provisions relates to the approach to statutory interpretation adopted by a particular Justice, with the method of statutory interpretation thus perhaps being one of the contributing factors in explaining the higher incidence of dissenting opinions in taxation cases. Part of the reasoning that suggests that the judiciary itself should bear some responsibility for the complexity of taxation legislation arises from what may be seen as an abdication of responsibility by the judiciary by way of excessive reliance on principles of strict literalism.<sup>45</sup>

## 10. INTERPRETING REVENUE STATUTES

In looking to the approach to the interpretation of revenue statutes, the early High Court adopted the English approach of a literal interpretation of the statute as a means to determine the intent of the legislature. The literal approach for determining the intent of taxation legislation received early endorsement in Australia, with Griffith CJ in *Tasmania v Commonwealth and South Australia*<sup>46</sup> drawing on authority from the House of Lords in a passage from Lord Chief Justice Tindal, that:

... the only rule for the construction of Acts of Parliament is, that they should be construed according to the intent of the Parliament which passed the Act. If the words of a statute are in themselves precise and unambiguous, then no more can be necessary than to expound these words in their natural and ordinary sense. The words themselves alone do in such a case best declare the intention of the law-giver.<sup>47</sup>

The proviso added to this approach suggested that when Parliament legislated for an imposition on the public, this must be done in clear and unambiguous terms, and if a construction of the statute is available which avoids the impost, such a construction is to be preferred. As summarised by Lord Russell of Killowen:

I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed if, in accordance with a Court's view of what it

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<sup>45</sup> Krever, above n 26, 470.

<sup>46</sup> *Tasmania v Commonwealth and South Australia* (1904) 1 CLR 329.

<sup>47</sup> *Sussex Peerage Case* (1844) 11 Cl. & F., 85 at p 143, quoted in *Tasmania v Commonwealth and South Australia* at [339].

considers the substance of the transaction, the Court thinks that the case falls within the contemplation or spirit of the statute. The subject is not taxable by inference or by analogy, but only by the plain words of a statute applicable to the facts and circumstances of his case.<sup>48</sup>

In effect, this principle of construction suggested that application of the literal rule would only see tax imposed if the circumstance fell within the ambit of the clear words of the section, with the taxpayer being given the benefit of any doubt in the wording of the enactment. Such an interpretation may be viewed as a shift away from the original objective of the literal approach, which had been stated to be the interpretation of the words as a means to discern the legislative intent, towards a narrower strict literal interpretation having regard only to the words as an end in themselves, rather than as a means to an end of determining legislative intent.

While it may be suggested that the approach to interpretation of fiscal statutes in Australia has been as much a function of the constituency of the judiciary as a function of the statute itself, the approach of Isaacs J seems to be echoed in the words of Gibbs J many years later when suggesting that ‘... if the terms of the Act plainly impose the tax they should be given effect, equally if they do not reveal a clear intention to do so the liability should not be inferred from ambiguous words’.<sup>49</sup>

The diversity of approaches to statutory interpretation and the question as to the correct application in relation to taxation statutes are all evidenced in Australian taxation judgments. What becomes apparent on examination of some of the noteworthy taxation decisions is that within one court a significant diversity of approaches by the judges can result in strongly divergent judgments. Of particular relevance for the discussion in this paper are the strong dissenting concerns which have been voiced, the dissenting views being in large part a function of different approaches to statutory interpretation.

## 11. THE EFFECT OF STATUTORY INTERPRETATION

While the literal interpretation of taxation provisions reigned for much of the twentieth century, it was the High Court under the stewardship of Barwick CJ which witnessed arguably the high water mark of a much narrower literal approach to statutory interpretation. This narrower literalism looked to the words of the statute, not to discern a legislative intent, but to judge whether the words envisaged the particular arrangement at issue. If it was found that the words did not specifically address the particular arrangement, then the statute was found to be not applicable.

In this way the Court arguably used the cloak of literalism to condone a range of tax minimisation schemes, which could hardly be seen as being the intent of the legislature when enacting the then existing general anti-avoidance provisions in the legislation. The Chief Justice himself led this line of reasoning, while also seeming to display a thinly veiled regard as taxpayers manipulated the law to avoid tax. An example of this is provided in the case of *FCT v Westrad*,<sup>50</sup> with His Honour

<sup>48</sup> *IR Commrs v Westminster (Duke)* [1936] AC 1 at 24.

<sup>49</sup> *Western Australian Trustee Executor and Agency Co Ltd v Commr of State Taxation of WA* (1980) 147 CLR 119, 126.

<sup>50</sup> *FCT v Westrad* (1980) 144 CLR 55.

characterising the taxpayer's claim as '... an ingenious use of the provisions ... of the *Income Tax Assessment Act*',<sup>51</sup>

A ready example of the approach taken by Barwick CJ is demonstrated in the case of *FCT v Westrad Pty Ltd* in which His Honour explained:

The function of the court is to interpret and apply the language in which the Parliament has specified those circumstances. The court is to do so by determining the meaning of the words employed by the Parliament according to the intention of the Parliament which is discoverable from the language used by the Parliament. It is not for the court to mould or to attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed.<sup>52</sup>

While paying lip-service to determining the intent of the Parliament, Barwick CJ arguably used the guise of a strict literal interpretation to produce an outcome which can hardly have been intended by the legislature, reading down the language of the anti-avoidance provision to the point where it was effectively inoperable.

However, not all members of the High Court followed this path, the notable exception being Murphy J who saw greater merit in a more purposive interpretation to better reflect the intention of the legislation. His Honour explained:

It is an error to think that the only acceptable method of interpretation is strict literalism. On the contrary, legal history suggests that strict literal interpretation is an extreme, which has generally been rejected as unworkable and a less than ideal performance of the judicial function.

It is universally accepted that in the general language it is wrong to take a sentence or statement out of context and treat it literally so that it has a meaning not intended by the author. It is just as wrong to take a section of a tax Act out of context, treat it literally and apply it in a way which Parliament could not have intended. The nature of language is such that it is impossible to express without bewildering complexity provisions which preclude the abuse of a strict literalistic approach.<sup>53</sup>

Such an alternative approach to statutory interpretation contributed in no small way to the higher incidence of dissent by Murphy J, among others, on the Barwick CJ High Court.

However, there have been indications in later cases of a return to the broader literal approach of using the literal words to determine the legislative intent. The early approach of Isaacs J would appear to echo in the words of Mason and Wilson JJ when stating that '(t)he courts are as much concerned in the interpretation of revenue statutes as in the case of other statutes to ascertain the legislative intention from the terms of the instrument viewed as a whole'.<sup>54</sup>

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<sup>51</sup> Ibid, 59.

<sup>52</sup> Ibid, 59-60.

<sup>53</sup> Ibid, 79-80.

<sup>54</sup> *Cooper Brookes (Wollongong) v FCT* (1981) 147 CLR 297 at 323.

While there have been suggestions that there has been evidence of a judicial trend away from strict literalism to encompass a more purposive approach,<sup>55</sup> an alternative view suggests that an examination of Australian decisions provides no evidence of such a significant change in approach.<sup>56</sup>

It may be thought that with the statutory imprimatur for a purposive approach to statutory interpretation,<sup>57</sup> it needs to be borne in mind that ultimately it is for the courts to determine the legislative purpose, and the starting point for this must of necessity be the literal words of the statute.

The example provided by *Westraders*, which is representative of others, demonstrates that differences in approaches to statutory interpretation can lead to different paths of reasoning, which in turn may well produce different conclusions as to the meaning of a statute, with the result that dissenting opinions can be generated. While this in itself may not appear surprising, when considered in conjunction with the complexity inherent in the taxation legislation, it emerges as one contributory factor in the myriad of factors which together would go towards explaining the higher incidence of dissenting voices in taxation related cases than in other areas of law.

## 12. INSTITUTIONAL FACTORS

It has been suggested that there are a number of institutional factors which have influenced judicial method over time,<sup>58</sup> and these factors may also play a role in explaining a judicial tendency to be more prepared to voice a dissenting opinion, particularly in complex taxation matters.

One of these institutional factors would relate to the composition of the Court at any particular time, and the attitude of the Court as to whether dissent was seen to be accepted as the norm, or to be shunned. A significant aspect which would bear on shaping the attitude of a Court would be the leadership style of the Chief Justice and how this was reflected in the leadership of the Court at that time. It may be that a Court which encouraged formal judicial conferences may witness less dissent, as judges may be subject to persuasion on points of law, and in the end agree with the majority. The danger with such an approach, however, may be that excessively dominant judicial personalities may act to dissuade others from a dissenting view, which may threaten judicial independence.<sup>59</sup> Also related to the composition of the Court would be whether particular judges were perceived as being activist judges, and how this may affect relations with colleagues in the operation of the Court.

A further factor suggested has related to the change in the manner in which cases are heard, and the judicial method. The English tradition for the judicial process involved an oral hearing followed by the delivery of *extempore* seriatim judgments. This

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<sup>55</sup> See, for example, A Mason 'Taxation Policy and the Courts' (1990) 2 *CCH Journal of Australian Taxation*, (4) 40, 42.

<sup>56</sup> See, for example, R Allerdice 'The Swinging Pendulum: Judicial Trends in the Interpretation of Revenue Statutes' (1996) 19(1) *University of New South Wales Law Journal* 162, 163.

<sup>57</sup> *Acts Interpretation Act* (Cth) s 15AA.

<sup>58</sup> See, for example, J D Heydon 'Varieties of Judicial Method in the Late 20th Century' (2012) 34 *Sydney Law Review* 219.

<sup>59</sup> Heydon, above n 43, 208.

process would involve no preliminary hearing or written submissions, with no preliminary consultations or private research by judges, leaving less opportunity for points to occur to judges after the hearing, as can be the situation with a reserved judgment.<sup>60</sup>

This traditional approach has been replaced by a case management approach, involving a requirement to file written submissions, preliminary conferences between judges, and the reserving of decisions. In conjunction with the increased factual complexity of cases, as outlined earlier, this has been seen to generate increased complexity in legal analysis, with voluminous reference to case law, including unreported cases which are now more readily available, and a greater tendency for judgments to provide detailed reasoning.<sup>61</sup>

In addition to matters surrounding the hearing of cases, factors in non-curial life may also create an increased tendency to dissent. Generally judges now have more personal staff than had traditionally been the case, with these staff often having been the brightest of law students with superior skills, and who are keen to impress. Wider research by the staff with technology now available would generate a great many more authorities than would previously have been the case, with the potential to again raise legal issues which had not been raised in the case itself. When combined with the use of technology, facilitating both a greater research capability, and the use of word processing for preparing judgments rather than handwriting judgments, it may be that judges are more prepared to express an opinion in disagreement with the majority more often than may have previously been the case.

While these reasons may go towards explaining a greater rate of dissent generally, when viewed in conjunction with the greater incidence of complexity of taxation matters appearing before the High Court, it may contribute to providing part of the explanation of the higher average incidence of dissent in taxation cases than has been observed in other areas of law. It must again be noted, however, that these matters are still present and yet the suggestion is that recent Justices have exhibited a declining incidence of dissent in taxation cases.

### 13. JUDGES THEMSELVES

A final matter for consideration in looking to the factors that may contribute to judicial dissent in taxation law is to consider those factors relating to individual judges themselves. The discussion above suggests no single factor stands alone, with all of the factors interacting. As an example, it would be expected that the approach to statutory interpretation taken by a particular judge would be a product of, and inextricably linked with, individual factors surrounding that particular judge.

Individual factors that may mould the attitudinal approach of a particular judge would include such matters as political beliefs or associations, demographic factors such as age and gender, and their social background. Judges themselves represent a constituency of competing societal values, and disagreements giving rise to dissent may lie with the incommensurable issues of justice or policy, representing ethical or

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<sup>60</sup> Ibid.

<sup>61</sup> Ibid, 228.

political values of the particular Justice. Arguably, taxation matters and taxation avoidance matters, dealing as they ultimately do with issues of fairness and justice in relation to individual contributions that should be made to society, have the potential to engender policy and justice issues in the decision-making process to a greater extent than may be the case with other areas of law. It is arguably the case that these ethical and political issues of individual Justices underlie the preference that a Justice may have for their approach to statutory interpretation, adopting the approach which provides an outcome that is more aligned to their particular values.

However, while it may appear intuitively appealing to suggest that personal characteristics may bear some relation to the likelihood of a particular judge dissenting, Australian research has suggested that court institutions have been a better predictor of rates of dissent than the social and political complexity of the external environment,<sup>62</sup> so it may be that this view is bestowing too great a role on the values and beliefs of the individual Justices in determining their predisposition to form a dissenting opinion.

## 14. CONCLUSION

The Australian judicial approach has followed the English tradition of accepting that Justices may voice an opinion in dissent from the majority decision of the court. The legal system accepts that dissent does not act to weaken the law, as under the doctrine of stare decisis it is the majority decision that establishes precedent. While not all dissents are of equal worth, with possibly most being forgotten, a dissenting voice may, however, have value in exposing weaknesses in other legal reasoning, or in foreshadowing change in an evolving area of law.

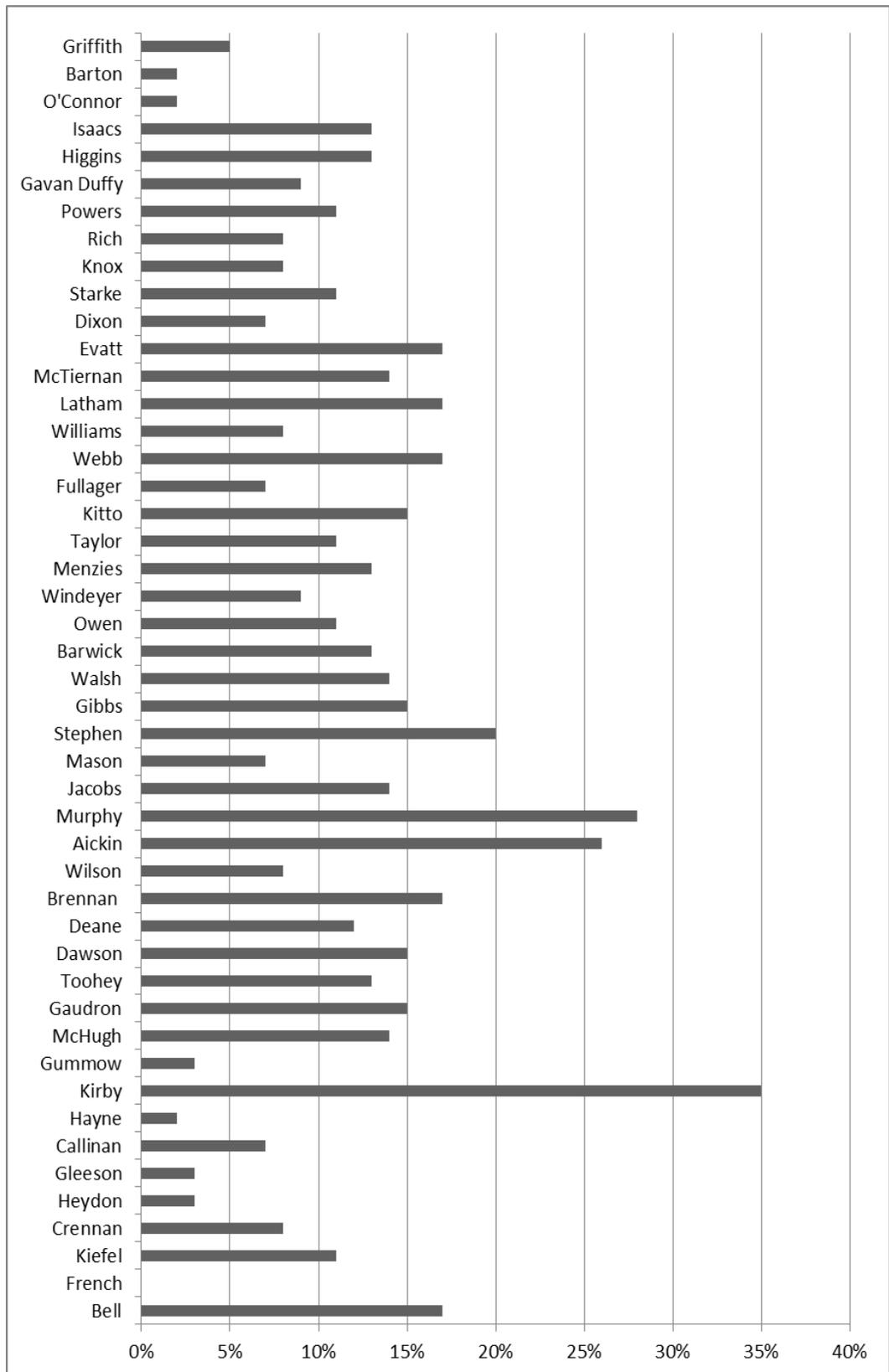
An examination of dissent in Australian High Court taxation decisions demonstrates an incidence of dissent in around one-third of all taxation matters heard, which may be a little surprising in an area of law that would be expected to provide certainty and stability to assist tax planning. While dissent is evidenced on average in around one-third of taxation decisions, only four of the High Court Justices have themselves dissented in more than 20 per cent of cases on which they sat. This appears to suggest that dissent in taxation cases is widespread among Justices, but with different Justices dissenting in different cases.

In looking to factors contributing to the incidence of dissent, there are a number of interlinked matters which suggest themselves as candidates in generating dissent. The complexities now inextricably interwoven into taxation legislation, in conjunction with increasingly complex commercial transactions, suggest they may contribute to alternative interpretations and dissenting judgments. When combined with varying approaches to statutory interpretation by different Justices, a range of institutional factors that may make dissent a less onerous option, and personal characteristics shaping individual Justices, it becomes apparent that the reasons contributing to a greater incidence of dissent in taxation decisions are wide and interlinked.

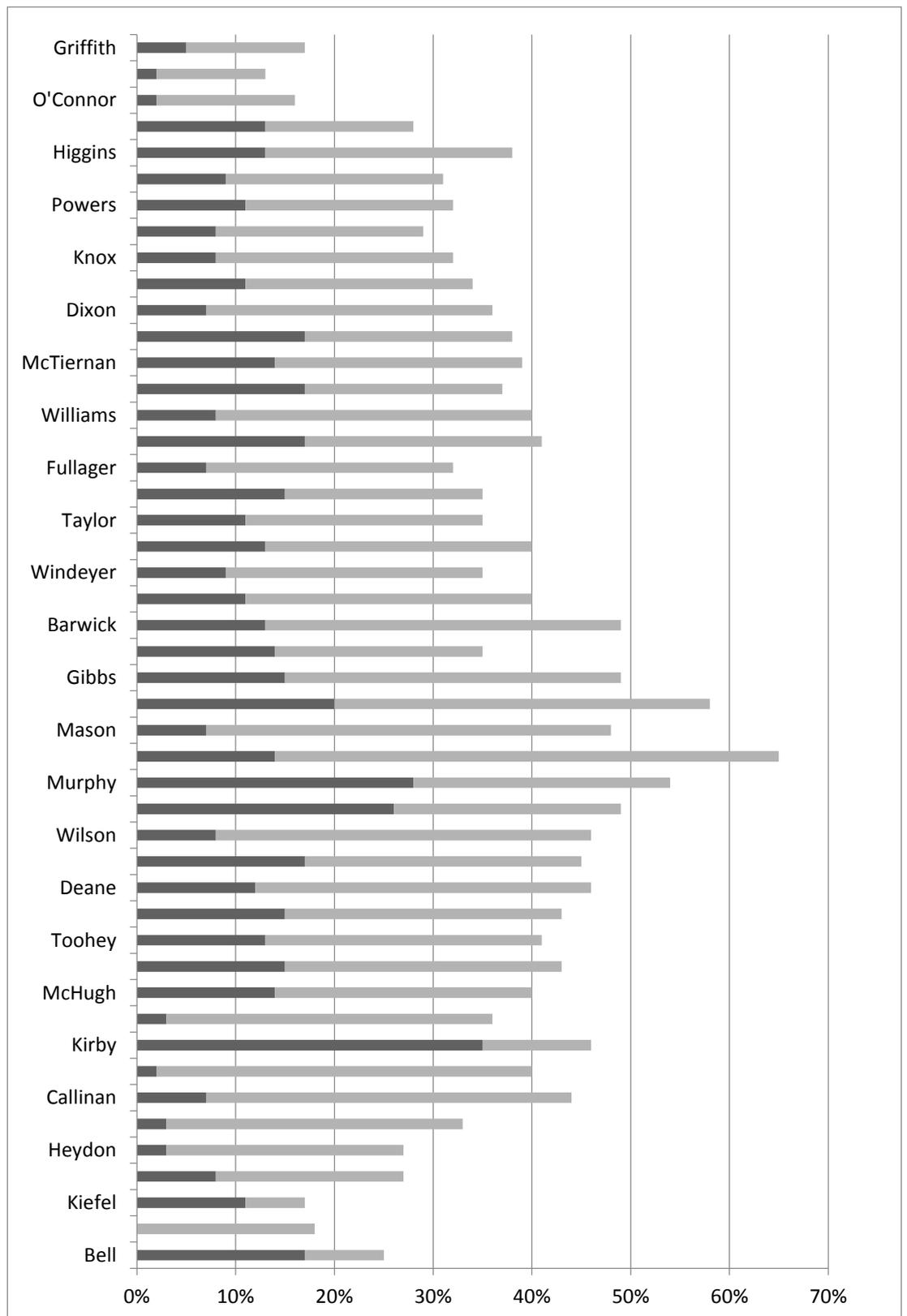
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<sup>62</sup> See Russell Smyth, 'What Explains Variations in Dissent Rates?: Time Series Evidence from the High Court' (2004) 26 *Sydney Law Review* 221.

**Appendix A—Incidence of dissent by individual Justices**



**Appendix B—For each Justice, incidence of dissent by any Justice in cases heard**



# Calm waters: GST and cash flow stability for small businesses in Australia

Melissa Belle Isle<sup>1</sup> and Dr Brett Freudenberg<sup>2</sup>

## ***Abstract***

Small businesses are seen as vital to the Australian economy. However one particular issue of concern is the stability of their cash flow which can be exacerbated by the unpredictability of the markets, management practices, availability of financing and taxes, such as the goods and services tax (GST).

This article reports a multiple case study of small (including micro) businesses which explored how the interaction with the GST affected small businesses' cash flow stability. Findings suggest that the cash flow stability of small businesses may be adversely affected when trading with retail consumers due to an inability to pass on the GST. Also, businesses trading with other businesses appear to face problems due to late payment by debtors. A common issue in supporting cash flow stability appears to be a lack of sophisticated cash management practices.

**Keywords:** *Small business, GST, cash flow, cash flow stability*

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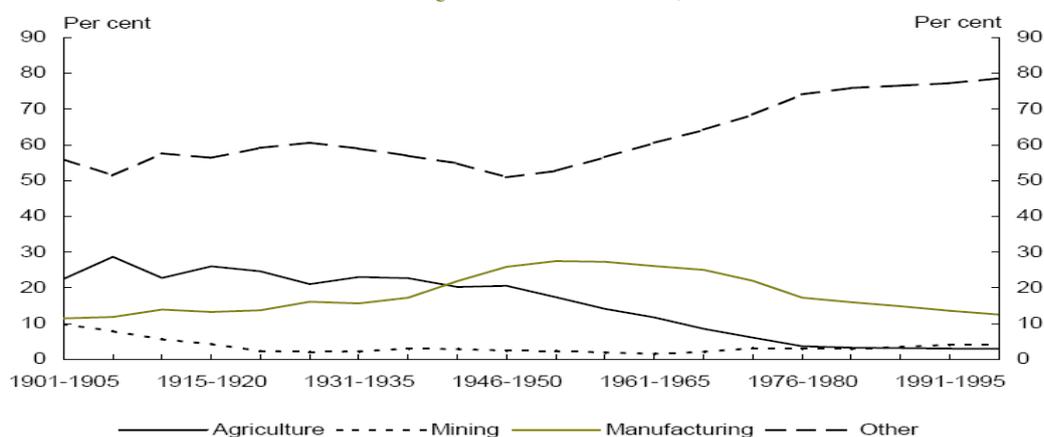
1 Griffith University, Email: m.belleisle@griffith.edu.au

2 Associate Professor, Griffith University, Email: b.freudenberg@griffith.edu.au; Phone: +61 7 3735 8071.

## 1. INTRODUCTION

On the 1st July 2000 the goods and services tax (GST) was introduced into Australia as part of an overall reform which saw the GST replace the Wholesale Sales Tax (WST) and various other state taxes. A principle reason for the GST to replace the WST was because while the WST was effective in collecting tax revenue early in the 20th Century when the Australian economy was focused on production of goods, over time this had diminished with services dominating.<sup>3</sup> Since the service sector was excluded from the WST this resulted in a large decline in revenue collected as the service sector grew. Figure 1 illustrates that at the beginning of the 20th Century services accounted for approximately 56 per cent of the Gross Domestic Product (GDP) compared to 79 per cent in 2000.<sup>4</sup> This growth has continued and in 2011 services accounted for 84 per cent of GDP.<sup>5</sup> Consequently the GST is an important tax revenue source for the Government.

**Figure 1: Industry shares of GDP 1901 – 2000**



Source: Commonwealth Government of Australia, *Australia's Century Since Federation at a Glance*, (Canberra, 2001), <<http://archive.treasury.gov.au/contentitem.asp?NavId=016&ContentID=110>>. (Note: Other indicates the service sector)<sup>6</sup>

<sup>3</sup> The goods proportion of the economy was one-third in 1998, just two years prior to the GST introduction quoted in P Costello, (1998), *Tax Reform: Not a New Tax, a New Tax System* Commonwealth Government of Australia, Canberra, 3.

<sup>4</sup> Commonwealth Government of Australia, *Australia's Century Since Federation at a Glance*, Economic Roundup Centenary Edition (2001), <<http://archive.treasury.gov.au/contentitem.asp?NavId=016&ContentID=110>>.

<sup>5</sup> Australian Bureau of Statistics, *Australian Industry*, 2011–12, cat no 8155.0 (Canberra, 2013).

<sup>6</sup> Commonwealth Government of Australia, above, n 4.

Due to the broad application of the GST it has the capacity to apply to all businesses including small businesses which can have potential positive and negative consequences. This broader application of the GST is of concern as research by Wallschutzky and Gibson<sup>7</sup> into the biggest issues confronting small businesses, found that of all the tax systems involved in their study the only tax system that was identified as being a continued problem to cash flow of small businesses was the WST.<sup>8</sup> Small business owners reported that this cash flow problem was as a result of the timing of the WST payment not falling in line with receipt of funds from sales.<sup>9</sup> Indeed, payment of the WST liability was often due before trade debtors had paid for the goods in question.<sup>10</sup> Such findings could suggest that WST's replacement, the GST, may also now have the potential to have an adverse effect on small business cash flow stability if the GST is required to be remitted prior to receiving payment. Also, Allan questions who economically bears the liability for GST, even though in theory it should be the final consumer.<sup>11</sup>

Cash flow is the extent of cash or near cash assets available for use, along with any inflow or outflow of cash related to those assets.<sup>12</sup> Cash flow is therefore any business activity that alters the balance of the cash accounts.<sup>13</sup> Business operations are the most significant source of cash inflow and outflow for businesses.<sup>14</sup> Stable cash flow is essential to support continued day-to-day operations of any business. For small business survival the importance of cash flow stability can be escalated by the unpredictability of the markets in which they operate, restrictions with internal management practices and limited availability to funding.

To date, there is a paucity of Australian research considering the effect of GST on cash flow stability for small businesses. While many authors have studied the effect of GST on small business entities in Australia,<sup>15</sup> the majority of these studies have related to the cost of compliance and a large portion of this research was conducted within the first five years of the introduction of GST. Few studies consider cash flow

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<sup>7</sup> IG Wallschutzky and B Gibson, 'Small Business Cost of Tax Compliance' (1993) 10(4) *Australian Tax Forum* 511.

<sup>8</sup> Ibid 528–530.

<sup>9</sup> Ibid 529, 535.

<sup>10</sup> Ibid 535.

<sup>11</sup> C Allan, *Theory of Taxation* (Penguin, Harmondsworth, 1971); C Sandford, 'Minimising the Compliance Costs of a GST' (1998) 14(2) *Australian Tax Reform* 125.

<sup>12</sup> I Ekanem, 'Liquidity management of small firms: a learning perspective' (2010) 17(1) *Journal of Small Business and Enterprise Development* 123.

<sup>13</sup> L Stockstill, S Dietz and W Maurer, 'A Cash Flow Focus for Small Business' (1989) 1(2) *Journal of Business and Entrepreneurship* 45.

<sup>14</sup> P Lignier, 'The Managerial Benefits of Tax Compliance: Perception by Small Business Taxpayers' (2009) 7(2) *eJournal of Tax Research* 106, 111.

<sup>15</sup> J Breen, S Bergin-Seers, I Roberts and R Sims, 'The Impact of the Introduction of the GST on Small Business in Australia' (2002) 10 (1) *Asian Review of Accounting* 89; J Glover and B Tran-Nam, 'The GST Recurrent Compliance Costs/Benefits of Small Business in Australia: A Case Study Approach' (2005) 1(2) *Journal of the Australian Tax Teachers Association* 237; J Pope, 'Estimating and Alleviating the Goods and Services Tax Compliance Cost Burden upon Small Business' (2001) 11(1) *Revenue Law Journal* 6; J Pope and N Rametse, 'Small Business Start-Up Compliance Costs of the Goods and Services Tax: Estimates and Lessons from Tax Reform' (2002) 5(3) *Journal of Australian Taxation* 382; M Reynolds, 'Report on the GST Compliance Costs for Independent Grocers' (Prepared for the National Association of Retail Grocers of Australia Pty Ltd, April 2001); B Tran-Nam and J Glover, 'Estimating the Transitional Compliance Costs of the GST in Australia' (2002) 17(4) *Australian Tax Forum* 499.

implications in any detail. While Reynolds did conduct cash flow benefit analysis for the retail grocery sector in 2001, his results related to the industry norms of that particular sector and are unlikely to be a representation of small businesses as a whole,<sup>16</sup> and did not consider the effect on cash flow stability. Similarly, while the study by Glover and Tran-Nam identified the compliance costs and benefits of the GST for small businesses in the rural sector of Australia from 1999 to 2002, their empirical findings did not focus on receipt of any related cash flow benefit by participants.<sup>17</sup> In a related project, Belle Isle et al. established that small business perceived that there should be a cash flow benefit from GST but in reality (especially for non-cash GST registrants) this was not likely to be achieved.<sup>18</sup>

The aim of the research is to gain a greater understanding of the effect of GST on the stability of small business cash flow. Section Two of this article will provide a broad summary of the characteristics of small businesses and their importance. The third section will then provide an outline of the issue of cash flow stability for small businesses and how this can be influenced by a number of factors, including management, access to finance and competitive markets. Section Four will provide the research methodology undertaken and the demographics of the participants, which will be followed by the results. Through the analysis of the results recommendations will be proposed, with future research being outlined in the fifth section of the article before the conclusion.

## 2. IMPORTANCE OF SMALL BUSINESSES

The Australian Taxation Office (ATO) and the Australian Bureau of Statistics define small businesses by their quantitative characteristics such as an annual turnover of \$10 million or less and a full time workforce of 20 or less employees.<sup>19</sup> Small businesses are important to Australia's economy with their contribution to private sector GDP being 34.4 per cent in 2011/12. It should be noted that small businesses themselves are heterogeneous, in terms of structure, industry sector, employee capabilities and position in the market.<sup>20</sup> This diversity further extends to owners of small businesses as they can vary considerably in age, nationality, education and experience.<sup>21</sup> In comparison to large businesses their capabilities, control and practices may differ.

<sup>16</sup> M Reynolds, "Report on the GST Compliance Costs for Independent Grocers" (Prepared for the National Association of Retail Grocers of Australia Pty Ltd, April 2001).

<sup>17</sup> Glover and Tran Nam, above n 15.

<sup>18</sup> M Belle Isle, B Freudenberg and R Copp, *Cash Flow Benefit from GST: Is it Realised By Small Businesses in Australia?* (Working Paper, Griffith University, 2014).

<sup>19</sup> Australian Bureau of Statistics (2013), *Counts of Australian Businesses including Entries and Exits (Jun 2008 to Jun 2012)*, cat. no. 8165.0 39, <[http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/0/4461C2EEC98E3A47CA257B7100149A76/\\$File/81650\\_jun%202008%20to%20jun%202012.pdf](http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/0/4461C2EEC98E3A47CA257B7100149A76/$File/81650_jun%202008%20to%20jun%202012.pdf)>..

<sup>20</sup> J Freedman, "Small Business Taxation: Policy Issues and the UK", in N Warren, *Taxing Small Business: Developing Good Tax Policies*, (Australian Tax Research Foundation Conference Series, Sydney, Australia, 2003) 13–44; A Hansford, J Hasseldine and C Howorth "Factors Affecting the Costs of UK VAT Compliance for Small and Medium-sized Enterprises" (2003) 21(4) *Environment and Planning C: Government Policy* 479; K Ritchie, "The Tax Compliance Costs of Small Business in New Zealand" in C Evans, J Pope and J Hasseldine, *Tax Compliance Costs: A Festschrift for Cedric Sandford* (Prospect Media Pty Ltd, 2001) 297–316, 300.

<sup>21</sup> Commonwealth Department of Industry, Innovation, Science, Research and Tertiary Education, *Australian Small Business Key Statistics and Analysis*, (Canberra, 2010), 9.

Broadly, small businesses are generally funded with private equity not public, they are internally controlled, the owner is normally the majority equity holder, assets are short term in nature and debt is secured by private assets.<sup>22</sup> However, small businesses have the advantage of being more flexible than large businesses as the absence of bureaucracy allows them the ability to make rapid changes to requirements of customers.<sup>23</sup>

Research regarding the effect that taxation has on small businesses has been a popular research topic in Australia over the last two decades. Of particular importance to this research project is the study completed by Wallschutzky and Gibson.<sup>24</sup> Not only does the study relate to small business and taxation, it also implemented a similar research methodology to the current research.

The Wallschutzky and Gibson<sup>25</sup> study was conducted prior to the introduction of the GST and evaluates various tax systems affecting small business at that time. Among the tax systems researched were Fringe Benefits, Capital Gains, Pay As You Earn (PAYE), Prescribed Payments System and WST. The purpose of the study was to identify which tax systems created the most significant problems for small business. Two important findings from the Wallschutzky and Gibson<sup>26</sup> study are relevant to this project. Firstly the authors anticipated that taxation was a critical issue for small businesses. In order to investigate this assumption, Wallschutzky and Gibson<sup>27</sup> queried small business participants about what they perceived were the three biggest issues facing their business. Taxation did not score highly on participant responses. A list of the main issues is presented in Table 1.

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<sup>22</sup> S Basu, 'Problems of Small Business' (1986) 5(4) *A Journal of Applied Economics and Policy* 92; C Coleman and C Evans, 'Tax Compliance Issues for Small Business in Australia' in N Warren, *Taxing Small Business: Developing Good Tax Policies*, (Australian Tax Research Foundation Conference Series 23, Sydney NSW, Australia, 2003) 147–182; L Libermann-Yaconi, T Hopper and K Hutchings, 'Toward a Model of Understanding Strategic Decision-Making in Micro-Firms: Exploring the Australian Information Technology Sector' (2010) 48(1) *Journal of Small Business Management* 70, 72.

<sup>23</sup> P Hutchinson, 'How Much Does Growth Determine SME's Capital Structure?' (2004) 12(1) *Small Enterprise Research* 81, 88; Libermann-Yaconi et al., above n 22; S Perera and P Baker, 'Performance Measurement Practices in Small and Medium Size Manufacturing Enterprises in Australia' (2007) 15(2) *Small Enterprise Research* 10, 12.

<sup>24</sup> Wallschutzky and Gibson, above n 7.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

**Table 1: Major issues of concern for small businesses**

Issues for small businesses	
Uncertainty concerning revenue	Lack of suitable staff
Cash flows	Breaking into new markets
The depressed economy	Changing the company's image
Low profit margins	Maintaining market share
Difficulty obtaining finance	Big business dictating trading laws
Bad debts	Lack of capital
Restructuring	Changes in funding arrangements
Design and development of new products	Property transaction costs
Competition	Increasing costs

Adapted from IG Wallschutzky and Gibson B, 'Small Business Cost of Tax Compliance' (1993) 10(4) *Australian Tax Forum* 511.

Wallschutzky and Gibson<sup>28</sup> summarised these issues and found that major concerns were related to cash flow including low turnover, low profits and higher costs for small business than large. The absence of tax being listed is consistent with a more recent report by McKerchar, Hodgson and Walpole to the Board of Taxation.<sup>29</sup>

Secondly due to identification that cash flow was a major concern for small business, Wallschutzky and Gibson investigated whether taxation was a mere aggravation to small business cash flow or whether payment of taxation caused cash flow problems. Of all the tax systems that were involved in the study the only tax system that was identified as being a continued problem to cash flow was the WST.<sup>30</sup> Small business owners reported that the problem presented as a result of the timing of the tax payment not falling in line with receipt of funds from sales.<sup>31</sup> Payment of the tax liability was often due before trade debtors had paid for the goods in question.<sup>32</sup> Wallschutzky and Gibson also reported that those small businesses trading in cash did not report that the WST presented a problem for their cash flow.<sup>33</sup>

It is possible that the WST's replacement, the GST, could also impose issues for small businesses' cash flow. The GST is a multi-staged broad based consumption tax with tax collected at more than one stage of the production and distribution chain.<sup>34</sup> Broadly, in Australia each stage of the supply of goods and services has GST liability

<sup>28</sup> Ibid.

<sup>29</sup> M McKerchar, H Hodgson and M Walpole, 'Scoping Study of Small Business Compliance Costs', *Report to the Board of Taxation* (Board of Taxation, Sydney, 2006).

<sup>30</sup> Wallschutzky and Gibson, above n 7, 528–530.

<sup>31</sup> Ibid 529, 535.

<sup>32</sup> Ibid 535.

<sup>33</sup> Ibid.

<sup>34</sup> C Sandford, M Godwin, P Hardwick and I Butterworth, *Costs and Benefits of VAT* (Heinemann Educational Books Ltd, London, 1981).

imposed. A GST input tax credit is available for GST registered enterprises to offset the GST paid on inputs against GST received on outputs.<sup>35</sup>

GST registration is mandatory for enterprises with a turnover<sup>36</sup> of \$75,000<sup>37</sup> or more, although voluntary registration is available to enterprises below this threshold.<sup>38</sup> Accounting for GST can be on a cash or non-cash basis.<sup>39</sup> Pursuant to the cash basis, GST is attributed to the period of payment for goods or services supplied or remittance date of payment for inputs obtained from other traders (and only to the extent of payment).<sup>40</sup> GST for non-cash accounting (also known as accruals) is recognised in the period where the earliest of either an invoice is generated or payment (or part thereof) is received.<sup>41</sup> The two forms of reporting systems discussed are not available to all entities within the economy. Cash accounting is only available to micro businesses with an annual turnover of less than \$2 million or who use a cash basis for income tax reporting.<sup>42</sup> Non-cash accounting is available to all registered entities, even those eligible to report on the cash method can elect to use non-cash.<sup>43</sup>

Determining the net amount of GST liability in a reporting period is calculated using total GST liability minus input tax credits.<sup>44</sup> GST is the sum of all GST liability on taxable supplies<sup>45</sup> and taxable importations<sup>46</sup> attributable to the tax period less the input tax credits on creditable acquisitions<sup>47</sup> and creditable importations<sup>48</sup> that are attributable to the tax period. The tax period that a business adheres to is determined predominantly by its aggregate turnover, however businesses can apply to the Commissioner for election of an alternate tax period.<sup>49</sup>

A touted potential benefit of the GST, is the possibility for businesses to hold onto extra cash due to the timing of tax periods and remittance of the GST collected, which could vary from up to 51 to 120 days. Monthly tax periods are required for businesses meeting the tax period turnover threshold of \$20 million.<sup>50</sup> Payment is due within 21 days of the following month<sup>51</sup> allowing these entities to hold the GST for up to 51 days.<sup>52</sup> For entities with turnover of less than \$20 million a quarterly payment of GST

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<sup>35</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) Div 17.

<sup>36</sup> GST turnover is determined by the current and projected year earnings. If earnings in the current year or preceding year are greater than \$75000, an entity will be required to register for GST. See *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 188-10 and section 195-1.

<sup>37</sup> Non-profit bodies registration is required for >\$150,000, see *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 23-15(2) item b.

<sup>38</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

<sup>39</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) Div 29.

<sup>40</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 29-5 (2) and section 29-10 (2).

<sup>41</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 29-5 (1) and section 29-10 (1).

<sup>42</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 27-40 and section 195-1.

<sup>43</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 27-5.

<sup>44</sup> See the formula in *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 17-5.

<sup>45</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 9-5.

<sup>46</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

<sup>47</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 11-5.

<sup>48</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 15-5.

<sup>49</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) Div 27.

<sup>50</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 27-15 item 3(a).

<sup>51</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 31-10 (1).

<sup>52</sup> Where an invoice is generated on the first day of the reporting period.

is possible.<sup>53</sup> Those enterprises with turnover above \$2 million are required to calculate their net GST liability quarterly.<sup>54</sup> Those earning below \$2 million however can pay a quarterly instalment<sup>55</sup> amount based on previous annual turnover.<sup>56</sup> Quarterly payments are due within 28 days of the month following the end of the quarter;<sup>57</sup> effectively this allows businesses to hold GST payments for up to 120 days<sup>58</sup> before the liability is due.

There have been a number of studies into consumption taxes, such as the GST. For example, Sandford et al. conducted a study of compliance costs of the GST equivalent in the United Kingdom—the Value Added Tax (VAT). The study identified that compliance cost could be reduced by two possible benefits including managerial benefits and cash flow benefits.<sup>59</sup> The findings of Sandford et al. are supported by later research conducted in Australia.<sup>60</sup> In Australia there have been a number of GST compliance costs studies.<sup>61</sup> Findings were reported suggesting that the GST escalated the tax burden already placed on small business entities.<sup>62</sup> Previous Australian cash flow benefit studies are incomprehensive; studies including Breen et al.<sup>63</sup> and Evans, Carlon and Massey<sup>64</sup> have acknowledged problems with cash flow as a result of the GST. However the purposes of these studies were not specific to cash flow or cash flow stability from the GST and only gave minimal attention to these issues.

Reynolds did conduct cash flow benefit analysis for the retail grocery sector in 2001 in terms of GST. However, the results of this study related to the industry norms of that particular sector and are unlikely to be a representation of small businesses as a whole.<sup>65</sup> The study by Glover and Tran-Nam identified the compliance costs and benefits of the GST for small businesses in the rural sector of Australia from 1999 to

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<sup>53</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 31-8 and section 195-1.

<sup>54</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

<sup>55</sup> Exception is given to Primary Producers and special professionals who are only required to pay to installments annually.

<sup>56</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 162-15. Except for those that are not required to be registered. Those entities are able to make an annual tax period election see *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 151-5.

<sup>57</sup> Except in the December quarter where payment is due 8 weeks later (28th February).

<sup>58</sup> Where an invoice is generated on the first day of the reporting period; Liability could be held for 151 days in the December quarter.

<sup>59</sup> Since then tax deductibility has been identified further as a benefit of complying with taxation.

<sup>60</sup> C Evans, K Ritchie, B Tran-Nam and M Walpole, *A Report into Taxpayer Costs of Compliance* (Australian Government Publishing Service, Canberra, 1997), 37–40; M McKerchar, H Hodgson and M Walpole, ‘Understanding Australian Small Businesses and the Drivers of Compliance Costs’ (2009) 24(2) *Australian Tax Forum* 151; P Lignier and C Evans, ‘The Rise and Rise of Tax Compliance Costs for the Small Business Sector in Australia’ (2012) 27(3) *Australian Tax Forum* 615; Wallschutzky and Gibson, above n 7.

<sup>61</sup> Studies include: Breen, Bergin-Seers, Roberts and Sims, above n 15; C Evans, S Carlon and D Massey ‘Record keeping Practices and Tax Compliance of SMEs’ (2005) 3(2) *eJournal of Tax Research* 288; Glover and Tran-Nam, above n 15; Pope and Rametse, above n 15; Reynolds, above n 16.

<sup>62</sup> McKerchar, Hodgson and Walpole, *Understanding Australian Small Businesses and the Drivers of Compliance Costs*, above n 60; Lignier and Evans, above n 60; RFE Warburton, *Scoping Study of Small Business Tax Compliance Cost* (A report to the Treasurer, December, 2007).

<sup>63</sup> Breen, Bergin-Seers, Roberts and Sims, above n 15.

<sup>64</sup> Evans, Carlon and Massey, above n 60.

<sup>65</sup> Reynolds, above n 16.

2002.<sup>66</sup> However, their empirical findings did not focus on receipt of any related cash flow benefit or stability by participants.<sup>67</sup>

Consequently, the important issue of the effect of GST on the cash flow stability for small businesses has not been fully addressed in Australian research, with cash flow stability explored in the next section.

### 3. CASH FLOW STABILITY FOR SMALL BUSINESSES

An issue facing small businesses is their cash flow, with liquidity strongly related to the strength of their cash flow. Liquidity is the ability to meet short-term commitments as measured by working capital, being current assets minus current liabilities.<sup>68</sup> Cash flow stability refers to the extent of cash or near cash assets available for use, along with any inflow or outflow of cash related to those assets.<sup>69</sup> Cash flow stability therefore is affected by any business activity that alters the balance of the cash accounts.<sup>70</sup>

Given the importance of small businesses to the health and stability of the economy it is crucial to understand how they maintain liquidity.<sup>71</sup> Primarily the greatest challenges for small businesses are the management capabilities of the owner or manager, the market in which they operate and their availability to external finance.<sup>72</sup>

However the continued success of small business is not always easily achieved, as they face numerous issues in the business environment as a consequence of their size and structure. These issues include market pressure, an absence of management procedures and finance restrictions (including cash flow issues). In particular cash flow can be pertinent due to limited availability to finance alternatives in the event there is a cash shortfall.

#### 3.1 Cash flow management

Small business viability can be affected by the requirement to pay taxes.<sup>73</sup> One cause of this is that there is a delay in time between the tax liability being incurred and the obligation to remit it to the tax authority. The time delay can result in the tax liability portion being used as working capital in the short term, leaving a shortfall when the due date for payment arises. In order to minimise the likelihood of this occurring small businesses need to engage in strong cash flow management practices to alleviate

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<sup>66</sup> Glover and Tran-Nam, above n 15.

<sup>67</sup> Sandford, Godwin, Hardwick and Butterworth, above n 34; C Sandford, M Godwin and P Hartwick, *Administrative and Compliance Costs of Taxation* (Fiscal Publications, Bath, 1989), 76.

<sup>68</sup> M Drever and P Hutchinson, 'Industry Differences in the Determinant of the Liquidity of Australian Small and Medium Enterprises' (2007) 15(1) *Small Enterprise Research* 60.

<sup>69</sup> Ekanem, above n 12.

<sup>70</sup> Stockstill, Dietz and Maurer, above n 13.

<sup>71</sup> R Lussier and C Halabi, 'A Three-Country Comparison of the Business Success versus Failure Prediction Model' (2010) 48(3) *Journal of Small Business Management* 360.

<sup>72</sup> K Ness, 'Small Business Success Factors in Regional Queensland' (2004) 12(2) *Small Enterprise Research* 1, 6.

<sup>73</sup> Hutchinson, above n 23, 89.

any short term cash restrictions. These restrictions can occur for a number of reasons, such as fluctuations in business cycles and trade credit to customers.

In Australia 85 per cent (or 1 820 952 businesses) have 4 or less employees.<sup>74</sup> Due to the high concentration of small firms with 4 or less employees, it is not unreasonable to suggest that the majority of Australian businesses are managed by their owners.<sup>75</sup> A consequence of this is that the ownership role is a multi-tasking exercise with owners often required to be the production, financial, marketing and operations manager.<sup>76</sup> Unfortunately their decision making as a result may not always be in the best interest of the business as they may be constricted by the owners' overemphasis of their own personal abilities.<sup>77</sup> Predominantly the skills of small business owners are refined to the goods and services that they provide and do not extend to these extra management tasks.<sup>78</sup> Owners are left to develop management practices on an as needed basis, which can lead to use of unstructured and inefficient practices.<sup>79</sup> A lack of formal systematic procedures can restrict the owners' ability to recognise a downturn with incoming cash flow and overall financial performance.<sup>80</sup>

Fluctuations in sales can impact cash levels by providing high volumes of funds in the short term with limited cash inflow in the long term. Where stringent policies for cash flow management are not employed, small businesses may be in the predicament of being cash poor to satisfy longer term obligations when they are due. Taxation has been identified as a longer term obligation as although the liability arises as business activities are conducted the requirement to pay falls sometime in the future.<sup>81</sup> Cash restrictions for small businesses are substantiated by the number of interest free loans issued by the ATO to small business clients.<sup>82</sup>

For continued performance, success and business survival it is necessary to implement effective decision making and planning practices.<sup>83</sup> These practices enable management to identify areas that will give them a competitive advantage in the market place and assist with obtaining finance should it be needed to support long term growth. Unfortunately effective decision making and planning is something that may not be established in small businesses, as they are often impromptu and not influenced by activities that are external to the business.<sup>84</sup> Prior research indicates that planning of small businesses only extends to external information in the situation of

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<sup>74</sup> Australian Bureau of Statistics, above n 19.

<sup>75</sup> B Freudenberg, *Tax Flow-Through Companies* (CCH, Sydney, 2011).

<sup>76</sup> Basu, above n 22, 108.

<sup>77</sup> G Cassar and B Gibson, 'Forecast Rationality in Small Firms' (2007) 45(3) *Journal of Small Business Management* 283, 286; B Kotey, 'Debt Financing and Factors Internal to the Business' (1999) 17(3) *International Small Business Journal* 11.

<sup>78</sup> Hansford, Hasseldine and Howorth, above n 20; N Opiela, 'Keeping Small Business Cash Flow on Track' (2006) 19(7) *Journal of Financial Planning* 26.

<sup>79</sup> Basu, above n 22, 108; Perera and Baker, above n 23, 13.

<sup>80</sup> Perera and Baker, above n 23, 15.

<sup>81</sup> Hutchinson, above n 23, 89.

<sup>82</sup> For example, 35,900 loans were recorded at 30 June 2012 indicating that small businesses were experiencing some form of short term cash flow difficulty: Australian Taxation Office, *Back to Business*, (Canberra, 2013), <<http://www.ato.gov.au/Business/Activity-statements/In-detail/Bulletins/2012-13/Back-to-business-bulletin---Quarter-3-2012-13/>>.

<sup>83</sup> Libermann-Yaconi et al., above n 22, 71.

<sup>84</sup> Cassar and Gibson, above n 77, 284.

considerable market or economic downturn.<sup>85</sup> Predominantly small businesses' forecasts are tainted by optimistic and over confident views of the market by owners and the use of previous projections and growth patterns to predict future business activity.<sup>86</sup> Unrealistic forecasting and planning affects rational commercial decision making, which in turn places pressure on the continued viability of the business.<sup>87</sup>

Small businesses can face difficulty managing their cash flow when they do not have a well-established accounting and data management system.<sup>88</sup> Issues with liquidity have diminished with advances in technology and higher concentration of smaller firms implementing the use of a 'computerised accounting system' (CAS).<sup>89</sup> It has been argued that greater firm success is related to the use of a CAS for cash flow management purposes as well as taxation requirements.<sup>90</sup>

### 3.2 Finance availability

Research has identified that the availability of finance is different for small business in comparison to large, with access to finance influencing cash flow stability. Important areas that will be discussed below include restrictions to finance, capital availability and alternate sources.

Research has demonstrated that small businesses are disadvantaged in comparison to large in relation to accessibility of loans from financial institutions.<sup>91</sup> The difference is evident in terms and conditions, interest rates and available products. It has been demonstrated that small businesses pay higher interest rates, have more extensive terms and conditions that are probable subject to frequent changes over the life of the loan and have limited access to longer term finance options.<sup>92</sup> In Australia from 2001-2008, the lending rate for small business was on average 1.5 per cent higher than for larger businesses.<sup>93</sup> This gap in lending rate increased to two per cent with the downturn in the economy as a result of a decline in the competitive banking market and tightening of bank lending standards.<sup>94</sup> This can make finance costly for small businesses and further impedes their ability to remain competitive in the marketplace.<sup>95</sup>

<sup>85</sup> M Bumgardner, U Buehlmann, A Schuter and J Crissey, 'Competitive Actions of Small Firms in a Declining Market' (2001) 49(4) *Journal of Small Business Management* 578, 579.

<sup>86</sup> Cassar and Gibson, above n 77, 291; Libermann-Yaconi et al., above n 22, 76.

<sup>87</sup> Cassar and Gibson, above n 77, 284.

<sup>88</sup> C Wu and A Young, 'Factors Resulting in Success and Failures for Small Business in the Small Business Institute Program at Syracuse University' (2003) 17(2) *Economic Development Quarterly* 205.

<sup>89</sup> Ibid.

<sup>90</sup> Ness, above n 72.

<sup>91</sup> Basu, above n 22, 92-110; S Basu, 'Deregulation: Small Business Access to the Capital Market – Theoretical Issues with Special Reference to Australian Bank Finance' (1989) 28(52) *Australian Economic Papers* 141; M Niskanen and J Niskanen, 'Small Business Borrowing and the Owner-Manager Agency Costs: Evidence on Finnish Data' (2010) 48(1) *Journal of Small Business Management* 16.

<sup>92</sup> Commonwealth Department of Industry, Innovation, Science, Research and Tertiary Education, *Australian Small Business Key Statistics and Analysis*, (Canberra, 2010), 61; Basu, above n 22, 104.

<sup>93</sup> Commonwealth Department of Industry, Innovation, Science, Research and Tertiary Education, above n 92.

<sup>94</sup> Ibid.

<sup>95</sup> Hutchinson, above n 23, 89.

The difference in lending standards for smaller business is presumed justifiable by the lending institutions because small businesses face greater volatility in their revenue streams and have a higher debt-to-asset ratio than their larger competitors.<sup>96</sup> While this may be commercially valid, placing funding restrictions on small businesses can hinder growth and effectively place further pressure on their financial stability. Banks and financial institutions substantiate their differential treatment of smaller firms to be a result of the limited managerial ability of small firm owners, inadequate capital for debt security and high single owner concentration.<sup>97</sup>

Part of this problem can be attributed to small business as they can have difficulty communicating their credibility and future prospects in finance applications.<sup>98</sup> The informal and impromptu management style that is preferred by small businesses affects their ability to convince banks of their capability to fulfil obligations under a loan contract.<sup>99</sup> This is due to factors including poor record keeping, limited information about current operations and absence of a business plan.

Financial institutions consequently impose tighter lending conditions on smaller firms including increased loan security. Due to smaller firms being privately owned and operated, the security increase requirement falls predominantly on the owners. Depending on the structure of the firm this can mean that lending institutions insist on personal guarantees from owners and/or a large portion of the owner's assets (including private residences) are exposed as collateral to secure the finance debt. Generally business owners are reluctant to engage in these requirements for fear that the assets offered as security will be vulnerable in the event of businesses failure. Consequently, to satisfy finance shortfalls small businesses pursue alternate sources of funding.

Alternate sources often include the business owners' personal savings. When the value of the savings is not sufficient to satisfy the cash shortfall, small business owners have been known to seek assistance from family members and friends for funding.<sup>100</sup> Secondary sources have been identified as household debt, such as credit cards and personal loans. For example, the household debt of individuals involved in small business in Australia is at a greater level of debt than those households which are not.<sup>101</sup> This suggests that small business owners are relying on these alternative personal finance options to fund their business operations.

A third option for alternate funding is the use of vehicle and equipment financing.<sup>102</sup> This type of short-term finance can suit security limitations of small businesses as the

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<sup>96</sup> Commonwealth Department of Industry, Innovation, Science, Research and Tertiary Education, *Australian Small Business Key Statistics and Analysis*, (Canberra, 2010), 56; Niskanen and Niskanen, above n 91, 24.

<sup>97</sup> Basu, above n 91, 141; Drever and Hutchinson, above n 68, 64; Niskanen and Niskanen, above n 91, 18–19.

<sup>98</sup> J Kennedy and B Tennent, 'Financial Management Practices in Small Businesses: Regional and Metropolitan' (2006) 14(1) *Small Enterprise Research* 55, 56–57.

<sup>99</sup> Basu, above n 91, 141–142.

<sup>100</sup> P Poutziouris and F Chittenden, 'Modelling the Tax Burden (Direct and Compliance Costs) on the UK Small Company Sector—A Simulation Model' in C Evans, J Pope and J Hasseldine, *Tax Compliance Costs: A Festschrift for Cedric Sandford*, (Prospect Media2001) 409–417, 412.

<sup>101</sup> Commonwealth Department of Industry, Innovation, Science, Research and Tertiary Education above n 96.

<sup>102</sup> *Ibid.*

security of the loan lies with the equipment that is under the finance agreement. Finally, small business can use trade credit as a source of finance.<sup>103</sup> The use of trade credit allows businesses to operate more efficiently,<sup>104</sup> with the time separation between purchasing and payment allowing businesses to maximise the use of those goods or services obtained to produce profit within their own organisation.<sup>105</sup> Where cash flow is tight relying on the maximum amount of credit available from suppliers can be necessary in order to satisfy immediate cash commitments.<sup>106</sup> Trade credit has been identified as a popular alternative for businesses with limited access to finance from banks and lending institutions.<sup>107</sup>

### 3.3 Competitive markets

Another issue confronting small businesses is that they may be disadvantaged when operating in open markets. Larger competitors may have the experience to build business relationships and quite successfully negotiate business contracts as a result.<sup>108</sup> In contrast, small businesses face considerable uncertainty due to their lack of influence over the markets in which they are engaged.<sup>109</sup> Any competitive advantage that smaller firms may have is influenced by many factors including supply chains, labour markets, inter-firm and institutional relationships, size of the market, population and their position in the market.<sup>110</sup>

Small businesses rarely hold the power in markets in which they operate, as the scale of their operations may cause detrimental effects on their costs of production.<sup>111</sup> The problem exists because the inputs used for production have varying costs for different sized businesses with purchase ratios of large businesses being much greater in comparison to small businesses. This can result in higher discount percentages being offered to large customers, with smaller businesses not able to take advantage of the same pricing. Considering that the production of goods or services requires the same inputs for both small and large businesses, the final product can be cheaper to produce for the larger firm due to greater economies of scale.<sup>112</sup> When pricing the product or service in the market the larger firm will be able to offer a lower price to customers than the small business. In order to retain market share the small business is likely to follow the sale prices set by their larger competitors.<sup>113</sup> This can be detrimental to the cash flow of smaller firms, as it results in a reduction in the profit earned from each good or service sold. This could lead to the situation of the business having to absorb,

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<sup>103</sup> P J Garcia-Teruel and P Martinez-Solano, 'Determinants of Trade Credit: A Comparative Study of European SME's' (2010) 28(3) *International Small Business Journal* 215, 217.

<sup>104</sup> Ibid 215.

<sup>105</sup> Ibid.

<sup>106</sup> F Chittenden and R Bragg, 'Trade Credit, Cash-flow and SME's in the UK, Germany and France' (1997) 16(1) *International Small Business Journal* 22.

<sup>107</sup> Niskanen and Niskanen, above n 91, 24.

<sup>108</sup> I Diez-Vial, 'Firm Size Effects on Vertical Boundaries' (2009) 47(2) *Journal of Small Business Management* 137, 142.

<sup>109</sup> R MacGregor and L Viazalic, 'A Profile of Australian Regional SME Non-Adaptors of E-Commerce' (2008) 16(1) *Small Enterprise Research* 27, 30.

<sup>110</sup> J Lowe and S Henson, 'The Nature of the Regional SME' (2006) 14(1) *Small Enterprise Research* 64, 67.

<sup>111</sup> Basu, above n 22, 98.

<sup>112</sup> Ibid.

<sup>113</sup> Ibid 99.

for example, the GST rather than pass it on.<sup>114</sup> In order to eradicate price and power vulnerability small businesses need to explore other avenues in order to gain power within the marketplace.

In relation to taxation the position of small businesses in the market can influence who bears the burden of a tax in the trading relationship. The incidence of a tax is the term given to define who bears the burden and can be distinguished by the statutory (formal) or economic (effective) incidence. For example, the burden of GST is assumed to be borne by the final consumer (formal), however in reality this may not be the case as the burden maybe absorbed by the last business in the production chain prior to the retail sale (effective), or alternatively it may be placed back on previous suppliers (effective) in the stages of production.<sup>115</sup> Whether the incidence remains statutory or becomes economic relies heavily on the elasticity of demand for goods and services and the power of the enterprise in the marketplace especially where small businesses are in competition with large businesses.<sup>116</sup>

Evidence indicates that large firms regularly backward shift the GST burden to their suppliers allowing them to retain a greater profit margin on the sale of goods or services to their customers.<sup>117</sup> Small businesses however can be at a competitive disadvantage because their volume purchase from suppliers does not give them power in the trading relationship therefore not allowing them the opportunity to demand lower supply prices.<sup>118</sup> As a consequence it is likely that small businesses may have to absorb the tax in order to retain customers, effectively eroding their profit margins further. Bearing the GST burden decreases the level of cash that may be held by the business as the shortfall in GST liability collected is required to be funded from working capital.

Small businesses can gain power in trading partnerships by distinguishing themselves from their competitors. This can be achieved in a number of ways including having a close personal relationship with customers in order to identify their needs as they occur, offering more flexible trading practices than competitors or creating unique products effectively allowing small businesses to create their own markets.<sup>119</sup>

Flexible trading practices in the form of extending credit can be offered to separate small businesses from their competitors.<sup>120</sup> As discussed above, trade credit can be an important source of finance for businesses especially where external and internal sources are restricted.<sup>121</sup> Therefore small businesses may be able to strengthen their commercial relationship by acting as a financial intermediary for their customers. Providing trade credit also indicates that the small business owner has confidence in

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<sup>114</sup> Allan, above n 11.

<sup>115</sup> Allan, above n 11; C Sandford, 'Minimising the Compliance Costs of a GST' (1998) 14(2) *Australian Tax Reform* 125.

<sup>116</sup> Sandford above n 115.

<sup>117</sup> J Stiglitz, *Economics of the Public Sector* (Norton, 2nd ed, 1998).

<sup>118</sup> Sandford, above n 115.

<sup>119</sup> Bumgardner, et al., above n 85, 596; Chittenden and Bragg, above n 106; Diez-Vial, above n 108, 139; Ness, above n 72, 5; M Withers, P Dinevich and L Marino, 'Doing More with less: The Disordinal Implications of Firm Age for Leveraging Capabilities for Innovation Activity' (2011) 49 (4) *Journal of Small Business Management* 515, 517.

<sup>120</sup> Chittenden and Bragg, above n 106.

<sup>121</sup> Garcia-Teruel and Martinez-Solano, above n 103.

the goods or services that they provide. The extended payment period allows the customer the opportunity to assess the quality of items purchased prior to payment.

However, providing commercial credit is not without its disadvantages. It can result in market power shifting to the customer. Customer dominance occurs when longer payment terms are imposed than are given in the trading contract.<sup>122</sup> This can result in the balance sheet of the small business being weakened and cash flow placed under pressure.<sup>123</sup> This may put the small business in the situation of having to remit the GST on supplies made to the ATO prior to receiving payment. Confrontation with the customer regarding late settlement can place the small business supplier in a problematic situation, as the customer may shift to an alternate supplier.<sup>124</sup>

Versatility of smaller firms could also extend to creating niche markets and engaging in innovative practices.<sup>125</sup> These two practices complement each other and allow the smaller firm to have greater strength in customer negotiation.<sup>126</sup> Authors argue that products should be developed that are of a high quality and require a refined skill set.<sup>127</sup> Concentration on a limited number of higher end products or services allows the smaller firm to create its own market,<sup>128</sup> thus eradicating market competition and removing the pressure to follow market prices set by less financially constrained competitors.<sup>129</sup> This could lead to a situation of being able to fully pass on the GST to the consumer.

### 3.4 Industry

Another factor that may influence cash flow is the industry in which a business operates.<sup>130</sup> For instance the wholesale trade sector is reported as having the greatest issues with internal finance, cash flow and debt management.<sup>131</sup> In comparison, the service sector requires a lower level of capital investment and generally as a result can retain a greater portion of retained profits.<sup>132</sup> Whereas the retail and manufacturing sectors can see prices for their products being forced to lower than their competitors, suggesting a lower profit margin in these industry sectors.<sup>133</sup>

Industry can also have an influence over whether businesses generally trade in cash or on credit.<sup>134</sup> For example cash trading is predominantly linked to those businesses that

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<sup>122</sup> Chittenden and Bragg, above n 106, 27.

<sup>123</sup> Ibid 22.

<sup>124</sup> Ibid.

<sup>125</sup> Diez-Vial, above n 108, 139; Ness, above n 72, 5; Withers, Dinevich and Marino, above n 119, 517.

<sup>126</sup> Diez-Vial, above n 108, 139; Ness, above n 72, 5; Withers, Dinevich and Marino, above n 119, 517.

<sup>127</sup> Bumgardner, et al., above n 85, 581–582; Withers, et al., above n 119.

<sup>128</sup> T Besser and N Miller, 'The Significance of Customers Base in the New Economy: Satisfaction and Perceptions of Success among Small Suppliers and Small Non-Suppliers' (2010) 48(1) *Journal of Small Business Management* 1, 3; Diez-Vial, above n 108, 139.

<sup>129</sup> Diez-Vial, above n 108, 139.

<sup>130</sup> D Gadenne, 'Critical Success Factors for Small Business: An Inter-industry Comparison' (1998) 17(1) *International Small Business Journal* 36, 42.

<sup>131</sup> X Huang and A Brown, 'An analysis and classification of Problems in Small Business' (1999) 18(1) *International Small Business Journal* 73, 80.

<sup>132</sup> Ibid.

<sup>133</sup> Gadenne, above n 130.

<sup>134</sup> Chittenden and Bragg, above n 106, 28.

are involved in the retail industry whereas providing credit to customers is generally found in industries of wholesale trade, construction<sup>135</sup> and manufacturing.<sup>136</sup> Trade credit is issued to customers to cover the period of time it takes to sell goods once received.<sup>137</sup> Effectively this delay in payment for goods or services received is a form of short term finance available for business customers. For those businesses trading in credit rather than cash, trade debtors would represent the majority of businesses' incoming cash flow,<sup>138</sup> and may have adverse effects on keeping a stable cash flow. Generally small businesses have a narrow customer base resulting in a majority of income tied up with a limited number of debtors.<sup>139</sup> This can have a large impact in a situation of business failure of a customer when considerable credit has been extended to one customer who fails.<sup>140</sup> Ways to minimise this include shortening credit terms and restricting the amount of money extended to customers.<sup>141</sup> However, the ability to make changes to customer credit terms can have serious effects on retaining the small business customer base, especially with regard to market competition.

From the literature it appears that the factors discussed could have detrimental effects on cash flow stability of small businesses. A consequence of these effects may be that the ongoing viability of small businesses is jeopardised.

#### 4. RESEARCH METHODOLOGY

Given the paucity of academic research about the potential effect of GST on cash flow stability for Australian small businesses this research project is exploratory in nature.<sup>142</sup> The exploratory design is supported by the use of a multiple case study methodology. That is pertinent cases have been selected to illustrate the research issue and procedures undertaken for data collection are replicated for all selected cases.<sup>143</sup> The justification for using a multiple case study is the heterogeneity of small businesses and the factors that will be explored in considering cash flow stability.<sup>144</sup> These factors include trading practices, market competition, availability of finance and management capabilities of the owner and the small business workforce.

A major strength of using case study methodology is the ability to utilise evidence from multiple sources of data collection instruments.<sup>145</sup> The use of a multitude of

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<sup>135</sup> An important component of the construction classification is the majority of services related to construction are included within this Division.

<sup>136</sup> Chittenden and Bragg, above n 106.

<sup>137</sup> Ibid.

<sup>138</sup> Ibid.

<sup>139</sup> Besser and Miller, above n 128, 4.

<sup>140</sup> Ekanem, above n 12; Opiela, above n 78.

<sup>141</sup> T Carroll and C VanBuskirk, 'They Say Cash is King. Are you Treating it Royally?' (2009) *Public Management* 30; Ekanem, above n 12; Opiela, above n 78.

<sup>142</sup> R Scapens, 'Doing Case Study Research' in C Humphrey and B Lee, *The Real Life Guide to Accounting Research: A Behind-the-Scenes View of Using Qualitative Research Methods* (Elsevier Ltd Oxford, 2004) 231–255, 263.

<sup>143</sup> J Creswell, *Qualitative Theory and Research Design* (Sage Publications, 3rd ed, 2013), 99.

<sup>144</sup> Ritchie, above n 20, 304.

<sup>145</sup> R Stake, 'Qualitative Case Studies' in N Denzin and Y Lincoln, *Strategies of Qualitative Inquiry* (Sage Publications) 127–141, 133; R Yin, *Case Study Research Design and methods* (Sage Publications, 4th ed, 2009), 114.

sources of data gives results more accuracy and credibility and allows for an increase in the data available for analysis than what would be achievable using a single source.<sup>146</sup> For this project evidence was gained from data sources including interviews, participant demographics, activity journals and small scale surveys.

Twelve businesses participated in the research project. The data collection process began in the 1st GST quarter<sup>147</sup> of the 2013-2014 financial year. Initially participants completed documentation relating to their business demographics. Following completion of this document participants recorded their weekly GST activities in a journal over a fourteen week period of the July to September 2013 GST quarter. Once completed, semi-structured interviews were conducted to enable greater flexibility to explore participant responses and comprehension of issues uncovered.<sup>148</sup> A small structured survey was also completed by participants. The purpose of the survey was to capture participants' perception on a number of issues relevant to the study including benefits received from GST, participant management practices, owner/staff capabilities and availability of finance.

Semi-structured interviews were also conducted with two small business accountants in order to identify if views and experiences of small business owners were congruent to those identified by the accountants. These interviews had the benefit of providing insight into small business experiences from varied industries as the accountants engaged with small businesses with diverse characteristics. Their inclusion was considered essential to the research as a means of validating findings of the small businesses participants within the project.

#### 4.1 Participants

Participants for this project were small business entities in Australia. All participants selected had an annual turnover of \$10 million or less and a full time workforce of 20 or less employees.<sup>149</sup> Participants satisfied one of two groups in order to adhere to the two-tail replication design. The majority of participants (eight) accounted for GST on a non-cash basis and the second group (four) accounted for GST on a cash basis.

Securing volunteer participants for this research project was a difficult exercise. This is not an uncommon situation with small business qualitative research projects. It was experienced in previous research studies conducted by Tran-Nam and Glover and Wallschutzky and Gibson.<sup>150</sup> Due to the set criteria as detailed above and the difficulty in recruiting volunteers it was decided that the use of several purposive sampling techniques should be implemented for the research project.

An overview of annual turnover, creditor and debtor trading terms, number of employees, GST accounting basis, industry sector, GST reporting, years trading and business form for each participant business is presented in Table 2. The table demonstrates that the business form of participant businesses are companies (eight participants), trusts (two participants) and a combination company/trust registration

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<sup>146</sup> Yin, above n 145, 114.

<sup>147</sup> July to September.

<sup>148</sup> Scapens, above n 142, 266.

<sup>149</sup> Australian Bureau of Statistics, above n 19, 39 box 3.1

<sup>150</sup> Tran-Nam and Glover, above n 15; Wallschutzky and Gibson, above n 7.

(two participants). Separation of businesses into sector classification shows that service, wholesale, manufacturing and retail are represented by seven, two, two and one participant respectively. Eight participants report GST quarterly followed by three monthly and one annually. The accounting basis for GST is divided into four registered for cash and eight for non-cash accounting basis.

Participant selection was based on annual turnover and number of full time employees in line with the unit of analysis for this project. Figure 2 illustrates that there were no participating businesses that recognise an annual turnover of between \$5,000,000 and \$10,000,000. Two-thirds (8 businesses) fell within the \$500,000 to \$2,000,000 annual turnover range, with the remaining four businesses apportioned equally to the less than \$500,000, and the \$2,000,000 to \$5,000,000 annual turnover range. This means that the experiences of more sizeable small businesses (\$5,000,000 to \$10,000,000) are outside the scope of this project.

**Table 2: Demographics of small business participants**

Participant No.	Annual Turnover	Creditor Trading Terms	Debtor Trading Terms	No. of Employees	Reporting Basis	Sector	Timing of GST Reporting	Years Trading	Business Form
1	\$2,000,000 < \$5,000,000	14 Days	30 Days	11-19	non-cash	Service	Quarterly	>5<10 years	Company
2	\$500,000 < \$2,000,000	30 Days	30 Days	5-10	non-cash	Manufacturing	Quarterly	>10<20 years	Company
3	\$500,000 < \$2,000,000	30 Days	30 Days	5-10	cash	Manufacturing	Quarterly	>20 years	Company
4	\$500,000 < \$2,000,000	14 Days	14 Days	1-4	non-cash	Service	Quarterly	>20 years	Company Trust combination
5	\$500,000 < \$2,000,000	30 Days	30 Days	1-4	non-cash	Wholesale	Monthly	>5<10 years	Company
6	< \$500,000	COD	COD	1-4	cash	Wholesale	Annually	<5 years	Company
7	\$500,000 < \$2,000,000	14 Days	COD	5-10	non-cash	Service	Quarterly	>10<20 years	Company
8	\$500,000 < \$2,000,000	30 Days	30 Days	1-4	non-cash	Service	Quarterly	>5<10 years	Company
9	\$500,000 < \$2,000,000	14 Days	COD	11-19	non-cash	Service	Quarterly	>10<20 years	Company
10	\$2,000,000 < \$5,000,000	30 Days	COD	5-10	cash	Retail	Monthly	>20 years	Trust
11	\$500,000 < \$2,000,000	30 Days	30 Days	1-4	non-cash	Service	Monthly	<5 years	Trust
12	< \$500,000	COD	14 Days	1-4	cash	Service	Quarterly	<5 years	Company Trust combination

**Figure 2: Participants categorised by Annual Turnover**

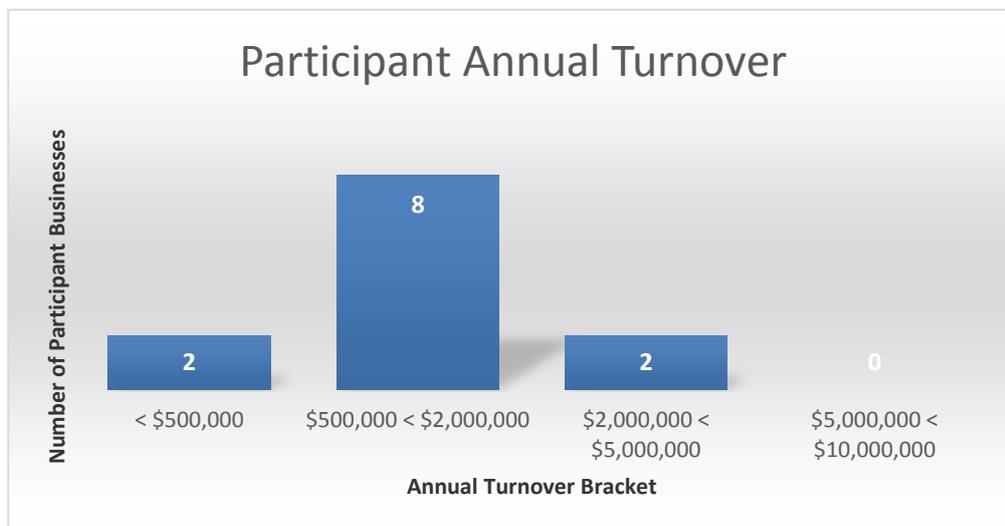


Table 3 separates participant businesses by full time employees within each small business workforce. Half of the participating businesses are responsible for employing 4 or less employees. The remaining businesses fall within the 5<20 bracket. In order to understand the structure of the small businesses within the study in greater depth the researcher has separated this group into 5 to 10 and 11 to 19 employment groups. In consideration that a high proportion of businesses in Australia employ less than 5 employees,<sup>151</sup> it was not surprising that half of the participating businesses would have this characteristic.

**Table 3: Participants grouped by number of employees<sup>152</sup>**

Number of employees	Participant responses
Non employing	0
1-4 employees	6
5-10 employees	4
11-19 employees	2

<sup>151</sup> Australian Bureau of Statistics, above n 19.

<sup>152</sup> See Australian Bureau of Statistics, above n 19. . Businesses are grouped as non-employing, 1-4 employees and 5-19 employees for micro and small business. To present a more in depth account of the participating businesses the researcher has divided the 5-19 bracket to 5-10 and 11-19 groups.

## 4.2 Results — cash flow stability

The viability of small businesses has a strong relationship with their ability to maintain a stable cash flow. This research considered the factors identified in the literature review as having the greatest impact on small business liquidity and considers the influence, if any, of the GST with these. These factors include small business management, availability of finance, competitive markets and industry. In order to explore the potential impact of the GST on cash flow stability this research project made use of semi-structured interviews, a GST activity journal and survey questions as data sources.

## 4.3 Cash flow stability and management

In the literature review it was identified that small businesses can be managed by their owners. This was advocated due to the high number of smaller firms employing four or less employees in Australia.<sup>153</sup> Basu<sup>154</sup> suggested that as a consequence of limited employee concentration within smaller firms, the ownership role becomes a multi-tasking exercise. Management functions in production, finance, marketing and operations are as a result a function that must be performed by owners irrespective of their skill within these areas. Half of the businesses within the research project were employing four or less employees. Those businesses employing six or less employees had a maximum of four employees that were not identified as being owners or directors (Table 4). All businesses earning less than \$2,000,000 in annual income had a full time work force of 6 or less employees. This would suggest that the management functions of those businesses earning less than \$2,000,000 are to a great extent performed by business owners. Those employing larger numbers of employees (17 and 8 employees) were the businesses having the highest annual income between \$2,000,000 and \$5,000,000.

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<sup>153</sup> Australian Bureau of Statistics, above n 19.

<sup>154</sup> Basu, above n 22, 108.

**Table 4: A summary of positions of employment within each participant business**

Participant	1	2	3	4	5	6	7	8	9	10	11	12
Job Category												
Directors	2	2 <sup>155</sup>	2 <sup>156</sup>	1 <sup>157</sup>	1 <sup>158</sup>	1 <sup>159</sup>	1 <sup>160</sup>	2 <sup>161</sup>	2 <sup>162</sup>	3	1 <sup>163</sup>	1 <sup>164</sup>
Administration	5	1	1	1	1		1	1	2	2	1	1
Technical		3	2	2				1				
Other	10				1		3		1	3		
TOTAL	17	6	5	4	3	1	5	4	5	8	2	2

Management practices and capabilities were examined using the survey. Investigation focused primarily on perception of owner capabilities and financial management. All participants strongly agreed that the owners of the business were important to its success and the majority (11 or 91.6%) concur that the financial management used by their businesses are effective. The majority of business participants (10 participants, the remaining 2 were neutral) confirmed that the management systems that they have implemented within their business assist with its successful day-to-day operation.

The survey results were supported by the activity journal. All participants engaged in data entry for day-to-day trading including customer and supplier invoicing and payments (Table 5). Time allocation was highest for those two participants (Participants 1 and 10) with the highest annual turnover and lowest for one of the participants (Participant 6) with the lowest annual turnover. Regardless of time allocated to data entry the results confirm that all participant businesses are actively involved in activities that involve the inflow and outflow of cash for their business.

<sup>155</sup> One Director is not included in technical counts but is involved in the technical group of the business and the other Director is not included in the administration count but is the Administration Manager.

<sup>156</sup> One Director is not included in technical counts but is involved in the technical group of the business and the other Director is not included in the administration count but is the Administration Manager.

<sup>157</sup> The Director is also the main technical personnel in this business.

<sup>158</sup> The Director is also the main sales and technical personnel of this business.

<sup>159</sup> The Director is also responsible for technical, sales and marketing in this business.

<sup>160</sup> The Director is actively involved in the day to day operations of this business.

<sup>161</sup> One Director is not included in technical counts but is involved in the technical group of the business and the other Director is not included in the administration count but is involved in both the administration and sales area of the business.

<sup>162</sup> The Directors are the event programmers for this business.

<sup>163</sup> The Director is actively involved in the day to day operations of this business.

<sup>164</sup> The Director is the only Accountant for this business.

**Table 5: Time allocated to data entry for trading accounts**

Participant	1	2	3	4	5	6	7	8	9	10	11	12
Activity												
Supplier Invoices	1785	625	570	560	805	130	300	635	45	1010	180	280
Customer Invoices	875	655	680	280	730	80	330	330	195	485	180	275
Supplier Payments	1640	535	610	190	590	40	285	240	320	600	90	90
Customer Payments	1115	370	330	120	445	50	280	170	80	290	20	130

Note: time was recorded in minutes over the GST quarter (1st July 2013 to 30th September 2013).

**Table 6: Time allocated to Financial Management**

Participant	1	2	3	4	5	6	7	8	9	10	11	12
Activity												
Chase Debtors	1535	450	0	20	40	0	150	145	60	380	90	110
Settle Creditors	670	0	110	120	265	0	155	75	0	420	60	50
Discuss fin position with bank	0	0	120	0	0	0	60	160	360	80	360	225
Arrange finances for GST payment	0	0	0	0	0	0	55	130	120	195	540	50

Note: time was recorded in minutes over the GST quarter (1st July 2013 to 30th September 2013).

However businesses were not as involved in activities that supported financial management which includes chasing debtors, settling creditors, discussing financial position with banking institutions and arranging finances for payment of GST (Table 6). This could be a result of differences in trading practices of the individual business or an indication that engagement in financial management procedures are not implemented by all participating businesses.

However, Perera and Baker<sup>165</sup> and Libermann-Yaconi, Hooper and Hutchings<sup>166</sup> submitted that a lack of formal systematic procedures and planning practices can have adverse effects on small business viability. Therefore regardless of time spent on cash flow activities the importance of having cash flow management processes should not be underestimated. The data collected in interviews appears to contradict some of the results of the survey suggesting that businesses practices are not as effective as indicated by small business owners' and confirms results of the activity journal that there is a lack of engagement in financial management practices (emphasis added):

<sup>165</sup> Perera and Baker, above n 23, 15.

<sup>166</sup> Libermann-Yaconi et al., above n 22, 71.

We use electronic banking and I review the bank account every couple of days to see what is going in and going out, I keep on top of it that way. I don't have any other particular system in place it is **mostly in my head**. So I have sort of got it all in the top of my head and trying to keep on top of it that way. You kind of have to when you're only small, **I can't really delegate** it to anybody (Participant 3).

I would have to say that when we are in a high growth period **I spend very little time** worrying about cash flow. However when cash flow is restricted I spend a lot of time keeping my MYOB file up-to-date via the use of online banking in order to work out what debtors have paid and what accounts need to be chased. This also influences the frequency of my invoicing cycle. If we have large amounts of cash available I will invoice irregularly whereas if we are cash poor, I will invoice as close as possible to when the job was completed and ensure that the invoice is received by the customer (Participant 4).

The only way I monitor my cash flow is **by looking at our bank accounts** (Participant 7).

Of all the participants only two appear to have some systematic process of managing their cash flow:

We have a really extensive budget that myself and the financial controller are constantly updating. The budget goes over two years, predictions are based on previous years and so we have an idea of the income that is expected (Participant 1).

Because time is limited the paperwork can't wait. Keeping up to date with invoices and making sure the bank balance is reconciled. I can't leave that go for too long without sorting it out. I use MYOB so all the information is there and up-to-date. I have historic information in MYOB and I also use a manual spreadsheet for forecasting into the future for cash flow (Participant 6).

It could be concluded that the conflicting results of the survey and interviews maybe a result of optimistic views of small business owners in their ability to implement cash flow management procedures. Indeed Cassar and Gibson<sup>167</sup> posited that over confidence in personal abilities is common to small business owners.

The research further investigated the activities of participants in managing their cash flow in terms of GST liability. The activity journal indicated that half of the participants spent time arranging their finances in order to remit the GST payment (Table 6). These same businesses spent considerable time discussing their financial position with their bank. Time allocated to these practices could be a result of the lack of financial management practices engaged in by the small business participants especially considering the business participants (Participant 1 and 6) that were

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<sup>167</sup> Cassar and Gibson, above n 77, 291.

considered to have some systematic process for managing their cash flow did not record any time for arrangement of finances for GST.<sup>168</sup>

Ness<sup>169</sup> along with Wu and Young<sup>170</sup> advocate that smaller firms have a higher likelihood of success when they use a CAS. The CAS is proposed to be important to cash flow management aiding small firms in having greater understanding of their financial position.<sup>171</sup> Results from the data collection confirm that all participating businesses use a CAS (Table 7).

**Table 7: Use of a computerised accounting system sorted by software program**

Software Program	No of participant users
MYOB	6
Xero	4
Quickbooks	1
Combination of Quicken and Cashflow Manager	1

In consideration of the findings and the recommendations of Ness, Watson and Everett and Wu and Young it could be suggested that all participating firms have an increased probability of success as a result of better cash flow management practices from use of a CAS.<sup>172</sup> Of further interest when making comparisons between the activity journal and the interview data, two of the participants (Participant 1 and 4) who did not record any time to plan for GST payment inferred that their use of CAS aided their knowledge of what the size of their GST liability was likely to be. Broadly this finding could suggest that reliance on reporting options available in CAS could reduce the time required to arrange finances for GST payment:

I do use the reporting options in MYOB to get a fair idea of the GST liability that will be due when the quarter is completed (Participant 4).

We pretty much know exactly what our GST is going to be over the next six months because of our budget. Our budget is prepared in our MYOB software (Participant 1).

Of interest here is that in the survey results presented in Table 8 (items c to f), both Participants 1 and 4 disagreed that GST provided them managerial benefits that assisted with cash flow and financial management within their respective businesses. Comparison of these findings suggests that correct and more thorough use of a CAS is likely to assist small businesses in managing their cash flow than that of GST reporting. This was supported by Accountant 2 who suggested that implementation of the GST has not been effective in making small business owners manage cash flow.

<sup>168</sup> Participant 6 does report on an annual basis however and would not be required to pay GST at this stage.

<sup>169</sup> Ness, above n 72, 7.

<sup>170</sup> Wu and Young, above n 88.

<sup>171</sup> Ness, above n 72, 7.

<sup>172</sup> Ness, above n 72, 7; J Watson and J Everett, 'Defining Small Business Failure' (1993) 11(3) *International Small Business Journal* 35; Wu and Young, above n 88.

**Table 8: Potential managerial benefits recognised from complying with GST**

Benefits of complying with GST		Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Not Sure
A	GST improves my business record keeping systems.	1	1	2	6	2	
B	My recording for GST assists with my income tax commitments.		1	2	6	3	
C	GST improves my cash flow monitoring.	1	7	2	1	1	
D	GST improves my business credit management.	1	7	3	1		
E	GST improves my knowledge of my business financial affairs.	1	8	1	2		
F	GST improves my decision making in my business.	1	7	2	1		1

Overall it is likely that the management functions of the small businesses within the research project earning an annual turnover of less than \$2 million are performed or heavily influenced by the business owner. The results also confirm that all small business participants are actively involved in day-to-day cash flow activities. However, despite the belief by the majority of participants that their planning and management procedures are effective for the ongoing success of their business the data collected via interviews and the activity journal suggests this may not be the case. From the results it appears that only two of the participating businesses have systematic cash flow management procedures in place. This would tend to suggest that the vast majority of small businesses are not supporting their ongoing liquidity with effective cash flow management procedures.

The relationship of cash flow management procedures and payment of GST were also analysed and the results suggest that those spending time on arranging finances for payment of GST were not participants identified as having systematic cash flow management procedures in place. The findings also appear to indicate that reporting options available in a CAS can assist with management of cash flow for payment of GST liabilities. Low engagement of use of CAS reporting may be a result of restricted knowledge on how the CAS works and what assistance it can provide to the knowledge of the businesses' financial position.

#### 4.4 Cash flow stability and finance availability

The literature review revealed that smaller firms are disadvantaged in comparison to large when trying to access financial products from banks and lending institutions. In support of this previous research the survey in the current study determined that there was a low uptake of businesses partaking in use of financial loan products that span five years or longer. From the survey results presented in Table 9Table 9 it can be

seen that 75 per cent (9) of the participating businesses disagreed or strongly disagreed that they have used long term financial products. From the survey results and the proposition by Kotey,<sup>173</sup> it could be surmised that one reason that participants have not used long term debt is due to the fact they want to have greater control over their business. However this conclusion may conflict with the findings presented further in financial availability, which suggests that the use of long term debt by small business is restricted as a result of their inability to satisfy extensive lending conditions imposed by financial institutions.

**Table 9: Use of long term debt**

Please indicate to what extent do you agree or disagree with the follow statements relating to Financial Products you have used:	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Not Sure
I have used financial loans which go for longer than 5 years.	1	8		1	2	

Difficulty relating to finance availability and extensive terms and conditions were supported by comments of Participant 4:

I think in the last five years it has been extremely difficult to obtain finance from financial institutions. But even before that time changes occurred to the borrowing criteria required from the banks. I remember as far back as 2003 having been a customer of the CBA and running very large overdrafts for quite some time. When the bank themselves got into strife from some unfavourable investment decisions of their own, they placed large restrictions on our bank accounts. For example they had been allowing us to extend past our overdraft by up to \$50,000 over a long period of time and then changed their mind on that and expected us to bring it into line immediately. This of course froze those accounts and left us in a situation of having to rely on our own personal savings or alternatively they wanted extra security. This also was a similar scenario with the Suncorp Bank some six years later. They changed their terms and conditions with a moment’s notice and expect that we can accommodate it (Participant 4).

Basu<sup>174</sup> further suggested that banks and lending institutions restrict finance to small business as a result of limitations in management ability, inadequate capital for debt security and difficulty communicating credibility as a result of issues including poor record keeping and absence of a business plan. In the previous section results indicate that the majority of participant businesses have no formal management systems in place indicating that management practices may be an issue for small business. In

<sup>173</sup> Kotey, above n 77.

<sup>174</sup> Basu, above n 91.

relation to level of capital and requirement of a business plan the results of the survey support the proposition of Basu.<sup>175</sup> A high proportion (83%) of participants confirmed that over the life of their business they had found it difficult to satisfy loan requirements of financial institutions including the need for business plans, up-to-date financial statements and inadequate levels of capital needed for loan security. Difficulty with satisfying loan conditions was validated by the small business Accountant 2:

If you haven't got security then you really have to go to second tier products and then they're paying 12 per cent interest and that is enormous and is a real issue for small business. At the moment unless you've got prime security banks just don't want to know you (Accountant 2).

As a result of strict lending conditions small business owners may be forced to obtain alternate sources of finance. Secondary sources include personal savings,<sup>176</sup> personal credit used by households,<sup>177</sup> short-term equipment finance<sup>178</sup> and trade credit.<sup>179</sup> The survey and the interviews investigated the use of secondary sources of finance.

In support of literature posited by Poutziouris and Chittenden,<sup>180</sup> 83 per cent of participants confirmed that they have used their personal savings to support the cash flow of their business. Furthermore, 66.7 per cent of participants strongly agreed that they use their personal credit cards as a source of finance for their business.<sup>181</sup> These findings were supported in the interview with Participant 6 discussing their previous difficulty with obtaining finance from lending institutions:

We did get a loan a couple of years ago for something else that I was going to buy into and it was a real palaver trying to do that and that was to buy into an established business. So I have gone down the path of using personal credit that I have so I can get the business established and then I have got a lot more to offer the bank when I go back to them for finance. At the moment they're all offering interest free, like nine months and 12 months interest free or 1.5 per cent, so it is cheaper than I can get a loan anyway (Participant 6).

As proposed by Bumgardner et al.<sup>182</sup> and Kennedy and Tennent,<sup>183</sup> shorter term financial products including leasing and hire purchase agreements have loan conditions that are easier to satisfy and require minimal or no capital security. This option is therefore important for businesses owners who have limited capital available for security especially when capital assets are needed for business growth.<sup>184</sup> Sixty

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<sup>175</sup> Basu, above n 91.

<sup>176</sup> Poutziouris and Chittenden, above n 100, 412.

<sup>177</sup> Commonwealth Department of Industry, Innovation, Science, Research and Tertiary Education, above n 92.

<sup>178</sup> Bumgardner, et al., above n 85, 56–57.

<sup>179</sup> Garcia-Teruel and Martinez-Solano, above n 85, 217.

<sup>180</sup> Poutziouris and Chittenden, above n 100, 412.

<sup>181</sup> Reinforces the results of the recent DIISRTE Australia. Commonwealth Department of Industry, Innovation, Science, Research and Tertiary Education, above n 96.

<sup>182</sup> Bumgardner, et al., above n 85, 580.

<sup>183</sup> Kennedy and Tennent, above n 98, 56–57.

<sup>184</sup> Bumgardner et al., above n 85, 580; Kennedy and Tennent, above n 98, 56–57.

seven percent of participant businesses indicated that they had made use of this type of shorter term financial product.

The final secondary source of finance discussed in the literature review was the use of trade credit. Trade credit has been identified as a popular alternative when businesses have limited access to finance from lending institutions.<sup>185</sup> The survey findings demonstrate that trade credit is regularly relied on to assist cash shortfalls with 75 per cent of participants verifying that they frequently depend on trade credit. Table 10 details the trading terms available to the participants.

**Table 10: Trade terms available to business participants from their suppliers**

Participant	Credit Terms
1	14 days
2	30 days
3	30 days
4	14 days
5	30 days
6	Imports – prepaid, Local - 60 days
7	14 days
8	30 days
9	14 days
10	30 days
11	30 days
12	14 days

Trade credit allows businesses to operate more efficiently as there is a time separation between the purchase date and payment date of supplies, essential giving businesses time to earn an income from the supplies purchased.<sup>186</sup> However, what this means for business-to-business operations are that their own debtors may be using them as an alternative source of finance. This could have adverse consequences in terms of remitting GST liability prior to receiving payment when reporting on a non-cash basis. One of the small business accountants confirmed that trade credit is a cheaper form of finance for smaller businesses and an easier alternative than lending from financial institutions:

When businesses are on an accruals basis and their debtors are much larger companies their payments can be held for up to 60 or 90 days. This places a lot of pressure on cash flow, so smaller companies delay paying their creditors as it is a cheaper form of finance than using a bank. This means they also don't have to go through the whole loan application process, which is time consuming and costly (Accountant 1).

Small business owners were asked whether the GST improves their finances, and one participant believed that the only improvement to their finance that they could recognise was that the GST liability may be used to pay trade creditors:

<sup>185</sup> Niskanen and Niskanen, above n 91, 24.

<sup>186</sup> Garcia-Teruel and Martinez-Solano, above n 103, 217.

The only thing the GST from sales may assist with is I might use it to pay trade creditors if cash flow is short (Participant 4).

The other important comments that were revealed is that tax liabilities including GST can limit the ability of businesses to obtain finance. One participant and one small business accountant suggested that overdue tax liabilities can impede the approval of finance applications:

All taxes impact the problem because in more recent times a condition that we encountered of being granted finance from institutions was that all our tax liabilities were up to date. I know that in the past when we needed finance we were forced to bring our tax liabilities up-to-date instead of our other liabilities in order to be granted that finance (Participant 4).

Banks would be looking at your profitability and if you haven't paid the ATO then it's a big cross against your name anyway. The first thing banks want to see is that your tax liabilities are up-to-date (Accountant 1).

Also results reported elsewhere demonstrate that businesses thought that there should be a cash flow benefit from holding onto GST before remittance, but in reality this was not realised for a number of reasons including unsubstantial time of holding GST, debtors expending payment terms and limited capacity to undertake short term investment.<sup>187</sup> Overall it appears that the small business participants have had limited use of longer term finance. The cause of low engagement in these forms of finance products appears to support those proposed by Basu<sup>188</sup> that small businesses are unable to satisfy lending conditions imposed by financial institutions. Areas of concern for participants in the current study were lack of capital, terms and conditions that are extensive and likely to change and high interest rates.

The findings suggest that as an alternative to long term finance the business participants place high importance on the use of at least one form of secondary finance options. The uptake of the use of personal savings and trade credit to support finance requirements was high across all participants. Whereas the use of personal credit cards and short term credit in the form of leasing or hire purchase is not as extensively used as the former finance possibilities.

A small number of participants suggested that having overdue GST liabilities (and other types of tax liabilities) can further hinder the availability of longer term finance. This raises the importance of businesses managing their GST liability to the ATO, as it may have adverse consequences when seeking external finance.

#### 4.5 Cash flow stability and competitive markets

The literature review revealed that competition within the marketplace can have detrimental effects on small business viability. Basu<sup>189</sup> identified that smaller firms are often forced to follow prices set by larger competitors in an effort to maintain their customer base and in-turn their sales ratio. This could be of concern given that it is

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<sup>187</sup> See Belle Isle, Freudenberg and Copp, above n 18.

<sup>188</sup> Basu, above n 22; Basu, above n 91.

<sup>189</sup> Basu, above n 22, 98.

the supplier that has the GST liability for taxable supplies.<sup>190</sup> The results of the survey indicate that 66.7 per cent of participants support Basu's<sup>191</sup> findings and confirm that the price of the products or services sold by their business are dictated by larger competitors within the market. Half of the participants reported that they have decreased their profit margins in order to remain competitive. Such action has adverse effects on liquidity and cash flow as a greater number of products or services need to be sold in order to earn the same level of profit. Thus, this means that the GST is further eroding this profit margin. The participants expressed varying problems that they recognised relating to competition in the market place:

I guess my pricing is dictated by the larger players in the market at the moment (Participant 6).

Our market is a mature market so yes there's a lot of competition (Participant 5).

I have had to reduce my profit margin to remain competitive (Participant 7).

... new business traders drove the price of installation down and caused a reduction in the profit margin that was being obtained (Participant 4).

Generally our industry is in a deflationary market. Pricing has dropped probably about 200 per cent, 300 per cent in the last five years. So in a deflationary market it's impossible to make any sort of profit. We've been finding it very hard to actually make sales in the last three months. ... lack of sales has been putting really intense pressure on our business. ... In the boom periods you sign a lease for bigger premises, you hire more staff, you buy more computers. Yeah, definitely the initial investment when you're growing is fine as a business owner to take that risk. Everything in business is a risk. But you're fine to take that risk in a growing market. But the moment it stops, and in our industry it stopped overnight, the moment that it stops suddenly, not only are you left with all the capital infrastructure but also then you've got to start laying off staff and you've got to try and cut back your overheads on contracts you've already signed, you know like phone and internet and stuff like that. So you get penalised when you try to go backwards as well (Participant 10).

Half of the participants discussed issues relating to competitive markets affecting their ongoing success. Problems appear to be apparent for a number of reasons including prices being set by larger competitors, services offered being of low importance to customers, the market being fully developed, lack of industry regulation and licensing and lower quality products being introduced into the marketplace. In any event what this means is if small businesses have limited ability to set prices, then their GST liability has the potential to further decrease margins.

The interview and survey explored further whether participants had attempted to eradicate vulnerability in the market place by distinguishing themselves from their competitors. Chittenden and Bragg<sup>192</sup> identified the importance of extending trade

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<sup>190</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 9-5.

<sup>191</sup> Basu, above n 22, 98.

<sup>192</sup> Chittenden and Bragg, above n 106.

credit to customers as an attempt to strengthen commercial relationships. Information sourced from the participant demographics and presented in Table 11 illustrates that two thirds of participants offer their customers some form of trade credit, however these terms of credit appear to be normal for trade terms and not overly generous.

**Table 11: Trade terms offered by participants to their customers**

Participant	Debtor Terms
1	30 days
2	30 days
3	30 days
4	14 days
5	30 days
6	COD
7	COD & 30 days
8	30 days
9	COD
10	COD
11	COD
12	14 days

Providing trade credit to customers can however have disadvantages. Customers have been known to take advantage of suppliers by extending their payment remittance further than the terms offered. This allows the customer to dominate the trade relationship again, as smaller firms are reluctant to take action to recover the debt for fear that dissensions between the two parties will result in customers seeking an alternate supplier. Situations of this type have been experienced by participant organisations and were communicated in the interviews:

Some customers have their payment terms and they tell us that they can't change them. So of course, we don't want to lose them as clients so we deal with it (Participant 8).

Our terms are that you pay up front before the event but in reality if they don't we've never not turned up because someone hasn't paid. We are so busy getting the event organised that we don't really push them for payment ... We did a last minute event for a big grocery company and they didn't pay us for three months. When we hit them with admin fees that they signed off on, in our terms 10 per cent interest is detailed on our booking confirmation form for late payment. They just knocked the interest off the top and pay the original amount, how am I going to chase it? (Participant 9).

Customers are a real issue because if people aren't paying within trading terms, do small businesses place pressure on these customers and risk losing those customers? They can't afford to, so they are accommodating the customer (Accountant 2).

Results discussed elsewhere suggest that receiving payment later than agreed terms can have adverse effects for compliance with GST, especially for those businesses remitting on a non-cash basis.<sup>193</sup>

Bumgardner et al.<sup>194</sup> suggested that another way to eradicate price and power vulnerability is to have a close professional relationship with customers allowing smaller firms to determine customer needs as they arise. All participants within the research project supported the findings of Bumgardner et al.<sup>195</sup> with five participants agreeing and seven strongly agreeing that they try to have a close relationship with their customer base. Withers, Dinevich and Marino<sup>196</sup> identified that this practice distinguishes smaller firms from their larger competitors as it allows small business to be more flexible to customer requests. It was found that 75 per cent of participants confirmed that they have created products or services that specifically suit their customer needs, which may provide some power to the small business in the trading relationship.<sup>197</sup>

The final proposition discussed in the literature that assists smaller firms in reducing market competition was the creation of unique products.<sup>198</sup> Developing distinct products or services that require a refined skill set allows smaller firms to establish their own market.<sup>199</sup> Interview data confirms that a large majority of the business participants have identified the requirement to invest time and resources in innovative practices in order to remain viable:

We have the licence on the only program that we sell and we have that trademarked, so no one should be selling our efficiency program (Participant 1).

We probably have a niche market and we do a lot of customised stuff. There is some imported equipment that is similar to ours but the quality is much cheaper and it breaks down and no one is able to repair it and then the customers come back to us (Participant 2).

We are a very niche market and we do specialised jobs and more often than not people can't get what we manufacture elsewhere. We have always headed in the niche market direction. (Participant 3).

In order to survive in business we were forced to reinvent ourselves. We moved back into electrical contracting and engineering and developed services to help commercial and industrial customers to reduce their carbon footprint by having more efficient and effective equipment on their sites. This has created a niche market for us and we now don't have a problem making a good profit (Participant 4).

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<sup>193</sup> See Belle Isle, Freudenberg and Copp, above n 18.

<sup>194</sup> Bumgardner, et al., above n 85, 596.

<sup>195</sup> Ibid 595.

<sup>196</sup> Withers et al., above n 119, 520.

<sup>197</sup> Bumgardner et al., above n 85, 596.

<sup>198</sup> Diez-Vial, above n 108, 139; Ness, above n 72, 5; Withers et al., above n 119, 517.

<sup>199</sup> Bumgardner above n 85, 591–582; Withers et al., above n 119, 520.

Our honey is raw which means it's unprocessed, so from a retail point of view we've been able to segregate ourselves or separate ourselves from the mainstream products. Our product is of premium quality (Participant 5).

At the moment bigger businesses have cheaper quality products, so I am trying to distinguish myself as a high quality product from the main players in the market (Participant 6).

We can offer specialised services that others can't. We actually do work for other plumbers as well because of the specialised services that we can offer. (Participant 8).

Evidence collected in the interviews suggests that businesses which trade predominantly with other businesses are more likely to create niche products in comparison to those that trade with consumers. Interestingly all of the participants involved in niche markets also provide their customers with some form of trade credit and confirm that they are actively involved in keeping close relationships with their customer base. All of the factors identified by Bumgardner et al., Chittenden and Bragg, Diez-Vial, Ness and Withers, Dinevich and Marino in assisting businesses to gain power within the marketplace are seen as important by these businesses (Participant 1, 2, 3, 4, 5 and 8).<sup>200</sup>

Market position and competition has been identified by Allan<sup>201</sup> and Sandford<sup>202</sup> as being of influence on who bears the burden of taxation in the marketplace. Incidence of taxation is the term used to define who bears the final burden. For the GST the incidence is assumed to be borne by the final consumer. However as proposed by Sandford<sup>203</sup> this may not always be the case as incidence relies heavily on the elasticity of supply and demand and the power of the business in the market place. In order to explore this proposition the current research investigated whether participants were able to pass the full amount of GST liability onto their customers for goods or services traded. Participants including both of the small business accountants provided extensive discussion on the topic. A brief outline is presented in Table 12 followed by discussion from the interviews.

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<sup>200</sup> Bumgardner et al., above n 85, 591–582; Withers et al., above n 119, 582; Chittenden and Bragg, above n 106; Diez-Vial, above n 108, 139; Ness, above n 72, 5; Withers et al., above n 119, 520.

<sup>201</sup> Allan, above n 11.

<sup>202</sup> Sandford, above n 116.

<sup>203</sup> Ibid.

**Table 12: Participant perception on incidence of GST**

Participant	Passes GST to Customer	Absorbs the GST
1	✓	
2	✓	
3	✓	
4	✓	
5	GST Free	GST Free
6	✓ For trade customers	✓ For retail customers
7		✓
8	✓	
9	✓	
10	✓	
11		✓
12	✓	

Most participants indicated that they passed on the GST:

We definitely pass the GST onto our customers (Participant 1).

I think I always pass the GST on to my customers. We work on GST exclusive price (Participant 8).

I think for accountants and other professions we charge for our service and add the GST on top. We always pass the GST on to the client (Participant 12).

... new business traders drove the price of installation down and caused a reduction in the profit margin that was being obtained. As this also became a highly concentrated consumer market prices were inclusive of GST which I believe caused us to absorb the GST in our price reduction at times (Participant 4).

My products are sold in two streams, retail and wholesale. For retail prices they are dictated by the market and are sold on a GST inclusive basis. So a reduction in the price as a result of market pressure means that some of the GST is absorbed in the price. For the wholesale and trade customers however changes in price of the product does not affect the GST as it is all GST exclusive (Participant 6).

I think in the hospitality industry the GST is absorbed in the price because the market is competitive. The fact that all the prices are GST inclusive is what creates the problem (Participant 11).

I think depending on the business, people are selling services and wearing the GST to remain competitive. Businesses like retailers or lawn mowing businesses for instance who are selling to the final consumer. The business owner employing three people and earning \$200,000 has to charge GST for

his services but the sole trader working for himself turning over less than the GST threshold does not. So the second person can charge a cheaper price. The consumer doesn't care if someone is registered for GST, their only concern is that they get the best price (Accountant 1).

Market competition is the problem more than anything. Now it's not across the board for example in the trade area it's not a big issue because they specifically charge by an hourly rate, materials and then they add the GST on top of the invoice and that gets paid. This issue is more in the hospitality industry whereby hotels, motels and resorts have not been able to pass. It is working on a GST inclusive basis that creates the problem (Accountant 2).

Accordingly, while the price may have been driven down due to competitive markets, for those supplying to other businesses there is the view that the GST liability is able to be passed on.

The evidence collated in the interviews supports the proposition of Sandford<sup>204</sup> that incidence of GST is not always borne by the final consumer. The findings suggest that those participants that trade on a GST inclusive basis perceive themselves to be disadvantaged by GST incidence in comparison to those that trade on an exclusive basis. Participants 4 and 6 confirm that they have recognised the difference in their own business when they have traded both on an inclusive and exclusive of GST basis. Predominantly those participant businesses trading inclusive of GST are conducting a retail business to final consumers. This suggests that consumers are very price driven and the influence of GST on the final price of goods or services they purchase is not taken into consideration when making a purchase decision. This is probably due to the fact that private customers are not able to claim an input tax credit on goods and services purchased in comparison to business customers.

In summary the results of the study imply that approximately half of the participants identify that the market in which they operate is competitive and as a consequence they have reduced their profit margins in order to retain market share. The combination of the survey and interview data suggests that market vulnerability is a multi-factor issue and can be a result of prices being dictated by larger competitors, services offered being of low importance to customers when their own cash flow is tight, the market being fully developed, lack of industry regulation and licensing and lower quality products being introduced to the marketplace.

It appears from the data that in order to eradicate market vulnerability participants are engaged in one or more of business practices identified in the literature as being capable of distinguishing them from their competitors. Two-thirds of participants offer trade credit to their customers. However some suggest this has often led to customers taking advantage of the terms provided and they have felt they are powerless to pressure customers to conform for fear of losing market share. All participants propose that they focus on having a close relationship with their customer base including identifying customer needs as they arise and being flexible to customer requests.

From the results it also appears that a large proportion of the business participants have identified the requirement to invest time and resources in innovative practices in

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<sup>204</sup> Ibid.

order to remain viable. Products and services that require a refined skill set and particular expertise are created by a significant number of participants. Predominantly it appears that those businesses that trade with other businesses are more likely to engage in these practices than those in the retail trade.

Finally the relationship between competitive markets and incidence of GST was explored and the findings suggest that businesses that trade on a GST exclusive basis with other businesses are able to pass on the full amount of GST to their customers. Those using a GST inclusive basis however report that the GST has diminished their profit margin as they have absorbed it in their pricing in order to remain competitive. The markets that these businesses operate within are predominantly retail. This suggests that consumers are very price driven and have no regard for the GST component in the final price of goods or services, since they are not able to claim back the GST.

Combining the findings, the results highlight that the relationship of factors of cash flow stability has the most considerable effects on those businesses trading directly with retail consumers. The lack of engagement in the use of systematic cash flow management processes appears to be resulting in considerable time spent on rearranging finances for payment of GST liability and consultation with banks regarding their financial position for these participants. A consequence of minimal financial management appears to be limiting availability to long term financial products. All participants regardless of their trading partners rely on the use of secondary sources of finance. Competition within the market place is of most concern for businesses trading with consumers. They have reduced their profit margins to retain market share to the point at times that they have absorbed the GST within the price. Trading on a GST inclusive basis is perceived to be the source of the problem. In comparison the cash flow of those that have created niche markets and trade with other businesses seem much less affected by their lack of management capabilities.

It appears that realisation of cash flow benefit for small businesses trading with consumers is not realisable as a result of the combination of lack of financial management and competition in the market place. These two factors also appear to limit the use of longer term financial products. Small business participants trading with retail consumers were registered both on a cash and non-cash basis for GST. Therefore regardless of registration there appears to be difficulty in passing on the GST when trading in the retail market. This can be compared to the findings of Wallschutzky and Gibson<sup>205</sup> about WST, which found those reporting on a cash basis did not have a problem. This is probably due to the fact that the WST did not apply to retail transactions. Consequently, the GST may have an adverse impact for those businesses in the retail industry, especially if they are not distinguishable from their competitors, as they may have to absorb the GST rather than passing it on. Such a result can be adverse to a firm's cash flow stability.

When aggregating the findings of the questions for participants that trade with private consumers (retail), examination confirms that perceived benefits are unlikely to be realised. They appear to have greater adversity as a result of factors of cash flow stability than those trading with businesses. In spite of the fact that they hold the GST from point of sale until the time it is remitted to the ATO, they still did not recognise

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<sup>205</sup> Wallschutzky and Gibson, above n 7.

any benefit. This can be explained by the highly competitive markets in which they operate and the low profit margins that are achievable as a result. These businesses have indicated that their price has been reduced as they absorb the GST, effectively reducing their profit further. It is noted that there was an absence of systematic cash flow management practices in place for these business. However this appears to be the case for most of the participating business regardless of who their trading partners are.

Examining the results in relation to businesses that trade with other businesses perception of participants also seems to be confirmed. Unlike those that trade with consumers they don't appear to suffer from factors that affect cash flow stability in spite of the fact that the majority do not employ systematic cash flow practices. Their investment in the creation of specialised markets in order to distinguish themselves from competitors appears to deliver them a fairly stable cash flow. However when exploring trading practices and timing of receipt of sales, realisation of cash flow benefit from GST appears impossible. Late paying debtors cause cash flow to be restricted as participants identify the need to pay for inputs when they are due in order to maintain business activity. This is the case regardless of how GST is attributed. When attribution laws are brought into consideration then those registered non-cash may be further burdened by late payment of customers. Creditor obligations increase as the requirement to pay GST liability for sales not yet paid is added into the equation. Small businesses trading with other businesses report that they often suffer a dis-benefit<sup>206</sup> from payment of GST as a result of attribution rules.

## 5. RECOMMENDATIONS

The findings of the research have emphasized that the small business participants have difficulty implementing a systematic cash flow management practice and make limited use of CAS reporting options, which as a result is having an adverse effect on their cash flow stability. It may be beneficial for small businesses to engage external advisors to assist with increasing their knowledge of the reporting options of a CAS and with implementation of a cash management system. However, considering the research has highlighted that cash flow is restricted it is unlikely that they could justify the expense of seeking external advice. Recommendations of a recent study by Freudenberg et al.<sup>207</sup> propose that a tax rebate for professional advice should be available to small businesses capped at \$10,000. Such a rebate could be used to address the implementation of systematic cash flow management practices. Freudenberg et al.<sup>208</sup> suggest that this rebate should be available in the second year of business operation. However in the current research it was found that regardless of number of years in operation the majority of participants were lacking in cash flow management practices. This suggests that the rebate should not be restricted to the second year of operation and could benefit small businesses if it is extended.

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<sup>206</sup> M D'Ascenzo, 'Regulation Impact Statements and Compliance Costs – An Australian Perspective' in C Evans, J Pope and J Hasseldine, *Tax Compliance Costs: A Festschrift for Cedric Sandford*, (Prospect Media, 2001) 353–367, 356.

<sup>207</sup> B Freudenberg, B Tran-Nam, S Karlinsky and R Gupta, 'A Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand' (2012) 27(4) *Australian Tax Forum* 677, 708.

<sup>208</sup> *Ibid.*

The ATO website allows businesses to access a ‘Business Viability Tool’<sup>209</sup> to assess the current status of their financial performance. When viability is in question the tool advises business owners to seek professional advice. The advice from the tool could be the qualifying condition for accessing the tax rebate. Therefore, it is recommended that availability of the rebate is not dependent on entry date of the business into the economy. An identified problem with allowing such a rebate to assist with implementation of a cash flow management system is regulating the relevance of the advice given by the professional. It may be beneficial to develop a tool that acts as a guide for professionals to follow when implementing the system.

## 5.1 Limitations of research and future research

A limitation of this study is the small number of participants; however, the purpose of the study was to present an accurate representation of the experiences that owner/managers have encountered in terms of cash flow stability and the factors that may influence realisation of cash flow benefit from the GST. The use of the exploratory case study design was employed in an attempt to uncover findings that are crucial to the research project. The design choice was selected to complement the need to extend the limited existing theory on how the GST affects cash flow of smaller businesses by uncovering findings not previously established. It is expected that these new findings will form a foundation for future research to build upon. Also since the study occurred after the global financial crisis this may influence the results when compared to a more positive economic climate.

A finding from the research was that some participants believed that they absorbed the GST as a result of trading on an inclusive GST basis, especially for those in the retail sector. It could be advantageous to understand the difference of trading on an inclusive and exclusive of GST basis and the effects that has on incidence of GST in more depth. Future research could include exploration of the varied trade terms of the retail sector in more depth and the effect that has on ongoing cash flow stability.

Prior research suggests that small businesses using a CAS have an increased likelihood of success. This is due to availability of up-to-date financial information. However the findings of this research appear to indicate that the CAS is not being used effectively to assist with management of cash flow, as there was low engagement in the use of CAS reporting options. As a result participants were spending considerable time arranging finances for payment of liabilities. The researcher suggests that this may be a result of knowledge restrictions on the use and benefits that a CAS can create for small businesses. Future research could investigate the level of knowledge that small businesses have of the CAS that they employ and the extent that it is used to understand the financial situation of their business. It is one thing to have a CAS, but it is another to utilise all of the resources available within a CAS.

The findings discussed the possibility that there is a relationship between inability to perceive a cash flow benefit from GST and low profit margins for businesses trading in cash and receiving payment at point of sale. Further investigation into this relationship would be beneficial.

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<sup>209</sup> Australian Taxation Office, Business Viability Assessment Tool, <[www.ato.gov.au/Calculators-and-tools/Business-viability-assessment-tool/](http://www.ato.gov.au/Calculators-and-tools/Business-viability-assessment-tool/)>.

Finally the study uncovered the possibility that approval of long term finance may be restricted as a result of overdue tax liabilities. If this is the case then the effect it has on small business loan applications could be investigated further.

## 6. CONCLUSION

Business liquidity has been identified as the ability to meet short term commitments as measured by working capital. In order to sustain liquidity, small businesses need to maintain a stable cash flow, and business operations are the most significant source of cash inflow and outflow. Cash flow stability can be impacted by management practices, finance availability and competitive markets.

Results of the data analysis confirm that the small business participants have made limited use of long term financial products from financial institutions. Recognised reasons for limitations included lack of capital, extensive terms and overdue tax liabilities. As a consequence a large majority of participants confirmed that they rely heavily on use of personal savings and trade credit to support the cash flow of their business.

Limitations in finance availability does not appear to be supported by effective implementation of cash flow management practices. The results suggest that all participating businesses are involved in activities that relate to cash inflow and outflow for their business. However it appears that only two of those businesses engage in any form of systematic cash flow management process. The findings suggest that in spite of the fact that all participants have availability of a CAS only two participants rely on the reporting options within the software to give them a better idea of their financial position. The absence of sufficient cash flow management appears to be causing the participants to invest considerable time arranging finances in order to settle their GST liabilities. Those businesses trading with consumers appear to be more involved in these activities than those that trade with businesses. This may be a consequence of the effect that competitive markets have on their cash flow.

Small businesses participants conveyed that market competition at times had forced them to reduce their profit margins in order to retain market share. Explanation of why participants felt that they did not have power in the market was diverse, suggesting there is no universal reason for competitive vulnerability for smaller firms. All participating businesses were engaged in at least one of the activities discussed in order to distinguish themselves from their competitors. Those businesses that have created niche products appear to be maximising all possible avenues to differentiate themselves from other businesses. In support of their niche market they are also offering trade credit and keeping close relationships with their customer base. Findings emerging from the data were that creation of specialised products or services are easier fulfilled for businesses engaged in trade with other businesses. The business to consumer market does not appear to support the use of specialised products or services. This can result in businesses that trade with consumers suffering greater constraints in cash flow as their inability to distinguish themselves from their competitors may force them to become price takers, in comparison to being price makers.

A consequence of highly competitive markets for businesses trading with consumers appears to be a change in who bears the incidence of GST. Participants suggest that they have reduced their profit margin to the point that the GST component is absorbed in their final price in order to retain market share. Their perception of the reason for incidence shifting from the consumer back to their business is that prices are displayed inclusive of GST.<sup>210</sup> When small businesses are in competition with enterprises that are not required to be registered for GST, the GST component would make their final price for the goods or services appear higher than their competitors. The purchasing decisions of consumers that are price driven will be made on the final price of the good or service without regard for the businesses requirement to remit GST. The resultant effect is that the cash flow of businesses that trade with consumers and who are registered for GST is further impeded by their requirement to comply with GST legislation. It is important that greater appreciation of the potential influence of GST on cash flow stability for small businesses is understood, as cash flow is a critical element to the success of this important section of the Australian economy.

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<sup>210</sup> This is in line with the GST legislation requiring the price to be displayed inclusive of the GST amount.

# Interest withholding tax reduction: Does absence make the heart grow fonder?

Andrew Smailes<sup>1</sup>

## ***Abstract***

The current trend in relation to interest withholding tax (IWT) is a decline in the application of such taxes. The Tony Abbott-led Coalition government has determined that it will not proceed with the further phase down of IWT, proposed in the Henry Tax Review. Thus this paper takes the opportunity to consider whether or not IWT phase down would be a worthwhile revenue reform. This paper concludes that, removal of IWTs potentially could be a positive step for corporate finance however the argument is more complex than simply one about increased investment. Furthermore, the opposite course could equally be justified.

**Keywords:** *Interest withholding tax*

The objects of a financier are, then, to secure an ample revenue; to impose it with judgment and equality; to employ it economically; and, when necessity obliges him to make use of credit, to secure its foundations in that instance, and for ever, by the clearness and candour of his proceedings, the exactness of his calculations, and the solidity of his funds

- Edmund Burke, *Reflections on the Revolution in France* (1790).

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<sup>1</sup> LLB, BBusman (UQ), Grad Dip Legal Practice (ANU), ATI, MTax (UNSW),  
andrews86@optusnet.com.au.

## 1. INTRODUCTION

*Australia's Future Tax System Review* (the Henry Review) recommendations 33 and 34 are that “financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents” and that “consideration should be given to negotiating, in future tax treaties or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance”<sup>2</sup>. As a result, this paper in part considers why in light of widespread austerity measures and concern over fiscal balance,<sup>3</sup> not just Australia, but a number of other countries are voluntarily forgoing the revenue from interest withholding tax (IWT)<sup>4</sup>. While the Australian Government committed to phase down IWT from 2014–15 in its *Tax Reform Road Map* of 2012, no action has taken place in this direction thus far and it now appears unlikely that such action will occur in the near future.<sup>5</sup> This delay presents an opportunity to pause and consider whether the current general trend of reduction and removal of IWTs is advisable in terms of efficiency, administration, commercial outcomes and overall revenue yield. For instance, one consideration that will be raised is that the removal of IWTs is unlike the removal of excises and taxes on trade (which is similar due to the international treaty and diplomacy aspects) because there is no reciprocal implementation of general consumption taxes to, in theory at least, replace forgone revenue.<sup>6</sup> Instead, the major benefits of an IWT reduction are a more nebulous ‘multiplier’ or ‘trickle down’ effect of increased economic activity. Admittedly the revenue from IWTs is not on par with that from income taxes and broad consumption taxes, however most governments are raising taxes to pay for spiralling debt—so is a reduction or removal of IWTs opportune or ill-advised? These questions are complicated by the growing debate in regards to base erosion and profit shifting (or BEPS) and the introduction of final withholding taxes in Europe on investment earnings. While this paper does not provide sufficient scope to cover the wide and growing topic of BEPS and these new withholding taxes in intricate detail, IWTs will at least be placed in this broader context.

## 2. THE LEGAL FRAMEWORK OF IWT IN AUSTRALIA

IWTs are part of a dual framework of both domestic law and international treaty articles. Ultimately, however, domestic law is the starting point with treaty articles merely moderating the operation of IWTs. In Australia, the domestic law in relation

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<sup>2</sup> Australia's Future Tax System Review, (2009), *Final Report*, Part Two, Volume One, p182.

<sup>3</sup> Organisation for Economic Co-operation and Development (OECD), ‘International Capital Mobility: Which Structural Policies Reduce Financial Fragility?’ (2012) *OECD Economic Policy Papers* no 2.

<sup>4</sup> Commonwealth Treasury, *International Comparison of Australia's Taxes* (2006); Hugh Ault and David Bradford, ‘Taxing International Income: An Analysis of the U.S. System and Its Economic Premises’ in Assaf Razin and Joel Slemrod (eds) *Taxation in the Global Economy* (1990); Zee, above n 4.

<sup>5</sup> Commonwealth Treasury, *Tax Reform : Road Map* (2012). However, it should be further noted that one of the commitments of the Tony Abbott-led government is to not proceed with this phase down—J Hockey and A Robb, ‘Coalition's Responsible Budget Savings’ (Media Release 28 August 2013).

<sup>6</sup> John Norregaard and Tehmina Khan, *Tax Policy : Recent Trends and Coming Challenges* (2007); Richard Bird and Eric Zolt, ‘The Limited Role of the Personal Income Tax in Developing Countries’ (2005) 16 *Journal of Asian Economics* 92; Richard Bird and Peirre Gendren, *The VAT in Developing and Transitional Countries* (2007); Cedric Sandford, *Why Tax Systems Differ : A Comparative Study of the Political Economy of Taxation* (2000).

to IWTs is Division 11A of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36) which requires that IWT be imposed on any interest derived by a non-resident when that interest payment is made by an Australian resident.<sup>7</sup> The rule is extended to include payments from non-residents where such payments are expenses of a permanent establishment in Australia. Conversely, there is an exemption from IWT in relation to interest payments by residents as part of their permanent establishments offshore.<sup>8</sup> An important point to note is that the use of the term ‘derived’ in this framework means that it covers not just interest paid but interest that is merely payable, such as interest that is reinvested.<sup>9</sup> Finally, the rate of IWT is 10 per cent<sup>10</sup> of the gross interest amount<sup>11</sup> which is important because, unlike income taxes which are based on net amounts, there is no concept of deductions.<sup>12</sup> This 10 per cent rate is merely the starting point and that in many cases, the rate is reduced by the operation of a tax treaty.<sup>13</sup> The OECD Model Convention, on which most worldwide treaties are based, allows for the concept of IWTs however the underlying rationale is that the rate used should be as low as possible, if not nil.<sup>14</sup> As a result, most treaties entered into by Australia since the 1980s include a sharp reduction of IWT, often to nil, in return for increased information exchange.<sup>15</sup> The overriding goal is for portfolio interest invested worldwide to be subject to taxation only in the source country rather than the destination country.<sup>16</sup>

For the purposes of the IWT provisions, the definition of ‘interest’ is an important issue and one that is not as simple as it appears. Interest is defined as any amount in the nature of interest or any amount that could be reasonably regarded as being in substitution for interest, such as amounts under a washing arrangement,<sup>17</sup> though returns on equity are specifically excluded.<sup>18</sup> Thus, as per the definition of interest

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<sup>7</sup> *Income Tax Assessment Act 1936* (Cth), section 128B.

<sup>8</sup> *Income Tax Assessment Act 1936* (Cth), section 128B.

<sup>9</sup> Australian Tax Office (ATO), *Income Tax: Should a Resident Deduct Withholding Tax From Interest Payable Under a Loan From a Non-resident If There is No Actual Payment of the Interest?*, TD 93/146 at [2]—“the requirement to withhold the tax from the interest does not require an actual payment of the interest. It is enough if the interest liability arises”.

<sup>10</sup> *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth), section 7.

<sup>11</sup> *Income Tax Assessment Act 1936* (Cth), section 128B.

<sup>12</sup> Johannes Jüttner and Norman Carlsen, ‘Taxing International Capital Income: Interest Withholding Tax’ (1998) 1(3) *Journal of Australian Taxation* 219; Zee, above n 4.

<sup>13</sup> As in force under the *International Tax Agreements Act 1953* (Cth).

<sup>14</sup> OECD, *Model Tax Convention on Income and on Capital—Full Version* (2010), Article 11.

<sup>15</sup> Commonwealth Treasury, *Australian Tax Treaties Table* (2013); Jüttner and Carlsen, above n 12; Zee, above n 12. As with most other developed countries, see –Joanna Khoo, ‘Reducing Withholding Tax Rates in Double Tax Treaties: Trends and Implications’ (2009) 24 *Australian Tax Forum* 597.

<sup>16</sup> Khoo, above n 15; Ewen McCann and Tim Edgar, ‘The International Income Taxation of Portfolio Debt in the Presence of Bi-Directional Capital Flows’ (2006) 4(1) *eJournal of Tax Research* 5; Jüttner and Carlsen, above n 12; Michael Dirki and Brett Bondfield, ‘Cataloguing International Tax Reform 12 Years On’ (2012) 27 *Australian Tax Forum* 25; Sylvester Eijffinger, Harry Huizinga and Jan Lemmen, ‘Short Term and Long Term Government Debt and Non-Resident Interest Withholding Taxes’ (1998) 68 *Journal of Public Economics* 309; Harry Huizinga, ‘The Incidence of Interest Withholding Taxes: Evidence from the LDC Loan Market’ (1996) 59 *Journal of Public Economics* 435; Alan Auerbach, ‘Taxation, Corporate Financial Policy and Cost of Capital’ (1983) 21 *Journal of Economic Literature* 905.

<sup>17</sup> *Income Tax Assessment Act 1936* (Cth), section 128A (A washing arrangement involves the transfer and reacquisition of a corporate debt instrument so that the coupon payments are made to a tax advantaged entity while the original entity retains the capital interest).

<sup>18</sup> *Income Tax Assessment Act 1936* (Cth), section 128A.

income for the general purposes of the ITAA 1936,<sup>19</sup> the bright line as to whether an amount is interest is whether an amount is paid as a return on debt rather than equity.<sup>20</sup> In practice however, there are a range of exclusions from IWT<sup>21</sup> which mean amounts which are clearly interest are not subject to IWT. For instance, IWT is not imposed on certain debentures offered to the public, government bonds and payments to offshore banking units.

IWT is a final 'income' tax for non-residents<sup>22</sup> as amounts that are subject to IWT become non-assessable non-exempt income.<sup>23</sup> While the legal incidence falls on the non-resident, the resident payer is responsible for withholding and remitting the tax which is then credited against the non-resident's liability.<sup>24</sup> Should the payer not withhold the correct sum *and* remit said sum to the ATO, the payer effectively steps into the shoes of the non-resident and is potentially required to pay the IWT, penalty and interest.<sup>25</sup> A further incentive for the payer to withhold and remit the correct sum is that the interest payment is precluded from being a deduction till IWT is paid<sup>26</sup> and a civil penalty can also be imposed.<sup>27</sup> The effect of these incentives is that non-residents almost never pay IWT as payers withhold an amount at least equal to the likely IWT liability. This author goes so far as to say that payers of interest may even have an incentive to overestimate IWT payable, especially if there is any uncertainty about quantum of the IWT liability. As a result, a commercial practice is common whereby, to avoid such overestimation and maintain the underlying rate of return in a transaction, the borrower (resident payer) indemnifies the non-resident lender for any IWT payable<sup>28</sup>. Interestingly, gross up amounts under such a practice are not classed as interest but may still be ordinary income.<sup>29</sup> Thus, in many cases IWT is first and foremost a concern for resident payers of interest rather than interest recipients. That is not to say however that IWT has no impact on the behaviour of non-resident lenders—there is an impact and this paper will address the issue shortly.

First, this paper will consider specific IWT implications<sup>30</sup> for resident financial institutions including authorised deposit-taking institutions (ADIs).<sup>31</sup> Chiefly this is

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<sup>19</sup> *Income Tax Assessment Act 1936* (Cth), section 6.

<sup>20</sup> However, as readers familiar with the debt and equity rules in Australia in Division 974 of ITAA36 will note, the dividing line between debt and equity is never entirely easy to discern in practice.

<sup>21</sup> *Income Tax Assessment Act 1936* (Cth), sections 128F, FA, GB.

<sup>22</sup> *Income Tax Assessment Act 1936* (Cth), section 128D.

<sup>23</sup> *Income Tax Assessment Act 1997* (Cth), sections 6-23.

<sup>24</sup> *Taxation Administration Act 1953* (Cth), Schedule 1 section 18-15.

<sup>25</sup> *Taxation Administration Act 1953* (Cth), Schedule 1 subdiv 16-B.

<sup>26</sup> *Income Tax Assessment Act 1997* (Cth), sections 26-25; ATO, *Income Tax: Deductibility of Royalties Where Withholding Tax Has Not Been Remitted to the Tax Office* TD 93/99. Though this applies to royalties, the underlying principles are the same.

<sup>27</sup> *Taxation Administration Act 1953* (Cth), Schedule 1 section 16-25.

<sup>28</sup> *FCT v. Century Yuasa Batteries* (1998) 38 ATR 442; TR 2002/4 'Income tax: taxation implications of the Century Yuasa Batteries decision'; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353; Richard Vann, 'International Aspects of Income Tax' in Victor Thuronyi (ed) *Tax Law Design and Drafting* (1998), 718 - 806.

<sup>29</sup> *FCT v Century Yuasa Batteries* (1998) 38 ATR 442; ATO, *Income Tax: Taxation Implications of the Century Yuasa Batteries Decision*, TR 2002/4.

<sup>30</sup> *Income Tax Assessment Act 1936* (Cth), sections 160ZZVA to 160ZZZJ and ATO, *Income Tax: Interest Withholding Tax—Cross-border Interbranch Funds Transfers Within Resident Authorised Deposit-taking Institutions*, TR 2006/9.

about the application of the permanent establishment rules in the IWT provisions because ADIs are rarely standalone entities but engage in borrowing at and through offshore and onshore establishments and branches.<sup>32</sup> The task of tracing the end use of such dispersed borrowings to determine if one of the IWT exceptions applies is understandably difficult and an ATO ruling notes that ‘Where it is not possible ... the interest outgoing is, subject to paragraph 16 of this Ruling, reasonably attributable to income derived by that part of the ADI (for example, offshore PE or Australian head office) through which the funds were borrowed’<sup>33</sup>. Furthermore, where an Australian branch borrows from its foreign parent, the nominal interest (which is based on LIBOR<sup>34</sup>) is subject to a five per cent IWT,<sup>35</sup> where the borrowing occurs from retail investors the rate is 10 per cent<sup>36</sup> and borrowings are exempt when they are sourced through public offers of debentures. Even with such rules of thumb, for many ADIs, the application of IWT is far from straightforward but certainly not insurmountable. More broadly, while the basic case is that IWT is a 10 per cent final tax on (all) interest payments to non-residents, there has been significant winding back of the application of IWTs in recent years. This trend is based on a certain rationale, present in the Henry Review which will now be explored.

### 3. HENRY REVIEW RECOMMENDATIONS

The basis of the Henry Review recommendations in relation to IWTs<sup>37</sup> is the fact that Australia is a capital importing country<sup>38</sup> and therefore relies on inbound finance which is often on-lent by larger financial institutions to other smaller market participants.<sup>39</sup> The Henry Review further points out that there is arguably an overall distortion in Australia in favour of debt over equity.<sup>40</sup> The Henry Review first introduces IWTs into its discourse because they may ‘moderate the bias against equity’<sup>41</sup> though the Henry Review notes that this will be a minor effect.<sup>42</sup> Turning to IWTs in more detail the Henry Review points out that IWT ‘will likely be passed onto Australian borrowers by way of higher interest rates on their borrowings—increasing

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<sup>31</sup> An Authorised Deposit Taking Institution (ADI) is an entity that has been granted a banking licence under the *Banking Act 1959* (Cth), and for Australian law is able to trade as a ‘bank’.

<sup>32</sup> ATO, above n 30; see also Tricia Ho Hudson, Tony Frost and Julian Pinson, ‘Capital Management of Financial Institutions and Related Tax Issues’ (2013) 16(4) *The Tax Specialist* 138; Michael Keen and Ruud de Mooij, ‘Debt, Taxes and Banks’ (2012) *IMF Working Paper* 12/48; Tony Clemens, ‘Australian Taxation Aspects of Major Funding Transactions’ (2005) 8(5) *The Tax Specialist* 255.

<sup>33</sup> ATO, above n 30 at [15].

<sup>34</sup> London Interbank Offered Rate is the established standard for inter-bank loans.

<sup>35</sup> *Income Tax Assessment Act 1936* (Cth), sections 160ZZVA to 160ZZZJ.

<sup>36</sup> As per normal IWT rules outlined above.

<sup>37</sup> Australia’s Future Tax System Review, *Final Report* (2009).

<sup>38</sup> See also Australia’s Future Tax System Review, *Architecture of Australia’s Tax and Transfer System* (2008); Australia’s Future Tax System Review, *Australia’s Future Tax System Consultation Paper* (2008); Khoo, above n 15; Jüttner and Carlsen, above n 12.

<sup>39</sup> Australia’s Future Tax System Review, above n 38.

<sup>40</sup> Australia’s Future Tax System Review, above n 38; Graeme Cooper, ‘Implementing an Allowance for Corporate Equity’ (2012) 27 *Australian Tax Forum* 241; Grace Weishi, Ruud de Mooij and Tigran Poghosyan ‘Taxation and Leverage in International Banking’ (2012) *IMF Working Paper* 12/281.

<sup>41</sup> Australia’s Future Tax System Review, above n 37 at 179.

<sup>42</sup> Australia’s Future Tax System Review, above n 37.

their cost of capital and reducing domestic investment'.<sup>43</sup> Furthermore the exemptions built into the IWT provisions and the patchwork nature of Australia's treaties mean that there are distortions created by IWT between different methods of accessing and structuring foreign debt and between accessing debt from different countries.<sup>44</sup>

The Henry Review goes on to state that on the other hand, IWTs can help prevent tax avoidance through off shore structures,<sup>45</sup> by reducing the benefits of such structures, and can provide valuable information for authorities to data match against.<sup>46</sup> The first of these points will become more relevant as this paper places IWTs within the overall BEPS debate. However, on balance, the Henry Review considered that the distortions introduced by IWTs favour a course of further reduction of IWT.<sup>47</sup> Therefore, the Henry Review recommended bilateral reduction of IWTs through treaties, and unilateral reduction of IWTs for financial institutions in Australia.<sup>48</sup> While there is no detailed justification given for why this unilateral reduction should only apply to financial institutions, it is perhaps possible to see why this is the case. Financial institutions, as noted previously, act as both capital importers in their own right as well as intermediaries for capital which is sourced overseas and re-lent domestically. While there is no IWT paid on this domestic borrowing, the IWT on the source of capital will generally already be priced in. Add this to the fact that financial institutions lend and borrow as their core business and have interest as one of their core expenses and it can be seen that financial institutions are perhaps the point of largest impact for IWTs. Thus, the Henry Review recommended a reduction of IWT largely due to the distortions that IWT causes, with further reference to the cost of capital and impacts on investment levels. However this course of action is perhaps not as straightforward as the Henry Review presents it in light of new developments with BEPS and with final withholding taxes now introduced in Europe.

#### 4. IWTs—REVENUE IMPACTS

The starting point for this evaluation of the trend in favour of removal and reduction of IWTs is the revenue outcomes of the tax. In Australia, IWTs account for a comparatively small amount of revenue as shown below.<sup>49</sup> This is a situation

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<sup>43</sup> Australia's Future Tax System Review, above n 37 at 180.

<sup>44</sup> Australia's Future Tax System Review, above n 37.

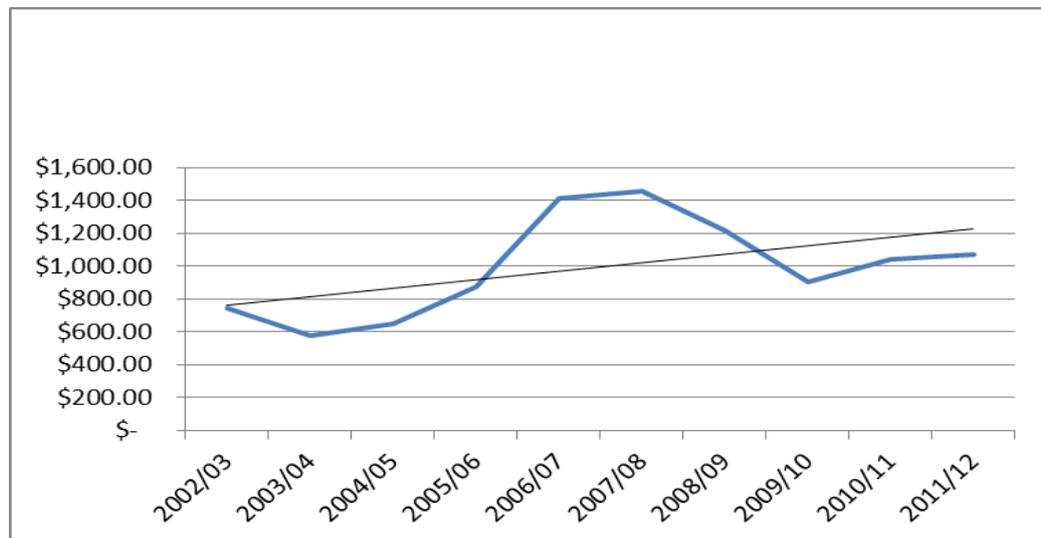
<sup>45</sup> Jüttner and Carlsen, above n 12; Zee, above n 4.

<sup>46</sup> Ibid.

<sup>47</sup> Australia's Future Tax System Review, above n 37.

<sup>48</sup> Ibid, 182.

<sup>49</sup> Data from Australian Bureau of Statistics (ABS). ABS, 2013, *Taxation Revenue, Australia, 2011-12*, cat. no. 5506.0, ABS;; see also Jüttner and Carlsen, above n 12.

**Figure 1: IWT collections in Australia (\$mill)**

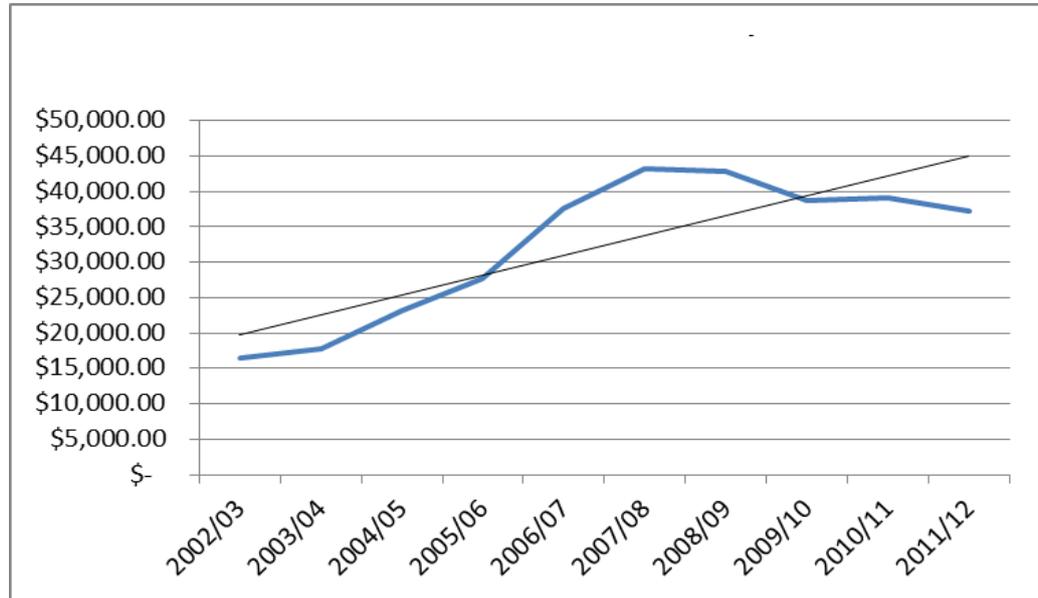
that is common throughout OECD countries.<sup>50</sup> However, though the direct revenue value of the tax (at or just over only \$1 billion in the last few years) is low the trend over the last ten years has actually been an increase in IWT collections in Australia. However, making a judgement on this fact alone would be an error. As further data from Australia's balance of payments below shows, the total interest debits overseas during the same period has increased at a far greater rate.<sup>51</sup> Such interest payments are the theoretical base of the IWT. If collections and interest debits are compared it is possible to determine an approximate effective rate of IWT in Australia once all exemptions are factored in. The result of this analysis, shown below, potentially indicate that the effective rate of IWT in Australia is just below three per cent, and declining.<sup>52</sup>

<sup>50</sup> Commonwealth Treasury, *International Comparison of Australia's Taxes* (2006); Ault and Bradford, above n 4; Zee, above n 4; OECD, 'Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series 2010' (2011).

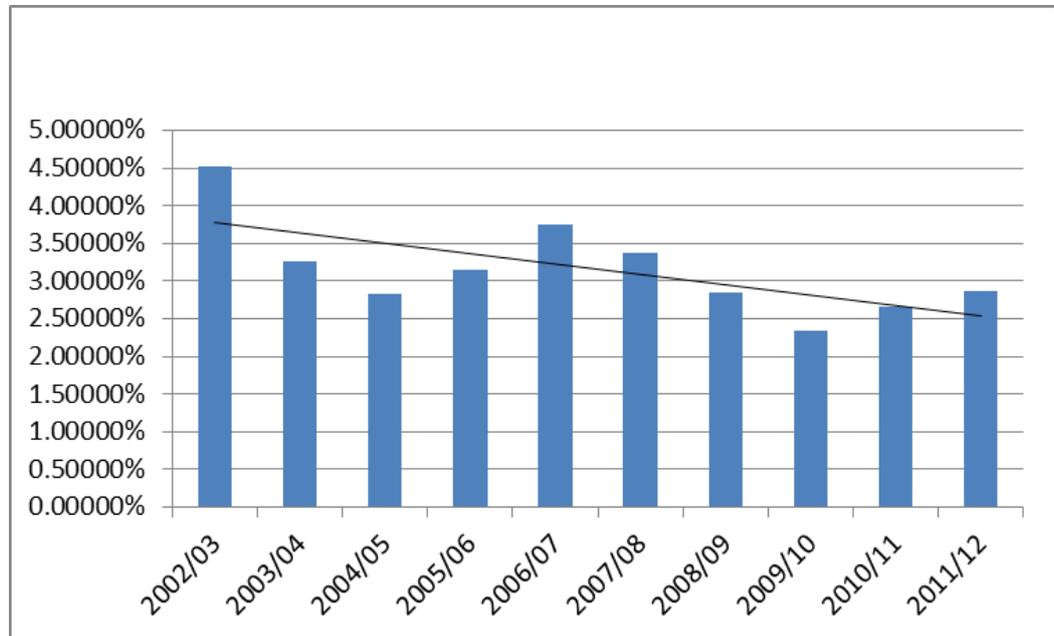
<sup>51</sup> Data from ABS. ABS, 2013, *Balance of Payments and International Investment Position, Australia 2011-12*, cat. no. 5302.0, ABS.

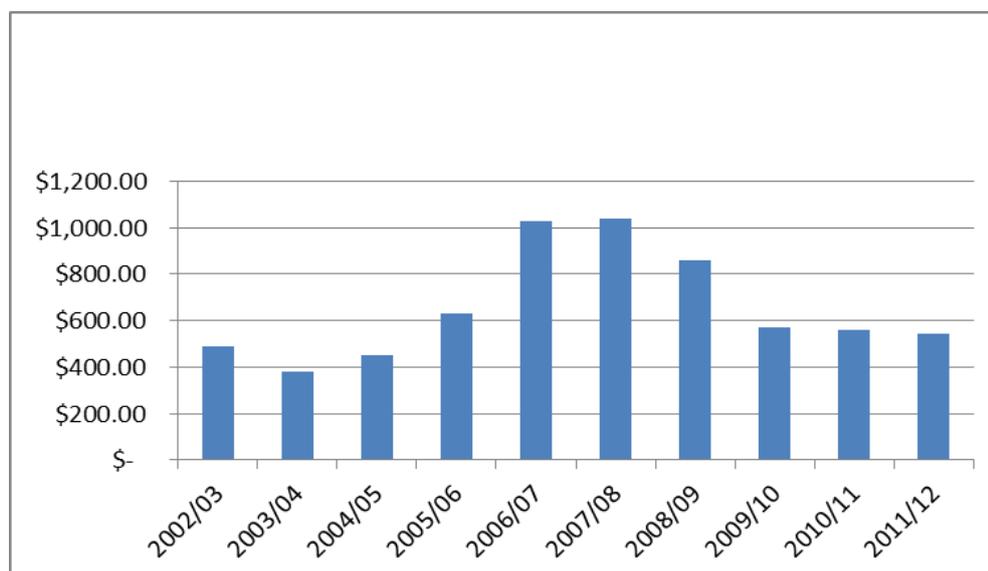
<sup>52</sup> See also Jüttner and Carlsen, above n 12.

**Figure 2: Interest debits (\$mill)**



**Figure 3: Effective IWT tax rate**



**Figure 4: Estimated IWT collections from financial institutions**

Further, if this approximate effective rate is applied against the interest debits from financial institutions alone,<sup>53</sup> the IWT collected from financial institutions over the last 10 years would vary between below \$400 million and over \$1 billion, which gives an indication of how much of the underlying IWT revenue is provided by financial institutions which are targeted for further exemptions under the Henry Review. Thus, over the last decade, in Australia an average of \$996 million in revenue per annum has come from IWT, including an estimated \$654 million from financial institutions per annum on average.

Thus, even if IWTs were entirely removed in Australia, the absolute revenue impact would be comparatively minimal.<sup>54</sup> That is not the point of tax reform, which is generally required to be revenue neutral. Generally, any revenue forgone under tax reform should be matched by compensating benefits, either in the form of increased direct revenue from other taxes or improved equity, efficiency or other substantive (though not necessarily monetary) outcomes which lead to greater overall welfare. This is an implication of the key requirement of revenue buoyancy.<sup>55</sup> Even though removing IWTs would not have a significant direct impact on revenues, as a matter of principle there must be some compensating factors for revenue forgone.

## 5. COMPENSATING FACTORS FROM A REMOVAL/REDUCTION OF IWT

The often stated reason for removal or reduction of IWTs is minimising the distortions they cause.<sup>56</sup> There are effectively two actors who are party to IWT imposition that

<sup>53</sup> Data from ABS, above n 51.

<sup>54</sup> Jüttner and Carlsen, above n 12.

<sup>55</sup> Sandford, above n 6.

<sup>56</sup> Dirkis and Bondfield, above n 16; Lawrence Goulder, 'Implications of Introducing U.S. Withholding Taxes on Foreigners' Interest Income' in Summers, Lawrence (ed) *Tax Policy and the Economy* (1990), 103 - 140; Zee, above n 4.

may have their behaviour distorted; the non-resident investor and the resident recipient of finance. For the investor, provided that the IWT is fully creditable and that the credit can be fully used to offset other tax (which is a common outcome)<sup>57</sup>, there is no immediate change to after tax return.<sup>58</sup> Thus in the majority of cases, if not the substantial majority, the after tax return of the investor is not immediately affected.<sup>59</sup> However, the conclusion that the investor will be “indifferent”<sup>60</sup> is perhaps a step too far. Even in the best case scenario when the investor obtains a dollar for dollar credit that is fully ‘valuable’ to them, there is arguably a timing distortion<sup>61</sup> as the offshore investor does not generally obtain the benefit of the IWT credit until they lodge and pay tax in their country of residence, which may be months after the IWT is withheld.

**Table 1: Illustration of different withholding tax scenarios for lender**

	Full credit to offshore investor (no indemnification)	Full indemnification by resident (no credit)	Full indemnification by resident (full credit)	No IWT	No Credit to offshore investor (no indemnification)
Gross Interest Paid at 1 July 2014	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
IWT Withheld on 1 July 2014	\$ 10.00	\$ 10.00	\$ 10.00	\$ -	\$ 10.00
Actual Payment Remitted at 1 July 2014	\$ 90.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 90.00
Tax Payable in Residence Country (assume 30% tax rate)	\$ 30.00	\$ 33.00	\$ 33.00	\$ 30.00	\$ 30.00
		(\$110 taxable income if indemnification considered income)			
Net Tax Payable	\$ 20.00	\$ 33.00	\$ 23.00	\$ 30.00	\$ 30.00
PV of net tax payable (assume 31 December 2014 financial year end) at 1 July 2014 with 3% discount rate	\$ 19.70	\$ 32.51	\$ 22.66	\$ 29.55	\$ 29.55
NPV at 1 July 2014	\$ 70.30	\$ 67.49	\$ 77.34	\$ 70.45	\$ 60.45

Furthermore, circumstances where the lender is indemnified by the borrower in relation to IWT are not totally equivalent to circumstances involving full credits. The best situation for an investor is where they are sufficiently powerful to require an indemnification clause *and* receive full credit. Failing this, in net present value terms, the next best option is no IWT. The situation of full credits is, based on this scenario, 0.21 per cent less profitable than no IWT. While this is a minuscule difference in

<sup>57</sup> Reuven Avi-Yonah, Nicola Sartori and Marian Omri, *Global Perspectives on Income Taxation Law* (2011).

<sup>58</sup> Khoo, above n 15; Eijffinger, Huizinga and Lemmen, above n 16.

<sup>59</sup> Jüttner and Carlsen, above n 12; Eijffinger, Huizinga, and Lemmen, above n 16.

<sup>60</sup> Khoo, above n 15; Herman, Doron, *Taxing Portfolio Income in Global Financial Markets* (2002).

<sup>61</sup> Jüttner and Carlsen, above n 12.

absolute terms, to wholesale debt financiers this may be a significant margin.<sup>62</sup> Conversely there will be a range of cases where a credit is not totally available and the net present value difference will be more substantial.<sup>63</sup> However, in reality the general distortion argument is about whether a potential investor decision to invest in Australia could be influenced by the presence of an IWT. While such a tax may influence a decision<sup>64</sup> the causative impact of an IWT alone not entirely clear. The decision to invest is arguably also based on a range of other more important factors,<sup>65</sup> and thus many investors may be *almost* indifferent to IWT when compared with other factors such as sovereign risk and currency values.

What of the recipient—will there be a distortion between foreign and non-foreign debt in the presence of an IWT? As shown by the scenarios below, because the recipient still has a deduction for the same gross interest amount, there is no net present value change provided the IWT withheld is actually remitted to the ATO. The only major distortion will be when there is an indemnification clause<sup>66</sup> because the borrower will be generally paying a higher gross interest amount (as noted above, such indemnification payments are generally deductible).

**Table 2: Illustration of different withholding tax scenarios for borrower**

	Foreign Debt - Indemnification	Foreign Debt - No Indemnification	Domestic Debt
Gross Interest Paid at 1 July 2014	\$ 110.00	\$ 100.00	\$ 100.00
IWT Withheld on 1 July 2014	\$ 10.00	\$ 10.00	\$ -
Tax Deduction	\$ 110.00	\$ 100.00	\$ 100.00
Maximum Value of Deduction (Assume 30% tax rate)	\$ 33.00	\$ 30.00	\$ 30.00
PV of deduction (assume 30 June 2015 financial year end) at 1 July 2014 with 3% discount rate	\$ 32.04	\$ 29.13	\$ 29.13

For both the borrower and the lender, this paper has considered a range of scenarios with different credit outcomes which is a reflection of what can result from the patchwork of treaty terms that apply throughout the world. The structure of the IWT provisions and treaty obligations mean that sourcing debt from some countries will give rise to no IWT<sup>67</sup> while sourcing debt through certain structures such as

<sup>62</sup> Weishi, de Mooij and Poghosyan, above n 40; Keen and de Mooij, , above n 32.

<sup>63</sup> Khoo, above n 15; Jüttner and Carlsen, above n 12; Goulder, above n 56.

<sup>64</sup> Richard Bird, *The Taxation of International Income Flows : Issues and Approaches* (1987); Goulder, above n 56; Geremia Palomba, 'Capital Income Taxation and Economic Growth in Open Economies' (2004) *IMF Working Paper* 04/91; Leslie Papke, 'International Differences in Capital Taxation and Corporate Borrowing Behaviour : Evidence from the US Withholding Tax' (1989) *NBER Working Paper* no 3129.

<sup>65</sup> Khoo, above n 15; David Holland and Richard Vann, 'Income Tax Incentives for Investment' in Thuronyi, Victor (ed) *Tax Law Design and Drafting* (1998); S Matthews, 'What is a "Competitive" Tax System?' (2011) *OECD Taxation Working Papers* no 2; OECD, *Corporate Tax Incentives for Foreign Direct Investment* (2001).

<sup>66</sup> Jüttner and Carlsen, above n 12.

<sup>67</sup> Khoo, above n 15.

Eurobonds will similarly incur no IWT.<sup>68</sup> Likewise, tax exempt entities and government lenders such as sovereign wealth funds are entitled to exemptions from IWT.<sup>69</sup> Thus, due to IWTs, investors may have a preference to invest in certain countries over others,<sup>70</sup> and as noted by the Henry Review,<sup>71</sup> give access to funds via different methods over others.<sup>72</sup> The result is that in Australia, the supply of debt from certain countries and through certain methods, such as Eurobonds, may be larger while the supply of debt through retail deposits may be smaller than if there had been no IWT.<sup>73</sup> This potential skewing of the apparatus of inbound capital can have an impact on the stability of domestic markets and the ability to withstand economic shocks.<sup>74</sup>

Once again though, this paper does not dispute that distortions due to IWT are possible but instead questions the significance of their impact on real world choices. Individual investors may be swayed by IWTs but there are also more significant factors, such as sovereign risk and currency values.<sup>75</sup> IWT is still collected in Australia meaning that although there is an option to invest capital in countries where there is no IWT, capital still flows to Australia. Consequently, despite a highly mobile capital base,<sup>76</sup> other factors pull capital perhaps in a stronger way than the presence of an IWT repels capital. Thus, the applicability of IWT on payments from Australia is perhaps not a determinative factor. Hence, in summary, IWTs may be distortionary but perhaps such distortions are not determinative or, in worst case, destructive. Distortions created by differentiated and patchwork IWTs are perhaps small when one considers the structural distortions created by debt and equity in general.<sup>77</sup> As a result, the decision to reduce IWTs cannot be justified by simply looking at distortions.

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<sup>68</sup> Jüttner and Carlsen, above n 12.

<sup>69</sup> Jüttner and Carlsen, above n 12; Norrengaard, John. 'The Tax Treatment of Government Bonds' (1997) *IMF Working Paper* 97/25.

<sup>70</sup> Papke, above n 64.

<sup>71</sup> Australia's Future Tax System Review, above n 37.

<sup>72</sup> Ho Hudson, Frost and Pinson, above n 32; Norrengaard, above n 69; Papke, above n 64.

<sup>73</sup> Norrengaard, above n 69.

<sup>74</sup> OECD, 'International Capital Mobility: Which Structural Policies Reduce Financial Fragility?' (2012) *OECD Economic Policy Papers* no 2; Norrengaard, above n 69; Zee, Howell. 'Retarding Short Term Capital Inflows Through Withholding Tax' (2000) *IMF Working Paper* 00/40.

<sup>75</sup> Khoo, above n 15; Holland and Vann, above n 65; Eric Zolt, 'Taxation of Investment Funds' in Thuronyi, Victor (ed) *Tax Law Design and Drafting* (1998), 969 - 985; Matthews, above n 65; OECD, above n 65.

<sup>76</sup> Jüttner and Carlsen, above n 12;; OECD. 'International capital mobility: Which structural policies reduce financial fragility?' (2012) *OECD Economic Policy Papers* no 2; D Carey and H Tchilinguirian, 'Average Effective Tax Rates on Capital, Labour and Consumption' (2000) *OECD Economics Department Working Papers* no 258; George Zodrow, 'Capital Mobility and Capital Tax Competition' (2010) 63(4) *National Tax Journal* 865.

<sup>77</sup> Weishi, de Mooij, and Poghosyan, above n 40; ; Cooper, above n 40; Keen and de Mooij, , above n 32; de Mooij, Ruud. 'Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions' (2011) *IMF Working Paper* 11/11; R Gordon, 'Taxation and Corporate Use of Debt: Implications for Tax Policy' (2010) 63 *National Tax Journal* 151.

## 6. CERTAINTY, INVESTMENT AND COST OF CAPITAL

Another argument that is often used to support a reduction of IWTs is that such a course will increase investment.<sup>78</sup> That is, reducing IWTs will potentially not only reduce distortions, which are bad per se because they potentially result in less than optimum welfare,<sup>79</sup> but will also lead to increased investment and economic activity.<sup>80</sup> While reduced distortions can lead to increased investment as a matter of general principle,<sup>81</sup> it is not only the distortionary effect of IWTs that impact on investment but the simplicity, certainty, stability and consistency of the tax as well;<sup>82</sup> or in other words, the investment climate. After all, investors often crave certainty and it is more certain that there will not be an unforeseen IWT liability if there is no IWT than if there are a range of technical exemptions that may apply in Australia. So the removal of IWTs can be *partly* justified due to a likely increased investment level owing to greater certainty. The ultimate justification being that such increased investment will increase revenue intake.

However, it is difficult to fully justify such a course of action by citing increased investment alone.<sup>83</sup> This is because the forgone IWT is a tax on gross amounts whereby any additional tax from increased investment will be on net amounts, thus compensating for lost revenue is difficult. A simple illustration is as follows. Assuming that IWTs are removed from financial institutions in Australia then an estimated \$541 million of revenue would be forgone based on the 2011–12 figures detailed above.<sup>84</sup> The additional tax revenue from this removal would be a product of the amount of new investment capital and the margin that this new capital could generate for resident taxpayers.<sup>85</sup> Assuming interest costs are deductible to the resident and that tax is paid at the corporate rate, a number of simulations can be run as shown below. To ‘break even’ at \$541 million, there would need to be around \$100 billion of new investment at a margin of around 1.75 per cent or \$50 billion at a margin of around 3.5 per cent. As new investment reaches more practical levels, the margin required to ‘break even’ increases significantly (shown in graph below). Even if there is a large multiplier effect, it would seem to be impractical to recover the lost revenue from IWTs due to increased investment alone because this would entail an

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<sup>78</sup> Khoo, above n 15; Avi-Yonah, Reuven. ‘Globalization, Tax Competition and the Fiscal Crisis of the Welfare State’ (2000) 113 *Harvard Law Review* 1573; Holland and Vann, above n 65; Neil Pereira, ‘Enhancing Investment in Australia—A Competitive Neutrality?’ (2011) 46(5) *Taxation in Australia* 186; OECD, *Possible Improvements to Procedures for Tax Relief for Cross Border Investors* (2009); Ault and Bradford, above n 4; Rachel Griffith, James Hines Peter and Sorensen, ‘International Capital Taxation’ in Mirrlees, J, Adam, S, Besley, T, Blundell, R, Bond, S, Chote, R, Gammie, M, Johnson, P, Myles G and Poterba J, (eds) *Dimensions of Tax Design: the Mirrlees Review* (2010).

<sup>79</sup> J Mirrlees, S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba J (eds) *Dimensions of Tax by Design: The Mirrlees Review* (2010); Bernard Salanié, *The Economics of Taxation* (2011); Goulder, above n 56. However, withholding taxes may be used as a form of corrective tax to distort behaviour away from ‘bad’ investment. See Zee, above n 74; T Piketty and E Saez, ‘A Theory of Optimal Capital Taxation’ (2012) *NBER Working Paper* 17989.

<sup>80</sup> OECD, above n 78.

<sup>81</sup> Palomba, above n 64.

<sup>82</sup> Holland and Vann, above n 65.

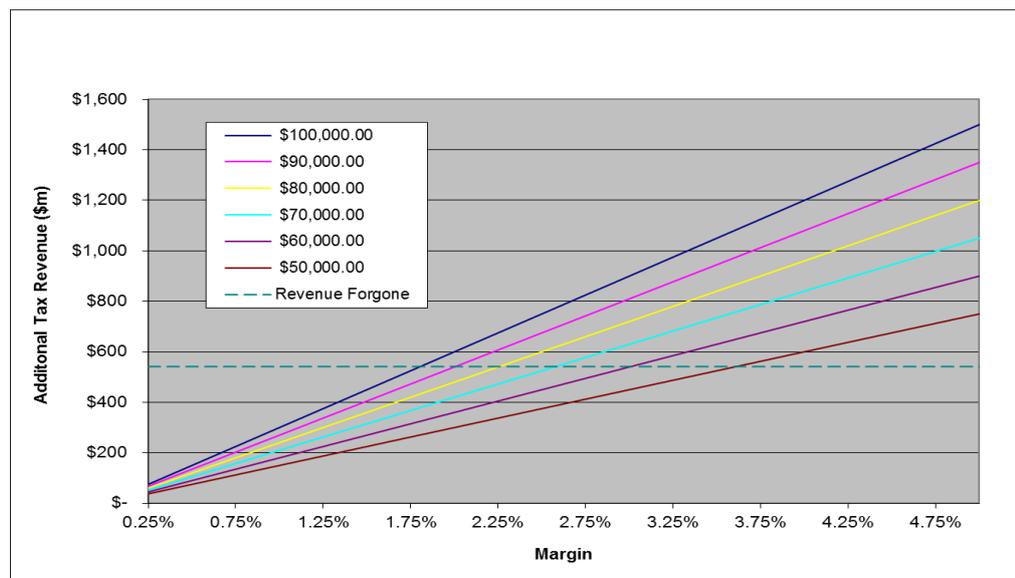
<sup>83</sup> Khoo, above n 15.

<sup>84</sup> \$541 (million) = 2.8680% effective tax rate x \$18,872 (million) interest debts.

<sup>85</sup> Additional Tax Revenue = (new capital x margin) x tax rate.

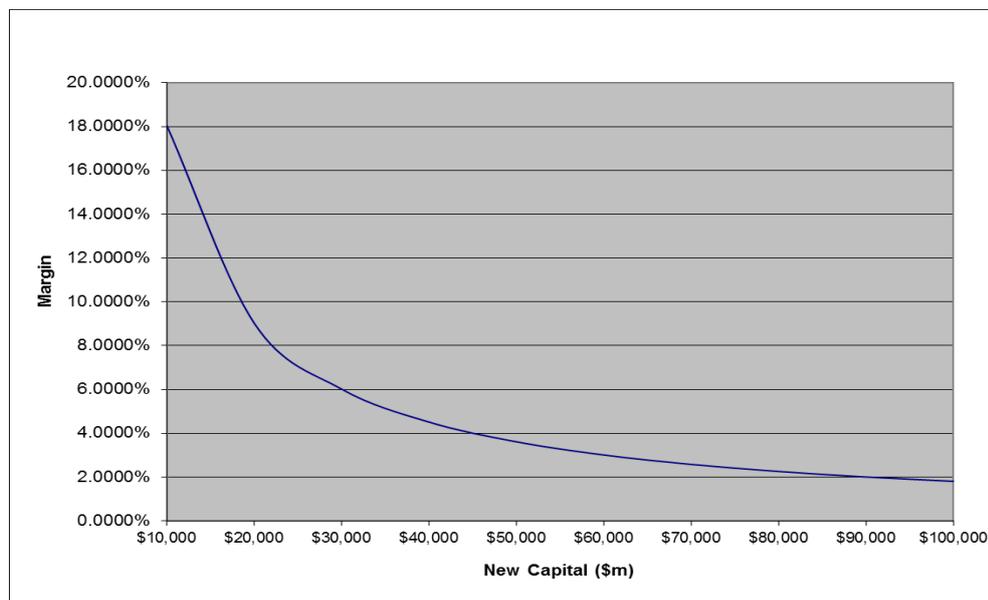
imponderable level of elasticity.<sup>86</sup> For instance, with these simulations, even if there is a best case scenario of an unrealistic margin of 18.0417 per cent, new capital investment of \$3.333 billion and a very high multiplier of 3 (giving total new activity of \$10 billion) there would be 'break even' but the elasticity inherent in such a situation would be over 6 (that is, \$6 of extra investment for each \$1 of tax saved).<sup>87</sup> To reiterate, though removal of IWTs in Australia would increase investment, it is difficult to see how the scale of extra investment alone would justify such a course of action.

**Figure 5: Additional tax revenue for different new capital levels**



<sup>86</sup> Ruud de Mooij, 'The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations' (2011) *IMF Working Paper* 11/95; For FDI see Ruud de Mooij and Sjeff Ederveen, 'Taxation and Foreign Direct Investment—A Synthesis of Empirical Research' (2003) 10 *International Tax and Public Finance* 673.

<sup>87</sup> Such a level of elasticity would be outside current empirically determined levels - de Mooij, above n 86. For FDI, see de Mooij and Ederveen, above n 86.

**Figure 6: Margin required at capital levels**

A related rationale for the removal of IWTs is the effect that this could have on the cost of capital for Australian firms.<sup>88</sup> As the Henry Review pointed out,<sup>89</sup> the presence of an IWT in Australia influences the interest rate and ultimately the cost of capital paid when accessing foreign capital.<sup>90</sup> This may be direct, in the form of indemnity arrangement, or it may be more indirect through increased interest rates. The impact of a reduction to the cost of capital due to a removal of IWT will likely be that resident borrowers will have additional capital with which to spend throughout the economy.<sup>91</sup> Therefore the ultimate effect on the revenue will be similar to that above, in the form of greater (net) tax on economic activity. Once again, even with the combined effect of additional investment and reduced cost of capital however it is still tough to envisage that there would be a dollar for dollar replacement of revenue forgone due to reduced IWTs. Thus, to justify a reduction of IWTs there must be ultimately something more than economics referred to; vis à vis - the reduction of IWTs also results in increased political capital and information. With IWTs the political capital and information aspects are, if anything, more important than the distortionary and investment aspects.

<sup>88</sup> McCann and Edgar, above n 16; Jüttner and Carlsen, above n 12; Dirkis and Bondfield, above n 16; Eijffinger, Huizinga, and Lemmen, above n 16; Huizinga, above n 16; Auerbach, above n 16.

<sup>89</sup> Australia's Future Tax System Review. *Final Report* (2009).

<sup>90</sup> Jack Mintz, 'An Evaluation of the Business Tax Recommendations of the Henry Review and the Australian Government Response' in Chris Evans, Richard Krever, Richard and Peter Mellor (eds) *Australia's Future Tax System: The Prospects After Henry* (2010); McCann and Edgar, above n 16; Vann, above n 28; Eijffinger, Huizinga, and Lemmen, above n 16; Huizinga, above n 16; Auerbach, above n 16.

<sup>91</sup> McCann and Edgar, above n 16.

## 7. POLITICAL CAPITAL AND INFORMATION

The bilateral negotiation of the reduction of IWTs through tax treaties represents the application of diplomacy rather than just simple economics.<sup>92</sup> Reducing the levels of IWT in a country transfers revenue from the country of the borrower to the country of the lender.<sup>93</sup> In return for such a transfer, the country of the lender generally provides access to information in the possession of the country, which is a tangible and valuable outcome for revenue administration.<sup>94</sup> In some cases, a country will even agree to act in the interests of the other country on request.<sup>95</sup> This information and resultant action can, in many cases, be more valuable than the IWT revenue forgone as it may enable revenue authorities to identify and reduce tax avoidance which may therefore result in hundreds of millions of dollars of amended assessments.<sup>96</sup> Under these trade-offs, a country forgoes the ability to partly tax overt funds (interest payments) in return for the ability to fully tax undeclared funds. Apart from being pragmatic, such an approach can also be efficient because it is always more efficient to tax previously un-taxed funds.<sup>97</sup>

The political capital created by forgoing IWT can also be used for any number of other tangible concessions from the treaty partner such as improved investment incentives or development loans.<sup>98</sup> Finally, while it is beyond the scope of this paper to fully discuss aspects of international diplomacy, the overwhelming trend worldwide, as endorsed by the OECD,<sup>99</sup> is for a reduction and removal of IWTs, and there is diplomatic credit to be gained by ‘going with the crowd’, so to speak. It is sometimes just as valuable to be *seen* to conform to the prevailing orthodoxy and therefore build a perception of productive diplomacy. So a reduction of IWTs is not just about investment capital but political capital. Furthermore these political and diplomatic

<sup>92</sup> Vann, above n 28; Michael Dirkis, ‘Looking Beyond Australia’s Horizon : The Internationalisation of Australia’s Domestic Taxation Information Gathering and Debt Collection Powers’ in Michael Walpole and Chris Evans, Chris (eds) *Tax Administration : Safe Harbours and New Horizons* (2008), 79 - 97; Dale Pinto, ‘The Theoretical Foundations and Continued Rationale for Source Based Taxation in an Electronic Commerce Environment’ (2012) 27 *Australian Tax Forum* 443; Ault and Bradford, above n 4.

<sup>93</sup> Jüttner and Carlsen, above n 12; Khoo, above n 15; Avi-Yonah, Sartori and Omri, above n 57; OECD, above n 78; Ault and Bradford, above n 4; Zee, above n 4; Griffith, Hines and Sorensen, above n 78.

<sup>94</sup> Dirkis, above n 92; Domingo Vasco and Pablo Porporatto, ‘Progress in Transparency and Exchange of Tax Information’ (2013) 35 *Tax Administration Review* 75; Isaác Esteban, ‘Effective Implementation of Exchange of Information and International Taxation Units’ (2013) 35 *Tax Administration Review* 105; OECD, *Tax Co-Operation 2010 : Towards a Level Playing Field* (2010); Congressional Research Service, *Tax Havens : International Tax Avoidance and Evasion* (2013); Ronald Davies, ‘Tax Treaties and Foreign Direct Investment: Potential versus Performance’ (2004) 11 *International Tax and Public Finance* 775.

<sup>95</sup> Dirkis, above n 92; Vasco and Porporatto, above note 94; Esteban, above n 94; OECD, above n 94; Congressional Research Service, above n 94.

<sup>96</sup> OECD, above n 94; Vasco and Porporatto, , above n 94; Esteban, above n 94; M D’Ascenzo, ‘Sustaining Good Practice Tax Administration’ (2009) 38 *Australian Tax Review* 76; J Shaw, K Slemrod and J Whiting, ‘Administration and Compliance’ in J Mirrlees, S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba (eds) *Dimensions of Tax Design: the Mirrlees Review* (2010), 1100–1203; International Tax Dialogue, ‘Revenue Administration in Sub-Saharan Africa’ (2010) *ITD Comparative Information Series* No 1.

<sup>97</sup> Richard Bird, ‘Smart Tax Administration’ (2010) 36 *Economic Practice* 57398; John Hasseldine, ‘The Administration of Tax Systems’ in E Albi and J Martinez-Vazquez (eds) *The Elgar Guide to Tax Systems* (2011), 360–375.

<sup>98</sup> Vann, above n 28; Vasco and Porporatto, above n 94; Esteban, above n 94.

<sup>99</sup> OECD, above n 14.

aspects are perhaps more important than the distortion and investment aspects outlined previously due to the lower scale of such aspects.

However, there are two provisos that are potentially moving the balance of political and diplomatic considerations in favour of not reducing IWTs. Firstly, the reduction of IWTs is only one in a number of concessions that can be proffered under diplomatic negotiations. Secondly, with the growing recognition of the problem of BEPS there has potentially been a reinvigoration of the consideration of IWTs. Under the OECD's 2013 *Base Erosion and Profit Shifting Action Plan* there is recognition of the issues of 'treaty shopping' and the use of hybrid instruments which are intertwined with IWT issues in the subject treaties.<sup>100</sup> While developing countries have often been noted as being at risk due to a reduction of IWTs,<sup>101</sup> Australia's reduction of IWT in its treaties may well have contributed to an incentive to lend funds to Australia from a low tax jurisdiction rather than invest directly. The issue of BEPS involves multinational entities utilising this incentive to the utmost. As such, a further reduction of IWT may be seen as further facilitating such issues. However, with action on BEPS being very much a live issue, it is yet to be seen whether IWT reduction comes off the table in future treaty negotiations.

## 8. THE ADMINISTRATIVE ASPECTS OF REMOVAL

Finally, removing withholding taxes in general has been part of the orthodox understanding of the progression from early stage revenue authority, with limited information capacity, to a more adept and more efficient authority.<sup>102</sup> Thus, there is an aspirational aspect to removal of IWTs from an administrative perspective. For a country like Australia, having significant withholding taxes could be seen as vestigial, though the position could be different in a less developed country which requires every cent of revenue it can get.<sup>103</sup> Once again, this is something of a *seen* to be done requirement. On the other hand, in terms of more tangible outcomes, the IWT in Australia raises little revenue but it can be seen as creating significant operating costs.<sup>104</sup> Unlike more broad based taxes, the operating costs of the IWT may actually be larger than the revenue gained (which is not significant). Furthermore, reducing the IWT would improve the level of complexity in relation to the tax system,<sup>105</sup> at least from the point of view of resident recipients and the ATO (rather than Australians

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<sup>100</sup> IMF, *Spillovers in International Corporate Taxation* (2014).

<sup>101</sup> IMF, above n 100; Peter Barnes, 'Limiting Interest Deductions' *UN Papers on Selected Topics in protecting the Tax Base of Developing Countries* (2014).

<sup>102</sup> John Hasseldine, 'The Search for Best Practice in Tax Administration' in Michael Walpole and Chris Evans, (eds) *Tax Administration : Safe Harbours and New Horizons* (2008), 7- 18; OECD, *Tax Administration 2013* (2013).

<sup>103</sup> Bird and Gendren, above n 6; Bird, above n 97.

<sup>104</sup> Lee Burns and Richard Krever, 'Taxation of Income From Business and Investment' in Victor Thuronyi, (ed) *Tax Law Design and Drafting* (1998); Mirrlees, et al., above n 79; OECD, above n 78; Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1(1) *eJournal of Tax Research* 64.

<sup>105</sup> Burns and Krever, above n 104. Though a simple IWT, unlike the Australian IWT, with its many exemptions and the like, may actually make things simpler because of the 'once and for all' character; Mirrlees, et al., above n 79; Binh Tran-Nam and Stewart Karlinsky, 'Small Business Tax Law Complexity in Australia' in Michael Walpole and Chris Evans (eds) *Tax Administration : Safe Harbours and New Horizons* (2008), 321 - 348; OECD, above n 78.

providing debt overseas who would deal with other IWT regimes) and it has been established that simplification, to a point, is beneficial in and of itself.<sup>106</sup> Offsetting these administrative gains is the fact that removing or reducing IWTs does reduce the amount of information available to the ATO to data match against<sup>107</sup> however this may well be compensated by increased information from treaty partners. Therefore, reducing IWTs would normally be recommended from an administrative point of view. However, a number of comparable jurisdictions have begun instituting withholding taxes on interest as a means of final taxation, which provides an alternative direction in which to move.

## 9. FINAL WITHHOLDING TAXES INSTEAD

As of 2014, a number of OECD countries have instituted final withholding taxes on interest income. Austria, Belgium, the Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Poland, Portugal, Slovak Republic, Slovenia and Turkey all have final withholding taxes on interest.<sup>108</sup> Such taxes are efficient in relation to the taxation of capital income (being flat rate taxes). Furthermore, a number of these taxes, such as the final withholding tax in Germany, are part of a final flat rate withholding tax on all investment income which was a measure recommended in the Henry Review as a means of fundamental tax reform. As well, such taxes provide a degree of administrative simplicity since the recipient does not need to report interest income on their tax returns nor does the revenue administration need to audit the reporting. Instead the revenue authority can deal with a smaller group of payers of interest. Therefore, IWTs need not be reduced; instead a worthwhile course may be to broaden their impact and merge such taxes with a general investment income withholding tax.

## 10. CONCLUSION

It has been argued in this paper that the current trend towards a reduction of IWTs cannot be justified by economic distortions and investment flows alone. Certainly, IWTs may impact on investment but it is far from clear whether IWTs can be a decisive causative factor rather than something that is costed into settled decisions. IWT reduction is more about international diplomacy and the search for political capital and access to offshore financial information. But of course, IWT would not be a valuable concession in such arenas unless it did have some impact on investment. The effect on corporate finance, from a removal of IWTs could be positive and so it could be recommended that the *Tax Reform Road Map* phase down of IWTs be continued forthwith. As to the recommendation that the reduction be partly targeted to financial institutions the position is more complex. Such a course would likely lead to the investment benefits as outlined above. The problem however is that, as already noted (by the Henry Review itself even), the patchwork nature of the IWT provisions contribute towards distortions. A targeted reduction for financial institutions alone

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<sup>106</sup> Sandford, above n 6.

<sup>107</sup> Jüttner and Carlsen, above n 12; Zee, above n 4.

<sup>108</sup> Michelle Harding, 'Taxation of Dividend, Interest and Capital Gains Income' (2013) *OECD Taxation Working Papers* no 19.

will potentially complicate existing distortions however it is not possible to be sure whether the net effect on welfare would be positive or negative. With the minimal amount of revenue at stake, it is possible, and may be better to dispense with IWTs altogether in one swoop rather than incrementally amend them and create new classes of exempt entities.

Thus, potentially, the broad recommendation of the Henry Review for a reduction of IWTs are potentially justified with some caveats but with new developments it would be perfectly possible to justify an opposite course. There is, in effect, more to the situation than just the distortions discussed by the Henry Review—though it is worth noting that some of these further developments have only been apparent post-Henry Review. The minimal revenue from IWTs in Australia perhaps hides the fact that IWTs may play an important part in how Australia deals with BEPS (not least of which because their phase down is perhaps one of the factors in how Australia got to where it is with BEPS). More importantly however the experience in a number of OECD countries suggests that the opposite course is possible. Instead of reducing IWTs, they could be retained and even expanded as part of a final withholding tax on interest, or even as part of a broad investment tax that could deliver efficiency and simplicity.

# Evaluating Australia's tax dispute resolution system: A dispute systems design perspective

Melinda Jone<sup>1</sup>

## ***Abstract***

Dispute Systems Design (DSD) refers to a deliberate effort to identify and improve the way an organisation addresses conflict by decisively and strategically arranging its dispute resolution processes. A number of principles have been put forward by various DSD practitioners for best practice in effective DSD. To date tax dispute resolution is an area that has not been examined extensively utilising DSD principles. Building on the limited prior research in this area, this paper evaluates the effectiveness of the design of the current Australian tax dispute resolution procedures utilising a comprehensive range of DSD principles and makes suggestions for improvements.

**Keywords:** *Dispute systems design, design principles, alternative dispute resolution, tax dispute resolution, Australia.*

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<sup>1</sup> PhD candidate, Department of Accounting and Information Systems, College of Business and Law, University of Canterbury, Christchurch, New Zealand. Email: Melinda.jone@pg.canterbury.ac.nz. An earlier version of this paper was presented on behalf of the author by her co-supervisor, Associate Professor Andrew Maples, at the Australasian Tax Teachers Association Conference 2015. The author wishes to thank Andrew for his presentation and the conference participants for their constructive comments.

## 1. INTRODUCTION

Dispute Systems Design (DSD) involves an organisation's conscious effort to channel disputes into a series of steps or options to manage conflict.<sup>2</sup> DSD concerns the design and implementation of a dispute resolution system that is a series of procedures for handling disputes, rather than handling individual disputes on an ad hoc basis.<sup>3</sup> The origin of DSD began in the context of workplace disputes and can be traced to the publication of *Getting Disputes Resolved: Designing Systems to Cut the Costs of Conflict* by Ury, Brett and Goldberg in 1988.<sup>4</sup> Ury, Brett and Goldberg's research drew on empirical evidence in the particular context of the unionised coal industry. The authors described how patterns of disputes can be found in closed settings and that by institutionalising avenues for addressing these disputes *ex ante*, conflicts could be handled more effectively and satisfactorily than through *ex post* measures.

DSD is aimed at reducing the costs and maximising the benefits associated with dispute resolution. Ury, Brett and Goldberg state that costs and benefits of dispute resolution can generally be measured by reference to four broad criteria: transaction costs (including the time, money and emotional energy expended in disputing); satisfaction with the outcomes; long-term effect on the parties' relationship; and recurrence of disputes.<sup>5</sup>

DSD is based on three inter-related theoretical propositions. The first is that dispute resolution procedures can be categorised according to whether they are primarily interests-based, rights-based or power-based in approach.<sup>6</sup> Interests-based approaches focus on the underlying interests or needs of the parties with the aim of producing solutions that satisfy as many of those interests as possible. Rights-based approaches involve a determination of which party is correct according to some independent and objective standard. Power-based approaches are characterised by the use of power, that is, the ability to coerce a party to do something he or she would not otherwise do.

The second DSD proposition is that interests-based procedures have the potential to be more cost effective than rights-based procedures, which in turn may be more cost effective than power-based procedures.<sup>7</sup> The third proposition is that the costs of disputing may be reduced by creating systems that are 'interests-oriented', that is systems which emphasise interests-based procedures, but also recognise that rights-based and power-based procedures are necessary and desirable components.<sup>8</sup>

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<sup>2</sup> William L Ury, Jeanne M Brett and Stephen B Goldberg, *Getting Disputes Resolved: Designing Systems to Cut the Costs of Conflict* (Program on Negotiation at Harvard Law School, first published 1988, 1993 ed); Cathy A Costantino and Christina S Merchant, *Designing Conflict Management Systems: A Guide to Creating Productive and Healthy Organizations* (Jossey-Bass, 1996).

<sup>3</sup> John Lande, 'Principles for Policymaking About Collaborative Law and Other ADR Processes' (2007) 22 *Ohio State Journal on Dispute Resolution* 619, 630.

<sup>4</sup> Ury, Brett and Goldberg, above n 2.

<sup>5</sup> *Ibid* 11-13.

<sup>6</sup> *Ibid* 4-9.

<sup>7</sup> *Ibid* 4, 10-15.

<sup>8</sup> *Ibid* 18.

A number of principles for the design of low-cost interests-oriented dispute resolution systems have been formulated by various practitioners in the DSD field.<sup>9</sup> However, to date, the area of tax disputes resolution has not been evaluated extensively using DSD principles. To the researcher's knowledge, currently only two researchers have conducted studies utilising DSD principles in analysing tax dispute resolution systems (and the supplementary procedures connected to them) around the world. These studies by Bentley<sup>10</sup> and Mookhey<sup>11</sup> were conducted with respect to the Australian Taxation Office's (ATO's) complaint handling procedures and tax dispute resolution procedures, respectively.

Given that Bentley's research focuses on evaluating the complaint handling procedures of the ATO, this paper primarily seeks to extend Mookhey's research in relation to the ATO's tax dispute resolution procedures by utilising a more comprehensive range of DSD principles (outlined in Section 2). This research is set against the background of the recent trend by tax authorities internationally, including the ATO, in employing different initiatives, including (primarily interests-based) alternative dispute resolution (ADR) processes, to resolve tax disputes without litigation.<sup>12</sup> Bentley states that 'ADR provides flow-on improvements in taxpayer compliance by making it easier to resolve disputes with revenue authorities or even to allay concerns.'<sup>13</sup> ADR also improves the effectiveness and efficiency of tax administration, as it focuses on avoiding time-consuming and expensive litigation before the courts.<sup>14</sup> The above outcomes are consistent with the aforementioned aims of DSD in reducing the cost and time of handling disputes and producing more satisfying and durable resolutions. Moreover, in the context of tax dispute resolution, particularly under a self-assessment system, a well-functioning tax disputes resolution system has the potential to positively impact on taxpayer voluntary compliance.

This paper further provides an extension to Mookhey's study in the respect that her study took place shortly after the completion of the Inspector-General of Taxation's (IGT's) *Review into the Australian Taxation Office's use of Early and Alternative Dispute Resolution: A report to the Assistant Treasurer* in May 2012.<sup>15</sup> The IGT's review was conducted to consider whether the ATO was making sufficient use of ADR and if the ATO and taxpayers could benefit from making greater use of ADR.

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<sup>9</sup> See Ibid; Costantino and Merchant, above n 2; Mary P Rowe, 'Dispute Resolution in the Non-Union Environment: An Evolution Toward Integrated Systems for Conflict Management?' in Sandra Gleason (ed), *Frontiers in Dispute Resolution in Labor Relations and Human Resources* (Michigan State University Press, 1997) 79; Jennifer Lynch, *CCRA: Contemporary Conflict Resolution Approaches* (Canada Customs and Revenue Agency, 1998); Karl A Slaikeu and Ralph H Hasson, *Controlling the Costs of Conflict: How to Design a System for Your Organization* (Jossey-Bass, 1998); Society for Professionals in Dispute Resolution, *Designing Integrated Conflict Management Systems: Guidelines for the Design of Integrated Conflict Management Systems within Organizations* (2001).

<sup>10</sup> Duncan Bentley, 'Problem Resolution: Does the ATO Approach Really Work?' (1996) 6(1) *Revenue Law Journal* 17 updated in Duncan Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law, 2007).

<sup>11</sup> Sheena Mookhey, 'Tax dispute systems design' (2013) 11 *eJournal of Tax Research* 79.

<sup>12</sup> Duncan Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law); Inspector-General of Taxation, *Review into the Australian Taxation Office's Use of Early and Alternative Dispute Resolution: A report to the Assistant Treasurer* (2012); EY, *Tax Dispute Resolution: A New Chapter Emerges—Tax Administration Without Borders* (2010).

<sup>13</sup> Bentley, above n 10, 172.

<sup>14</sup> Ibid.

<sup>15</sup> Inspector-General of Taxation, above n 12.

Following the review, a number of developments with respect to ADR were made by the ATO (although these developments were not captured in Mookhey's research). These developments include: the revising and updating of Practice Statement Law Administration 2007/23 (PS LA 2007/23);<sup>16</sup> the development and introduction of the *ATO Plain English Guide to Alternative Dispute Resolution*;<sup>17</sup> conducting an indirect tax ADR facilitation pilot using trained ATO officers as ADR facilitators and subsequently making permanent an ATO in-house facilitation process; introducing an independent review function for large business taxpayers at the audit stage; and engaging the Australian Centre for Justice Innovation (ACJI) at Monash University to design and implement a mechanism for independently evaluating the ATO's use of ADR in tax disputes.<sup>18</sup> These and other additional aspects are consequently incorporated within the DSD evaluation of the current Australian tax disputes resolution procedures in this paper.<sup>19</sup>

The remainder of this paper is organised as follows. Section 2 outlines the DSD principles utilised in this study. This is followed by a description of the Australian tax disputes resolution procedures in Section 3. In Section 4, the disputes resolution procedures are evaluated using the DSD principles outlined in Section 2. A discussion of the findings from the DSD evaluation and recommendations for improvements to the Australian tax dispute resolution procedures is then provided in Section 5. Concluding remarks are made in Section 6.

## 2. THE DISPUTE SYSTEMS DESIGN PRINCIPLES UTILISED IN THIS STUDY

The DSD literature identifies six specific conflict management models that have been developed by DSD practitioners beginning with Ury, Brett and Goldberg.<sup>20</sup> The work on these conflict management models has been cumulative in the respect that each author or group of authors has built on the concepts contained in the earlier models.<sup>21</sup>

<sup>16</sup> ATO, *Practice Statement Law Administration 2007/23: Alternative Dispute Resolution in ATO Disputes and Litigation* (2007) <<http://law.ato.gov.au/atolaw/view.htm?docid=PSR/PS200723/NAT/ATO/00001#P1>> (PS LA 2007/23) provides instructions to ATO staff on what policies and guidelines must be followed when attempting to resolve or limit disputes by means of ADR. PSLA 2007/23 was withdrawn with effect from 31 July 2013 and replaced by Practice Statement Law Administration 2013/3. See ATO, *Practice Statement Law Administration 2013/3: Alternative Dispute Resolution in ATO Disputes* (2013) <<http://law.ato.gov.au/atolaw/view.htm?locid=PSR/PS20133/NAT/ATO>> (PS LA 2013/3).

<sup>17</sup> ATO, *ATO Plain English Guide to Alternative Dispute Resolution* (6 August 2013) <<http://www.ato.gov.au/About-ATO/About-us/In-detail/Key-documents/ATO-plain-English-guide-to-alternative-dispute-resolution/>>.

<sup>18</sup> The developments in the ATO's dispute resolution and prevention processes were also recently addressed by ATO Second Commissioner Andrew Mills in his keynote address to the Australasian Tax Teachers Association 27th annual conference on 20 January 2015. See Andrew Mills, 'It's Time for Tax (Administration) Reform' (speech delivered at the Australasian Tax Teachers Association Conference 2015, University of Adelaide, 20 January 2015) <[https://www.ato.gov.au/Media-centre/Speeches/Other/It-s-time-for-tax-\(administration\)-reform/](https://www.ato.gov.au/Media-centre/Speeches/Other/It-s-time-for-tax-(administration)-reform/)>.

<sup>19</sup> Note that the description of the Australian tax disputes resolution process and ADR procedures and their subsequent DSD evaluation in this paper are in respect of the procedures in place as at February 2015.

<sup>20</sup> The other five DSD practitioners are Costantino and Merchant, above n 2; Rowe, above n 9; Lynch, above n 9; Slaikeu and Hasson, above n 9; Society for Professionals in Dispute Resolution, above n 9.

<sup>21</sup> John P Conbere, 'Theory Building for Conflict Management System Design' (2001) 19 *Conflict Resolution Quarterly* 215, 217.

The specific DSD principles from the six conflict management models are not reproduced in this paper—they are the subject of a separate analysis which is beyond the scope of this paper.<sup>22</sup> However, summarised in Table 1 below are 14 DSD principles synthesised by the researcher from the six models collectively.

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<sup>22</sup> A detailed comparison of the DSD principles contained in the six conflict management models was carried out as part of the researcher's PhD thesis, currently in progress. The researcher's comparison was conducted based on a comparison of the six models undertaken earlier by Conbere.

**Table 1: The 14 DSD Principles utilised in this study.**

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

It should be noted that, although the focus of the six conflict management models is on DSD in the context of workplace conflict, as stated by the Society of Professionals in Dispute Resolution (SPIDR), 'the principles have equal applicability to all other places where people convene regularly for a purpose and have continuing relationships.'<sup>23</sup> Arguably, in the tax context, taxpayers and revenue authorities have a continuing relationship with respect to the compulsory imposition of tax (and interest and penalties, where applicable) by the revenue authority. However, the fundamental nature of the relationship between the tax authority and the taxpayer in tax disputes is a legal one which is distinct from a relationship concerned with the underlying needs and concerns (interests) of the parties. Therefore, the application of DSD in tax dispute resolution may differ from other dispute resolution contexts in the respect that the application of an interests-orientated system may be limited by the underlying legal relationship between the parties. Moreover, this particular relationship overtly lends itself to the use of rights-based dispute resolution approaches.

Nevertheless, the studies by Bentley and Mookhey provide support for the applicability of DSD in addressing disputes between revenue authorities and taxpayers. However, it is acknowledged that there are some discrepancies which emerge with the direct application of the DSD principles (drawn directly from the DSD literature) in the context of tax disputes resolution. These discrepancies will be highlighted in the DSD evaluation of the Australian tax disputes resolution procedures conducted in Section 4.

The DSD principles utilised by both Bentley and Mookhey were the six fundamental DSD principles originally proposed by Ury, Brett and Goldberg. These are stated as follows:

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

In terms of the 14 principles in Table 1, Ury, Brett and Goldberg's principles can be found in principles 2 (The system has multiple options for addressing conflict including interests and rights-based processes), 3 (The system provides for loops backward and forward), 4 (There is notification and consultation before and feedback after the resolution process), 6 (Procedures are ordered from low to high cost) and 8 (The system includes training and education).<sup>24</sup>

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<sup>23</sup> Society for Professionals in Dispute Resolution, above n 9, 33.

<sup>24</sup> Note that Ury, Brett and Goldberg's principles correspond to only five of the principles in Table 1 as there is some overlap in the 14 principles. For example, principle 2 in Table 1 corresponds to Ury, Brett and Goldberg's first and third principles and principle 6 in Table 1 corresponds to Ury, Brett and

The rationale behind the researcher's use of a more comprehensive range of DSD principles lies in the development of DSD principles over time from Ury, Brett and Goldberg's six fundamental principles to include a more extensive range of factors including aspects such as involving stakeholders in the design process, providing disputants with multiple access points to the system, providing disputants with the right to choose a preferred process, providing assistance for choosing the most appropriate process, providing systemic support and structures that integrate the dispute resolution system into the organisation and including evaluation of the system to foster continuous improvement.<sup>25</sup>

Section 3 now outlines the Australian tax dispute resolution procedures before using the 14 DSD principles to evaluate the effectiveness of their design in Section 4.

### 3. THE AUSTRALIAN TAX DISPUTES RESOLUTION PROCEDURES

An important difference to note between Bentley's and Mookhey's studies and this current study is that both of the previous researchers have included the ATO's complaint handling process (and the subsequent external recourse to the Commonwealth Ombudsman)<sup>26</sup> as part of the Australian tax disputes resolution procedures. However, given that this research focuses on tax disputes in their substantive form, this study specifically excludes the ATO's internal complaint handling procedures and external recourse for taxpayer complaints (now to the IGT).

Conventionally, tax disputes are said to occur when there is a disagreement between the taxpayer and the revenue authority in respect of the taxpayer's tax liabilities or entitlements and related issues.<sup>27</sup> In contrast, a complaint can be defined as 'an expression of dissatisfaction or concern about goods, services, actions or inaction that is made by a complainant (often a consumer) or by another person on their behalf (for example, a carer or a member of staff).'<sup>28</sup> A complaint may not involve any disagreement.<sup>29</sup> In the context of tax administration, complaints can be about: undue delays; unclear or misleading information; staff behaviour; or mistakes, which could result from misunderstanding, omissions or oversights.<sup>30</sup>

Generally, complaints cannot be filed by taxpayers for substantive tax issues, for example, relating to how much tax is owed or about laws that the taxpayer thinks are wrong.<sup>31</sup> Such issues are usually dealt with through a tax administration's review and

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Goldberg's third and fifth principles. In her study, Mookhey also recognised an overlap between the principles and dealt with Ury, Brett and Goldberg's third and fifth principles together.

<sup>25</sup> These aspects (expressed in various forms) are espoused by Costantino and Merchant, above n 2; Rowe, above n 9; Lynch, above n 9; Slaikeu and Hasson, above n 9; Society for Professionals in Dispute Resolution, above n 9.

<sup>26</sup> Note that, from 1 May 2015, the tax complaint handling role of the Commonwealth Ombudsman was transferred to the IGT.

<sup>27</sup> Binh Tran-Nam and Michael Walpole, 'Independent Tax Dispute Resolution and Social Justice in Australia' (2012) 35 *University of New South Wales Law Journal* 470, 477.

<sup>28</sup> Tania Sourdin, *Alternative Dispute Resolution* (Thomson Reuters, 4<sup>th</sup> ed, 2012) 133.

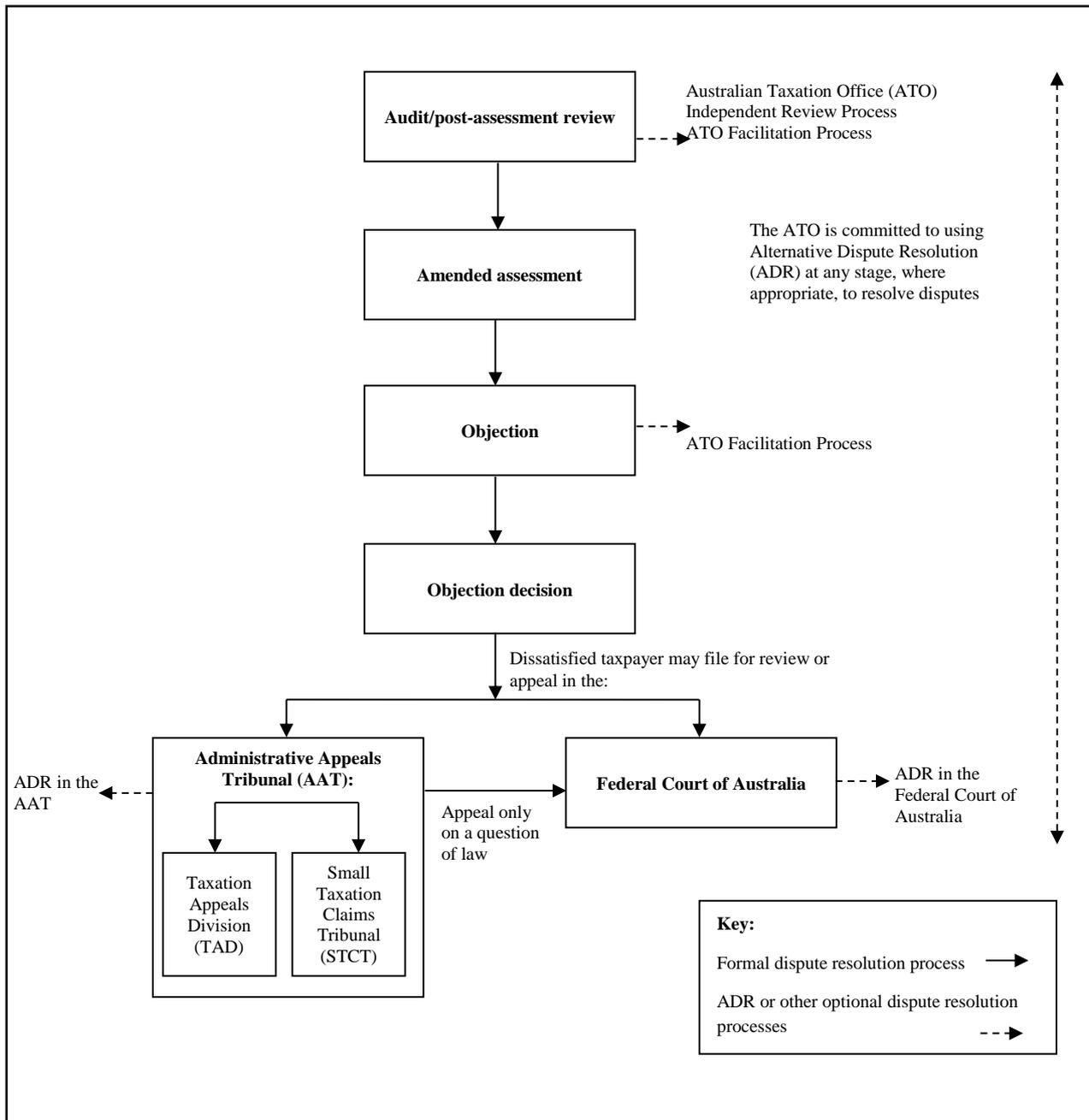
<sup>29</sup> Sourdin, above n 28, 8.

<sup>30</sup> Canada Revenue Agency, *What is a Service Complaint, and What is Not a Service Complaint?* (26 June 2013) <<http://www.cra-arc.gc.ca/gncy/cmplntsdpts/srvccmplnts/dfntn-eng.html>>.

<sup>31</sup> *Ibid.*

appeal procedures. Accordingly, the elements of the Australian dispute resolution procedures which are considered in this study encompass the ATO's internal review process, external appeal to the Administrative Appeals Tribunal (AAT) and the Federal Court of Australia as well as the ADR and other early dispute resolution procedures incorporated within the internal review and external appeal stages. Figure 1 below depicts these elements of the Australian tax dispute resolution procedures.

**Figure 1: The Australian tax disputes resolution procedures**



### 3.1 The Australian tax disputes resolution process<sup>32</sup>

Under the current self-assessment system in Australia, most Australian taxpayers have an obligation to provide the details of their taxable income, in the form of an annual tax return. On this basis, the Australian Commissioner of Taxation (the Australian Commissioner) is required to raise an assessment under section 161 of the *Income Tax Assessment Act 1936* (Cth), and to provide that assessment to the taxpayer. Where there is a tax debt, the taxpayer is obliged to pay that debt by the due date. Otherwise, where there is a tax refund due, that amount will be repaid by the ATO.

A tax dispute occurring between a taxpayer and the ATO would typically commence at the point at which the assessment is under review. There may be an audit of the taxpayer's affairs or a post-assessment review of their affairs. In the period following either of the above events, an informal dispute may be considered as occurring. If this dispute cannot be resolved, an (amended) assessment will be issued by the ATO, with the result of amended taxable income. At this point, a dissatisfied taxpayer may formally lodge an objection in accordance with Part IVC of the *Taxation Administration Act 1953* (Cth).<sup>33</sup> The tax dispute is said to have formally commenced at this stage.

An objection must be lodged with the Australian Commissioner within two years,<sup>34</sup> four years<sup>35</sup> or 60 days<sup>36</sup> of the Australian Commissioner's assessment (or other taxation decision)<sup>37</sup> depending upon the type of tax decision to which the objection relates, and in some situations, the nature of the taxpayer.<sup>38</sup> Where a valid objection to an assessment or other taxation decision has been lodged by the taxpayer, an internal review of the assessment will be conducted by ATO officers. As a matter of practice, the objection officer is a separate ATO official from the ATO officer that made the initial taxation decision (being objected to by the taxpayer), but is from within the same business line.<sup>39</sup> The internal review relates to matters raised in that objection, and not in respect of the entire assessment.<sup>40</sup> Sixty days must pass before the taxpayer can demand a decision to the objection. If no objection decision is provided after 60 days, section 14ZYA(2) of the *Taxation Administration Act 1953* (Cth) permits the taxpayer to make a written request to the Australian Commissioner

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<sup>32</sup> An earlier version of the material contained in Sections 3.1-3.3 below was reviewed by Michael Walpole (Professor, Associate Head of School (Research), Tax and Business Law (incorporating Atax) Australian School of Business, University of New South Wales). The researcher is grateful for his feedback.

<sup>33</sup> Certain decisions of the Australian Commissioner which do not actually relate to the assessment or calculation of tax, such as the exercise of one of the Australian Commissioner's many discretions, may be reviewed under the *Administrative Decisions (Judicial Review) Act 1977* (Cth).

<sup>34</sup> This time limit applies to most individuals and very small business taxpayers.

<sup>35</sup> This time limit applies to, for example, taxpayers with more complex affairs, companies, superannuation funds, approved deposit funds (ADFs) and pooled superannuation trusts (PSTs).

<sup>36</sup> This time limit applies to all other cases.

<sup>37</sup> A 'taxation decision' includes an initial assessment issued by the ATO, amended assessment, determination, private ruling or other decision of the ATO: *Taxation Administration Act 1953* (Cth) section 14ZQ.

<sup>38</sup> *Taxation Administration Act 1953* (Cth) section 14ZW.

<sup>39</sup> Joanne Dunne and Elissa Romanin, 'The Australian Tax Objection Procedures: Time for Legislative Reform' (2010) 45(1) *Taxation in Australia* 21, 22.

<sup>40</sup> Tran-Nam and Walpole, above n 27, 481.

for an objection decision within a further 60 days. If no decision is made within 60 days of the Australian Commissioner receiving that notice, the Australian Commissioner is deemed to have disallowed the objection.<sup>41</sup> A deemed disallowance is subject to review or appeal in the same way as any other objection decision.

A taxpayer dissatisfied with the Australian Commissioner's objection decision, (for example, a decision to disallow or only allow in part an objection), has the option of either applying to the AAT<sup>42</sup> for a review of the decision or appealing to the Federal Court of Australia, within 60 days of being served with a notice of the objection decision.<sup>43</sup> The tribunal or court processes then follow.<sup>44</sup>

## 3.2 Alternative dispute resolution procedures

Sections 3.2.1 and 3.2.2 below respectively outline the availability of ADR within the ATO and at the litigation stage of the Australian disputes procedures.

### 3.2.1 *Alternative dispute resolution in the Australian Taxation Office*

The ATO's Practice Statement Law Administration 2013/3 (PS LA 2013/3)<sup>45</sup> states that: 'When disputes cannot be resolved by early engagement and direct negotiation, the ATO is committed to using ADR where appropriate to resolve disputes.'<sup>46</sup> PS LA 2013/3 provides that, although there is no optimal time for ADR, it may potentially be appropriate: after the ATO issues a position paper during an audit; during a review at the objection stage before a final decision is made by an ATO officer; or during the litigation stage.<sup>47</sup>

ADR is generally initiated by agreement between the parties. PS LA 2013/3 provides that ATO personnel involved in disputes should 'actively look for opportunities where ADR can help to resolve or progress the dispute.'<sup>48</sup> Taxpayers can also request ADR. However, if ADR is requested by a taxpayer and the ATO considers that ADR is not appropriate, the ATO will communicate the reasons to the taxpayer.<sup>49</sup>

PS LA 2013/3 classifies, and provides examples of, the ADR processes that may generally be employed. These processes are: facilitative (for example, mediation), advisory (for example, neutral evaluation or case appraisal) or determinative (for

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<sup>41</sup> *Taxation Administration Act 1953* (Cth) section 14ZYA(3).

<sup>42</sup> An application for review in the AAT may generally be made in the Taxation Appeals Division (TAD) or where the amount in dispute is under \$5000, or if the ATO refuses the taxpayer's request to be released from a tax debt (any amount), the taxpayer has the option of electing for the matter to be dealt with in the Small Taxation Claims Tribunal (STCT) of the AAT.

<sup>43</sup> *Taxation Administration Act 1953* (Cth) sections 14ZZC, 14ZZN.

<sup>44</sup> If dissatisfied with the Federal Court's decision, the taxpayer or the Australian Commissioner can appeal against the decision to the full Federal Court and ultimately, with leave, to the High Court of Australia.

<sup>45</sup> ATO, 'PS LA 2013/3', above n 16.

<sup>46</sup> *Ibid* [5]. PS LA 2013/3 further outlines that ADR may be appropriate when: there are issues that are able to be negotiated; the ATO has something to give; the taxpayer has something to give; the dispute is capable of being settled within existing settlement policies and practices; and early resolution is preferable to judicial determination: at [7].

<sup>47</sup> *Ibid* [17].

<sup>48</sup> *Ibid* [20].

<sup>49</sup> *Ibid* [22].

example, arbitration).<sup>50</sup> Blended processes where the ADR practitioner plays multiple roles may also be utilised (for example, conferencing or conciliation).<sup>51</sup>

In addition to the above ADR processes being generally available to parties during the disputes resolution procedures, the ATO also offers, as a specifically-developed ADR program, an in-house facilitation process for less complex disputes arising from indirect tax, small business and individual audits and objections (see Figure 1). ATO facilitation, formally introduced in April 2014, is a process where 'an impartial ATO facilitator meets with the taxpayer/their agent and the ATO case officers to identify issues in dispute, develop options, consider alternatives, and attempt to reach an agreement.'<sup>52</sup> The facilitators are ATO officers who have been trained in facilitation and mediation techniques but are not usually accredited mediators. In addition, the facilitator will not have had any previous involvement in the dispute.

### 3.2.2 *Alternative dispute resolution at the litigation stage*

As stated in PS LA 2013/3, parties to a tax dispute may participate in ADR at the litigation stage.<sup>53</sup> Both the AAT and Federal Court of Australia can direct the ATO and the taxpayer to participate in certain ADR proceedings.<sup>54</sup> Furthermore, the *Civil Dispute Resolution Act 2011* (Cth) requires all parties appearing at the Federal Court of Australia to demonstrate to the satisfaction of the judge that they have taken genuine steps (which can include the consideration of ADR) to resolve their dispute before coming to a formal hearing before the Court.<sup>55</sup>

ADR in the AAT includes the Tribunal's routine practice of referring all matters to a conference moderated by a Conference Registrar.<sup>56</sup> The Conference Registrars typically assess the suitability of a matter for any further ADR processes in the AAT. These processes include mediation, neutral evaluation, case appraisal and conciliation.<sup>57</sup> The ADR processes offered by the Federal Court of Australia include mediation, arbitration and conference of experts. However, mediation is the most commonly used ADR process in tax disputes in the Federal Court of Australia.

## 3.3 **Early dispute resolution procedures—independent review process**

While not classified as an ADR process, the ATO's independent review process, which started on 1 July 2013, aims to promote the earlier resolution of large market

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<sup>50</sup>Ibid [23]. However, the ATO note that arbitration is generally not appropriate for tax disputes because it can incur similar costs and delays as litigation, potentially conflicts with the statutory responsibilities of the Commissioner as decision-maker, and can lack the openness and transparency of a court or tribunal decision: at [24].

<sup>51</sup> Ibid [23].

<sup>52</sup> ATO, *In-House Facilitation* (1 June 2015) <<https://www.ato.gov.au/General/Dispute-or-object-to-an-ATO-decision/In-detail/Avoiding-and-resolving-disputes/Alternative-Dispute-Resolution/In-house-Facilitation/>>

<sup>53</sup> ATO, 'PS LA 2013/3', above n 16, [17].

<sup>54</sup> *Administrative Appeals Tribunal Act 1975* (Cth) section 34A; *Federal Court of Australia Act 1976* (Cth) section 53A.

<sup>55</sup> *Civil Disputes Resolution Act 2011* (Cth) sections 6–7.

<sup>56</sup> *Administrative Appeals Tribunal Act 1975* (Cth) section 34A.

<sup>57</sup> *Administrative Appeals Tribunal Act 1975* (Cth) section 3(1).

disputes.<sup>58</sup> It is available at position paper stage in audits, prior to the issue of assessments (see Figure 1). The independent review process provides an opportunity for an 'independent officer' outside of the audit area to review the technical merits of an audit case prior to finalisation of the ATO position. This function is conducted by a senior officer (reviewer) from the Review and Dispute Resolution (RDR) business line and who will not have been involved in the audit process.<sup>59</sup> As part of the independent review process, the reviewer also conducts a case conference, where the audit team and taxpayer meet face-to-face to discuss the technical merits of their respective positions.

#### **4. DISPUTE SYSTEMS DESIGN EVALUATION OF THE AUSTRALIAN TAX DISPUTES RESOLUTION PROCEDURES**

This Section evaluates the Australian tax dispute resolution procedures utilising the 14 DSD principles outlined in Section 2.

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

Stakeholders are included in the design process of the Australian tax disputes in various ways. The ATO involves stakeholders in the pilot testing of ATO ADR processes (for example, the ATO's in-house ADR facilitation pilot) and through seeking taxpayers' views on their experiences with ADR in tax disputes with the ATO (for example, through the ACJI ADR feedback survey).<sup>60</sup>

The ATO also involves stakeholders in the design process through collaborating with consultative groups such as the Dispute Resolution Working Group which was formed in December 2013 to consult on specific strategies around dispute prevention and early resolution of disputes. Representation in this consultative group includes the main tax professional associations including the Law Council of Australia, the Federal Court of Australia, AAT, and Director of the ACJI, Professor Tania Sourdin. The National Tax Liaison Group (NTLG) which is the peak consultative forum for tax practitioners and other intermediaries is also involved in the design process (for example, the NTLG was consulted with during the implementation of the ATO's independent review process and in the updating of PS LA 2013/3).<sup>61</sup> The NTLG comprises representatives of the major tax, law, superannuation and accounting professional associations and senior members of the ATO.

In addition, a range of stakeholders are included in the design process through reviews of and submissions sought on the tax disputes resolution process by independent

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<sup>58</sup> The ATO's large market segment includes 1800 economic groups or entities encompassing some 35000 businesses. Of those 1800, approximately 1100 have an annual turnover greater than \$250 million: ATO, *Large Business and Tax Compliance* (May 2014), 4.

<sup>59</sup> ATO, *Independent Review of Large Business and International Statement of Audit Position* (16 January 2014) <<https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Independent-review-of-Large-Business-and-International-Statement-of-Audit-Position/>>.

<sup>60</sup> See Tania Sourdin and Alan Shanks, 'Evaluating Alternative Dispute Resolution in Taxation Disputes' (Final Report, Australian Centre for Justice Innovation, 28 November 2014).

<sup>61</sup> During 2011–2013 the former NTLG Dispute Resolution subcommittee made a number of contributions regarding ADR issues. The Dispute Resolution subcommittee was formed to foster continuous improvement in dispute resolution.

statutory bodies and through submissions sought on inquiries conducted by parliamentary committees. For example, the IGT's *Review into the Australian Taxation Office's use of early and Alternative Dispute Resolution*<sup>62</sup> (requested by the Australian Commissioner) drew a wide range of submissions from stakeholders including taxpayers, tax practitioners and their representative bodies, dispute resolution experts and members of the judiciary. As part of this review the IGT also consulted with ATO representatives and met with interested taxpayers, tax practitioners and their respective representative bodies as well as legal experts and dispute resolution practitioners.

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

The Australian tax disputes resolution system has multiple options for addressing conflict. The ATO encourage disputes to be resolved through direct negotiation with the ATO officer involved in the dispute in the first instance. If the dispute cannot be resolved, the taxpayer may lodge a formal objection with the ATO where the decision is internally reviewed by a different ATO officer. If the taxpayer is dissatisfied with the internal review outcome then they may utilise rights-based processes by proceeding to litigation in either the AAT or the Federal Court of Australia. As provided by PS LA 2013/3, ADR processes generally are available at any stage of the disputes process including: 'after the ATO issues a position paper during an audit; during a review at the objection stage before a final decision is made by an ATO officer; or during the litigation stage.'<sup>63</sup> These ADR processes include both interests-based procedures (for example, facilitation or mediation) and rights-based procedures (for example, arbitration, early neutral evaluation or case appraisal). The system also offers the option to resolve disputes using ATO dispute resolution programs which are available at specific points of the disputes process, including the in-house facilitation (an interests-based ADR process) available at the audit and objection stages and the independent review process available at the audit stage. ADR processes (interests and rights-based) are further available at the litigation stage, prior to commencing formal proceedings in the AAT and the Federal Court of Australia.

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

Loop-backs in the disputes process are provided for in the respect that ADR options are theoretically available at all stages of the disputes resolution process. In this respect, the various ADR processes possibly available in the AAT and the Federal Court of Australia when disputes reach the litigation stage provide the most obvious examples of loop-backs from rights-based to interests-based processes.<sup>64</sup> The Early Assessment and Resolution (EAR) process in the AAT also constitutes a loop-back mechanism in the sense that the focus of the process is to identify cases in the AAT

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<sup>62</sup> Inspector-General of Taxation, above n 12.

<sup>63</sup> ATO, 'PS LA 2013/3', above n 16, [17].

<sup>64</sup> However, other examples of loop-backs do exist. For example, following the lodgment of an objection by a taxpayer, the parties may agree to participate in neutral evaluation before the ATO's objection decision is issued, whereby the ADR practitioner gives advice to the parties about the likely outcome if the matter were to proceed to the AAT or the Federal Court of Australia. As a result, the parties may negotiate an agreement based on the advice received.

which can be preferably be resolved through direct negotiation (without the need for an AAT hearing).

Given that taxpayers must go through the ATO's internal review process before appealing an ATO decision externally to the AAT or the Federal Court of Australia, taxpayers are unable to loop-forward in the formal disputes process. Thus, while the Australian tax disputes resolution system provides for loop-back mechanisms, it lacks any loop-forward procedures.

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

Notification before and feedback after both feature in the Australian tax disputes resolution system. Notification is built into the dispute resolution process through the ATO's Taxpayer's Charter which requires the ATO to clearly stipulate its decision to the taxpayer, provide an explanation of its reasons for the decision and inform the taxpayer of their rights and obligations in relation to the decision.<sup>65</sup> Other ATO initiatives such as its compliance strategy, which is outlined in "Building Confidence", serve as a form of notification.<sup>66</sup> This web-based resource delivers messages to the community about the risks and issues that the ATO sees in the tax and superannuation systems and what the ATO intends to do about them. This acts to highlight compliance activities and risk areas where potential disputes may arise. ATO Decision Impact Statements which are succinct statements of the Australian Commissioner's response to significant cases decided by the courts or tribunal are another example of notification. They advise the community of the ATO's view on the implications of a particular court or tribunal decision.<sup>67</sup>

Feedback occurs through general statistics regarding resolving disputes, and ATO compliance activities and objections provided on the ATO's website.<sup>68</sup> Systemic feedback and analysis are also provided in ATO publications such as *Your Case Matters*<sup>69</sup> and the ATO annual report which includes a separate section on litigation and disputes.<sup>70</sup> Although, worth noting is that submissions to the House of Representatives Standing Committee on Tax and Revenue's inquiry into *Tax Disputes*<sup>71</sup> stated that, while the ATO's reporting on its dispute resolution function has increased in recent years, 'the publication of 'real time' statistics is still

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<sup>65</sup> ATO, *Taxpayer's Charter—What You Need to Know* (June 2010) 14.

<sup>66</sup> ATO, *Building Confidence* (13 August 2015) <<https://www.ato.gov.au/General/Building-confidence/>> Building Confidence replaces the ATO's former Compliance Program and Compliance in Focus publication.

<sup>67</sup> ATO Decision Impact Statements listed by calendar year are available from the ATO's Legal Database on the ATO's website: <<http://law.ato.gov.au/atolaw/index.htm>>.

<sup>68</sup> See ATO, *Resolving Disputes* (19 May 2014) <<https://www.ato.gov.au/General/Dispute-or-object-to-an-ATO-decision/In-detail/Statistics/Resolving-disputes/>>; ATO, *Compliance Activity and Objections* (19 May 2014) <<https://www.ato.gov.au/General/Dispute-or-object-to-an-ATO-decision/In-detail/Statistics/Compliance-activity-and-objections/>>.

<sup>69</sup> *Your Case Matters* provides key data and analysis on ATO tax and superannuation litigation trends and includes a section on dispute resolution. See, for example, ATO, *Your Case Matters: Tax and Superannuation Litigation Trends* (3rd ed, March 2013).

<sup>70</sup> See, for example, ATO, *Commissioner of Taxation Annual Report 2012–13* (2013) 57–59.

<sup>71</sup> House of Representatives Standing Committee on Tax and Revenue, Parliament of Australia, *Tax Disputes* (2015).

unsatisfactory.<sup>72</sup> The litigation and ADR landscape moves quickly and statistics that are only published annually or biannually do not provide a strong platform for taxpayers to form their decisions.<sup>73</sup> This suggests that there is room for improvement in the ATO's publication of dispute resolution statistics in real time.

Feedback at the micro-level on specific ATO ADR programs is provided in the respect that following the completion of ADR programs such as ATO facilitation and ATO independent review, taxpayers are invited to complete a feedback form on the ADR process and at the end of an ATO independent review, a thorough debrief involving all participants is conducted. The feedback obtained is used by the ATO to improve processes. Internal feedback on ADR also occurs through maintenance of the ATO's internal ADR register in which ATO staff are required to record details of all matters in which an externally facilitated ADR process is undertaken.

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

In the context of tax dispute resolution, internal independent confidential neutrals serving both the revenue authority and taxpayers in dispute, generally do not exist. This is largely due to the fact that tax disputes occur between the revenue authority and an external party (the taxpayer) as opposed to between employees in an organisation (as occurring in the context of organisational disputes). Moreover, the dispute between the parties is generally not focused on the needs and concerns of the parties, but rather on resolving disagreements arising over substantive tax issues. However, the ATO has established an ADR Network which consists of senior ATO officers who are available to mentor and advise ATO case officers on the use of ADR techniques and would thus function as internal independent confidential neutrals for ATO case officers. The names of the network's members are published on the ATO's intranet. There is no internal independent person within the ATO to whom taxpayers can go to for coaching, referring and problem-solving in relation to dispute resolution options and techniques. Although, this is not unexpected in the context of tax dispute resolution given that it would be reasonable to expect that taxpayers could seek advice on ADR and dispute resolution techniques externally at their own expense. This would not be dissimilar from taxpayers having to engage professional advisors on tax technical matters in relation to tax disputes.

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

The formal disputes procedures are ordered in a low to high cost sequence in the respect that there is the opportunity for direct negotiation in the first instance, followed by the ATO's internal review process and then external review or appeal to the AAT or the Federal Court of Australia respectively. This sequence generally implies an increase in costs at each level, particularly when the dispute is escalated to a tribunal or court. The option to employ ADR potentially at any stage of the disputes process also adds further costs at the stage(s) at which ADR is utilised into the disputes

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<sup>72</sup> CPA Australia, Submission No 7 to the House of Representatives Standing Committee on Tax and Revenue *Inquiry into Tax Disputes*, , 3. See also Australian National Audit Office, Submission No 4 to the House of Representatives Standing Committee on Tax and Revenue *Inquiry into Tax Disputes*, 4–5.

<sup>73</sup> CPA Australia, above n 72, 3.

process. However, if the dispute is settled at that stage, then parties do not subsequently have to move further up the sequence to higher cost processes.

While the DSD literature suggests that there should be an increase in costs at each level in order to increase the pressure for a negotiated outcome at an early stage,<sup>74</sup> it is worth noting that in the context of the Australian tax disputes resolution procedures, the low to high cost sequence impacts differently on different types of taxpayers. For small taxpayers there may be a noticeable increase in costs at each level, particularly if they pursue informal processes and/or recourse to the AAT or the Federal Court of Australia.<sup>75</sup> However, it has been observed that rather than increasing the pressure for a negotiated outcome at an early stage, the increasing incremental costs may in fact form a deterrent for small taxpayers in pursuing tax disputes very far or at all and therefore, a barrier to social justice.<sup>76</sup> Whereas for large taxpayers, whatever the minimal difference in costs to them between the levels is unlikely to increase the pressure for a negotiated outcome and deciding which recourse to pursue is likely to be a strategic-based and commercial decision rather than costs based.<sup>77</sup>

It is further important to note that the Australian tax dispute resolution process can require substantial upfront costs (for example, the time spent by the taxpayer in preparing for, and participating in negotiations as well as the cost of professional advisors) from the taxpayer. This may serve as a further barrier for small taxpayers as professional advice and assistance, if required, generally represent the bulk of the costs to taxpayers.<sup>78</sup> However, such high upfront costs may not necessarily be a deficiency in the Australian disputes procedures per se, but rather a common feature of tax disputes resolution in general. This is because, given the arguably complex nature of many tax disputes, taxpayers are required to work out their positions from the outset and as a consequence, may require professional advice and assistance (which incur related costs) in order to do so.

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

Structurally speaking, the Australian tax disputes resolution procedures does not have multiple access points. This is because the formal disputes process commences when a taxpayer lodges an objection with the ATO and as such, there is only one structural entry point to the system. However, procedurally, there are multiple access points to the system in the respect that there are different methods by which an objection may be lodged. That is, objections can be lodged by fax, post, hand delivered to an ATO shopfront or lodged online.

In the traditional context of workplace disputes, having multiple access points also generally entails the provision of a choice of persons to whom system users may

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<sup>74</sup> Ury et al., above n 2, 62-63.

<sup>75</sup> Mookhey, above n 11, 91.

<sup>76</sup> Ibid. This has also been observed in other jurisdictions such as New Zealand. See, for example, Melinda Jone and Andrew J Maples 'Mediation as an Alternative Option in New Zealand's Tax Dispute Resolution Procedures' (2012) 18 *New Zealand Journal of Taxation Law and Policy* 412; Melinda Jone and Andrew J Maples 'Mediation as an Alternative Option in New Zealand's Tax Disputes Resolution Procedures: Refining a Proposed Regime' (2013) 19 *New Zealand Journal of Taxation Law and Policy* 301.

<sup>77</sup> Mookhey, above n 11, 91.

<sup>78</sup> Tran-Nam and Walpole, above n 27, 488.

approach in the first instance so that 'people with concerns and problems can find access points of different ethnicity and gender, and varied technical backgrounds, to help them'.<sup>79</sup> Against this background, the Australian tax dispute resolution procedures offers a choice of persons to whom system users can approach in the first instance in the respect that the ATO offers a range of support services to help people from non-English speaking backgrounds, Indigenous Australians and people with disabilities. For example, people from non-English speaking backgrounds can phone the Translating and Interpreting Service for help with their calls or if they want to speak to an ATO officer in their preferred language, Aboriginal and Torres Strait Islander people can ring the ATO's Indigenous Helpline which specialises in helping indigenous clients with a range of matters, and people who are deaf or have a hearing or speech impairment can contact the ATO through the National Relay Service.<sup>80</sup> While these services assist the above taxpayers with contacting the ATO generally, they arguably also may provide a means of access for these taxpayers to the ATO's tax disputes resolution system and thus, constitute the provision of multiple access persons for certain taxpayers.

#### 4.8 DSD Principle 8: The system includes training and education

The Australian dispute resolution system includes education (primarily through the provision of information) about the system for stakeholders. The ATO's webpage 'Correct a mistake or dispute a decision' provides information on the avenues available to taxpayers where they wish to correct a mistake on their tax return or dispute a decision.<sup>81</sup> Links are provided to further pages that provide information on, inter alia, how to object to an ATO decision, seek an external review of an ATO decision and the various ADR processes available for avoiding and resolving disputes.

The ATO also provides an extensive range of information concerning ADR. PS LA 2013/3 provides guidance and instructions for ATO personnel on what policies and guidelines must be followed when attempting to resolve or limit disputes by means of ADR.<sup>82</sup> The *ATO Plain English Guide to Alternative Dispute Resolution* on the ATO's website is a guide which explains in simple language dispute resolution, ADR and the types of ADR processes that are used in tax and superannuation disputes and also provides links to other ADR resources internal and external to the ATO.<sup>83</sup> In addition, other documents such as the ATO's Disputes Policy,<sup>84</sup> Dispute Management Plan,<sup>85</sup> and Code of Settlement<sup>86</sup> provide information on the ATO's approach towards dispute resolution and the settlement of tax disputes.<sup>87</sup>

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<sup>79</sup> Rowe, above n 9, 88. Different access persons in the context of workplace disputes can include human resource managers, employee assistance providers and equal opportunity specialists.

<sup>80</sup> See ATO, *Contact us* (22 April 2014), <<https://www.ato.gov.au/about-ato/about-us/contact-us/>>.

<sup>81</sup> See ATO, *Correcting a Mistake or Disputing a Decision* (11 December 2012), <<https://www.ato.gov.au/business/research-and-development-tax-incentive/correcting-mistakes-and-disputing-decisions/>>.

<sup>82</sup> ATO, 'PS LA 2013/3', above n 16.

<sup>83</sup> See ATO, above n 17.

<sup>84</sup> See ATO, *Disputes Policy* <<https://www.ato.gov.au/general/dispute-or-object-to-an-ato-decision/in-detail/avoiding-and-resolving-disputes/resolving-disputes/disputes-policy/>>.

<sup>85</sup> For the current Dispute Management Plan, see ATO, *Dispute Management Plan 2013–14* (20 January 2014).

In relation to the training in ADR of various ATO staff, the ATO states that ATO case officers may but do not always have training in negotiation from an in-house training provider.<sup>88</sup> In-house ATO solicitors ordinarily would have completed some ADR training as part of their qualifications. ATO facilitators have the equivalent of four days of mediation training. This would usually be provided by a professional ADR association such as the Association of Dispute Resolvers (LEADR)<sup>89</sup> or an ADR specialist or ADR academic.<sup>90</sup> The foregoing indicates that, at present, the training in dispute resolution of certain ATO staff is arguably provided on an ad hoc basis. Moreover, currently lacking from the system is a specific dispute resolution component provided to (or required by) all ATO staff who regularly interact with taxpayers as part of their professional training and development.

The IGT, in his review on ADR, recommended that the ATO should develop a targeted suite of training products (focusing on early identification of potential issues in dispute, and negotiation and conflict management skills) with the relevant ATO staff being required to complete the above targeted training as part of their performance development agreements.<sup>91</sup> Consequently, the ATO Learning and Development team has been engaged in 'working on building an enterprise wide curriculum for dispute management and resolution.'<sup>92</sup> A comprehensive dispute resolution curriculum has been designed containing many different negotiation and dispute resolution related courses which suit the needs of different ATO roles.<sup>93</sup> The ATO 'are endeavouring to target these courses to those who need to use the skills in their day-to-day roles.'<sup>94</sup> Arguably, when fully implemented, the dispute resolution curriculum should address the current deficiencies in the dispute resolution training of ATO staff.<sup>95</sup>

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<sup>86</sup> ATO, *Code of Settlement* <<https://www.ato.gov.au/general/dispute-or-object-to-an-ato-decision/in-detail/avoiding-and-resolving-disputes/settlement/code-of-settlement/>>. See also ATO, *A Practical Guide to the ATO Code of Settlement* (15 October 2014) <<https://www.ato.gov.au/general/dispute-or-object-to-an-ato-decision/in-detail/avoiding-and-resolving-disputes/settlement/a-practical-guide-to-the-ato-code-of-settlement/>>.

<sup>87</sup> Also of relevance is ATO (2009), *Practice Statement Law Administration 2009/9: Conduct of ATO Litigation and Engagement of ATO Dispute Resolution* <<http://law.ato.gov.au/atolaw/view.htm?DocID=PSR/PS20099/NAT/ATO/00001>> (PS LA 2009/9) which outlines policies and guidelines relevant to the conduct of ATO litigation.

<sup>88</sup> Email from Julie Coates, Senior Principal Lawyer, Dispute Resolution Specialist, Review and Dispute Resolution, Australian Taxation Office, 9 June 2014.

<sup>89</sup> On 1 January 2015, LEADR and the Institute of Arbitrators and Mediators Australia (IAMA) integrated to become one ADR membership organisation, LEADR & IAMA.

<sup>90</sup> Email from Julie Coates, above n 88.

<sup>91</sup> Inspector-General of Taxation, above n 12, 47.

<sup>92</sup> ATO, Submission No 10 to the House of Representatives Standing Committee on Tax and Revenue, *Inquiry into Tax Disputes*, 4 July 2014, 18–19 [67].

<sup>93</sup> *Ibid.*

<sup>94</sup> *Ibid* 19 [68].

<sup>95</sup> Submissions to the House of Representatives Standing Committee on Tax and Revenue, *Inquiry into Tax Disputes*, indicate that the current Australian tax dispute resolution system still remains deficient with respect to the training of ATO staff in negotiation and dispute resolution skills. See, for example, Chartered Accountants Australia and New Zealand, Submission No 5 to the House of Representatives Standing Committee on Tax and Revenue, *Inquiry into Tax Disputes*, 7 July 2014, 12 [2.5]; The Tax Institute, Submission No 11 to the House of Representatives Standing Committee on Tax and Revenue *Inquiry into Tax Disputes*, 4 July 2014, 7 [28].

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

The ATO provides various forms of assistance with respect to choosing ADR processes. PS LA 2013/3 provides guidelines on the use of ADR and describes circumstances when ADR may or may not be appropriate.<sup>96</sup> The ATO's RDR business line is responsible for administering ADR processes and policies and providing advice on ADR generally. In addition, requests for ADR by either the ATO officer involved in the dispute or the taxpayer must be reviewed as to their appropriateness for ADR by the relevant ATO manager(s) and ATO technical staff (including RDR officers).<sup>97</sup>

The early engagement process for large business taxpayers assists in the selection of processes prior to the commencement of the formal disputes process (that is, prior to the lodging of any objection). The early engagement process provides an opportunity for taxpayers to meet with ATO staff in order to discuss the best way to deal with a correction or change to a large business tax return. The process assists large business taxpayers in deciding whether to request an amendment or lodge an objection.

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

As noted earlier, taxpayers must go through the ATO's internal review process before appealing externally to the AAT or the Federal Court of Australia. Consequently, there is no opportunity for taxpayers to choose a preferred process in this respect. However, disputants have the right to choose a preferred process in the sense that ADR is available at any stage of the disputes process. This feature means that the Australian disputes process is theoretically multi-option in the respect that disputants are able to select between the formal disputes process and various ADR processes at a given stage of the disputes process. Moreover, if an ADR process is unable to resolve a dispute in whole or in part, taxpayers' review and appeal rights in the formal ADR process are unaffected by their participation in ADR, subject to the terms of any settlement reached and compliance with the legislative timeframes. In the Federal Court of Australia parties also have the option of requesting that a matter be referred to mediation either court annexed (through a registrar) or a private mediation prior to commencing formal proceedings.

In addition, where a dispute is appealed to the AAT, for 'small' tax cases there is the option for certain taxpayers to choose a preferred process in the respect that if the amount of tax in dispute is under \$A5,000 or if the ATO refuses the taxpayer's request to be released from a tax debt (any amount), then the qualifying taxpayer may elect to have the matter dealt with by the STCT (where proceedings may be conducted with less formality) instead of the TAD of the AAT. Thus, with the exception of being unable to choose the initial entry point to the system, taxpayers generally have a number of opportunities in the Australian tax dispute resolution procedures where they are able to choose a preferred process.

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<sup>96</sup> ATO, 'PS LA 2013/3', above n 16, [7]-[9].

<sup>97</sup> ATO, 'PS LA 2013/3', above n 16, [20]-[21].

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

The IGT's *Review into the Australian Taxation Office's use of Early and Alternative Dispute Resolution: A report to the Assistant Treasurer*<sup>98</sup> highlighted mixed views on the operation of the Australian tax dispute system and the ATO's use of ADR. The IGT's report found that in some instances, the ATO's dispute resolution processes were seen as working well, with senior staff appropriately engaged, issues identified and ADR processes employed to address and resolve specific cases.<sup>99</sup> However, in other cases, some taxpayers' experiences appeared to be varied with officers appearing uncertain of their ability or authority to engage in discussions with taxpayers to address concerns and resolve disputes early in the process.<sup>100</sup>

More recently submissions to the House of Representatives Standing Committee on Tax and Revenue's Inquiry into Tax Disputes<sup>101</sup> have reiterated concerns with respect to the lack of consistency across the ATO in the management of tax disputes.<sup>102</sup> For example, a submission by PricewaterhouseCoopers (PwC) stated:<sup>103</sup>

We observe ATO disputes that are managed efficiently, effectively and fairly. But we also observe the opposite, where ATO [officers] exhibit behaviours or engage in practices which call into question the ATO's objectivity, transparency or fairness. At worst, this can damage the relationship between taxpayers and the ATO to such an extent that trust is lost and positions become entrenched through lack of engagement.

A submission by the Commonwealth Ombudsman,<sup>104</sup> primarily based on complaints received from individual taxpayers and small businesses, further identified specific areas of concern about the ATO's conduct during the dispute resolution process.<sup>105</sup> Complaints to the Commonwealth Ombudsman indicated that the key concerns were in relation to:<sup>106</sup>

- the ATO's engagement with taxpayers prior to the litigation stage;
- individual taxpayers and small businesses feeling intimidated by the ATO during litigation and the settlement process;
- poor communication from the ATO to individual taxpayers and small businesses during the dispute resolution process, and

<sup>98</sup> Inspector-General of Taxation, above n 12.

<sup>99</sup> Ibid.

<sup>100</sup> Ibid.

<sup>101</sup> Parliament of Australia, above n 71.

<sup>102</sup> See, for example, BDO, Submission No 1 to the House of Representatives Standing Committee on Tax and Revenue *Inquiry into Tax Disputes*, 4 July 2014, 1; CPA Australia, above n 72, 3; PricewaterhouseCoopers, Submission No 23 to the House of Representatives Standing Committee on Tax and Revenue *Inquiry into Tax Disputes*, 29 July 2014, 2.

<sup>103</sup> PricewaterhouseCoopers, above n 102, 2.

<sup>104</sup> Commonwealth Ombudsman, Submission No 14 to the House of Representatives Standing Committee on Tax and Revenue *Inquiry into Tax Disputes*, July 2014.

<sup>105</sup> Submissions and hearings heard on the inquiry further highlighted the perceived unequal treatment of individual and small business taxpayers in comparison to big business taxpayers by the ATO. See The Tax Institute, above n 95, 4–5 [17].

<sup>106</sup> Commonwealth Ombudsman, above n 104, 5.

- undue delays by the ATO which contributed to a protracted dispute resolution and/or debt recovery process.

The associated body of literature on procedural fairness indicates that the abovementioned aspects can in turn negatively impact on taxpayers' perceptions of fairness of the dispute resolution system.<sup>107</sup> The procedural fairness literature states that if individuals do not perceive an authority to be acting fairly and neutrally, and they do not feel treated with respect and dignity, they will be less willing to trust that authority and are less likely to voluntarily obey and defer to the authority's decisions and rules.<sup>108</sup>

In addition, there are generally also mixed findings with respect to stakeholder perceptions of fairness of specific ATO dispute resolution processes. The ATO's ADR facilitation pilot found that taxpayers were 'generally comfortable' with having an ATO officer as a facilitator and only one case in the pilot expressed concerns over the lack of independence of the facilitator.<sup>109</sup> However, current anecdotal evidence suggests that stakeholders are still reluctant to try the ATO's internal ADR program.<sup>110</sup> There are similar findings with respect to fairness perceptions of the ATO's independent review process. In a post implementation review of the ATO's independent review process conducted in January 2014, the ATO stated: 'Feedback from internal and external stakeholders was positive and constructive, noting the independence of process and the professionalism of the reviewers.'<sup>111</sup> Yet, on the other hand:<sup>112</sup>

As it stands ... independent review is only available for the big end of town, and in any case while the Tax Office thinks it is working beautifully, tax advisers don't think it is independent enough.

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

Support and championship of a dispute resolution culture in the ATO and an emphasis on the use of ADR by the ATO have featured as recurring topics in various speeches made by the Australian Commissioner.<sup>113</sup> Changes to the organisational structure of

<sup>107</sup> Tom R Tyler and Edgar A Lind 'A Relational Model of Authority in Groups' in Mark P Zanna (ed), *Advances in Experimental Social Psychology* (Academic Press, 1992), 115; Tom R Tyler and Peter Degoe, 'Trust in Organizational Authorities: The Influence of Motive Attributions on Willingness to Accept Decisions' in Roderick M Kramer and Tom R Tyler (eds), *Trust in Organizations: Frontiers of Theory and Research* (Sage, 1996), 331; Kristina Murphy, 'The Role of Trust in Nurturing Tax Compliance: A Study of Accused Tax Avoiders' (2004) 28 *Law and Human Behavior* 187.

<sup>108</sup> Murphy, above n 107, 190.

<sup>109</sup> ATO, *GST Administration Annual Performance Report 2012–13* (November 2013), 52.

<sup>110</sup> Nassim Khadem, 'ATO 'cowboys' culture ruined lives, inquiry told', *Sydney Morning Herald* (online), 29 November 2014 <<http://www.smh.com.au/business/ato-cowboys-culture-ruined-lives-inquiry-told-20141128-11vuf1.html>>.

<sup>111</sup> ATO, *Australian Taxation Office (ATO) Submission - Productivity Commission Review: Access to Justice Arrangements - Dispute Management in the Australian Taxation Office* (12 February 2014) 10–11 [45].

<sup>112</sup> Khadem, above n 110.

<sup>113</sup> See, for example, Chris Jordan, 'It's About Time' (Speech delivered at the National Small Business Summit, Brisbane, 25 July 2013)

the ATO have also been made to give effect to the aim of the earlier resolution of disputes including by utilising ADR. A restructure of the ATO in 2013 reshaped the role of Second Commissioner Law to be responsible for the Law Design and Practice Group comprising Integrated Tax Design, Tax Counsel Network and RDR. RDR, led by the First Assistant Commissioner, has a particular focus on 'delivering new ways of doing specific activities that include ATO wide responsibility for resolving disputes earlier; championing the use of ADR to resolve disputes; [and] establishing an independent review process for large business.'<sup>114</sup> The Second Commissioner Law and First Assistant Commissioner, RDR have also made a number of speeches and conference presentations on dispute resolution and ADR in the ATO.<sup>115</sup> The above suggests that the system appears to be reasonably well supported by the top management of the ATO.

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

The disputes system is integrated into the organisation through various mechanisms including the Taxpayers' Charter which outlines what taxpayers can expect when they deal with the ATO. The Taxpayers' Charter provides that taxpayers have a right to request a review of an ATO decision and also a right to make a complaint where they are not satisfied with the decisions services or actions of the ATO.<sup>116</sup> The ATO's Dispute Management Plan<sup>117</sup> outlines the ATO's high-level framework for managing and resolving disputes. The ATO issues a Dispute Management Plan each year to outline its key focus areas in dispute management for the year. The ATO's Disputes Policy<sup>118</sup> is a supporting document that complements and provides the underpinning framework for the annual Dispute Management Plan and sets out the ATO's principles for managing disputes. These documents are intended to provide a coordinated and consistent approach to dispute management within the ATO.

The ATO's objectives in managing its disputes with taxpayers, as set out in its current Dispute Management Plan, are:<sup>119</sup>

- Faster and earlier resolution of disputes
- Reduce the number of disputes
- Lower your costs and our costs

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<<http://www.ato.gov.au/Media-centre/Speeches/Commissioner/It-s-about-time/>>; Chris Jordan, 'Tax, the Way Ahead' (Speech delivered at the Tax Institute 28th Annual Convention, Perth, 14 March 2013) <<http://www.ato.gov.au/Media-centre/Speeches/Commissioner/Tax,-the-way-ahead/>>; Chris Jordan, 'Reinventing the ATO' (Speech delivered at the Tax Institute of Australia 29th National Convention, Hobart, 27 March 2014) <<http://www.ato.gov.au/Media-centre/Speeches/Commissioner/Commissioner-s-address-to-TIA/>>.

<sup>114</sup> ATO, above n 111, 4 [11].

<sup>115</sup> The speeches of the current Second Commissioner Law, Andrew Mills and First Assistant Commissioner, RDR, Debbie Hastings, are available at the Media Centre on the ATO's website <<https://www.ato.gov.au/Media-centre/?sorttype=SortByType>>.

<sup>116</sup> ATO, above n 65, 11–12.

<sup>117</sup> ATO, above n 85.

<sup>118</sup> ATO, above n 84.

<sup>119</sup> ATO, above n 85, 1.

- Enhance our relationship with the community
- Make your interactions with us easier.

The ATO's overall organisational mission, vision, values and goals are outlined in Figure 2:<sup>120</sup>

**Figure 2: The ATO's Mission, Vision, Values and Goals**

<p><b>Mission</b> We contribute to the economic and social wellbeing of Australians by fostering willing participation in our tax and superannuation systems.</p> <p><b>Vision</b> We are a leading tax and superannuation administration, known for our contemporary service, expertise and integrity.</p> <p><b>Values</b> We are impartial, committed to service, accountable, respectful and ethical.</p> <p><b>Goals</b></p> <ul style="list-style-type: none"> <li>• Easy for people to participate</li> <li>• Contemporary and tailored service</li> <li>• Purposeful and respectful relationships</li> <li>• Professional and productive organisation.</li> </ul>
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Comparing the ATO's objectives for managing and resolving disputes with taxpayers outlined in the Dispute Management Plan with the mission, vision, values and goals of the ATO, it can generally be said that the dispute resolution objectives are intended to meet the aspirations espoused by the ATO's overall organisational mission, vision, values and goals.<sup>121</sup>

In addition, the ATO's Code of Settlement provides underlying guidance on the ATO's approach towards the settlement of tax disputes in relation to all taxpayers. It provides that tax disputes must be settled in a manner that is consistent with good management of the tax system, overall fairness and best use of ATO and other community resources. The dispute system (as well as the use of ADR) is also shaped by the ATO's model litigant obligations under the Attorney-General's *Legal Services Directions 2005* (Cth) which require the ATO to avoid, prevent and limit the scope of legal proceedings, including by giving consideration to ADR before initiating legal

<sup>120</sup> ATO, *Vision, Mission and Values Statement* (4 September 2014) <<https://www.ato.gov.au/about-ato/about-us/in-detail/strategic-direction/ato-vision,-mission-and-values-statement/>>.

<sup>121</sup> The objectives are also generally consistent with the primary approach of the ATO's Compliance Model whereby the ATO aims to encourage the majority of people to 'do the right thing' through making it as easy as possible to comply: ATO, *Compliance Model* (27 April 2015) <<https://www.ato.gov.au/about-ato/about-us/in-detail/key-documents/compliance-model/>>.

proceedings.<sup>122</sup> Similarly, the *Civil Disputes Resolution Act 2011* (Cth) requires the ATO, as a party to a dispute, to take 'genuine steps' to resolve a dispute before commencing proceedings in the Federal Court of Australia, including considering ADR.<sup>123</sup> The aspects discussed above all indicate that the dispute resolution system is integrated into the ATO and reflects the organisation's mission, vision and values.

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

There is provision for evaluation of the system in the respect that taxpayers can provide general feedback (compliments, complaints and suggestions) to the ATO through various means including online, by phone, fax or mail. In addition, following the completion of specific dispute resolution processes such as the ATO's facilitation and independent review processes, participants are invited to complete a feedback form to capture their views on the process and to identify areas for improvement.

The ATO engages external market research companies to conduct regular (on-going) surveys to monitor perceptions in the community generally, in the business community and among tax professionals about the way they administer the tax system and to gauge satisfaction levels with the way the ATO operates. Evaluation of the dispute system is provided by those surveys which relate to stakeholder perceptions on, and satisfaction with, the ATO's tax disputes resolution system.<sup>124</sup> Evaluation of the system also occurs through one-off surveys or research projects such as the ADR feedback survey conducted for the ATO by the ACJI.<sup>125</sup>

In addition, evaluation can occur through inquiries conducted by parliamentary committees on tax disputes and the tax disputes resolution system.<sup>126</sup> Evaluation of the disputes system is further provided by a number of government-appointed entities that examine various aspects relating to how the ATO administers Australia's tax and superannuation systems. These entities include the IGT<sup>127</sup> and the Australian National Audit Office (ANAO).<sup>128</sup>

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<sup>122</sup> *Legal Services Directions 2005* (Cth) Appendix B, section 2(e)(iii).

<sup>123</sup> *Civil Disputes Resolution Act 2011* (Cth) sections 6–7.

<sup>124</sup> For example, the ATO currently commissions a quarterly survey designed to understand the perceptions of fairness of taxpayers who have recently finalised a tax dispute with the ATO. Australian Taxation Office, Submission No 10 to the House of Representatives Standing Committee on Tax and Revenue—Supplementary Submission, *Inquiry into Tax Disputes*, 16 July 2014, 4.

<sup>125</sup> Sourdin and Shanks, above n 60.

<sup>126</sup> See, for example, Parliament of Australia, above n 71.

<sup>127</sup> The IGT reviews potential systemic issues in tax administration and makes recommendations to Government for improvement.

<sup>128</sup> The ANAO conducts performance audits that examine the efficiency and effectiveness of ATO administration.

## 5. DISCUSSION AND RECOMMENDATIONS

The DSD evaluation conducted in Section 4 indicates that the Australian tax dispute resolution system follows many of the DSD principles of best practice identified in the prior DSD literature, including: involving stakeholders in the design process; providing multiple options for addressing conflict; providing loop-back mechanisms; allowing for notification before and feedback after the dispute resolution process; the inclusion of 'internal independent confidential neutrals' in the system (for ATO officers); the formal disputes procedures are arranged in a low to high cost sequence; and offering assistance with choosing the best process. A key strength of the system is that it is visibly supported by senior management. In addition, the ATO's dispute resolution approach as outlined in its Dispute Management Plan is aligned with the mission, vision and values of the organisation. There are also several internal and external mechanisms to evaluate the system which serve to foster the continuous improvement of the dispute resolution procedures.

Similarly, in her DSD evaluation of the Australian tax disputes resolution system, Mookhey concludes that the ATO dispute resolution model possesses 'much of the best-practice principles advocated by the Ury, Brett and Goldberg model such as clear, multi-step procedures and emphasis on negotiation, notification and consultation.'<sup>129</sup> However, she makes some particular recommendations for reforming the ATO dispute resolution model. Mookhey suggests that the ATO model should be reformed so that there is an 'increase in transaction costs at each level and affordable access to first-level external review is highly desirable, so as to increase the pressure for a negotiated outcome at an early stage'.<sup>130</sup> However, as noted in Section 4, the researcher of this current study argues that the formal Australian tax disputes resolution procedures are apparently arranged in a low to high cost sequence notwithstanding the arguably unavoidable high upfront costs that may be incurred by taxpayers. Moreover, the sequence of procedures followed by the formal Australian tax disputes resolution system is typical of tax dispute resolution systems generally.<sup>131</sup>

Nevertheless, the DSD evaluation conducted in this study indicates that the Australian tax disputes procedures still remain deficient in the respect that there is an absence of a loop-forward mechanism that can allow parties to by-pass the internal review process and proceed directly to external review by a tribunal or court. It follows that the system has only one structural entry point and there is no option for taxpayers to choose a preferred process (that is, between internal review and external appeal) at the outset. The researcher suggests that the above deficiencies could be addressed by providing taxpayers with the ability to enter the dispute resolution procedures at either the internal review level or external appeal level. Accordingly, this would also provide taxpayers with 'affordable access to first-level external review' as suggested by Mookhey.<sup>132</sup> As a consequence, structural (and legislative) changes to the Australian tax disputes resolution system would be necessary.

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<sup>129</sup> Mookhey, above n 11, 94.

<sup>130</sup> *Ibid.*

<sup>131</sup> Bentley, above n 12, 365.

<sup>132</sup> Mookhey, above n 11, 94.

In addition, Mookhey suggests that 'further improvement to the ATO model should come with the specific dispute resolution training initiatives for ATO personnel.'<sup>133</sup> The DSD evaluation in this current study draws essentially the same conclusion. The fact that currently ATO case officers 'may but do not always'<sup>134</sup> have training in negotiation and other relevant conflict management and early resolution skills arguably indicates that the ATO has been slow to address the need to enhance the skills of ATO personnel via specific dispute resolution training initiatives. The present system could thus be improved with the provision of training in conflict management and early resolution for ATO staff who interact with taxpayers as a required component of their professional training and development regimes. However, as noted in Section 4, the ATO is currently working on building a comprehensive enterprise wide dispute resolution curriculum. Such training initiatives may help to improve perceptions of fairness of the dispute resolution system that exist with respect to the ability and authority of ATO officers to engage with taxpayers and resolve disputes. Moreover, improved perceptions of fairness as well as more positive interactions with taxpayers can in turn enhance voluntary compliance.

Mookhey further states that 'significantly missing from the ATO model is a formal procedure for obtaining feedback from taxpayers as parties to tax disputes'.<sup>135</sup> As outlined in Section 4, since Mookhey's study, the ATO has implemented various feedback mechanisms such as inviting participants in the ATO's facilitation and independent review processes to complete feedback forms and conducting debriefing sessions at the end of independent reviews. Feedback on ADR has also been obtained through the one-off ACJI ADR feedback survey. Notwithstanding the above developments, as noted in Section 4, further improvement to the ATO's feedback mechanisms could be made with the real time publication of the ATO's litigation and ADR statistics (as opposed to being published annually or biannually). Taxpayers use the statistics produced to assess their likelihood of successfully engaging with the ATO at each stage of the dispute resolution process and the time typically taken for each level of engagement. Accordingly, the real time publication of statistics may prevent the unnecessary escalation of disputes.

The foregoing discussion indicates that despite the various ADR initiatives implemented by the ATO in recent years, from a DSD perspective the Australian tax disputes resolution system remains structurally deficient in terms of the absence of multiple entry points to the system (and thus, the system does not provide affordable access to first-level external review). Moreover, notwithstanding the more comprehensive range of DSD principles utilised in this current study, it appears that essentially the same fundamental deficiencies in the design of the Australian tax disputes resolution procedures as identified by Mookhey, continue to exist. While there is some overlap in the 14 principles, (for example, the deficiency in multiple access points is also reflected in the lack of a loop-forward mechanism in the system and the inability for taxpayers to choose a preferred process), there appear to be no 'new' deficiencies identifiable (among the 14 principles) in the design of the Australian tax disputes resolution system. This is notwithstanding the fact that certain design deficiencies may arguably be distinguished in the context of tax disputes resolution in general, such as the provision of an 'internal independent confidential

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<sup>133</sup> Ibid 92.

<sup>134</sup> Email from Julie Coates, above n 88.

<sup>135</sup> Mookhey, above n 11, 93.

neutral' within the tax authority providing mentoring and advice for taxpayers with respect to ADR techniques.

## 6. CONCLUSION

This paper has evaluated the effectiveness of the design of the Australian tax disputes resolution system utilising a comprehensive range of DSD principles drawn from the prior DSD literature. This evaluation has been set against the background of a number of developments in ADR and other dispute resolution initiatives implemented by the ATO in recent years. Overall these initiatives suggest that the Australian tax disputes resolution system is culturally well supported by the ATO's top management. The ATO's Dispute Management Plan further indicates that the ATO's approach to the management of disputes and ADR align with the ATO's organisational mission, vision and values.

However, the DSD evaluation conducted indicates that essentially the same structural deficiencies in the design of the Australian tax disputes resolution as identified by Mookhey, remain. Although, arguably this is not unexpected given the short time period since Mookhey's evaluation. While the ATO has made some progress in certain areas in relation to implementing procedures for obtaining feedback from taxpayers as parties to tax disputes and the provision of specific dispute resolution training initiatives for ATO personnel, the Australian tax disputes resolution system remains deficient in the respect that the system has only one structural entry point and thus, no first-level access to external review.

It was beyond the scope of this study to address how the recommended structural changes associated with providing multiple entry points to the Australian tax disputes resolution system would be implemented in practice (and also what associated legislative changes would be required). Exploration of the viable practical options for reform is a future area for research.

As noted in Section 5, notwithstanding the fact that this study has utilised a more comprehensive range of DSD principles than in previous studies, a limitation to this research is that some aspects of the DSD principles as expressed in their original context of workplace disputes appear not to be directly transferable to the tax disputes resolution context. For instance, tax dispute resolution procedures arguably are generally arranged in a low to high cost sequence. However, an exception to this, (owing to the particular nature of tax disputes which typically requires that taxpayers work out their positions from the outset), is that high upfront costs generally must initially be incurred by taxpayers. In addition, while it would be viewed as applicable for a tax authority to provide an 'internal independent confidential neutral' for providing mentoring and advice on ADR techniques to revenue authority staff, it would generally not be regarded as appropriate to provide such an equivalent to taxpayers. Therefore, an avenue for further research could lie in establishing a set of best practice tax DSD principles that can be applied by tax administrations in the specific context of tax disputes resolution.

It should also be noted that for a particular dispute resolution system, it is not necessarily the case that all DSD principles should be met for it to be regarded as an optimal dispute resolution system and trade-offs among principles may exist.

Moreover, this research has been conducted based on the assumption that all DSD principles rank equally in importance. However, in practice some DSD principles may be regarded as more important than others depending on the given context. In the case of the ATO, arguably a greater emphasis appears to be placed on the cultural aspects of DSD (for example, support and championship of ADR by top management) as opposed to the structural aspects (for example multiple structural access points). Further research could be conducted to ascertain which DSD principles are viewed as the most (and least) critical in the particular context of tax dispute resolution.

This study was also limited to evaluating the effectiveness of the design of the Australian tax disputes resolution system. This suggests that future research could be conducted to compare the effectiveness of the design of the Australian tax disputes resolution system against other jurisdictions.

# How compliant are the large corporate taxpayers? The Bangladesh experience

Zakir Akhand<sup>1</sup>

## ***Abstract***

Several tax compliance approaches have been designed to improve the tax compliance of large corporate taxpayers. In many tax administrations, Large Taxpayer Unit (LTUs) have been set up to closely monitor the assessment and collection of revenues from the large corporations. There has not been any research conducted to investigate how compliant the large corporations have been under the LTU model of tax administration. This research is an attempt to fill this gap taking Bangladesh LTU as an example. Using original survey data, this paper finds that the finance sector corporations achieve the highest compliance in return filing, while the manufacturing and service sectors corporations achieve the highest compliance in payment and reporting compliance respectively. In overall compliance, manufacturing sector corporations are the top compliers. The study findings would be different if tax compliance as a variable is measured differently. Additionally, differences in legal and regulatory structure of tax audits might limit the study findings further.

**Keywords:** *Tax compliance, LTU, large taxpayers, corporate sector, Bangladesh*

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<sup>1</sup> Associate Research Fellow, Tax Administration Research Centre, Room 0.31, School of Business, University of Exeter, Rennes Drive, Exeter, EX4 4ST, UK  
e-mail: zha202@exeter.ac.uk

## 1. INTRODUCTION

Taxpayers are not homogeneous in their risk and revenue characteristics. Each group of taxpayers poses different risk and revenue potentialities to the tax base and therefore requires a different set of compliance tools to regulate them. Tax compliance models employed to induce tax compliance by the large corporations include the Co-operative Compliance Model (CCM), Horizontal Monitoring Approach and Real Time Compliance Approaches etc. The unique feature of these compliance models is that they can be tailored according to the risk and revenue characteristics of the taxpayers (Braithwaite, 2007). To incite compliance, the CCM, for example, employs self-regulation through consultation and taxpayer services on the one hand and audit and prosecution on the other, depending on the compliance history and behavioural pattern of the taxpayer (Brondolo, 2009; Andreoni and Feinstein, 1998; Song and Yarbrough, 1978). The main driver of the CCM and other models (elaborated in section 4) is enhanced commitment towards a professional relationship between tax administrations and large corporations in order to increase voluntary compliance and reduce compliance costs (Braithwaite, 2007).

However a deep concern is how useful these compliance models have been in improving large corporate tax compliance. Shover et al. (2003) argue, despite the Australian Tax Office (ATO) providing sufficient resources to implement the CCM model, there is huge ambivalence among field-level tax officials about its long-term effect on tax compliance. Braithwaite and Braithwaite (2001) state that sixty percent of large corporations in Australia were found to be underpaying taxes in the 1990s and their compliance level seemed to be below the Organisation for Economic Co-operation and Development (OECD) average. A newspaper report shows that almost half of the 1100 largest corporations, of which 20 per cent made a profit, did not pay any taxes between the tax years 2005 and 2008 (The Sunday Morning Herald, 2010).

Similarly, in the UK, of the 700 largest business taxpayers with the Large Business Service (LBS), 181 did not pay any taxes in the tax year 2005–2006 (House of Commons, UK, 2008). The House of Commons report states that, ‘businesses pay little or no corporation tax because, for example, they have made a loss, or had losses in previous years, or they are using tax reliefs, or engaging in tax avoidance’. It is also reported that UK multinational corporations largely avoid and underpay taxes. In 2007, the LBS estimated a tax evasion of £8.5 billion by large businesses and successfully detected £2.7 billion of false claims for capital allowances and tax relief. Recently, global large corporations such as Google, Starbucks and Amazon have come under fire for avoiding taxes on their sales in the UK (Barford & Holt, 2013).

As for the US large corporations, the tax compliance scenario is equally unsatisfactory. The US International Confederation of Free Trade Unions (ICFTU) report in 2004 shows that one third of the 275 largest multinationals in the US did not pay any taxes from 2001 to 2003. In 2003, 46 of these corporations paid no taxes or were entitled to a refund, despite the fact that they disclosed profits of US\$ 42.6 billion. Other multinationals paid taxes at a falling effective tax rate during the period mentioned. The ICFTU found that large multinationals paid an effective federal tax rate of 26.5 per cent in 2001 and 21.4 per cent in 2003. The ICFTU report is apparent evidence that the large multinationals are underpaying taxes, although reasons could be other than tax administration issues.

Such evasive tax culture among large corporations call into question the contribution of cooperation and gentle persuasion for improving tax compliance among the large corporations (CATA 2006).

One of the ways to examine the contribution of this soft, persuasion-based LTU compliance models is to see whether the corporate tax compliance in the LTUs have increased or decreased over time. Thus the purpose of this paper is to measure the level of tax compliance achieved by large corporations, taking Bangladesh as the case, to understand the usefulness of LTU compliance model. The paper is mainly divided into four sections. The first section discusses the nature of large corporations and the Large Taxpayer Units (LTUs). The second section presents the research methodology. The third section produces the analysis and research findings, and the fourth section presents the conclusion of the study.

## **2. LARGE CORPORATE TAXPAYERS: DEFINITIONS AND SELECTION CRITERIA**

In general, big taxpaying corporate entities are treated as large corporate taxpayers. Watts (1978, p. 22) comments that, 'defining a large industrial enterprise is beset with problems. For example, size can be measured in several ways—number of staff employed, net assets (capital employed), value added (net output), turnover, issued capital and market capitalisation'. Watts (1978) identifies six characteristics by which large businesses can be distinguished from small and medium businesses in the non-corporate sector: separation of ownership and control; formal organisational structure; special influence on the national economy; multi-national exposure; varied outputs; and control from overseas. The distinguishing criterion changes with the variations in organisational forms of business because, firstly, in all large corporations ownership and management are separate due to public float of shares; secondly, many large corporations have international operations controlled under a parent-subsidiary relationship.

According to the OECD (2009, 6), 'large business or large taxpayer differs from one tax administration to another' as 'the identification criteria for large businesses vary from country to country'. The most frequently used criteria, according to the OECD (2009, p. 7) are: 'gross business turnover or sales; value of assets; amount of taxes paid; businesses belonging to certain industrial categories (banks, petroleum etc.); volume of international trade; and number of employees'. For Joulfaian and Mark (1999), the simple measure for organisation size is revenue receipts.

Using tax payments as a basis for identifying large corporate taxpayers is risky. Corporations may successfully underreport income to remain outside LTUs; or use tax holidays to end up with zero tax liability. This leads Baer et al. (2002, p. 14) to suggest, 'taxpayers who regularly underreport or underpay tax, large firms who enjoy a tax holiday and large exporters with significant amounts of refunds' should be excluded from LTUs. The exclusion of corporations from the LTU may however exacerbate the problem: in a non-LTU tax system. Large corporations may easily outsmart the tax administration and take advantage of its unprofessionalism (US GAO, 1997, p. 7).

However, the development of trade and commerce and the shifting state of tax revenues have generated a set of criteria that provides a general guidance on whether to define a business as large or medium. Some of them are net worth, number of

foreign affiliates, weighted average of all taxes—income tax, employment tax and value added tax (VAT) or state sales taxes for the US. Moreover, in its life cycle, a corporation may drop down in size to medium or small due to changes in business activities or changes in the set of defining criteria. Hamilton (1994, p. 6) mentions that, ‘large taxpayers are not simply a large version of small taxpayers and large taxpayers continually evolve’.

In Bangladesh, yearly turnover or sales is the main criteria to identify the large corporations. In addition, the whole of the finance and banking sector corporations are placed under LTU, irrespective to their levels of turnover. When the LTU came into being in Bangladesh in 2003, the National Board of Revenue (NBR), by its special order placed 254 large corporate taxpayers under the LTU’s jurisdiction, while in tax year 2011–2012, the number increased to 317 as a result of the initiative that placed merchant banks under the LTU’s jurisdiction. This suggests that the LTU has had an increase of  $(317-254) = 63$  corporate taxpayers during the last 9 years. Similarly, the LTU Lahore and Islamabad started with large businesses from banks, garments, cements, oil and gas and a few other specialised sectors (FBR, 2014). While in India the basis for selecting large corporations for LTU was tax payment over a certain amount, including excise tax, service tax and income tax, rather than turnover or sales (Ministry of Finance, India, 2014). Thus the selection criteria of large corporations for Bangladesh LTU are mixed which is more similar to the case of Pakistan than India.

### 3. LARGE TAXPAYER UNITS (LTUS): DEFINITIONS AND HISTORICAL BACKGROUND

To measure the effectiveness of the LTU compliance models through measuring the corporate tax compliance, an understanding of LTU as a tax administration unit and its historical background would be crucial.

In general, an LTU is a self-contained tax administration office, parallel to or embedded in the tax system, which attempts to provide one-stop services in most tax jurisdictions. In some countries, LTUs, however, deal with a single tax. For example, LTU in Canada, Norway, and the US deal only with income tax (see Table 1). Similarly, in Bangladesh and Pakistan, there are separate LTUs to administer VAT and income tax liabilities.

The broad consensus among researchers and academics on the definition of an LTU is that it deals only with the largest taxpayers. In Perry’s view, large taxpayer units are ‘designed to provide full management of a small percentage of the biggest taxpayers in the country ... a subset of taxpayer-segment-based organizational structure’ (2004, p. 382). Some researchers view LTUs as a nucleus for tax administration reform (McCarten, 2004). Their existence brings a complete change in the tax administration and opens up new windows for modernisation. McCarten (2004, p. 2) describes an LTU as ‘a potential Trojan horse for reform in tax administration ... an institutional reform substitute for a semi- autonomous revenue agency’ (SARA) and as a public sector analytical tool to manage public revenues. In the changing regulatory environment, LTUs are a glaring example of how power-based techniques can be supplanted by soft approaches that reduce the cost of compliance and increase compliance (Tuck, 2004). LTUs have a comparatively efficient and less corrupt workforce, and their organisation follows a functional design. In particular, their collection efforts through intensive monitoring of filing, and collection of arrears,

make LTUs an essential organ of tax administration (Bodin, 2003, quoted in Ainsworth, 2006; Santos, 1994).

The concept of the LTU was introduced in Argentina in the late 1970s (McCarten, 2003). In the early days, LTUs used to audit high turnover corporations to increase reporting compliance. During the early 1980s, the concept of the LTU was adopted in Bolivia and Peru, with the sole aim of increasing filing compliance. Vazquez-Caro (1996) emphasises two issues in the spread of the LTU in Latin America: first, close monitoring of those taxpayers with the highest revenue concentrations; and second, a shift of assessment and collection responsibilities from the public to the private sector. LTU expansion got its momentum in the early 1990s, under IMF patronage. By 2002, 50 countries, and by 2006, 67 countries, had established LTUs as an independent unit or as a special wing within the semi-autonomous revenue administrations (Baer et al., 2002; CATA, 2006).

**Table 1: Tax collection by LTUs in OECD countries for 2006–2007**

Country	Tax collected (Figures in billion Euros)	Percentage of tax collected	Taxes administered
Australia	€29.3	64.5%	Corporate income tax (CIT)
Canada	€12.9	53%	CIT
France	€118	33%	CIT and business local tax, VAT, local Tax
Ireland	€18.8	41.3%	CIT, VAT, employment tax, excise, customs, vehicle registration tax, stamp duties
Netherlands	€80	60%	CIT, VAT, employment withholding tax
Norway	€1.25	16%	CIT
UK	€160.8	70%	CIT, VAT, employment tax, petroleum tax
US	€228.4	90%	CIT

Source: OECD, 2009.

A review of revenue collection in selected OECD countries (see Table 1 above) shows that LTU corporate taxpayers' share of corporate income tax revenues ranges from a minimum of 16 per cent (Norway) to a maximum of 90 per cent (the US). The US Large Business Unit collected €228.4 billion of corporate income tax in the tax year 2006–2007, which equals 14.6 per cent of US national tax revenues, and 90 per cent of corporate tax revenues. Australia collects 64.5 per cent of corporate income taxes from LTUs and Canada 53 per cent. In some countries, for instance the UK and

France, LTUs collect more than one tax, including income tax, VAT, customs, excise and employment taxes. Seventy percent of the aforementioned taxes in the UK and 60 per cent in the Netherlands are provided by the LTUs.

In the developing countries, the potentiality of revenue collection from the large taxpayers is also very high. The International Monetary Fund (2011) finds that usually a few hundred large corporations in the developing countries can secure 60 per cent to 80 per cent of domestic taxes. Table 2 shows that in Africa and in the Middle Eastern countries large corporations are less than one per cent of the total taxpayers, but they provide over 70 per cent of tax revenues. One reason for this, as the International Tax Dialogue (2007) explains, is that the large corporations act as the withholding agents for medium and small taxpayers, so some of the tax payments made by the large corporations constitute the advance taxes and prepayments made by the smaller enterprises.

**Table 2: Concentration of tax revenues in large corporations (selected countries)**

Country	Percentage of taxpayers	Percentage of tax revenues
<b>Brazil</b>	0.3	80.0
<b>Argentina</b>	0.1	49.0
<b>Benin</b>	1.0	90.0
<b>Bulgaria</b>	0.1	51.4
<b>Kenya</b>	0.4	61.0
<b>Spain</b>	0.1	40.2

Source: International Tax Dialogue, 2007.

#### 4. TAX COMPLIANCE MODELS USED IN THE LTUS

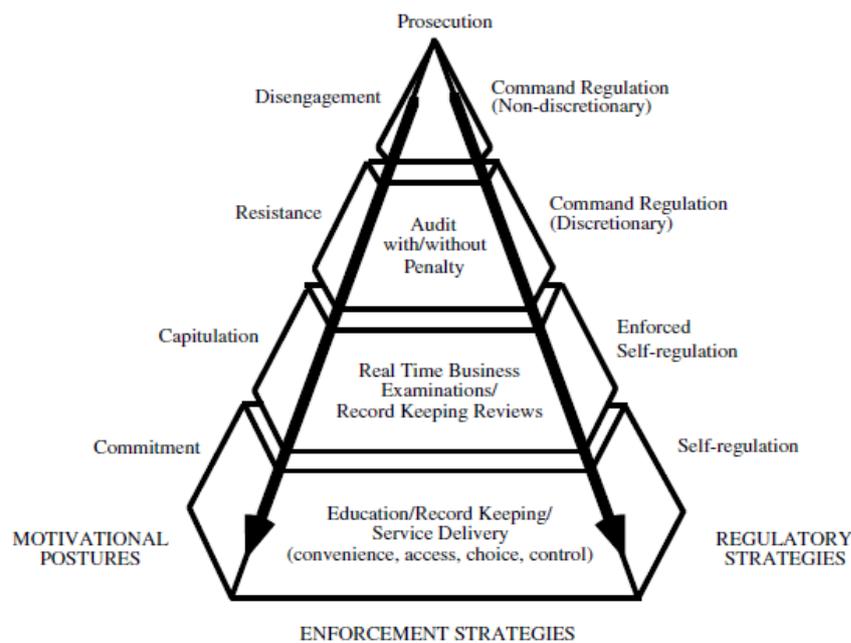
The leading compliance models employed to induce large corporate tax compliance are examined in this section. The ultimate objective of these models is to increase the level of self-assessed voluntary compliance, focusing more on the motivational postures of tax compliance than the hard actions.

##### 4.1 Co-operative Compliance Model (CCM)

This compliance model was developed by the ATO. The unique feature of the model is that it can be tailored according to the risk and revenue characteristics of the taxpayer (Braithwaite, 2007). To control compliance, the CCM encourages self-regulation through consultation and taxpayer services on the one side and audit and prosecution on the other (Brondolo, 2009). The idea that this model restricts the capacity of tax agencies to examine tax compliance through coercive actions is therefore not correct. In practice, audits are conducted on a random basis and prosecutions are used as a last resort. The basic philosophy of this compliance approach is to prioritise community cooperation and confidence-building.

The compliance pyramid presented below in Figure 1 shows that the vast majority of taxpayers are managed at the bottom by motivational procedures, and the non-compliant at the top are managed by coercive procedures.

**Figure 1: Regulatory practice of ATO cooperative compliance mode**



Source: Braithwaite, 2003.

The main driver of this model is the committed professional relationship between tax agencies and large corporations that reduces compliance costs, increases voluntary compliance, and improves the clarity of the law. Most of the LTUs, including Bangladesh, India and Pakistan, use this model to manage tax compliance.

#### 4.2 Horizontal monitoring approach

Developed by the Netherlands Tax and Customs Administration (NTCA), this compliance model focuses on corrective measures to improve large taxpayer compliance and assumes that risk-based approaches do not solve all compliance problems. Based on findings about risk-based approaches, changing social norms and values, and the behaviour of taxpayers, the following have been quoted as the essentials of the horizontal monitoring approach (CIAT, 2009, p. 2): mutual trust; understanding and transparency; shared responsibility; real-time working; advance ruling; cooperation with other authorities; and focus on outcome rather than output.

In effecting its changes, this approach replaces the traditional vertical approaches of compliance monitoring. It decides which compliance instruments are to be used to change particular compliance behaviour. It emphasises proactive rules and taxpayer services instead of audits and investigations. The proactive tools attempt to avert non-compliance before it happens to bring long-term improvements in tax compliance.

The approach is successful where taxpayers have been persistently failing to comply because of a lack of knowledge of tax laws, enhanced communication or quality taxpayer services. However, in some cases the approach demonstrates the need for audit measures to increase awareness among the taxpayers.

During compliance supervision, this approach proceeds thematically through tax and non-tax issues. For example, for measurement of tax risks in the labour market, issues of illegal labour, including human trafficking, are studied in order to understand the problem comprehensively. In the supervision mechanism for tax compliance, the roles and responsibilities of all partners are well-defined, and issues of transparency, equality, and mutual trust are acknowledged. Mutual trust lies at the centre of this compliance approach, and is nurtured through transparency and understanding between large corporations and tax agencies. For the most part, the role of the tax agencies is corrective, motivational and persuasive in the actualisation of higher tax compliance.

### **4.3 Real time compliance approaches**

This approach belongs to the cooperative compliance model. The essence of this approach is to address a compliance problem before it arises and resolve it immediately. The approach is different from others in that it does not depend on post-facto analysis of risk.

Some of the methods and programmes commonly in use are as follows:

#### *4.3.1 Forward compliance agreement (FCA)*

This model was developed by the ATO to offer early resolution of compliance issues. It allows taxpayers to discuss return-filing and tax payment issues easily, in order to avoid penalties and interest. The method is expensive and time-consuming, and has recently been replaced with the Annual Compliance Agreement (ACA).

#### *4.3.2 Advance ruling*

Slightly different from the above, this approach interprets tax laws, and their revenue and non-compliance implications, for specific business transactions by large corporations, usually cross-border transactions. The major objective of this approach is to cut the high cost of forward compliance agreements and at the same time solve real compliance issues. For example, in order to handle potential compliance risks in transfer pricing, the tax agency may define the pricing methodology in consultation with the concerned parties through an Advance Pricing Agreement (APA) (Arnold & McIntyre, 2002). The rulings frame the transaction procedure to be followed under certain terms and conditions for a certain period, failing which sanctions and penalties will be attracted.

Apparently these models focus more on the softer measures than the tougher ones to improve tax compliance. However, few, if any, studies exist regarding the effectiveness of these models in boosting tax compliance, especially among the large corporations which is challenging for many tax administrations.

The next section discusses the challenges and the benefits the tax administrations face in improving tax compliance by large corporations.

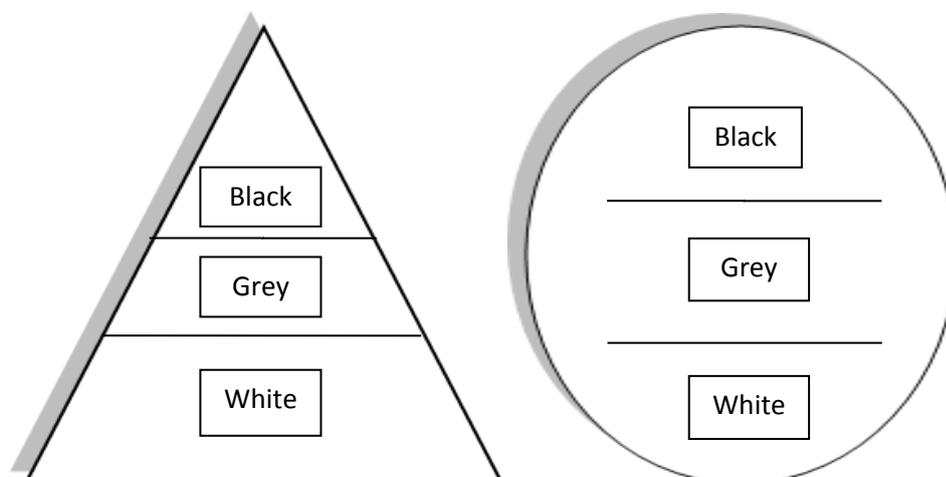
## 5. CHALLENGES AND BENEFITS OF MANAGING LARGE CORPORATE TAXPAYERS

This research is conducted in the context of developing countries' tax administration, whose common features are: a small revenue base, low tax compliance, high collection costs and a huge informal sector (Joshi & Ayee, 2008). In developing countries, tax administrations suffer from serious problems of poor record-keeping, inefficiency and bureaucratically designed corporate governance systems (Moore, 2004).

In tackling these problems, the assessment, collection and enforcement of the taxes of large corporate taxpayers in LTUs have been separated through the functional distribution of the work. A big challenge however is that enforcement actions towards large corporate taxpayers in many developing countries including Bangladesh are weak compared to the other functions. For instance, the Ugandan Large Taxpayer Department (LTD) failed to achieve its monitoring and enforcement goals after an initial success, like other sub-Saharan revenue authorities (DFID, 2001; Kangave, 2005). In evaluating the performance of the Ugandan LTD, the DFID (2001, p. 34) states, 'it is still too soon to judge the impact on revenue of the Large Tax-payer Department in Uganda, but so far this appears to have been limited'.

Another challenge, often argued, is that the explicit focus on large corporations may have an adverse effect on small taxpayers which as a result may weaken the LTUs' capacity to raise tax compliance in a socially cohesive manner (Terkper, 2003; Phillips, 2008). The strategy of specialization may sometimes be at the expense of other parts of the organizations, as the LTUs usually require and attract the most senior and skilled officials (Alink & Kommer, 2011).

In addition, large corporate taxpayers' view of tax law complicates the compliance issues further. McBarnet (1992) argues that the tendency of large taxpayers is to follow tax law by its intention, rather than by letter of the law. Large taxpayers actively try to transform the law into routes of tax avoidance, or finally break the law in such a way, with the help of hired expertise and political contacts, that they are not caught (Braithwaite & Wirth, 2001; Brondolo, 2009; Phillips, 2008; Clinard and Yeager, 1980; Conley and O'Barr, 1997). Sometimes the LTU officials or the tax administration has an involvement in the misinterpretation of tax laws so as to have a share of the potential gain arising from such connivances (McCarten, 2004). Braithwaite and Wirth (2001) note that managing large corporate tax compliance is more daunting than managing that of individual taxpayers because of the differences in their compliance patterns.

**Figure 2: Patterns of individual (left) and corporate (right) tax compliance**

Source: Braithwaite & Wirth, 2001.

As shown above in Figure 2, the pyramid depicts the tax compliance pattern of individual taxpayers, while the oval depicts the tax compliance patterns of the large corporations. The individual tax compliance pattern is pyramidal; most taxpayers are lying at the bottom, whereas the large corporate tax compliance pattern is oval, with most of the taxpayers falling within the grey area in the middle. What is needed to make the compliance pattern pyramidal, according to Braithwaite and Wirth (2001), is to push the middle group towards the bottom. Braithwaite and Wirth (2001) argue that an acceptable way to achieve pyramidal compliance for the large corporations is to apply more of the self-regulatory instruments (that is, taxpayer education, service delivery etc.) instead of command regulations (penalty, tax audit etc.).

A further challenge for large corporate tax compliance management is a continued lack of professionalism, widespread corruption and political intervention. Many large taxpayers successfully hide income by setting up ‘shell’ offshore corporations or having a partnership with their parent corporation instead of a subsidiary relationship (Easter, 2008), or enjoying tax holidays through undue political intervention (McCarten, 2004). A survey of US corporations shows that nearly all large corporations and more than half of medium sized corporations have been offered safe transfer of money by tax shelter promoters (Slemrod, 2004). According to Christian Aid (2010), as a result of trade mispricing by the multinational companies, the poor countries are deprived of US\$160 billion of tax revenues every year and Bangladesh is one of the five low-income countries suffering the biggest tax losses (£186m).

The ‘good side’ of managing large corporations is that, due to the requirement of high-quality financial and accounting standards set by local and international accounting bodies, large corporations have to follow strong reporting requirements with respect to their investment, revenue and profit (Kieso et al., 2011, p. 6). These control mechanisms ensure access to the transaction records needed to make the auditing process transparent. Also, large corporate taxpayers are particularly helpful in collecting taxes from other taxpayers under the withholding tax arrangement.

## 6. METHODOLOGY

### 6.1 Data sources and sample descriptions

The purpose of this paper is to measure the level of tax compliance achieved by the large corporate taxpayers in the LTU of Bangladesh. This will help with evaluating and understanding the contribution of the LTU compliance model in encouraging tax compliance from large corporations. It is worth noting that this study will not assess the success or failure of LTUs as a unit of tax administration. Measuring the performance of the LTU as a tax administration unit and measuring its compliance models is somewhat different. Measuring the overall performance of the LTU or any tax administration office would require developing a comprehensive set of performance indicators including taxpayer service and education, returns processing and payments, arrears collections, audit and investigations and appeals, in addition to the compliance scenario of the large taxpayers (Crandall, 2010).

The population of corporate taxpayers in the LTU of Bangladesh is 275, which includes finance, manufacturing and service sector corporations. This paper takes tax compliance data of 2010 tax year—the year in which the LTU reform ended and the year considered to be comparatively stable in terms of collection, assessment and audit actions. A written approval was granted by the Bangladesh LTU authority to use their database (see Appendix 1). Real tax office records and documents provided primary data which gave valuable information on return filing, tax payment, and audit adjustments. In studying tax compliance in Australia, Tran-Nam et al. (2000, p. 243) state, ‘the ability to use the tax authority’s database instead of commercial mailing ... represents a significant improvement’.

For in-depth information on the research context and explanations on compliance behaviour, one-to-one personal interviews based on semi-structured questions were conducted. The interview technique enables clarification and elaboration of a respondent’s observations and confirms or rules out ways of reasoning (Kvale, 1996). In a tax compliance study like this one, as Hasseldine et al. (2007) argue, field interviews allow the researcher to probe taxpayers’ attitudes to sanctions and motivational issues, and to gain an in-depth understanding of the research problem.

A stratified random sampling was adopted for this study, where every item of the strata would have an equal chance of being selected. In social science research, the alpha level applied in determining sample size is either 0.05 or 0.01, with 0.05 used more commonly, and for categorical data the standard margin error being five per cent (Lohr, 2010). Israel (2009) suggests using the following formula to determine the sample size for a given population.

$$n = N/[1+N(e)^2]$$

where, n= sample size, N= population, e = alpha level.

Using the above formula, the sample size derived for the study is:  $n = 275/[(1+275(.05)^2)] = 162$ .

**Table 3: Descriptive statistics on sample corporations (N = 154)**

Characteristics	Categories	Frequencies	Percentages	Cumulative ratios*
<b>Ownership Structure</b>	Public limited	115	74.7	74.7
	Private limited	39	25.3	100
<b>Corporate sector</b>	Finance	80	51.9	51.9
	Manufacturing	43	27.9	79.9
	Service	31	20.2	100
<b>Corporate location</b>	Local	129	83.8	83.8
	Multinational	25	16.2	100
<b>Corporate size</b>	A (assets) <\$3m	25	16.2	16.2
	\$3m<A<\$7m	36	23.4	39.6
	\$7m<A<\$25	31	20.1	59.7
	\$25m<A<\$80m	24	15.6	75.3
	\$80m<A<\$500m	17	11.0	86.3
	A>\$500m	21	13.7	100
<b>Incorporation age</b>	3–6 years	13	8.4	8.4
	7–10 years	52	33.7	42.1
	11–14 years	28	18.1	60.2
	15 years or more	61	39.8	100

\* For all characteristics, cumulative percentages are calculated on valid percentages, for example, 154.

Table 3 above shows the demographic composition of the sample large corporate taxpayers. The sample size for the study is 162. Since the tax files of some corporations were either not produced or pertaining to matters currently before the appeal courts, sample size was reduced to 154. As it shows, 74.7 per cent of the corporations had public limited ownership, with only 25.3 per cent being private. Of these, finance sector corporations constituted the majority (51.9%) followed by the manufacturing sector (27.9%) and service sector (20.1%) corporations. Large corporations with multinational locations numbered only a few (16.2%), with local corporations being the majority (83.8%). Corporations with assets between US\$3

million and US\$7 million comprised the largest band (23.4%), followed by assets within the range of US\$7 million to US\$20 million (20.1%). Statistics for incorporation age (for example, age group) show that large corporations in the 15 years or more group formed the principal category (39.8%).

## 6.2 Tax compliance: Definitions and measurement

In its simplest form, tax compliance means filing returns for all taxes at the appropriate time, as required by income tax laws (Roth et al., 1989). According to Brown and Mazur (2003), tax compliance has three levels: filing, reporting and payment. Filing compliance refers to the proportion of registered taxpayers submitting returns. In calculating the percentage of filing compliance, large taxpayers registered within the LTU has been used as the basis. There may be large taxpayers in other tax jurisdictions of Bangladesh, although according to the NBR notification all large taxpayers have been placed with the LTU. Assessing payment compliance involves measuring the percentage of taxes paid by the due date. Finally, reporting compliance measures whether income is concealed or expenses are overcharged or any inadmissible expenses are claimed as admissible.

These three compliance segments maintain a mutually exclusive relationship in the sense that filing compliance by a corporation does not necessarily mean that it is reporting and payment compliant. The opposite, a mutually inclusive and concurrent relationship, may also prevail among the three segments, for example, the return is filed on time, all income is declared, and taxes are paid in full. Another possibility for the relationship of the components is that returns are filed on time and incomes are reported properly, but taxes are not paid in full; for reporting fully does not mean paying fully. The only possible absurdity in the relationship would be for taxes to be paid in full but income not to be reported or tax returns not to be filed.

Given the above components of tax compliance, the measurement of full or overall tax compliance is only possible by summing up compliance achieved for each of the three components. However the process of summation depends on how compliance is defined in a particular context. In the extant literature, tax compliance is defined as a continuous variable. For example, Hamm (1995) and Palil (2010) measured tax compliance as a ratio or proportion. In their formula, reported income is divided by the total taxable income to measure the extent to which the taxpayer is compliant in its reporting obligation. The same technique can be applied to measure payment compliance, but for measuring filing compliance this technique is potentially flawed. This is because filing is either full or zero—a taxpayer cannot be partially filing compliant. Thus filing compliance would be best measured as a dichotomous variable. A variable is dichotomous when it can have only two possible values (Nachmias & Guerrero, 2011).

Similar argument can be made in the measurement process of reporting and payment compliance, namely, after taking into account all disclosed incomes and tax payments, the final status of a taxpayer is either compliant or non-compliant—a binary outcome as presented in Table 4.

**Table 4: Binary measurement of tax compliance**

<b>Compliance type</b>	<b>Compliant</b>	<b>Non-compliant</b>
<b>Filing compliance</b>	1	0
<b>Reporting compliance</b>	1	0
<b>Payment compliance</b>	1	0
<b>Overall compliance, if shown</b>	3	-
<b>Overall non-compliance, if shown</b>	-	0, 1 or 2

Table 4 demonstrates that corporations filing tax returns within time are filing compliant and are assigned a value of 1; those failing to file tax returns within the time are filing non-compliant and assigned a value of 0. Filing compliance was measured directly from the tax office records that showed whether tax returns had been filed in time or not. According to the Income Tax Ordinance 1984 (Bangladesh), all corporate taxpayers, small, medium or large, are required to submit annual tax returns by 15 July. However, if 15 July precedes the expiry of six months from the end of the income year then filing should be made within six months from the end of that income year. Filing non-compliance is difficult for a corporate taxpayer, especially a large one, since getting registered with the tax authority is a pre-condition to incorporation by the Joint Stock Office of Bangladesh.

Similarly, reporting compliance was measured from LTU audit adjustments. The LTU audit records contain information as to whether there was audit adjustment. Any adjustment imposed on a firm means that there has been a case of underreporting of income. For measurement purposes, no audit adjustment means the taxpayer has been found to be 'clean' in its income declaration, although practically it may mean that the audit measures have failed to uncover any unreported income or over claimed deductions. No audit adjustments means the taxpayer is reporting compliant (value = 1), whereas audit adjustments means reporting non-compliant (value = 0). Finally, payment compliance was also measured from the LTU payment registers, which showed whether taxes have been paid fully on the correct taxable income. Taxes here imply only income tax, not VAT, employment and other taxes. No shortfall between the payable and the paid taxes makes a taxpayer payment compliant (value = 1). Any shortfall between these two makes a taxpayer payment non-compliant (value = 0).

Based on the above arguments, a taxpayer is considered overall compliant if each of the components has scored 1 (filing = 1, reporting = 1 and payment = 1), that is, a total score of 3. Taxpayers will be overall non-compliant if their total score is less than 3 (for example, score from 0 to 2). Obviously, the number of overall compliant taxpayers is likely to be less as this approach necessitates compliance in all three areas at the same time. However, to ascertain the extent of tax compliance accurately, the fate of audit adjustments or other non-compliances in the appellate forums needs to be taken into account.

The next section discusses the impact of appeals on the measurement of tax compliance.

### 6.3 Effects of appeals on compliance measurement

In consideration of the high appeal rate and its probable impact on study results, adjustments were made in the measurement of tax compliance. Without considering the effects of appeals, the tax collections reported in the LTU annual reports and studies based on such reporting are going to be misleading and methodologically inappropriate.

As in the LTU of Bangladesh, corporations declared non-compliant for any compliance component may opt for an appeal to the Taxes Appellate Authority (TAA). If a taxpayer fails at the TAA stage, it may opt for a second appeal to the Taxes Tribunal Authority (TTA). Finally, there may be an appeal to the High Court (HC) of Bangladesh. The LTU also reserves the right to challenge any appellate or tribunal judgment passed in favour of a taxpayer.

**Table 5: Appeal outcome on cases found non-compliant by desk and comprehensive audit (N=154).**

Appeal cases	Frequency	Percentage	Valid percentage	Cumulative percentage
Dismissed	58	37.7	37.7	37.7
Allowed	14	9.1	9.1	46.8
Others	13	8.4	8.4	55.2
<b>Total</b>	<b>85</b>	<b>55.2</b>	<b>55.2</b>	
Not an appealable case	61	39.6	39.6	94.8
Did not opt for an appeal	8	5.2	5.2	100.0
<b>Total</b>	<b>154</b>	<b>100.0</b>	<b>100.0</b>	

Of the 154 sample large corporations as reported in Table 5, 85 lodged appeal cases against the LTU's audit decisions, of which 58 appellants failed, 14 won and 13 had their appeal cases set aside or re-assessed. Of the remaining large corporations (154-85) = 61 were happy with the LTU's decision and 8 corporations did not opt for an appeal, although there were grounds for one. All the 14 appeals yielding positive outcome relate mainly to reporting non-compliance. While measuring reporting compliance, corporations that were treated as non-compliant by the LTU but were later judged compliant by appeals courts were considered reporting compliant. LTU records show that only 68 corporations were reporting compliant, but when the appeal and re-assessment effects were included, the number of reporting compliant

corporations increased to 83. If this adjustment had not been made, the measurement of both reporting compliance and overall compliance would have been affected. However, no records were found on how many of those who failed in the first appeal opted for further appeals in the TAA or HC levels. Since some appeals were still pending in the TAA and HC levels, at the time the survey was conducted, it was not possible to take into account the effects of these appeals on the study design. Therefore the adverse effect of high appeals on the study outcome could be mitigated largely, but not fully.

Another issue related to the accuracy of this measurement is the quality and neutrality of appeal judgments. It was argued by a respondent that ‘the appellate authority is outright corrupt and they sell judgments for money’ (Respondent 26). Another respondent stated, ‘Large corporations know that if the LTU does not accept the audit report, they have to go for an appeal and have to spend money in the appellate forums to get justice’ (Respondent 9). Other respondents commented that the money taxpayers spent in buying justice made them underreport income. The next section discusses the analysis and findings about the level of tax compliance achieved by the large corporations.

#### **6.4 Methodological limitations and constraints**

It is important to keep in mind several limitations regarding this study before claiming any authoritative conclusions. The first limitation is that there may be taxpayers with highly tax-averse nature with respect to ‘grey areas’ of taxation for which it’s difficult to account. Second, filing returns in time may be beyond the control of the taxpayer. In some cases the tax authority may fail to register the taxpayer in time. Recently, many taxpayers in Bangladesh failed to register in time due to technical difficulties in mandatory e-TIN (Taxpayers’ Identification Number) software. Third, there are concerns about the audit adjustments made on immaterial technical grounds (Fuest and Riedel, 2009). Fourth, determining tax liabilities for large corporations requires specialised knowledge. Lack of professional knowledge and understanding by the LTU officials may give rise to instances of reporting and payment non-compliance (elaborated in section 7.2). Again, tax evasion and corruption are endemic in Bangladesh (Khan, 1996; Chowdhury, 2006) which raises a basic concern about the effectiveness of tax audit as a measure of reporting compliance. Fifth, a major limitation is the non-compliances occurring due to complex technical interpretation, a new court decision or unintentional mistakes committed by the taxpayers.

### **7. ANALYSIS AND FINDINGS**

#### **7.1 Tax compliance by components**

Based on the interrelationship between tax compliance components and the measurement process, this section measures the level of compliance for each of the compliance components created by large corporate taxpayers.

Table 6 below provides summary statistics for compliant and non-compliant taxpayers. The first important observation is that filing compliance is the highest among the three compliance components (84.4%). Second, as large corporate taxpayers move to the next compliance component, that is from filing to reporting, the rate goes down; and it goes up again from reporting to payment compliance. Tax compliance by income

reporting is 53.9 per cent and by payment of taxes is 75.3 per cent. Filing compliance has a mean of 0.84 which means that 84 per cent of taxpayers are filing compliant, since the higher code 1 is treated as tax compliance and 0 as non-compliance. The mean value for any nominal variable that has only two categories has meaning (Leech et al., 2008). In the case of tax payment, mean compliance ( $M = 0.75$ ) falls as compared to filing compliance; and for reporting compliance, mean value falls further ( $M = 0.54$ ). In each case, the modal group is 1, which represents tax compliance.

**Table 6: Descriptive statistics on the tax compliance levels of large corporations (N = 154)**

Tax compliance components	Compliance status	Frequencies	Percentages	Cumulative percentages
<b>Filing compliance (FC)</b>	Compliant	130	84.4	84.4
	Non-compliant	24	15.6	100
<b>Reporting compliance (RC)</b>	Compliant	83	53.9	53.9
	Non-compliant	71	46.1	100
<b>Payment compliance (PC)</b>	Compliant	116	75.3	75.3
	Non-compliant	38	24.7	100
<b>Overall compliance</b>	Compliant	57	37.0	37.0
	Non-compliant	97	63.00	100

In measuring overall tax compliance for a particular taxpayer, the individual component scores are added. Table 7 below shows that 96 large corporate taxpayers in the sample are both filing and payment compliant. If reporting compliance were not included, then overall compliance, based on the filing and payment components, would be 62.3 per cent, but the number of taxpayers who are both filing and reporting compliant is 65, which reduces the level of overall compliance to 42 per cent. There are only 57 taxpayers who are filing, reporting and payment compliant, making 37.0 per cent of large corporate taxpayers compliant in overall terms. Thus, the mean composite compliance is 0.37 and the modal group is 0, meaning in overall terms large corporate tax compliance is not impressive.

**Table 7: Cross-tabulation on measurement of overall tax compliance**

Compliance types			Payment		Reporting		Overall	
			Com	Non-com	Com	Non-com	Com	Non-com
Filing by payment, reporting and overall compliance	Filing	Com	96	34	65	65	57	73
		Non-Com	20	4	18	6	0	24
Payment by reporting and overall compliance	-		Payment	Com	72	44	57	59
				Non-com	11	27	0	38
Reporting to overall compliance	-				Reporting	Com	57	26
						Non-com	0	71

To make the above findings robust, binomial test statistics are derived, which show whether the proportion of compliant and non-compliant large corporations differed by chance or by pre-specified probability (Bryman and Cramer, 2005). The test results show that there is a statistically significant difference in the proportion of compliant and non-compliant taxpayers in the cases of filing, payment and overall compliance ( $p = 0.001$ ). But for reporting compliance, the difference is not statistically significant ( $p = 0.375$ ). Again, a McNemar test, conducted to see the marginal frequencies of two binary outcomes, reveals that there is a statistically significant difference in the proportion of compliant and non-compliant taxpayers between component and overall tax compliance ( $p = 0.001$ ). Finally, the value of phi and Camri's V, measuring correlation between binary variables (Argyrous, 2011), are found to be weak between filing and overall compliance (phi and  $V = 0.329$ ,  $p = 0.001$ ) and between payment and overall compliance (phi and  $V = 0.439$ ,  $p = 0.001$ ). But between reporting and overall compliance, the relationship is found to be strong (phi and  $V = 0.709$ ,  $p = 0.001$ )—meaning most of the non-compliance came from the reporting component.

## 7.2 Audit adjustments and additional tax revenues

Large corporations in Bangladesh LTU are subject to auditing on a selective basis once the deadline for return of submissions has passed. The audit programme is based on those returns submitted within the time stipulated by tax law. Those who fail to submit returns on time incur a penalty. Before the audit decisions are made, the tax returns are screened through the revenue accounting departments to detect any apparent non-compliance, for example, miscalculation of tax liabilities. The audit rate—the percentage of filed returns to be audited—is not made known to the corporations; but the audit rate of large corporate taxpayers in Bangladesh is usually high, given the possibility of revenue leakages from non-reporting. It is important to note that the rate of large corporate audit actions is high across the world. For

example, in Hungary all large corporations are audited every second year (Pitti & Vazquez-Caro, 1998). In the US, the audit rate for large corporations in 2006 was nearly 50 percent up from 2003 (IRS, 2006), although in the recent years there has been a decline in the number of large business audits (TRAC, 2011). However, as Table 8 reveals, the amount of audit demands (column 6) and collections from these (column 7) have decreased over the years, except in tax year 2005–2006.

**Table 8: Annual audit outputs from large corporate taxpayers in millions of Bangladeshi Taka**

Tax year (1)	Completed audits				Audit demands created (6)	Collected from audit demands (7)
	Desk verification audit		Comprehensive audit			
	Files targeted to audit (2)	Files audited (3)	Files targeted to audit (4)	Files audited (5)		
2003–2004	80	80	0	0	5,340.0	3,320.0
2004–2005	193	193	6	6	1,501.1	752.0
2005–2006	196	196	6	6	3,142.3	1,527.1
2006–2007	180	180	3	3	1,012.5	542.5
2007–2008	84	26	0	0	112.3	23.5
2008–2009	201	86	0	0	350.4	54.6
Total	934	761	15	15	11,458.4	6,219.7

Source: LTU Annual Report, 2009.

For example, in tax year 2003–2004, additional tax of 5,340.00 million Bangladeshi Taka was demanded from the tax audits of 80 files (column 2), that is, the per file audited tax demand was 66.75 million Taka. In 2005–2006, per file audit demand decreased to 16 million Taka, and in 2007–2008 to 1.33 million Taka.

Declining audit demands may have two potential explanations: first, audit actions have been successful in reducing the amount of income underreporting. Second, the deterrent effect of tax audit has fallen in the face of complicated game-playing techniques by the corporations. It should be noted that roughly half of the demands created in every tax year remained uncollected (column 7), may be because the audit demands were fictitious or the enforcement measures were weak or ineffective. Aside from enforcement measures, political instability and the quality of institutions might be associated with the tax compliance and audit of the large companies (Tsibouris et al, 2006).

The other explanation for the declining audit demands may be the huge knowledge and skills gap between the audit teams and the representatives of large corporations. An investigation was carried out into the taxation and accounting knowledge of tax officials (see Appendix 2), which many respondents identified as a potential barrier to make undisputed audit adjustments. Fourteen tax officials were interviewed, only 4 of whom had academic knowledge of accounting and taxation. The remainder had only in-service training on tax law.

To address this significant accounting and tax knowledge deficit, the respondents argued that tax officials must have a thorough understanding of financial and tax accounting standards and rules. A respondent made the following observation about an occasion on which penalty was wrongly allowed as an admissible expense, when it should have been added as income.

Because of poor knowledge of a mobile operator's business and its accounting software, we foolishly allowed penalty as an admissible expense that was imposed on the income from hidden business operations. We failed to understand that the concealed income had to be added to the income of the corporation. Such non-compliances arose only due to our lack of understanding of the mobile operator's business. (Respondent, 27).

In the same vein, another respondent stated:

LTU tax officials don't know their job properly and want too many papers. Sometimes they lack proper accounting knowledge and arrive at a wrong understanding of the books of accounts. This creates mistrust between the tax officials and the large corporate taxpayers. (Respondent, 17).

### **7.3 Tax compliance by corporate demographic features and interview responses**

Demographic issues are important to contextualise an analysis of organisational studies (Cordes et al., 1999; Hernes, 2004). Morris and Lonsdale (2004) argue that business type, size—sole-proprietor, partnership or corporation—and industry location influence tax compliance. Corporate size, ownership structure, and membership of a corporate sector emerge as some of the most significant demographic features in this study. Table 9 shows the tax compliance performance of large corporations based on their salient demographic features. It demonstrates that overall compliance is higher in private limited corporations (43.6%) than in public limited corporations (34.8%). Tax compliance measured by corporate location shows that multinational corporations (40.0%) are better than the local corporations (36.4%), but only marginally.

In terms of filing compliance, the finance sector corporations have the highest level of compliance (91.25%), followed by the service sector (80.6%) and manufacturing sector corporations (74.4%). However in reporting compliance, service and manufacturing corporations jointly have the highest compliance rate (67.7%) and (67.4%) respectively, whilst rates for this compliance are 41.3 per cent for finance corporations. Finally, in terms of payment compliance, manufacturing corporations are the most compliant (83.7%) followed by finance (73.6%) and the service corporations (67.7%). When the compliance components are combined, manufacturing corporations are the most compliant (44.2%), in comparison with service (38.7%) and finance (32.5%) corporations.

**Table 9: Tax compliance by large corporations viewed from corporate ownership, corporate sector, and corporate location (N = 154)**

Compliance types	Compliance status	Ownership structure		Corporate sectors			Location	
		Public limited	Private limited	Finance	Manufacturing	Service	Local	Multi
Filing	Compliant	100 (86.9)	30 (76.9)	73 (91.2)	32 (74.4)	25 (80.6)	108 (83.7)	22 (88.0)
	Non-compliant	15	9	7	11	6	21	3
Reporting	Compliant	57 (49.5)	26 (66.6)	33 (41.2)	29 (67.4)	21 (67.7)	68 (52.7)	15 (60.0)
	Non-compliant	58	13	47	14	10	61	10
Payment	Compliant	84 (73.0)	32 (82.0)	59 (73.7)	36 (83.7)	21 (67.7)	98 (75.9)	18 (72.0)
	Non-compliant	31	7	21	7	10	31	7
Full	Compliant	40 (34.7)	17 (43.5)	26 (32.5)	19 (44.1)	12 (38.7)	47 (36.4)	10 (40.0)
	Non-compliant	75	22	54	24	19	82	15

Note: Figures in parentheses indicate compliance percentage in the respective category.

Two things are worth noting: first, none of the sector corporations achieve top compliance in more than one component. The finance sector has the highest level of compliance in filing; the manufacturing sector in payment; and the service sector in reporting compliance. On average, the manufacturing sector corporations are the most compliant. The question is, why should this be so? Perhaps, central banking regulations and monitoring, as argued by some respondents, require finance sector corporations to prepare their audit reports on time; but such regulations are not enough to ensure they fully report their business income. One respondent expressed his views about this in the following way.

There are high level manipulations affecting tax compliance behaviour despite strong rules and regulations. For example, the accounts of banks are prepared on the basis of papers sent from the branches, which are huge. It is quite difficult to audit all the papers and find underreported income. Thus tax non-compliance may be a capacity-related issue as well as an intentional attempt to hide some income or expenses. (Respondent 5).

The reason that service sector corporations are the top reporting compliers may be due to the fact that compared to finance and manufacturing corporations, the percentage of multinational corporations is relatively high in the service sector. Of the service sector corporations, 30 per cent are multinationals, whereas the percentage is 11.2 per cent and 16.3 per cent respectively for finance and manufacturing sector corporations (see Table 10).

**Table 10: Distribution of large corporations by corporate sector and location (N = 154)**

Local / multinational	Corporate sectors			Total
	Finance	Manufacturing	Service	
Local	71 (88.8)	36 (83.7)	22(70)	129
Multinational	9 (11.2)	7(16.3)	9 (30)	25
<b>Total</b>	80	43	31	154

Note: Figures in the parentheses indicate percentage with respect to total.

As argued by the respondents, multinational corporations are comparatively better in their reporting behaviour than local corporations. Consider the following comments submitted by the respondents:

I don't think there is much underreporting in LTU multinational corporations, except over the issue of transfer pricing. (Respondent 12).

Large foreign corporations comply, if not fully at least nearly fully. They have some subtle non-compliance; the local ones commit very crude non-compliance. (Respondent 22).

Tax compliance by the multinational corporations is high. Among the others, the publicly-traded are better. Privately owned run by the family members have poor tax compliance. (Respondent 3).

Among the large corporations, multinationals and publicly traded are comparatively good in tax compliance. My only headache is the local big manufacturing corporations. (Respondent 2).

In the international literature there is a little support for the above arguments. As stated earlier, one third of the 275 large multinationals in the US did not pay any taxes during 2001–2003 (ICFTU, 2004). A similar situation exists regarding many multinational corporations in the UK. Among large corporate taxpayers in the manufacturing sectors of the US, Mills (1998) observed a positive relationship between excess of book income over taxable income and proposed audit adjustment.

The fact that the manufacturing corporations emerge as the best compliers in payment compliance may be because the tax burden for this group of taxpayers is low. Manufacturing corporations are charged a tax rate of 27.5 per cent. It is the lowest of

all corporate tax rates in Bangladesh. The international literature on tax compliance suggests that the tax rates for manufacturing and non-manufacturing corporations are almost the same. In Pakistan, for example, the tax rate in 2014 for all corporations is 34 per cent, except for commercial banks which is 35 per cent, while in India the corporate tax rate is 33.99 per cent, with some differences for domestic (30%) and foreign owned companies (40%) (KPMG, 2014). In Canada, similar to Bangladesh, the basic rate of federal tax on large corporations belonging to manufacturing and processing industries is 21 per cent, and 28 per cent for other industries (Erard, 1997).

However, the corporate tax rate for manufacturing corporations in Bangladesh whose shares are not traded publicly is 37.5 per cent. This tax rate can be even lower if a manufacturing corporation declares dividends of more than 10 per cent in a year. Collected data shows that 63 per cent of manufacturing corporations are taxed the marginal rate of 27.5 per cent. Another reason may be that most manufacturing corporations are likely to export their products, and hence may be able to gain from transfer pricing manipulation or export subsidy. But for finance sector corporations the marginal tax rate was 45 per cent in tax year 2009–2010, which may have created a huge tax burden for corporations that reported and paid taxes in accordance with the law.

## 8. CONCLUSIONS

Large corporations provide the majority of corporate taxes in most of the tax administration. Ninety percent of corporate taxes in the US and 70 per cent in the UK are provided by large corporations (OECD, 2009), although the share of corporate taxes, as a percentage of total tax revenues, is relatively small in both these countries—eight per cent in the UK and nine per cent in the US (Auerbach et al., 2008). In developing countries, their contribution tends to be much higher. In Bangladesh and Pakistan, for example, large corporations provide one third of the national tax revenue, and a large percentage of corporate taxes (FBR, 2008; NBR, 2009). In many countries, large companies are placed under the LTU system of tax administration to minimise the risk they pose to tax collection. Sophisticated tax compliance models have been developed to combat tax non-compliance by these giant taxpayers both in developed and developing countries. The concept of LTU formation and monitoring of tax collection from the large corporations has been a challenge for tax administrations.

This paper found that large corporations in Bangladesh are mainly divided into three sectors: finance, manufacturing, and service sector corporations. The finance sector corporations achieved the highest compliance rate in tax return filing (91.3%), while the manufacturing and service sectors corporations achieved the highest rate of compliance in payment (83.7%) and reporting compliance (67.7%), respectively. In overall terms, manufacturing sector corporations were the top compliers (44.2%). These findings suggest that none of the sector corporations dominate in more than one compliance component. As revealed in the paper, large taxpayers achieved their highest level of compliance in filing (84.4%), followed by payment (75.3%) and reporting (53.9%) compliance. The overall compliance, measured by totalling these three components, was 37.0 per cent. In calculating tax compliance rates, the effects of appeal decisions were considered. When viewed from the perspective of other corporate characteristics, for example, corporate ownership pattern, private limited corporations are more compliant in overall terms (43.6%) than public limited

corporations (34.8%). Tax compliance measured by corporate location shows that multinational corporations (40.0%) are marginally more compliant than local corporations (36.4%).

As this study suggests, the LTU compliance models applied by the Bangladesh LTU are successful in creating higher levels of filing compliance among large corporations. The level of compliance achieved for tax payment is also very high. However, for reporting compliance the level of compliance is only moderate. Overall, the level of tax compliance is below average.

The findings may be relevant to countries with comparable tax systems and circumstances. There are many areas of tax compliance and the accompanying legal framework in which developing countries follow common practices. For example, the tax laws in India, Bangladesh and Pakistan are similar—all these countries inherited the Income Tax Act 1923, which was enacted during the British colonial period. (Shirazi & Shah, 1991). According to Moore (2008), the tax systems of developing countries share many features—a high level of tax complexity, litigation practices, poor record-keeping and bureaucratically designed tax governance. However, the large number of finance sector corporations represented in the sample data might not be a common feature for LTUs in other jurisdictions. In Bangladesh, all finance sector corporations—banks, insurance and leasing—are placed within the LTU's jurisdiction. This may reduce the generalisability of the study results. Thus where the study variables are measured differently and the legal and regulatory systems of tax audits vary, the study findings might well be different.

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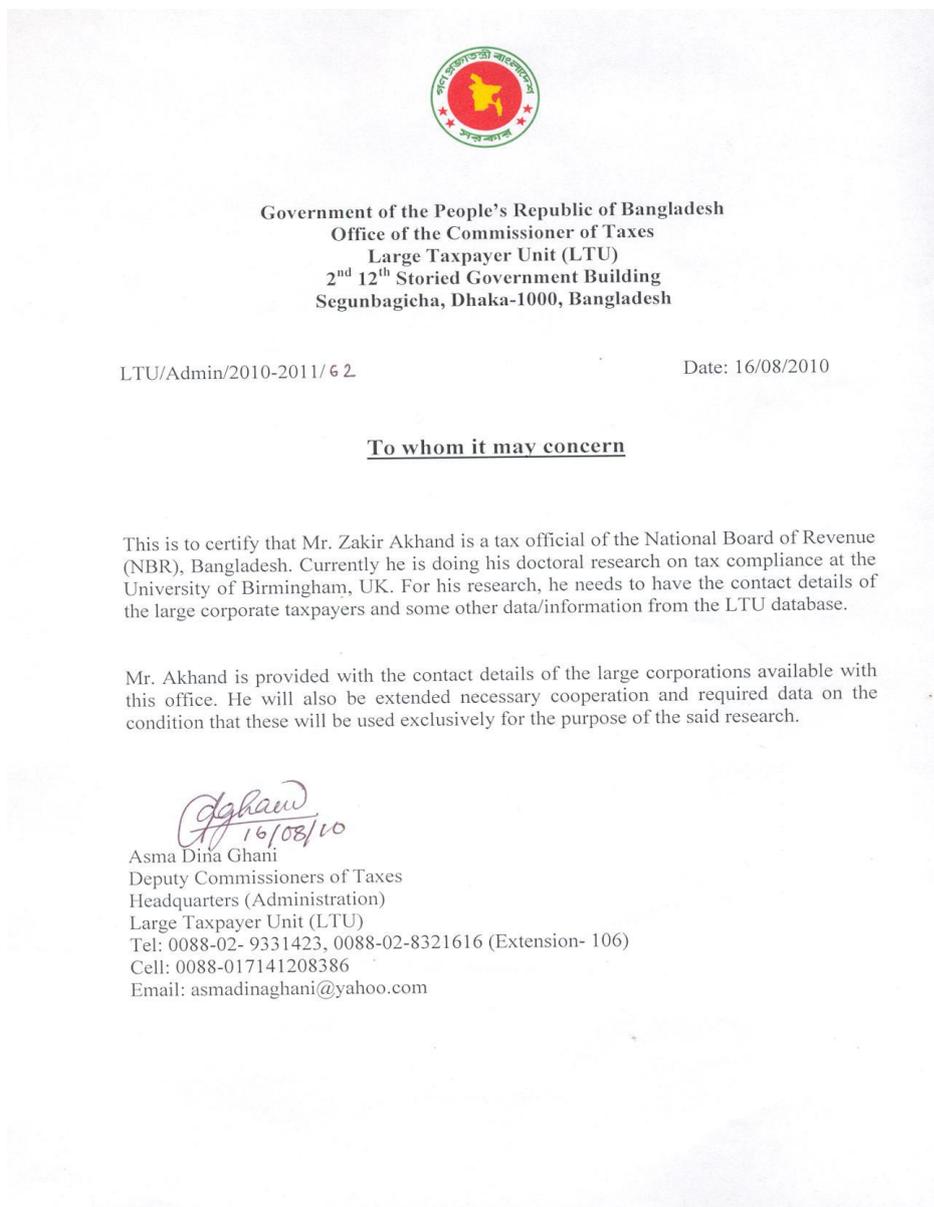
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## 10. APPENDICES

### Appendix 1: Approval letter from the LTU Bangladesh.



**Appendix 2: Lack of knowledge and training.**

Figure 1: Respondents' academic knowledge of accounting and taxation.

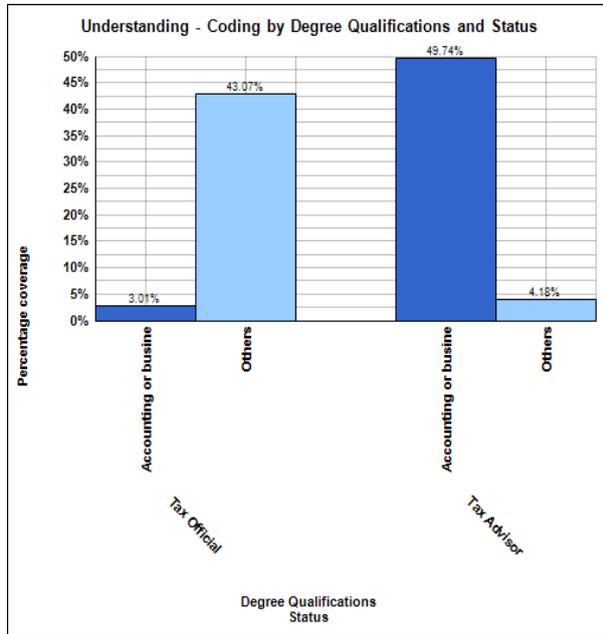


Figure 2 Respondents' work experience and accounting knowledge

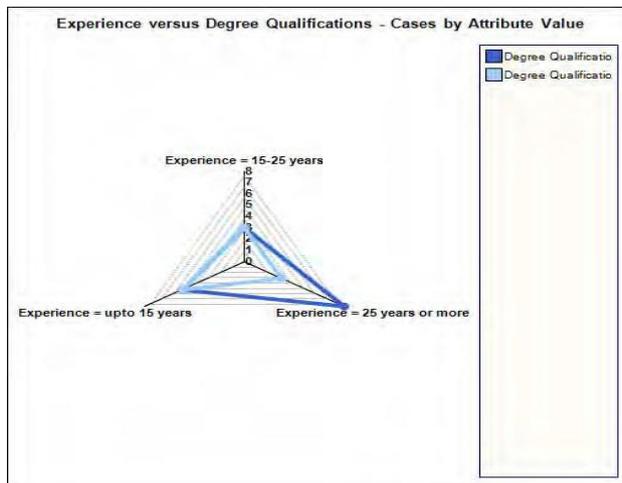


Chart 1 shows that out of fourteen tax officials interviewed, only four had academic knowledge of accounting and taxation; the others had only in-service training on tax law. Almost all tax professionals have accounting or business degrees. Four per cent of tax professionals have no qualification in accounting, because the ITO, 1984 has allowed retired tax officials to plead tax cases, who do not require having academic qualifications in accounting or taxation.

Chart 2 illustrates all respondents having 25 or more years of experience have degrees in accounting, because respondents in this experience group are tax professionals. But respondents in the other two experience groups, mostly tax officials, have lesser qualifications in business and accounting. Of the eight respondents in the below-15-years-experience groups, only four have accounting degrees, one of which is a tax professional. In the 15-25 year experience group only three out of nine have accounting degrees, most of which are tax officials.

### Appendix 3: Summary of key evidence from interviews

RESPONDENT NO.	TITLE	ISSUES
RES-01	Chartered Accountant	Focused on the importance of corporate sector characteristics and the influence of power and politics on tax compliance.
RES-02	Corporate Managing Director	Provided a general review of the coercive and persuasive instruments and emphasised mutual understanding as an option. Acknowledged the role of corporate sectors in compliance behaviour.
RES-03	Corporate Finance Director	Focused on the importance of corporate sector characteristics and compliance behaviour: multinationals are better; services do not reduce the cost of compliance or produce value for money.
RES-04	Chartered Accountant	It's the probability of any coercive action and regulatory discipline that induces compliance, not the amount of the penalty.
RES-05	Bank Finance Director	Argued that structural deficiency in the accounting system and lack of competent accounting staff cause many compliance problems.
RES-06	Additional Commissioner, LTU	Focused on why taxpayer service fails and emphasised the need for coercion.
RES-07	Joint Commissioner, Khulna Tax Zone	Insisted that the possibility of a huge financial penalty was more coercive than its probability merited; preference for powerful, severe actions over soft, persuasive solutions.
RES-08	Second Secretary, NBR	Poor regulatory framework of the financial accounting system and its impact on income underreporting.
RES-09	Inspector, LTU	Tax officials' discretionary powers and their potential impact on compliance; large corporations are greedy profit-makers. Also concentrated on complex tax law and uneven competition.
RES-10	Income Tax Practitioner	Audit adjustment process and the influence on compliance, and noted that the taxpayer service can be futile in creating compliance.
RES-11	Chief Finance Officer	Argued that imprisonment and other tough action can only bring transitory change, rather than permanent change.

RES-12	Tax Commissioner, Chittagong	Hierarchical tax bureaucracy and tax audit problems; focused on the necessity for simplified tax law and reducing knowledge gaps.
RES-13	Tax Commissioner, LTU	Acknowledged the issue of transfer pricing among large corporate taxpayers.
RES-14	Additional Commissioner	Concentrated on mutual understanding and the probable impact on tax laws. Supported the persuasive mode of encouraging tax compliance.
RES-15	Chief Finance Officer	Complex and costly tax laws make bribery likely and stimulate non-compliance.
RES-16	Deputy Commissioner, LTU	Focused on the issues of corporate sector affiliation and compliance behaviour.
RES-17	Managing Director	Discussed conflicting local and international accounting standards. tax officials' inefficiency, mistrust, and lack of mutual understanding.
RES-18	Chief Finance Officer	Argued that financial audit is corrupt and a strong source of tax non-compliance.
RES-19	Income Tax Practitioner	Disbelief, trust and negative attitude of the tax administration in creating tax non-compliance issues. Tough laws cannot bring the desired outcome—you need to persuade.
RES-20	First Secretary, NBR	Explained why services may fail and persuasive measures become ineffective.
RES-21	Deputy Commissioner, LTU	Audit selection process and its impact on filing compliance. Political vengeance and patronage as an explanation for tax compliance.
RES-22	Member, NBR	Explained how political intervention becomes a factor in the compliance process and service provisions become ineffective in creating compliance.
RES-23	Joint Commissioner, LTU	Inefficient and complex tax law discourages taxpayers from being compliant and indirectly makes them unreceptive to coercive actions. Complex tax laws affect the trust-building process.

RES-24	Former Member, NBR	Tax officials' inefficiency and chaotic procedures make taxpayer service fail.
RES-25	Chartered Accountant	Argued for coercive actions and focused on increasing penal actions and strengthening regulation.
RES-26	Chartered Accountant	Taxpayer service and simplified tax law can be a good source of high corporate tax compliance.
RES-27	Second Secretary— NBR	Explained why mutual understanding fails and complicates the compliance process.

# Regulatory compliance, case selection and coverage—calculating compliance gaps

Stuart Hamilton<sup>1</sup>

## **Abstract**

This paper initially considers the significant difficulties and costs associated with reliably and robustly estimating tax gaps. It then outlines an innovative ‘bottom-up’ method for regulatory agencies to (1) evaluate the effectiveness of case selection for compliance activities and (2) to estimate possible gross and net compliance gaps. The approach may provide an alternate or supplementary means of estimating the tax gap, for some areas, without the need for an extensive (and expensive) random audit program.

The methodology approaches the issue of compliance case selection as a detection / discovery activity for perceived non-compliant behaviours and applies the Receiver Operating Characteristic (ROC) approach to the problem. Using relatively simple probabilities, important understandings regarding optimal coverage, expected ‘strike’ rates, and (via Bayesian ‘triangulation’), insights into the initial and residual compliance gaps are derived.

The approach is used to calculate a plausible view of the gross and net assessed income tax gap for the Large Market in Australia; the 1,400 corporate groups with a turnover of more than \$A250 million per annum in Australia. Finally the approach is used to support an analysis of possible causal factors for recent changes in strike rates in the Large Market<sup>2</sup>

**Keywords:** Case selection, coverage, strike rate, compliance gap, tax gap, Receiver Operating Characteristic, ROC, regulatory agency.

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<sup>1</sup> Stuart Hamilton (B.Ec, MBA), was most recently the Assistant Deputy Commissioner of Risk Strategy with the Australian Taxation Office’s Large Business Line. He has over 30 years of experience in taxation compliance matters working for the ATO, and the OECD where he set up the Forum on Tax Administration and conceived the FTA guidance paper series. He is undertaking a PhD at UNSW.

<sup>2</sup> The views expressed in this paper are those of the author and do not reflect the considered views of any organisation or person mentioned or otherwise associated with the author.

## 1. INTRODUCTION

### 1.1 Introduction to the issue – compliance gaps and their uncertainty

For any regulatory agency measuring (1) compliance effectiveness and (2) the ‘gap’ between full compliance and the estimated level of voluntary compliance, are enduring problems that go to the heart of community trust in the integrity of the system and the regulatory agency’s administration of it.

In taxation regulation, tax gaps have particular prominence and a number of methods have been used to estimate them (Toder 2007b; Gemmell & Hasseldine 2012). Usually the tax gap is considered to be the difference between the tax **legally** due and the tax **actually** paid. It thus excludes legal tax ‘minimisation’ intended by the law, and tax ‘avoidance’ not intended by the law but nonetheless legal.

The tax gap is perceived to be an important indicator of the overall health and effectiveness of the tax system. It could broadly indicate:

- the clarity and acceptance of tax policies by the community
- the ease of interpretation of laws that enact those policies, and
- the effectiveness of the tax administration in both making those laws easy to understand and comply with, and in following up non-compliance with existing law.

The recent *Assessment of HMRC’s Tax Gap Analysis* report by the International Monetary Fund (IMF 2013) notes that efforts to measure the tax gap can have multiple goals, three of which were considered by the IMF as important:

- measuring tax revenue losses, providing a view of the overall effectiveness of the tax system over time
- supporting efficiency in allocation of resources to reduce the tax gap
- enhancing perceptions of fairness and transparency in the tax administration’s efforts.

The ability to measure and ascertain progress towards these goals is significantly constrained by how accurately and precisely the tax gap can be estimated. In practice tax gap estimates all have a significant and irreducible degree of uncertainty associated with them. These inherent uncertainties make their utility and integrity, that is, their real value over their costs of production, questionable, particularly when a significant random audit program is used as part of the calculation methodology.

The methods used to calculate tax gap components broadly break down into ‘top-down’ or ‘bottom-up’ calculations. While purely top-down or purely bottom-up estimates might be made, in practice no one approach is *generally* used to produce an overall tax gap figure. Instead, various components of an overall tax gap are calculated using the most robust method for a particular tax type or subpopulation and a final overall estimate is then assembled from these components.

For example, overall tax gap estimates made in broadly comparable countries to Australia, such as the UK, USA and Denmark, have used an ensemble of:

- Top-down methods that estimate a tax gap component using formulas applied to relatively high-level economic data. These top-down methods are typically used for volumetric and value added taxes such as the GST. For example, about 38% of the UK tax gap estimate is based on top-down methods (IMF 2013). As Australia has a higher reliance on direct taxes, the proportion of an overall tax gap supported here by the use of such top-down methods would probably be somewhat less.
- Bottom-up methods that extrapolate a tax gap component estimate from random audit or similar survey data. These methods are typically used for individuals and small to medium businesses' income tax components of the tax gap. Only about 20% of the UK tax gap estimate is based on these methods. While such methods are often a key focus of discussions on tax gaps, the proportion of overall tax gap estimate supported by extrapolation from random audits is typically less than half. There may be other drivers for the use of random audits, with a tax gap calculation being ancillary aspect.
- Bottom-up methods that use expert judgements to construct plausible tax gap component estimates from operational (that is, non-random) audit or survey data. These methods are typically used for the income tax component of the tax gap for both large corporations and high wealth individuals. About 37% of the UK estimated tax gap used this approach.

It should be noted that bottom-up approaches to the estimate of the tax gap generally use 'multipliers' to attempt to address 'non-detection bias', that is the level of undetected non-compliance<sup>3</sup> in audits, to form more plausible tax gap estimates (Feinstein 1990; Erard & Feinstein 2011). In most bottom-up calculations the estimated correction for non-detection bias actually **dominates** the calculated tax gap. (Often it is a ratio of about 3:1—a point perhaps overlooked by commentators who push for random audit based methods for 'credibility' purposes.)

However not all bottom up tax gap estimates have used detection control multipliers. For example, the 2006 and 2008 Danish Business Tax Gap estimates, based on extensive random samples do not appear to have made any adjustment for non-detection (SKAT 2009, SKAT 2010). Similarly the Swedish Tax Gap estimate also appears to have made no adjustment for auditor non-detection (SNTA 2008). Perhaps unsurprisingly the tax gap estimates produced have been significantly lower than the IRS estimate.

Each tax gap calculation approach has its strengths and weaknesses, costs and benefits, which need to be weighed against the overall purpose of deriving a tax gap figure—the decisions that are to be made with that knowledge. Otherwise a tax gap estimate is just a piece of 'nice to know' noise, rather than a 'need to know' signal for a critical policy or management decision point.

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<sup>3</sup> A consideration sometimes missed by commentators is that non-compliance that is undetected by audits cannot then be addressed by additional 'active compliance' resources. Auditing more isn't the answer in those circumstances; instead addressing undetected non-compliance would require significant policy and system changes such as increased third party reporting, data matching, pre-filing or withholding taxes.

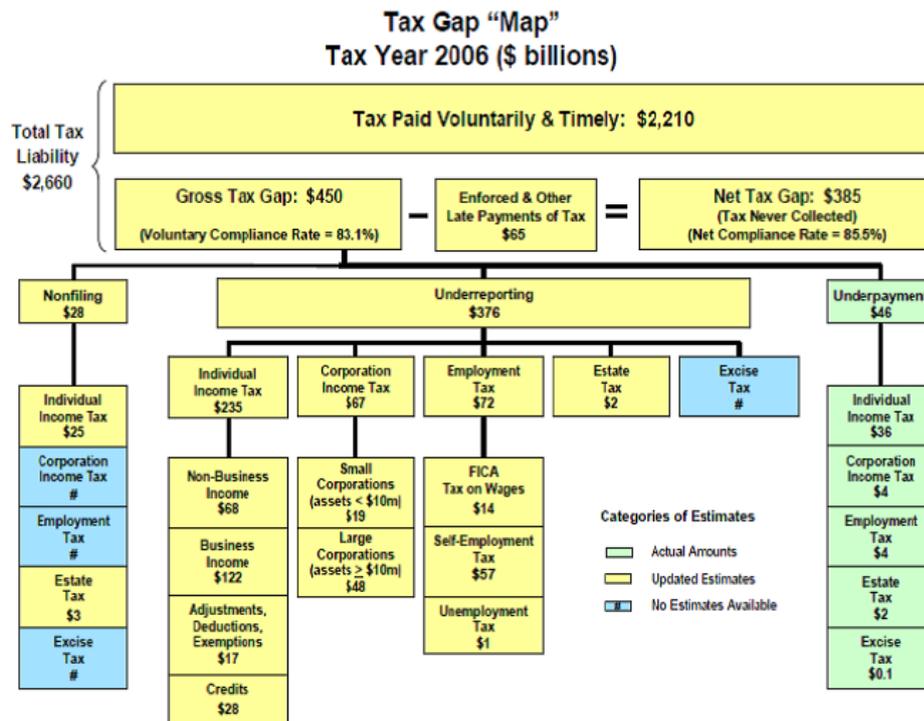
There are some relatively minor definitional differences between countries as to what is ‘in’ and ‘out’ of the tax gap. For example, a number of countries exclude considerations of tax on income from criminal activities, such as the production and sale of illicit drugs.

As has already been touched on, most tax gap estimates also exclude ‘legal’ tax minimisation, that is, tax reduction arrangements considered non contestable by the tax administration.

Countries that estimate their tax gap usually distinguish between a gross and net tax gap; the latter being the tax gap after taxes collected from enforcement activities. Many countries also usefully distinguish the attribution of the tax gap between the basic obligations of registering / filing, reporting accurately, and paying on time.

The standard US Tax Gap diagram very usefully shows all of these aspects in the one chart:

**Figure 1: Tax Gap Map for 2006**



Source: Internal Revenue Service, 2012a.

**1.2 A benchmark approach to tax gap estimates - HMRC**

The benchmark for current tax gap estimation is perhaps that of the HM Revenue & Customs (HMRC). The HMRC tax gap estimate forms part of the UK Official Statistics and the HMRC has been continuing to refine its tax gap estimation process for some years. (See HMRC 2005, 2008, 2010, 2011, 2012, 2013).

At the HMRC's request, the IMF reviewed the UK approach and found: 'the models and methodologies used by HMRC to estimate the tax gap across taxes are sound and consistent with the general approaches used by other countries' (IMF 2013).

While perhaps the current benchmark approach for tax gap analysis, the HMRC's tax gap has been heavily criticised by various interest groups (eg Murphy 2014) that hold other views as to what should be in the tax gap, such as tax avoidance which the tax administration considers legal (for example, tax base erosion practices that legally exploit policy weaknesses, such as the definition of a permanent establishment giving a State a taxing right).

This highlights important differences of views (value judgements) that exist in constructing an estimate of how much tax should (or could) be paid but isn't. While views differ, with a degree of linguistic / definitional ambiguity or uncertainty about the tax gap, most comparator countries' (US, UK, Denmark) tax gaps are calculated in a manner that excludes any estimate of 'legal' tax avoidance or tax minimisation.

Similarly unintended, though legal avoidance, tends not to be officially reported anywhere. This may change somewhat in the near future as Organisation for Economic Cooperation and Development Base Erosion and Profit Shifting (OECD BEPS) Action Item 11 is examining ways of consistently calculating certain base erosion practices, while BEPS Action Item 12 is examining ways of increasing disclosure and transparency, and Action Item 13 proposes country by country reporting of taxes paid.

Because base erosion depends, to some extent, on the dominant business intent, the reliability of such estimates is likely to be questionable. For example a company relocating operations to a low tax jurisdiction for tax reasons is obviously base erosion, while a company trading from a strategically placed market location to improve its multi market access and centralise its skilled staff would generally not be considered base erosion (the tax aspect merely being incidental to the businesses location).

Deliberate (that is, intended) tax policy concessions are sometimes reported upon in Treasury tax expenditure statements where these exist. However estimates of the value of many tax concessional treatments, such as differences between the tax payable on an individual's business operations and those run through a family partnership, trust or corporate structure do not appear in Tax expenditure statements.

### 1.3 Tax Gap components and their contribution

The 2013 IMF report (table 1, p. 10) shows that the HMRC tax gap estimate is drawn together from:

- Top-down estimates that inform ~38 per cent of the estimate      ~2.8%
- Random audits that inform ~20% of the estimate                      ~1.4%
- Constructed estimates (expert views) that inform ~37%                ~2.8%
- Giving an overall point estimate of the UK tax gap of                      ~7.0%

In greater detail the relative component contributions to the UK tax gap by methods are:

**Table 1: UK tax gap estimation components – IMF analysis**

Tax	Component	Main Components of Methodology 1/	Proportion of the 2011 Gap 2/
Income Tax, National Insurance Contributions (NIC), Capital Gains Tax	Pay-as-you-earn (PAYE): small-medium enterprises (SMEs)	Bottom-up estimate based on random audit results.	2%
	PAYE: large taxpayers	Constructed estimate based on the results for the SMEs.	7%
	Self-assessment: individuals and businesses	Bottom-up estimate based on random audit results.	14%
	Self-assessment: large partnerships	Constructed estimate bases on error levels comparable to results for the SMEs.	2%
	Nondeclaration of income by individuals not in self-assessment "Moonlighters" "Ghosts"	Bottom-up estimate based on cross-matching PAYE data with third party information.	3%
		Estimate based on study results.	6%
		Estimate based on labor force survey and immigration data.	4%
	Avoidance	Estimate constructed using avoidance schemes being tracked in the "risk register."	7%
Corporation Tax	Large business services (LBS) clients	Constructed estimate based on data on Tax under Consideration (TuC) data from the LBS case management system.	4%
	Large and complex businesses	Constructed estimate based on the results for the LBS clients.	4%
	Small-medium enterprises	Bottom-up estimate based on random-audit results.	4%
VAT		Top down estimate based on consumption statistics. (A bottom-up estimate is also performed in order to determine the composition of the gap).	30%
Excises	Alcoholic beverages, Tobacco	Top-down estimate based on consumption statistics.	7%
	Petroleum fuels	Top-down estimate based on travel distance statistics and fleet characteristics, and "cross-border shopping."	1%

Source: Prepared by the IMF team based on HMRC publications.

1/ There are other components to the total estimate for some of these items, such as the addition of the value of nonpayment; this table only summarizes the main estimation methodology component.

2/ Total adds to only 95 percent; the minor indirect and direct tax gaps estimates are left out.

Source: International Monetary Fund, 2013.

The UK HMRC uses of a mix of data sources and approaches to construct an overall tax gap estimate that is broadly similar to the methodology used by the US Internal Revenue Service (IRS).

**Table 2: US tax tap estimation components**

Tax Type	Underreporting	Underpayment	Nonfiling
Individual Tax	Audits of a random sample	IRS Master File <sup>13</sup> records	Random sample of Social Security Numbers matched to administrative data
S Corporation	Audits of a random sample	Pass-through to individual	
Partnership		Pass-through to individual	
Corporation (small)	Based on operational examinations	IRS Master File records	No estimate
Corporations (mid-size and large)	Based on operational examinations	IRS Master File records	No estimate
Employment Tax (self)	Audits of a random sample (from individual tax)	IRS Master File records	
Employment Tax	Estimated compliance rate from 1984 to current	IRS Master File records	No estimate
Estate Tax	Based on operational examinations	IRS Master File records	Modeling from Michigan Health and Retirement Study and National Center for Health Statistics
Excise	No estimate	IRS Master File records	No estimate

Source: Treasury Inspector General of Taxation (TIGTA), 2013 (p.7)

The UK HMRC random audit sample sizes used have been consistently modest compared to those used by the extensive US TCMP and NRP efforts. The UK HMRC used interval-sampling approaches (approximating simple random selection) for a number of years (hence the somewhat odd sample sizes), and moved to smaller stratified random approaches in the most recent years.

**Table 3: UK HMRC sample sizes for the self assessment, employer compliance and corporation tax random enquiry programs**

Self Assessment		Employer Compliance		Corporation Tax Self Assessment Accounting	
Tax return year	Sample size	Tax return year	Sample size	period ending in year	Sample size
2004-05	6,482	2004-05	1,649	2004-05	408
2005-06	5,834	2005-06	1,649	2005-06	419
2006-07	3,217	2006-07	1,649	2006-07	460
2007-08	3,219	2007-08	1,649	2007-08	491
2008-09	3,221	2008-09	1,649	2008-09	492
2009-10	2,599	2009-10	1,649	2009-10	480
Results not yet analysed		2010-11	825	2010-11	490

Source: HMRC, 2013b.

The 2013 IMF report makes a number of recommendations about how the HMRC estimates might be improved and goes on to note that ‘any tax gap estimate—even the most developed and sophisticated model—has a potentially large margin of error, one which is difficult to precisely quantify, not least because standard statistical methods are generally of limited use’. (The UK tax gap approach is explained in some detail in HMRC 2013b.)

The US National Research Project (NRP) makes use of much larger samples sizes (approximately 50,000 drawn equally over three years) on a more periodic basis. However even this relatively large sample size did not enable the US to update the 2006 tax gap Detection Control Estimates (DCE) for income undetected by auditors from the 2001 figures (Black et al. 2012, p. 7).

#### 1.4 Concerns about the accuracy of tax gap estimates

It should be noted that the UK Treasury Committee commented that it was not:

convinced that the process of calculating, publishing and publicising an aggregate figure for the tax gap is a sensible use of the HMRC’s limited resources. The aggregate tax gap figure is misleading and risks focusing HMRC on the wrong task as it only provides an order of magnitude. (UK House of Commons Treasury Committee 2012).

In this regard it is perhaps of interest that the Canada Revenue Agency (CRA) does not currently calculate a view of the tax gap, citing recently the significant ‘debate about the precision, accuracy and utility of any methodology to calculate the tax gap’ and that it ‘would be a very significant and costly endeavour’. (CRA 2013a).

In a subsequent letter on the matter, the CRA Commissioner stated:

Most countries do not estimate the tax gap. In fact according to the Organisation for Economic Co-operation and Development's Tax Administration [comparative information paper for 2013, 33 of 52 revenue bodies surveyed do not measure the tax gap. Of the countries that do measure the tax gap, estimates are not usually published annually, but every few years, reflecting the high cost of producing such an estimate. The countries that calculate a tax gap do so using different methodologies, and as a result, estimates are not comparable. (CRA 2013b).

Consistently, over a decade earlier the Canadian Customs and Revenue Agency (CCRA 2002, p. 25) stated:

Rather than attempt to estimate overall levels of reporting non-compliance, such as the 'tax gap' or the total amount of smuggling activity, which is fraught with difficulty, we rely on information derived from our compliance programs and other indirect measures to make a qualitative assessment. Our judgement, based on our experience, available evidence and estimates, is that while non-compliance is material, it remains at relatively low levels—in line with prior years and compared to other countries.

The Canadians have used random audits as part of an effectiveness evaluation for specific subpopulations. For example the CRA *Annual Report to Parliament 2009-2010* noted that for Individual Tax Return Reporting Compliance the effectiveness of targeted reviews was some 3.6 times that of random reviews; that the non-compliance rate for this group was 15.4% with estimated dollars at risk of \$987m (CRA 2010, p. 35). This analysis was not carried forward into subsequent annual reports.

While the ATO used small random audit programs as part of its Industry Scoping Audit Program in the early 1990's (Wickerson 1994) the ATO was at that stage disinclined to use the approach to support estimates of the overall Tax Gap:

while a rigorous and large scale random audit program might be one way of gaining reasonably accurate and reliable information, such programs take time to set up, to complete the audits required, and to analyse the results. This type of program is extremely costly to undertake. Not only would it consume large amounts of Tax Office resources that could otherwise be targeted at substantive compliance risks, it would place a significant additional burden on compliant taxpayers who otherwise would not need to incur audit related costs. (Source page 2 ATO 2004)

The then Commissioner Michael Carmody went on to state:

The Tax Office has concluded that accurate and defensible measures of the absolute size of the tax gap are impossible to achieve in a practical sense. This view is shared by Treasury and is consistent with conclusions drawn by the Australian Bureau of Statistics in its discussion paper on the underground economy. The ABS concludes that the official estimates of GDP are highly unlikely to be understated by any more than about 2 per cent. Further, the Tax Office believes that such absolute measures, even if they could be achieved, are unlikely to provide pertinent information for understanding the overall efficacy of the range of measures undertaken by the Tax Office. (Ibid Page 2)

Ten years on, there appears to have been a change of view on this as more recently the ATO Commissioner Chris Jordan stated:

Following extensive consultation with Tax Gap experts and representatives from jurisdictions already publishing estimates, the ATO executive endorsed extending our Tax Gap estimation program to cover all taxes administered. (Page 29 Australian House of Representatives Standing Committee on Tax and Revenue, 2013)

This will include the use of random audits for some of the estimate, largely it appears for credibility purposes:

credible Tax Gap estimates cannot be produced for individuals and small businesses without subjecting a small proportion of this population to random audits. (Ibid Page 30)

Though Commissioner Jordan did note

“I have expressed in prior hearings my concern over this issue [random audits]. **We are subjecting citizens to an intervention for the sake of collecting data.** But we have committed to this [Tax Gap] measurement now, and I absolutely get and share your concern on that issue... We are told that for reliability – and the experts advise us – there does need to be an element of that random audit in there.” (**Bold** emphasis added. Ibid Page 31)

## 1.5 Causes of tax gap uncertainty

As is noted in the 2013 IMF report, in practice, tax gap calculations all have inherent uncertainties associated with them. The sources and nature of the uncertainties vary, with some degree of overlap, across methods. As overall tax gap estimates are constructed from a variety of top-down and bottom-up methods, each with varying levels of uncertainty and ignorance, there generally is not a published estimate of the overall degree of uncertainty associated with any point estimate, though expert commentators (for example, Toder, Erard and Gemmill) agree that the level of uncertainty is quite significant.

Top-down methods have uncertainties associated with:

- the strength of the associations assumed between the economic variables used in the calculation and the level of non-compliance. For example, the oft cited approach MIMIC / velocity of money approach by Schneider (Schneider 2005) was found by Breusch (Breusch 2005) to be unreliable, capable of producing vastly different tax gap estimates with relatively minor changes in assumptions.
- the accuracy of those overall economic variables—often compiled from national statistical surveys (samples) that include estimates (some arbitrary, but plausible) for the non-observed economy (NOE) and non-reported consumption of goods and services. For example the Australian Bureau of Statistics (ABS) allows that the NOE could be double the amount allowed for (1.5% of GDP), but considers it to be highly unlikely to be three times the figure (ABS, 2013). Top-down models inherit this often unstated and uncommented upon uncertainty.

Bottom-up methods (both random and operational audit/survey) have uncertainties with:

- the detection of the level of mistakes, evasion and contestable avoidance, particularly for low dollar values and where third party reporting is absent. (This is significant with US data indicating that audit detection averages out at about \$1 in \$3 and can be as low as \$1 in \$20 [See Erard & Feinstein, 2011])
- legal interpretation, the difference between legal minimisation and contestable avoidance, particularly for complex, innovative high value transactions. (The US data indicates that the initial tax administration estimate overstates the amount adjusted on assessment, particularly after objection, by about \$4:\$1 [TIGTA 2013, p. 24.]) The Australian experience is similar with the reported audit pool of tax issues being much larger than amounts finally assessed. The amount collected is smaller still, by about 50%.
- expected sample variation which is inversely proportional to the square root of the sample size
- sample bias, if stratified random samples are not used (for example risk-based operational data)
- important ‘hard to sample areas’ such as large business entities that exhibit significant heterogeneity and heteroscedastic characteristics, making normal random sample extrapolation unreliable. In practice for these areas the tax gap component is calculated (constructed) using expert views applied to operational data.

These uncertainties mean that a point estimate of the overall tax gap is unlikely to ‘be’ the true value. Instead the true value is likely to be within a plus or minus range of the point estimate—a confidence or reliability interval; an indicator of a belief of how often the true value is estimated as being within the interval.

In practice this confidence interval is likely to be skewed rather than symmetrical. That is, we would be more confident that the true tax gap is closer to one end of the confidence interval, often the ‘at least’ or lower bound than the other; the ‘at most’. For example, the 2005 UK HMRC tax gap estimate income tax component had a point estimate of 12.5%, an estimated lower bound of 6.1% and an upper bound of 23.4%. This hasn’t stopped commentators (media and political) drawing lines through the year on year point estimates and claiming that the tax gap has increased or decreased, when in reality any apparent movement is still well within the error margin.

**Table 4: UK 2005 tax gap uncertainty estimates**

	General non-compliance			Avoidance			Non Payment			Total		
	Point	Lower	Upper	Point	Lower	Upper	Point	Lower	Upper	Point	Lower	Upper
Income Tax, CGT, NIC	8.1	3.7	17.1	3.9	1.9	5.9	0.5	0.5	0.5	12.5	6.1	23.4
Corporation Tax	2.9	1.4	6.9	4.4	2.1	6.6	0.2	0.2	0.2	7.4	3.7	13.7
Inheritance Tax	0.1	0.1	0.4	1.5	0.7	2.2	0	0	0	2.0	1.0	3.5
Stamp Duty	0.5	0.2	1.0				0	0	0			

Source: HMRC, 2005b.

**Table 5: UK 2008 tax gap uncertainty estimates**

Tax	Component <sup>1</sup>	Estimates (£ billion)			% Tax gap
		Point <sup>2</sup>	Lower	Upper	
<b>Indirect taxes<sup>3</sup></b>					
Value Added Tax (VAT)		11.5	N/A	N/A	12%
Spirits duty		0.1	0.0	0.2	5%
Cigarette duty		1.2	0.8	1.8	13%
Hand rolled tobacco duty		0.5	0.4	0.6	54%
Great Britain Diesel duty		0.5	0.0	0.9	4%
Great Britain Petrol duty <sup>4</sup>		0.0	0.0	0.0	0%
Northern Ireland Diesel duty <sup>5</sup>		0.1	0.1	0.2	34%
Northern Ireland Petrol duty <sup>4</sup>		0.0	0.0	0.0	15%
Other (illustrative indicator) <sup>6</sup>		0.9	N/A	N/A	
<b>Total Indirect taxes</b>		<b>15</b>	<b>N/A</b>	<b>N/A</b>	<b>10%</b>
<b>Direct Taxes</b>					
Income tax, National Insurance Contributions (NICS), Capital Gains Tax	Inaccurate self-assessment returns from individuals	7.2	3.3	13.4	
	Non-declaration of unearned <sup>7</sup> income and capital gains by individuals who do not receive returns	0.3	N/A	N/A	
	Hidden economy (Income from un-declared employment and self-employment) <sup>8</sup>	2.8	1.3	6.9	
	Inaccurate returns from small and medium sized employers (PAYE) <sup>8,9</sup>	0.4	0.2	0.8	
	Avoidance <sup>10</sup>	1.1	0.8	1.6	
	Non-payment	1.4	1.4	1.4	
	Other (illustrative indicator) <sup>11</sup>	2.7	N/A	N/A	
	<b>Total Income Tax, NICS, Capital Gains Tax</b>	<b>15.8</b>	<b>N/A</b>	<b>N/A</b>	<b>6%</b>
Corporation Tax	Inaccurate returns from Small and Medium sized businesses <sup>12</sup>	3.6	1.2	8.1	
	Avoidance by Very Large businesses <sup>13</sup>	3.1	N/A	N/A	
	Other tax gap for Very Large businesses <sup>15</sup>	0.2	N/A	N/A	
	Avoidance by Large and SME businesses <sup>10,12</sup>	0.3	0.2	0.4	
	Non-payment	0.4	0.4	0.4	
	Other (illustrative indicator) <sup>14</sup>	1.3	N/A	N/A	
	<b>Total Corporation Tax</b>	<b>8.9</b>	<b>N/A</b>	<b>N/A</b>	<b>16%</b>
Cross-tax avoidance	Cross tax and stamp duty land tax avoidance <sup>16</sup>	0.2	0.1	0.3	
Other (illustrative indicator) <sup>15</sup>		1.6	N/A	N/A	
<b>Total direct taxes</b>		<b>25</b>	<b>N/A</b>	<b>N/A</b>	<b>8%</b>
<b>Total HMRC Tax Gap</b>		<b>40</b>	<b>N/A</b>	<b>N/A</b>	<b>8%</b>

<span style="display:inline-block; width:15px; height:15px; background-color:#90EE90; border:1px solid black;"></span>	Established methodology, estimate updated annually
<span style="display:inline-block; width:15px; height:15px; background-color:#ADD8E6; border:1px solid black;"></span>	Developing methodology, estimate updated annually
<span style="display:inline-block; width:15px; height:15px; background-color:#FFFF00; border:1px solid black;"></span>	Experimental methodology, not updated annually and illustrative indicators for gaps with no direct measure

Source: HMRC, 2009.

For bottom-up estimates, the width of the standard statistical component of the confidence interval is influenced by factors such as how confident we wish to be (for example, the z or t statistic giving 95% confidence), the level of sample variation, the sample size, and allowances for any reasonable well-known and objectively computed bias.

There is also the impact of sources of bias whose values are not well-known, which means that in practice there is an irreducible level of uncertainty (a level of ignorance or subjectivity) associated with any overall tax gap estimate.

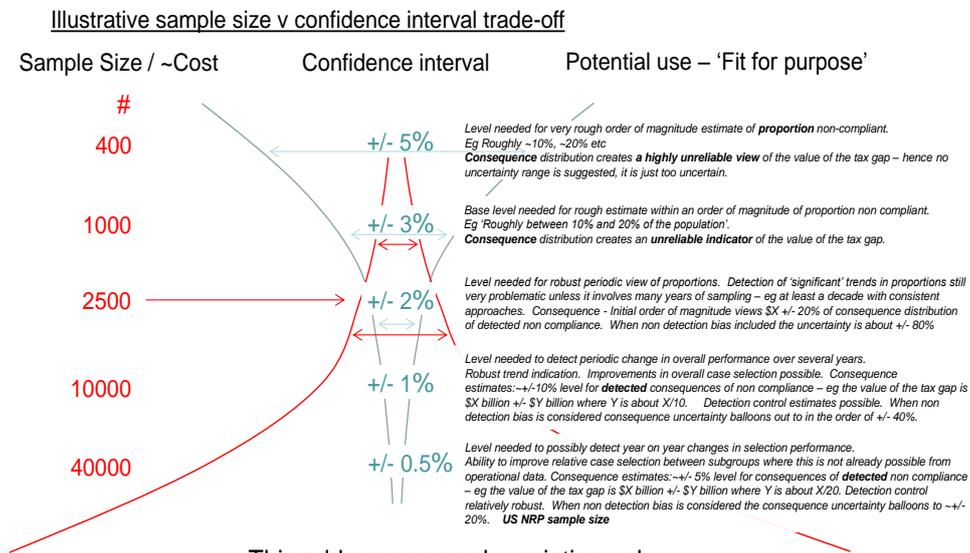
In this respect overall tax gap estimates and their confidence or reliability intervals are in practice judgement views (or ‘best guesses’), based on a range of plausible assumptions.

**2. THE TAX GAP FIGURE IS AN ITEM OF INFORMATION THAT HAS A COST OF PRODUCTION**

It should always be kept in mind that tax gap estimates are an item of information that has a real cost of production. These costs can be internal and include opportunity costs from alternate uses of the resources, and can also include costs imposed upon taxpayers where random audit approaches or surveys are used. The purposes for which the information is used, the different decisions made on account of it, should outweigh this overall cost of production.

Generally the more detailed, reliable and accurate the estimate needs to be, the greater the cost of production. For example, knowing the likely overall tax gap to some degree of reliability and accuracy may enable better decisions regarding tax policy in certain areas, such as on the level of third party reporting or withholding or the resourcing of the tax administration, but this knowledge comes at a cost. Where a tax gap component is produced by extrapolation from a random sample, the improvements broadly come at a cost that rapidly balloons out with the square of the improvement in precision sought. So halving the confidence interval typically requires four times the sample size, for example, from ~100 to ~400.

**Figure 2: Confidence figures using Wilson Score Interval (See Brown et al 2001).**



This addresses sample variation only. It does not address detection uncertainty, litigation/interpretation uncertainty, or risk based selection bias. **All are significant factors.**

\*‘Fit for purpose’ use is author’s own views.

A conflating factor here is that if random audit approaches are used to obtain a view of the tax gap then compliance costs are necessarily imposed on compliant taxpayers, rather than being borne by the decision maker. They are thus in the nature of an economic externality and, for good decision-making, need to be appropriately factored into decisions regarding the size and intensity of any random audit program.

Relevantly in this respect the Inspector-General of Taxation (IGT) *Review into Aspects of the Australian Taxation Office's Use of Compliance Risk Assessment Tools* suggested reimbursing taxpayers for the additional compliance costs incurred from inclusion in a random audit program (IGT 2013, para. 8.42 and 8.45).

The cost imposed on taxpayers was a key reason for the IRS significantly scaling down their TCMP random audit program, yet without an extensive random audit program the production of Detection Control Estimates, so necessary to adjust for auditor detection variation, becomes difficult and the 'credibility' of component tax gap estimates diminishes substantially.

As an aside, it seems somewhat odd to the Author that random tax audits for the purpose of producing an inevitably inaccurate tax gap figure seem so easily contemplated when, for comparison, random colonoscopies would never be countenanced for the purposes of producing an estimate of colon cancer rates.

Perhaps this is an unfair comparison as Tax audits take longer and are done without anaesthetic, but both are seen as relatively unpleasant experiences to undergo. Unless the random tax audits, a discovery process, are undertaken to improve later risk based detection capabilities and thus lessen future false positive rates, they can seem a rather questionable value add.

The number of random audits needed to accurately improve detection capabilities is significantly higher than the number needed to roughly estimate the tax gap (eg IRS NRP ~50,000 for detection improvement v HRMC ~5,000 for rough tax gap estimate).

For very high levels of accuracy very large samples are typically required, for example a sample of ~40,000 normally gives an accuracy of about +/- 0.5% *for easily observed* matters. The validity or trueness of such an apparently precise estimate can still be very questionable if the aspect being measured has a systemic bias, such as a relatively low or unknown detection rate.

As such we might 'know' the detected value of non-compliance to within say 5%, but still have much less precise 'guesstimates' (for example, ~+/- 20% or so) about the undetected value of non-compliance.

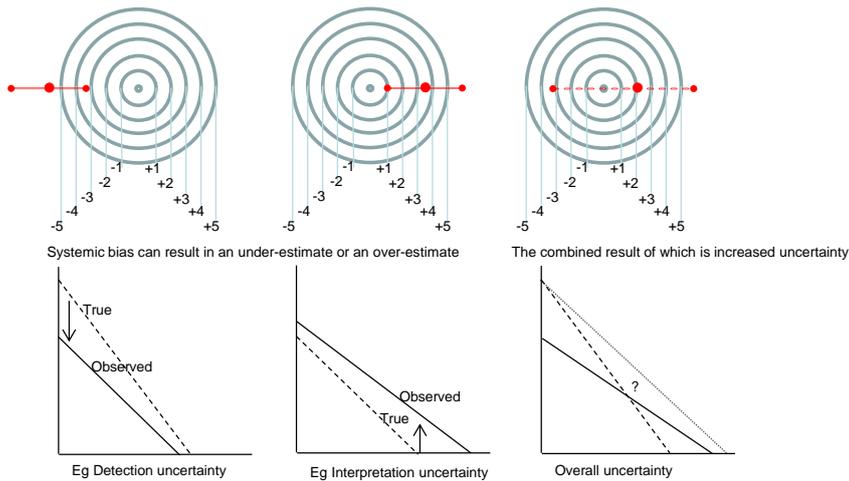
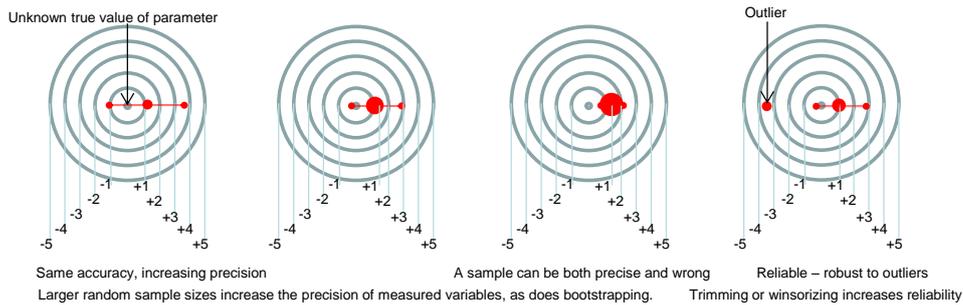
The following graphics attempt to illustrate some of these uncertainty concepts:

- **Accuracy** (trueness) here means the estimate is likely to be relatively close to the unknown true value. Accuracy can be improved by reducing systemic bias via the use of techniques such as basing the estimate on the outputs of a stratified random sample where this is practical.
- **Precise** means there is a relatively smaller confidence interval for a given level of confidence. Precision can be improved by increased sample size [ $\sim 1/\sqrt{n}$ ] in certain situations.

- Reliable** means the estimate is robust to the effect of extreme sample values, outliers or changes in approach. Reliability can be improved by the use of techniques such as the use of medians, trimmed means, Winsorized variance, and bootstrapping (generating many samples on a computer from a single sample to give a distribution). Using these techniques improves the stability of the estimate but could result in an understatement of the true value.

**Figure 3: Accuracy, Precision and Reliability**

Illustrative concepts – accuracy (trueness), precision, and reliability



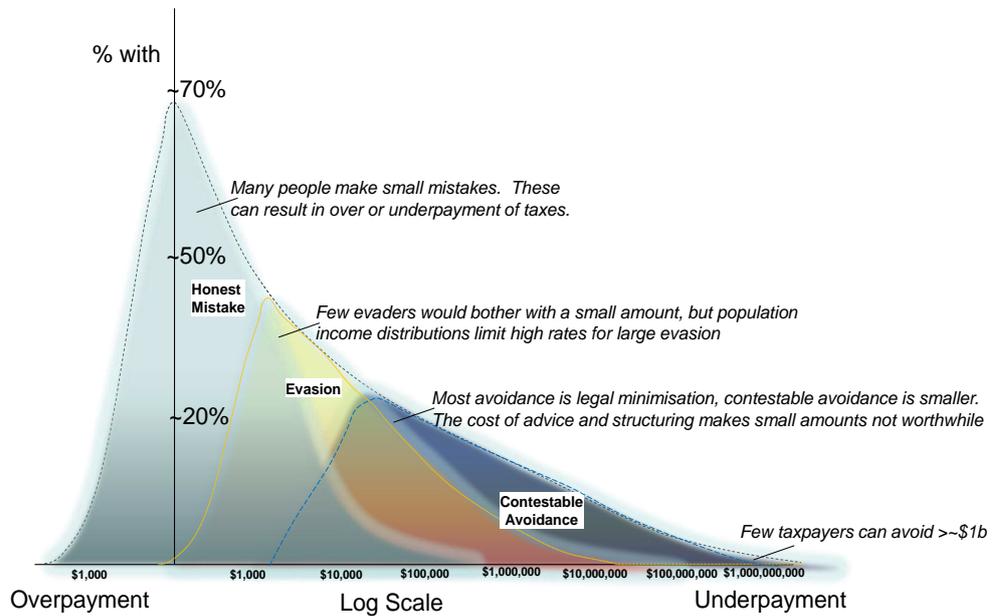
Source Author

Example probability distributions distinguishing between ‘honest mistake’, evasion and contestable avoidance, giving an overall and overlapping distribution of non-compliance:

**Figure 4: Hypothetical tax gap distributions for honest mistake, evasion and avoidance**

- Illustrative distributions
- Honest mistake
  - Evasion
  - Contestable avoidance

*Note: This is log 10 scaled so the area does not represent the relative levels.*



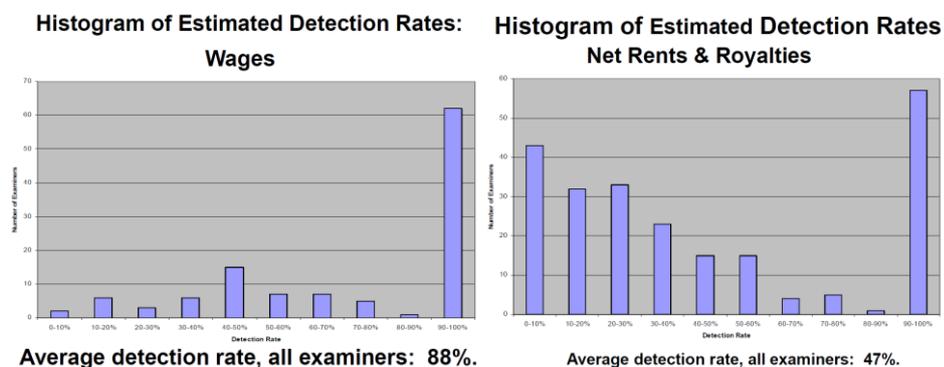
Source Author

While with random audit approaches selection bias is generally not a problem, particularly with larger sample sizes and stratification, significant bias / uncertainty can still occur from imperfect detection and interpretation capabilities.

For simple matters, where strong data matching is used, this bias can be fairly minimal, but overseas studies by the IRS indicate that it can be very significant (for example, > 5:1 for non-compliance) where there is no third party reported income or deductions.

For example, compare the differences in wage detection (88% reported on) with rents and royalties (47% not reported on):

**Figure 5: IRS detection variation example—wages versus rents**



Source: Erard & Feinstein, 2011.

On average the IRS found the level of estimated non-compliance as a ratio to detected non-compliance is quite significant, particularly for income not subject to third party reporting:

**Table 6: Implicit DCE multipliers**

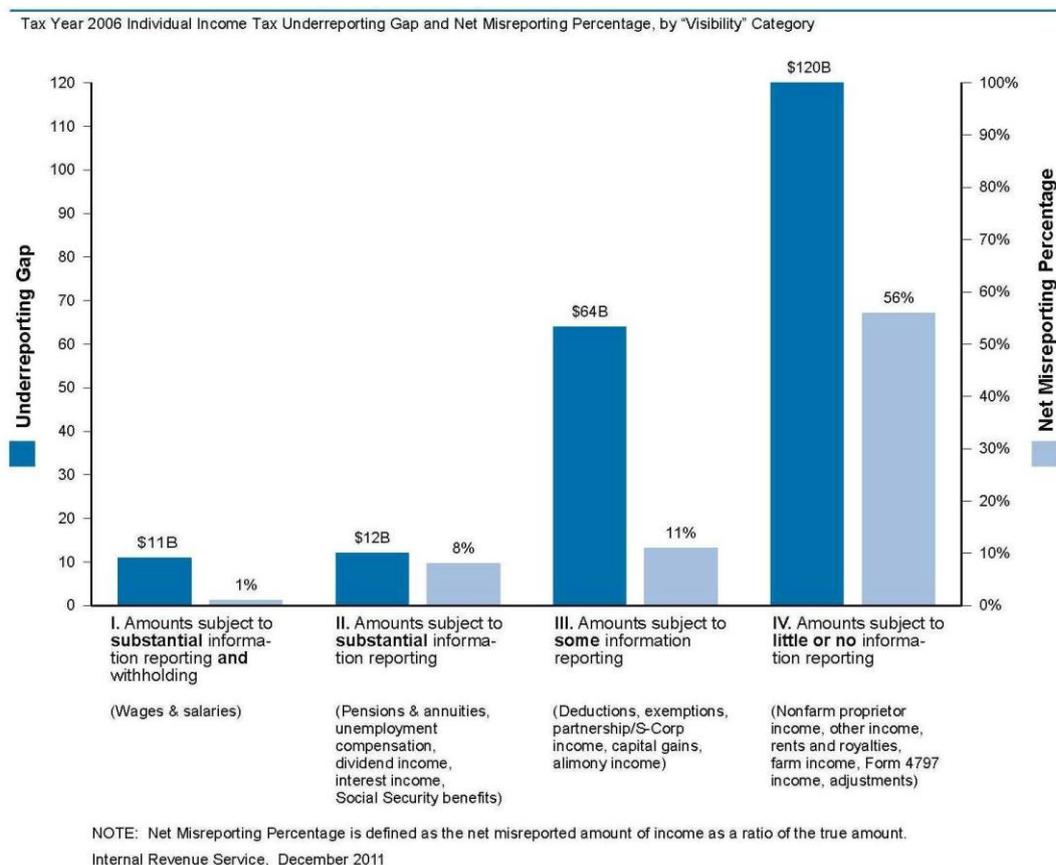
Income Category	Multiplier	Income Category	Multiplier
<b>High 3rd Party Information Reporting*</b>		<b>Schedule C</b>	
Classified	1.46	Schedule Reported	2.92
Not Classified	5.37	Scheduled Not Reported	16.4
Overall	2.52	Overall	3.4
<b>Routinely Classified*</b>		<b>Schedule F</b>	
Items Reported	2.86	Schedule Reported	3.18
Items Not Reported	4.80	Schedule Not Reported	20.0
Overall	3.26	Overall	3.41

\*These implicit multipliers are averaged over several line items, which were estimated separately.

Source: Erard & Feinstein, 2011.

In more detail, the key determinant of the level of detection was found to be the degree of third party reporting:

**Figure 6: US Tax gap—information reporting and levels of mis-reporting 2006.**



Source: IRS 2012b

The construction of detection control estimate multipliers (DCE) is a very complex statistical undertaking requiring an audit of the data by auditor and sufficient sample sizes per auditor (>15) to form useful distributions. For this reason, without a relatively large scale well-constructed audit program, deriving reliable, precise and accurate DCEs is quite problematic (Erard & Feinstein 2011).

Given the sample sizes and other data needed, the HMRC used the US DCE multipliers which created a point of suggested improvement by the IMF review panel, but one that is very difficult to correct with the sample sizes actually used in the UK.

Because of the significant skew of consequences of non-compliance coupled with a relatively high proportion of compliant taxpayers, the sample size producing robust and reliable views of the dollar value distribution (magnitude of non-compliance) are much larger than the sample size for the rate of non-compliance. For example, a 90% compliant population will, on average, only have 10% of the sample providing data on the distribution and magnitude of non-compliance. With a modest random sample of 2,500 that is only about 250 values of non-compliance, on average.

Here is a simple analogy: Think of a pocket full of coins. We will be able to estimate the average number of coins contained in a pocket with much more accuracy than the estimate of the aggregate (sum) value of those coins.

The problem is actually much more difficult for the tax gap, as much of the sample will be compliant and thus provide no information on the spread of the non-compliant state or the spread (variation) of possible values of non-compliance, and their range (for example, \$10 to \$1b) is also significantly larger (and hence less certain) than the spread of values of coins and their likelihoods.

Where a representative sample of an important sub group cannot be formed, such as where the population is highly skewed, heterogeneous (they vary from one another) and heteroscedastic (the level of variation itself varies) as with large corporates, simple extrapolation from random audits is effectively impractical. For such subpopulations, expert judgement, extrapolated from operational data and experience, is essentially used to 'construct' a plausible view of the tax gap.

If a random audit program is utilised in the calculation of the tax gap it is also important that the cases that are selected 'complete' the dispute cycle. The time requirement to complete the audit / objection / appeal cycle may limit the case types and subpopulations that are appropriate for a random audit program to relatively small taxpayers with fairly simple affairs.

Matters likely to go to court may be unsuitable for random audits unless it is accepted that several years may be needed to form a view of the tax gap.

The level of irreducible uncertainty associated with overall tax gap estimates, an aggregate view constructed using multiple methods, means that the estimates really should be broad-banded in practice, a bit like school report cards, rather than stated as point figures that inevitably are interpreted as implying a level of certainty that just does not exist.

An example of broad banding schema for overall tax gaps might be something like:

**Table 7: Hypothetical broad banding schema for overall tax gaps**

<b>Tax Gap Magnitude %</b>	<b>Grade</b>	<b>Description</b>
<i>0+% to ~5%</i>	A	Excellent – world best practice level
<i>5+% to ~10%</i>	B	Good
<i>10+% to ~15%</i>	C	Could improve
<i>15+% to ~20%</i>	D	In danger of failing
<i>&gt;20%</i>	E	Failing

\*Author's own views.

## 2.1 Disclosing the uncertainty in tax gap estimates

The IMF review of the HMRC tax gap analysis notes that, '[t]here is a clear benefit in cautioning the audience about the inherent difficulties in providing precise point estimates, although margins of error themselves are not exact science either.' Oddly it then suggests that, 'on balance, it seems sensible to not publish specific margins of error. However, broad indications of margins of error could still be useful—for example, by grouping gap estimates with similar level of margins of error' (IMF 2013, fn. 31).

More positively for well informed decision making, the recent *Estimates Of Uncertainty Around Budget Forecasts* paper from the Australian Treasury states:

Estimates of uncertainty around such forecasts can help convey to readers a better appreciation of the risks associated with the economic and fiscal outlook. ... Estimates of forecast uncertainty can also improve the credibility and transparency ... Explicit estimates of uncertainty can aid in making clear that point forecasts may turn out to be incorrect and that forecasts may be more usefully considered as a range rather than a point estimate. Being explicit about inherent uncertainties may lead to fewer misunderstandings about the forecasts and what they represent. (Australian Treasury 2014, Page 1)

## 2.2 Imputing changes in compliance levels

Imputing changes in compliance levels from tax gap estimation is particularly difficult and is generally considered unreliable. Toder (2007b) notes that while the US tax gap estimate is a good order of magnitude estimate, it should not be used for measuring trends or evaluating IRS performance because 'there is so much noise and uncertainty in the compliance estimates that changes in year to year tax gap numbers could be purely random'.

Similarly Gemmell and Hasseldine (2012) note:

the margins of error associated with individual estimates are just too big for these methods to form a reliable guide to year-to-year changes in tax compliance or 'tax gaps'. ... a shift in the tax gap index of say 10% from one year to the other ... might be dominated by margins of error of, say 30% around each estimate.

In the same vein, the IMF states that, 'one needs to assess very carefully whether changes (or differences) of the estimate are due to spurious factors or real ones' (2013, p. 42). It is of note that the ABS does not attempt to impute year on year changes to the somewhat analogous (and linked to the tax gap) NOE, simply making an aggregate adjustment to the national accounts of 1.5% of GDP. This adjustment is an informed judgement compatible with the evidence they have.

## 2.3 Issues in identifying tax gap trends

Given the inherent uncertainties that exist, even with an extensive random audit program similar in size to the US (~50,000 audits over three years), the credible confidence interval of the overall tax gap value would seem to be about \$Xb +/- \$X/5 (that is, +/- 20%). The interval backed by a smaller random audit component would

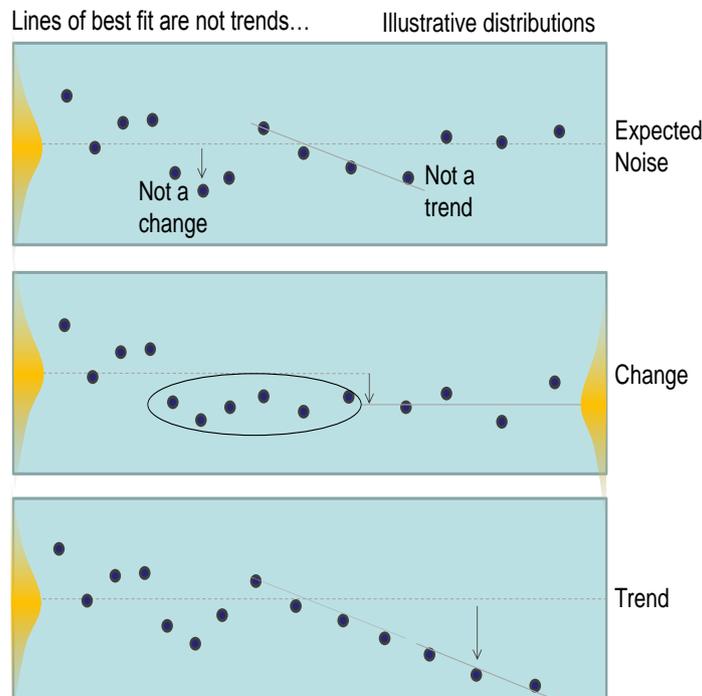
appear to be about double to quadruple that—from  $\$Xb \sim \pm \$Xb/2$  (significant program with 10,000 random audits) to about  $\$Xb \sim \pm \$X$  (modest program with 2,500 random audits), effectively limiting any meaningful analysis to order of magnitude views.

As the annual ‘real’ movements would seem to be relatively small (there is likely to be an ‘inertia’ in unaddressed evasion and avoidance arrangements), extracting a ‘signal’ of real annual change (period 1 to period 2) from the expected wider uncertainty / ‘noise’, even if the unknown calculation bias remains unchanged over time, is probably unrealistic despite its obvious desirability, without a random audit program in the tens of thousands.

As more periods are included, providing more data, the ability to reliably detect the ‘signal’ of real changes against a background of sample ‘noise’, improves as each period’s samples effectively sum—provided there is consistency of approach and data.

The following diagram attempts to illustrate the problem of detecting the signal of real change from apparent noise over relatively short time scales (that is, a few periods). This is a relatively common business issue and statistical process control approaches such as Shewhart Control Charts with various decision rules, for example, Nelson rules, Western Electric Rules, (both detailed on Wikipedia) have been designed to more reliably identify the ‘signal’ of changes and trends from expected ‘noise’ and reduce the risk of confirmation bias. It is somewhat surprising that these fairly basic techniques (a key aspect of statistical process control regimes such as Six Sigma) do not appear to be widely used in public service processing.

**Figure 7: Identifying signal from noise – using control charts**



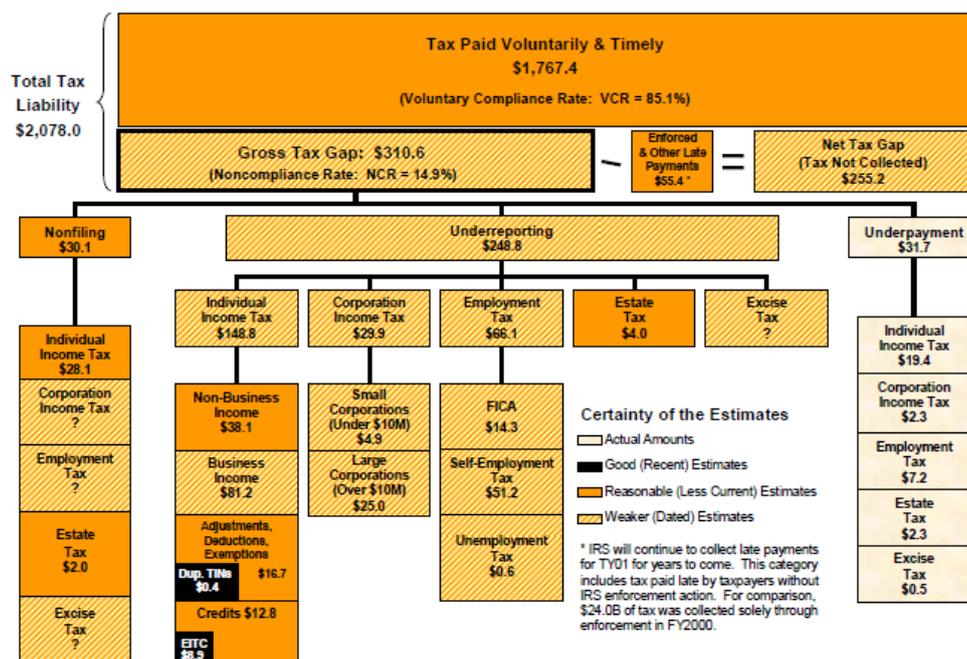
See ISO 8258:1991 Shewhart Control Charts.

The ability to correctly determine whether a change or trend exists can be a problematic area of understanding, particularly where there is potentially a strong interest in seeing a ‘change’ or ‘trend’. Agencies and their management understandably want to make a difference and then demonstrate the difference they may have made, however confirmatory bias is something both science and good decision makers should be particularly conscious of, and vigilant about.

It should be noted that imputing causation is then yet another step up in difficulty from correctly identifying a change or trend. Without proper control group approaches the causation analysis may have about the same degree of credibility as performing a rain dance and then noticing that it has rained ... somewhere, sometime.

A useful illustration of some aspects of the level of uncertainty associated with overall tax gap estimates can be drawn from the following two estimates for the US 2001 tax gap. The first estimate of 14.9% was made in 2004, largely based on various extrapolations from the 1988 Tax Compliance Measurement Program:

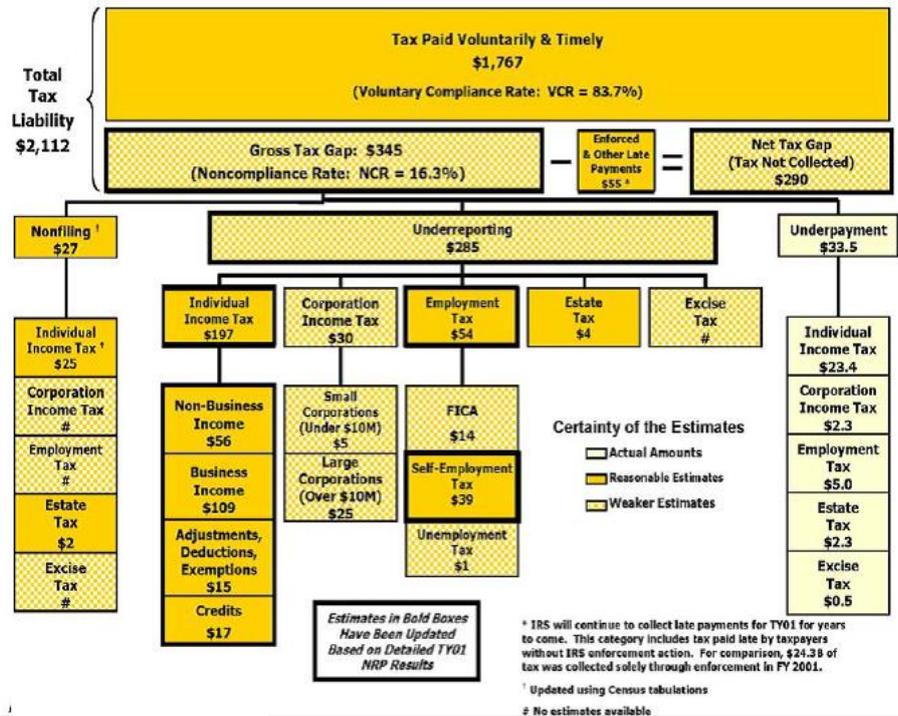
**Figure 8: Tax gap map for TY 2001 (in US billions)**



Source: IRS, 2004.

A revised estimate of 16.3% was made in 2006 in the National Research Project (NRP):

Figure 9: Tax gap map for TY 2001 (in US billions)



Source: IRS, 2006.

In an IRS report to Congress, the cost of the NRP, ignoring compliance costs imposed upon taxpayers, for the period 2000 to 2004 was calculated as being US\$119,689,770 (IRS 2004). While there are some significant internal variations in the estimates, for example, the estimate of underreporting by individuals changed from US\$148.8 b to \$197 b, the refinement in the overall point estimate of the tax gap only changed from 85.1% to 83.7%. For practical purposes, given the level of remaining uncertainty from detection and interpretation bias, the overall tax gap estimate was essentially unchanged. However as the IRS uses the research to update the case selection processes among other things, the tax gap estimate is not the sole or even dominant purpose of the \$120m research undertaken.

This goes to the key point—the information value needs to be fit for purpose and worth the cost of production. A tax administration can potentially spend a lot of time and effort and inconvenience thousands of compliant taxpayers to produce a number that has very limited use in reality—one that is inherently inaccurate. It may be a ‘nice to know’ figure, costing millions, for some politician wishing to score points rather than a ‘need to know’ one for a tax administration charged with dealing with it.

One could go further and say that due to the irreducible levels of uncertainty, in practice, all overall tax gap estimates are judgements backed by a level of statistics based on plausible associations or extrapolations made from observed data, whether it be data from national accounts, operational audit data or data from random audits or surveys. In effect the tax gap estimate is a Bayesian belief.

The tax gap is likely to be a quasi-equilibrium state for factors such as the economy, compliance culture, tax policies, laws and administration that exist. Changes in any of these factors are likely to produce some change in the overall tax gap and controlling for them to ascertain causality is likely to be difficult-to-impossible in practice.

Given the size of the Australian economy (roughly \$1.5 trillion dollars) and the overall tax to GDP ratio (about 22%), the overall tax gap is likely, if of the same magnitude as the US or UK, to be about 2% of GDP. (This figure is not a formal estimate of the Australian tax gap, merely an illustration of a probable order of magnitude).

It is of note that tax expenditures (deliberate policy concessions in the tax system) are about three times this estimate of leakage, at ~8% of GDP.

**Table 8: Total measured tax expenditures**

<b>Year</b>	<b>Housing</b>	<b>Superannuation</b>	<b>Other</b>	<b>Total</b>	<b>GDP</b>
\$m	\$m	\$m	\$m	\$m	%
2010–11 (est)	35,500	27,450	52,032	114,982	8.2
2011–12 (est)	31,000	30,262	50,072	111,334	7.6
2012–13 (p)	30,000	31,846	53,174	115,020	7.5
2013–14 (p)	29,500	34,645	55,436	119,581	7.4

Source: Adapted from Table 1.1 in the Australian Government the Treasury, 2014, *Tax expenditure statement 2013*, Canberra.

As such it should be readily apparent that changes in economic conditions, tax policy, and tax rates, are likely to have a significantly larger impact on the overall tax take than the likely annual change in compliance levels.

For example, the impact of the GFC and the recession of the early 1990s is clearly apparent in the following chart:

**Figure 10: Australian federal government tax to GDP ratio over time**

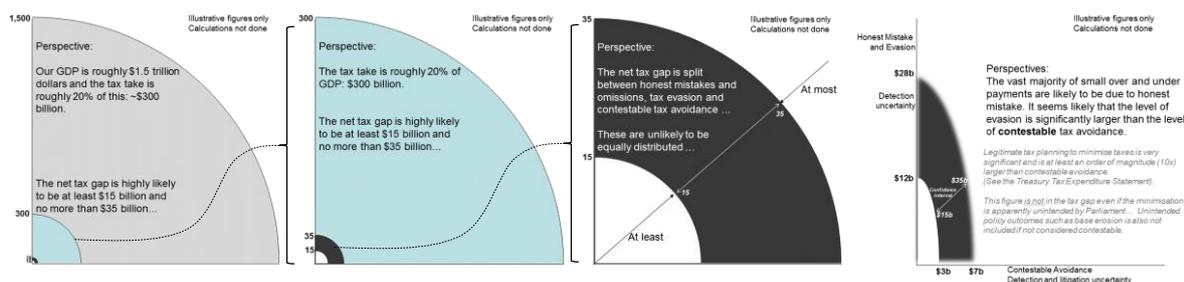


Source Australian Treasury 2013

It should be obvious at this stage of the paper that to significantly reduce the overall tax gap is likely to require major policy changes, such as increased third party reporting or withholding regimes, or significant resource increases for the tax administration. (Toder, 2007a). Indeed one of the real dangers of a tax administration rather than the Treasury producing a tax gap figure is the simplistic response that often follows: “close it”.

Changes that would significantly impact upon the relatively steady state tax gap have their own administrative, compliance, and deadweight social costs that may render them politically unpalatable, such as with the Australia Card Proposal, or as led to the demise of the Prescribed Payments System, even if revenue-positive.

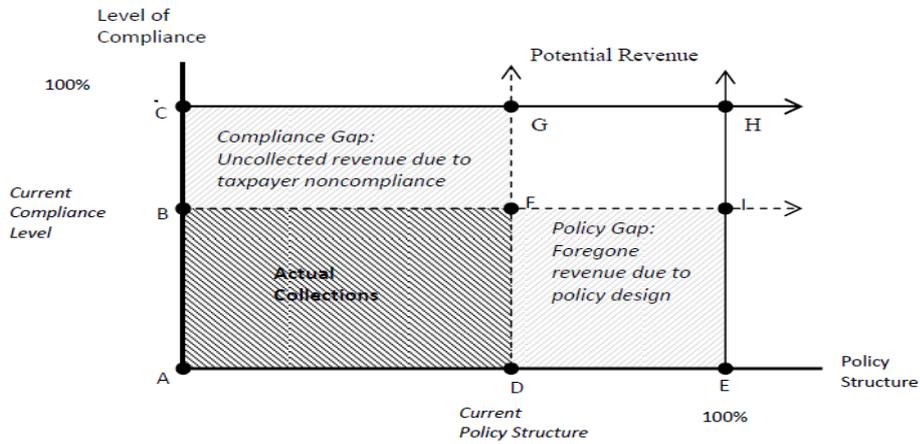
**Figure 11: Tax gap perspectives (illustrative rather than indicative figures only)**



Source: Author illustrative estimates

The IMF assessment of the HMRC tax gap analysis usefully provides a conceptual model that separates the compliance tax gap and policy tax gap components:

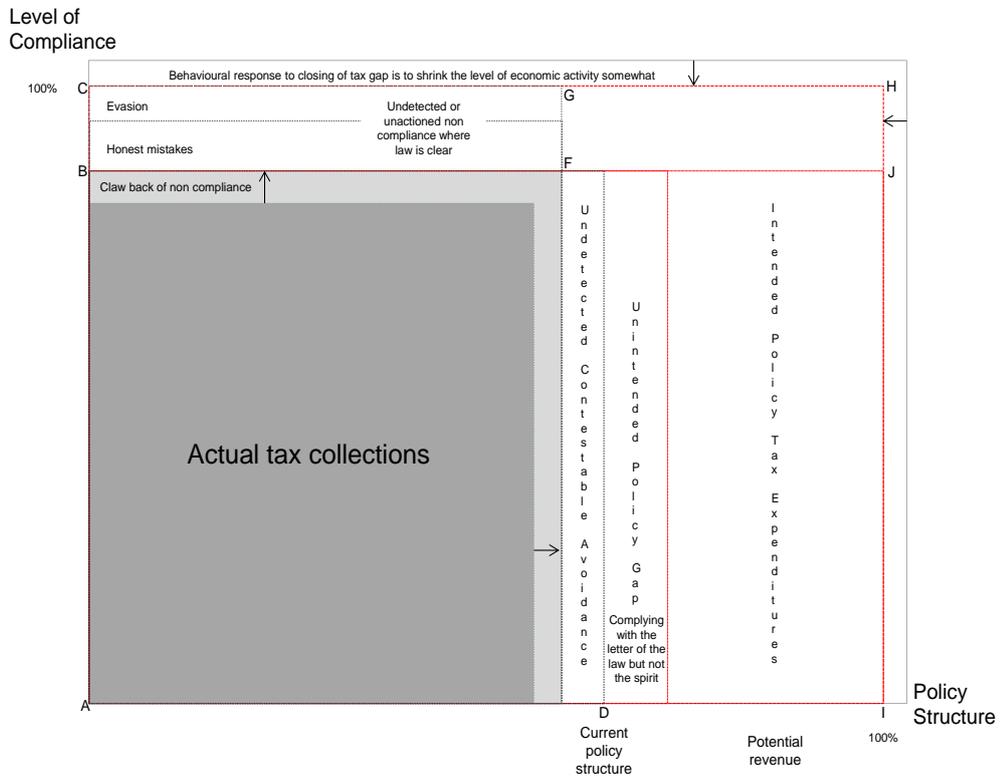
**Figure 12: Tax compliance versus tax policy gap**



Source: IMF, 2013.

In practice however there are many more nuances and a significant degree of blurring or overlap between these two aspects, and the tax gap will be dynamic to efforts to reduce it:

**Figure 13: More nuanced tax compliance versus tax policy gap**



### 3. A POTENTIAL METHODOLOGY TO ESTIMATE TAX COMPLIANCE LEVELS.

The bottom-up ROC methodology now outlined in this part of the paper works from known ‘strike’<sup>4</sup> rates and explicitly allows for a level of undetected non-compliance, false negatives, so care does need to be taken with the subsequent use of any DCE multipliers to avoid double counting.

It should also be noted that as it is based on observed strike rates, the methodology does not identify ‘avoidance’ that is considered non-contestable (that is, legal tax minimisation) by the regulator. Also where the regulator’s view of compliance is ultimately not accepted by the court and is reversed, it may overstate the level of non-compliance (as would other bottom-up approaches, such as the US IRS NRP, that mainly utilise the regulators initial view, rather than the court’s final view, of compliance).

#### 3.1 Background to the Receiver Operating Characteristic approach

The Receiver Operating Characteristic (ROC) analysis originated during the Second World War (hence the name derivation from Radar Receiver Operator Characteristic) to analyse and categorise signal detection capabilities, that is, whether the blip on the radar screen was a plane or just a flock of birds. This can be thought of as a binary classification or decision process by the operator: ‘Yes’ the blip is a plane; ‘No’ it is a flock of birds. Two types of error can emerge from this classification process. The blip could be incorrectly be classified as a plane when in fact it was a flock of birds (a type 1 error or false positive) or the blip could be classified as a flock of birds when it was in fact a plane (a type 2 error or false negative). By listing and ranking the operator’s decisions a view of the operator’s detection accuracy could be obtained.

Different operators had different levels of ‘capability’, and hence effectiveness, and the ROC analysis was used as a way to formally analyse the ability of an operator receiving a stimulus to correctly categorise a ‘true’ signal from ‘false’ noise. (Wheeler 2011 provides a good overview of the history of ROC analysis for those interested).

The ability to correctly classify a signal against a background of noise was important then and is no less so now. Because it provides a relatively simple yet robust method by which to evaluate the effectiveness of ‘classifiers’ (signal detection systems), the ROC approach has become a fundamental tool in a broad range of decision-making disciplines involving detection such as: physiological testing, for example, does the person have a mental condition; clinical medicine evaluations, for example, is the shadow on the x-ray cancer, (Metz 1978; Zweig & Campbell 1993); and machine learning approaches (Flach 2004; Fawcett & Flach 2005).

ROC approaches have been used in data mining model evaluation by some regulatory agencies for a number of years. This paper extends the basic concepts to the overall regulatory compliance problem at a client population level and in so doing develops a model by which to triangulate possible initial (before compliance action clawback) and residual (after compliance action claw back) ‘compliance gaps’, that is, the differences between the regulators estimate of full compliance and that which actually exists (Toder 2007b; Gemmell & Hasseldine 2012).

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<sup>4</sup> The strike rate is the rate of detected non-compliance in the sample being reviewed or audited.

The classification process for regulatory compliance can be thought of as a decision regarding the compliance state of a client, that is, the case selection and review process.

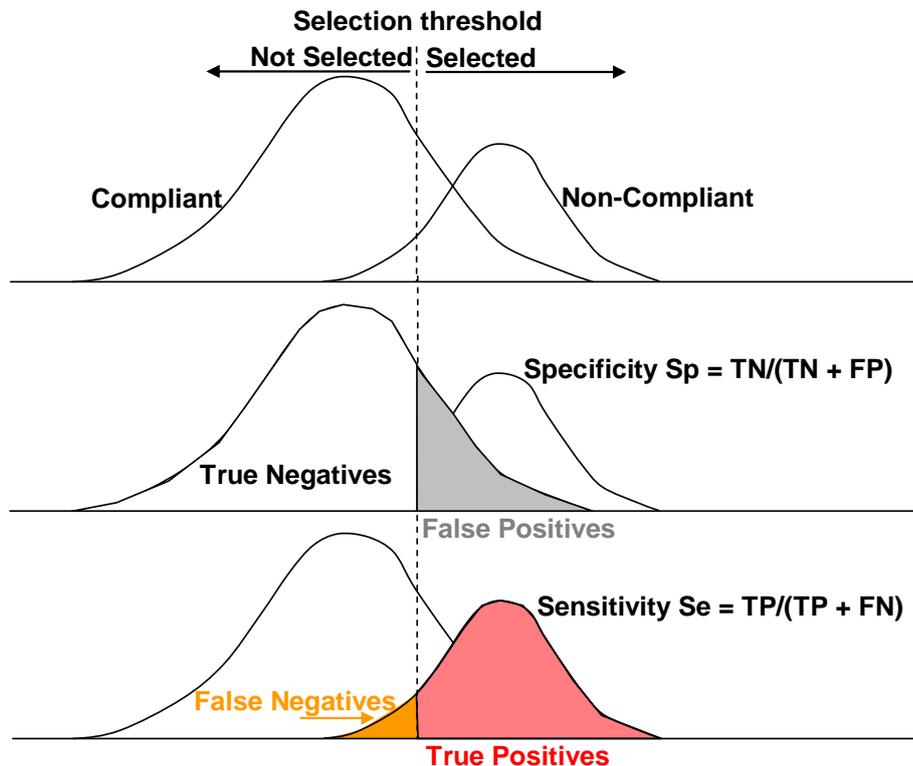
### 3.2 Approach and terminology

Consider a population ( $N$ ) subject to various laws and regulations that are administered, and enforced where necessary, by a regulatory agency. In most such situations a percentage ( $P$ ) of this population, generally small (Hamilton 2012), is likely to be viewed as being potentially non-compliant with some aspect of those laws and be subject to some review activity to confirm whether or not they are compliant.

Those who are selected for review and are found non-compliant can be considered as True Positives ( $TP$ ), while those who are selected and found to be compliant are False Positives ( $FP$ ). Those members of the population who are non-compliant, but are not detected and reviewed are False Negatives ( $FN$ ), while the remaining population who are compliant are True Negatives ( $TN$ ).<sup>5</sup>

The ability to detect non-compliance, when it is present, is the selection system or classifiers' **sensitivity** ( $Se = TP/(TP+FN)$ ), while the ability to correctly categorise a compliant client as being compliant is the selection systems **specificity** ( $Sp = TN/(TN+FP)$ ).

**Figure 14: True Positives, False Positives, True Negatives and False Negatives**



<sup>5</sup> While the terms ‘True Noncompliant’, ‘False Noncompliant’, ‘True Compliant’ and ‘False Compliant’ were suggested by a reviewer, the standard and accepted terminology for ROC analysis is ‘True Positives’, ‘False Positives’, ‘True Negatives’ and ‘False Negatives’, and thus are used throughout.

These relatively few variables are used to construct a relatively simple model for further analysis. The first step is to set up a contingency table reflecting the relative aspects identified and their probabilities:

**Table 9: Contingency table (aka confusion matrix)**

	<b>Compliant</b>	<b>Non-Compliant</b>	Metrics
<b>Detected</b>	False Positive ( <i>FP</i> ) (False Alarm) $[N \times (1 - P) \times (1 - Sp)]$	True Positive ( <i>TP</i> ) (Hit) $[N \times P \times Se]$	Precision: (Strike rate) $TP / (TP + FP)$
<b>Not Detected</b>	True Negative ( <i>TN</i> ) $[N \times (1 - P) \times Sp]$	False Negative ( <i>FN</i> ) (Miss) $[N \times P \times (1 - Se)]$	False omission rate: $FN / (TN + FN)$
	<b>(1-P)</b>	<b>Prevalence (P)</b>	Accuracy: $(TN + TP) / N$

This gives an optimal sample size ( $n^*$  = a sample that, on average, would enable the review of all detected cases), not taking into account the administrative costs of reviewing, the compliance costs of being reviewed, and benefits from dealing with all detected non-compliance at this stage, for the selection system as:

$$n^* = TP^* + FP^* \text{ where } TP^* = N \times P \times Se \text{ and } FP^* = N \times (1 - P) \times (1 - Sp).$$

$$\text{i.e. } n^* = (N \times P \times Se) + (N \times (1 - P) \times (1 - Sp))$$

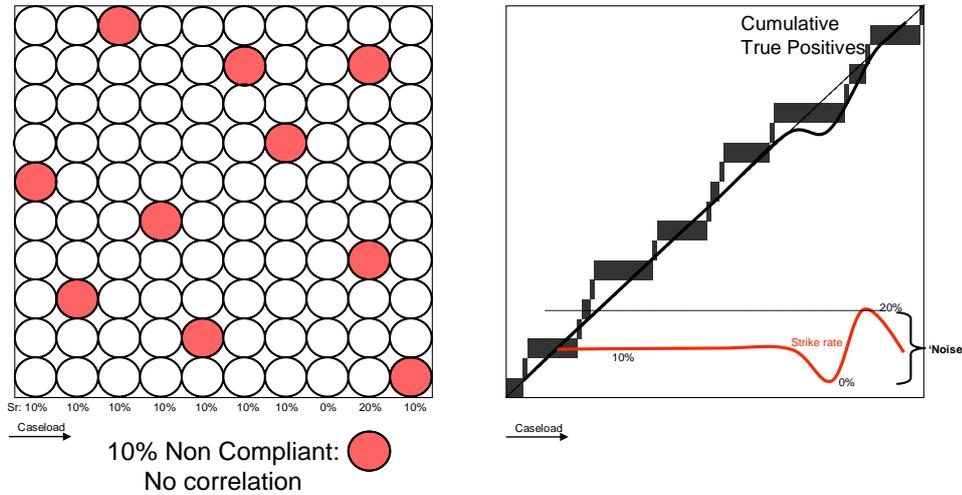
Such a sample is ‘optimal’ in the sense that in order to review all of the detected<sup>6</sup> non-compliant clients, the regulatory agency would need to check all detected non-compliant clients ( $TP^*$ ) and all of the false positives ( $FP^*$ ) at that point.

If the sample size ( $n$ ), the number selected for review, is less than or equal to  $n^*$  then the strike rate or precision of the selection process will be  $TP^* / (TP^* + FP^*)$ . If the sample size (coverage) is greater than  $n^*$  then additional non-compliant clients will start to be ‘discovered’ at a rate of  $FN^* / (TN^* + FN^*)$  where  $FN^* = N \times P \times (1 - Se)$  and  $TN^* = N \times (1 - P) \times Sp$ .

Putting in some example numbers: Assume that the population is 100 ( $N$ ) with a 10% non-compliance rate ( $P$  is prevalence) and that the selection system can correctly categorise or detect 70% of non-compliance when it is present (selection sensitivity  $Se$ ), and 70% of compliant clients when they are compliant (selection specificity  $Sp$ ).

<sup>6</sup> At this point the analysis assumes that a review or audit is the ‘gold standard’ 100% determinant of the compliance state for the regulator and that the classifier’s accuracy is known. These assumptions are relaxed later.

**Figure 15: Prior to selection  $N = 100, P = 10$**



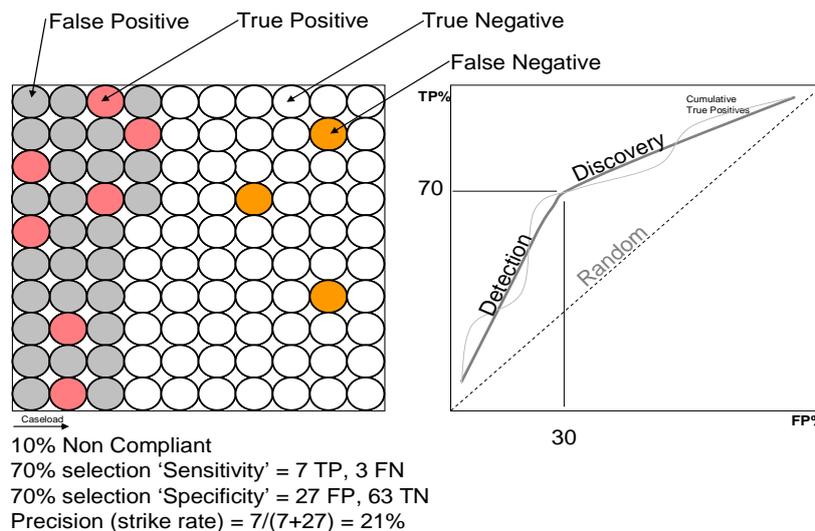
Then the optimal sample size  $n^*$  to select all detected non-compliance, ignoring costs and benefits at this stage, is equal to:

$$TP^* + FP^* = (N \times P \times Se) + (N \times (1-P) \times (1 - Sp)) =$$

$$100 \times 10\% \times 70\% + 100 \times 90\% \times 30\% = 100 \times 7\% + 100 \times 27\% = 100 \times 34\% = 34.$$

So, on average, reviewing 34 clients who appeared to be non-compliant would be a large enough sample to reveal all detected true positives (7 instances).

**Figure 16: After selection:  $N = 100, P = 10\%, Se = 70\%, Sp = 70\%, n^* = 34$**



Within this sample the agency will, on average, detect non-compliance at a rate of 20.6% (that is,  $TP/(TP+FP) = 7/(7+27)$ ), which is significantly better than the, on average, 10% strike rate a random approach to case selection might provide.

If the sample size is larger than 34, then the regulatory agency’s selection precision or ‘strike rate’ will decline as it starts to ‘discover’ additional non-compliant clients (*FN*) at a rate of:

$$FN/(TN+FN) = (N \times P \times (1 - Se))/((N \times P \times (1 - Se)) + (N \times (1 - P) \times Sp)) = 100 \times 10\% \times 30\%/((100 \times 10\% \times 30\%) + 100 \times (90\% \times 70\%)) = 30/(30+630) = 4.5\%.$$

Thus if the agency reviewed, for example, an additional 11 clients, for a total of 45, given these parameters, its average expected strike rate would decline from 21% to 16.7% = (34 x 20.6% + 11 x 4.5%)/45).

### 3.3 Optimal coverage level

If the costs (and benefits) of the selection decision-making are considered, then the optimal coverage point may well vary from *n\**.

In the simple binary model outlined above the possible optimal points are, depending on the relative probability and costs / benefits of having a true positive, false positive and false negative:

1. *do none*, (Review no one because it costs too much for the benefit achieved),
2. *do some* (i.e.  $n^* = TP^* + FP^*$ ), (Review all detected clients ( $TP + FP$ )), or
3. *do all* ( $N$ ) (Review all clients due to the net benefit achieved, for example, airport screening)

**Table 10: Enhanced contingency table—bringing in relative costs and benefits**

	Compliant	Non-Compliant
Detected	False Positive ( $\$FP$ ) $[N \times (1 - P) \times (1 - Sp) \times \$FP]$	True Positive ( $\$TP$ ) <sup>7</sup> $[N \times P \times Se \times \$TP]$
Not Detected	True Negative ( $\$TN$ ) $[N \times (1 - P) \times Sp \times \$TN]$	False Negative ( $\$FN$ ) $[N \times P \times (1 - Se) \times \$FN]$
	<b>(1-P)</b>	<b>Prevalence (P)</b>

Fairly obviously, if the relative cost of potential false positives outweighs the benefits of true positives then the optimal coverage point is ‘do none’, that is, if  $[N \times (1-P) \times (1-Sp) \times \$FP] > [N \times P \times Se \times \$TP]$  then ‘do none’.

If the probability times the benefits of discovering false negatives is greater than the cost of reviewing everyone, then the optimal point is ‘do all’ (as with airport

<sup>7</sup> The value of  $TP\$$  and  $FN\$$  may be constrained, as for a fixed price permit, or it may exhibit a distribution of values, such as a Pareto-like distribution, as is typical for tax adjustments.

screening—check everyone through the scanner), i.e. if  $[N \times (1 - P) \times Sp \times \$TN] < [N \times P \times (1 - Se) \times \$FN]$  then ‘do all’.

For all other situations in this simple model, the optimal coverage is ‘do some’, namely  $n^*$ .

That is, if  $[N \times (1 - P) \times (1 - Sp) \times \$FP] < [N \times P \times Se \times \$TP]$  and  $[N \times (1 - P) \times Sp \times \$TN] > [N \times P \times (1 - Se) \times \$FN]$  then ‘do some’:  $n^* = TP^* + FP^*$

### 3.4 Estimating the compliance gap

The gross compliance gap in this simple binary model is  $N \times P$  clients =  $N \times (TP + FN)$  =  $N \times P \times Se + N \times P \times (1 - Se)$  and the value of the gross compliance gap is:

$$\text{Equation 1: } N \times P \times Se \times \$TP + (N \times P \times (1 - Se) \times \$FN)$$

Putting some illustrative values on these (say:  $\$TP = 15$ ,  $\$FP = 2$ ,  $\$FN = 5$ ,  $\$TN = 0$ ) using the same probabilities and prevalence of the earlier example the gross compliance gap is:

$$(N \times P \times Se \times \$TP) + (N \times P \times (1 - Se) \times \$FN) = \\ (100 \times 10\% \times 70\% \times \$15) + (100 \times 10\% \times 30\% \times \$5) = \$120$$

After selecting  $n$  cases for review, if  $n$  is less than or equal to  $n^*$ , the net compliance gap is:

$$\text{Equation 2: } (N \times P \times Se \times \$TP) + (N \times P \times (1 - Se) \times \$FN) - (N \times P \times Se \times \$TP) \times n/n^* \\ \text{achieved at a compliance cost of:}$$

$$\text{Equation 3: } N \times (1 - P) \times (1 - Sp) \times \$FP \times n/n^*$$

If  $n$  is greater than  $n^*$  (i.e.  $n > (N \times P \times Se) + (N \times (1 - P) \times (1 - Sp))$ ) then additional non-compliant clients will be ‘discovered’ at a rate of  $FN/(FN+TN)$  and the net compliance gap becomes:

$$\text{Equation 4: } (N \times P \times (1 - Se) \times \$FN) - \$FN \times (n - n^*) \times FN^*/(TN^* + FN^*) \\ \text{achieved at a compliance cost of:}$$

$$\text{Equation 5: } N \times (1 - P) \times (1 - Sp) \times \$FP + \$FP \times (n - n^*) \times TN^*/(TN^* + FN^*)$$

So using the probabilities and prevalence of the earlier example with 34 ( $n = n^*$ ) clients for review the residual compliance gap is  $(100 \times 10\% \times 70\% \times \$15) + (100 \times 10\% \times 30\% \times \$5) - (100 \times 10\% \times 70\% \times \$15) \times 1 = \$15$ , a reduction of \$105, achieved at a cost of  $100 \times 90\% \times 30\% \times \$2 \times 1 = \$54$ . A net benefit of  $\$105 - \$54 = \$51$ .

If the sample ( $n$ ) were to increase to 45, which in this example is 11 above  $n^*$ , then the residual compliance gap becomes the value of the remaining undiscovered false negatives:  $(100 \times 10\% \times 30\% \times \$5) - (\$5 \times 11 \times 4.5\%) = \$15 - \$2.5 = \$12.5$ , a reduction of \$107.5 on the initial compliance gap achieved at a cost of:  $100 \times 90\% \times 30\% \times \$2 + (\$2 \times 11 \times 63)/(63+3) = \$54 + \$21 = \$75$  giving a net benefit at this coverage point of  $\$107.5 - \$75 = \$32.5$  with a residual gap remaining of \$12.5.

If **all** 100 clients were reviewed ( $n = N$ ), the entire \$120 initial compliance gap would be clawed back at a cost of:

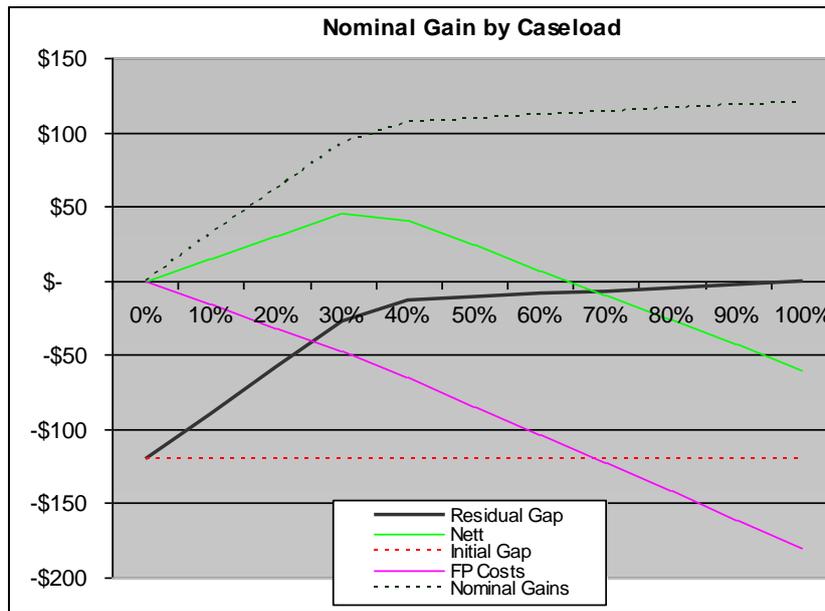
$$N \times (1-P) \times (1-Sp) \times \$FP + \$FP \times (n - n^*) \times TN^*/(TN^*+FN^*) =$$

$$100 \times 90\% \times 30\% \times \$2 + \$2 \times (100 - 34) \times 63/(63 + 3) = \$54 + \$126 = \$180$$

providing for a net loss at this point of complete coverage of \$120 — \$180 = -\$60.

Graphically:

**Figure 17: Compliance gap, costs and gains by coverage (sample size)**



So this relatively simple ‘toy’ model allows the identification of both an optimum level of coverage and the likely gross and net compliance gap given the Sensitivity and Specificity of the classifier and a Prevalence of non-compliance.

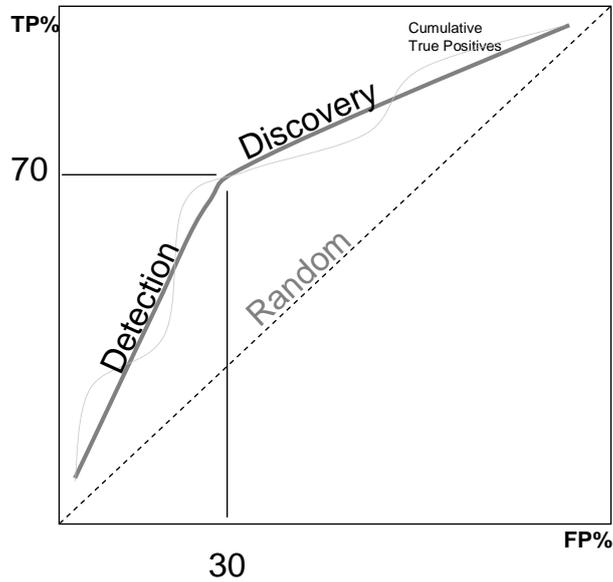
### 3.5 Enter ROC

A Receiver Operating Characteristic curve for selection sensitivity and specificity is created by ranking clients using the selection system (the classifier) and then charting the percentage of True Positives against the percentage of False Positives, starting with the highest suggested *TP* likelihood first and working through to the lowest. At any point on the ROC curve its slope is the ‘likelihood’ at that cut-off point or selection threshold (Fawcett 2006).

For the simple binary model in this paper, the ROC curve is a triangle created by charting from (0, 0) to the peak detection point ( $Se, 1 - Sp$ ) to 100%, 100%.

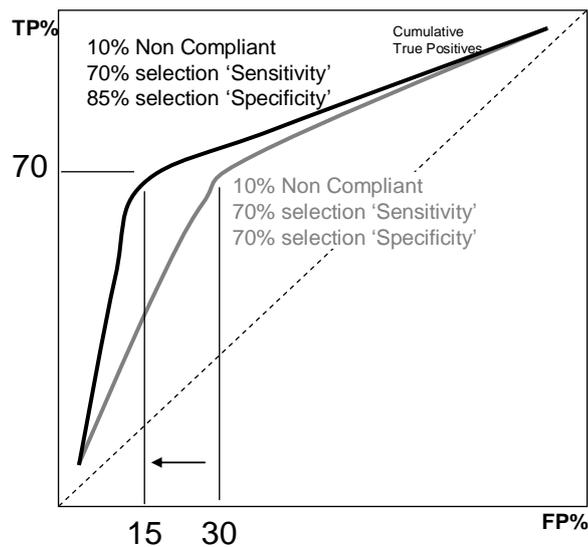
So for the example figures used, the ROC Curve would be (0, 0) to (70, 30) to (100, 100) and will look like the following graph:

**Figure 18: ROC chart: curve for 70% sensitivity, 70% specificity**



This graph shows that the initial gain from ‘detection’ is subsequently countered by a lower rate of ‘discovery’, lower than an initial random approach would produce because there are fewer non-compliant clients remaining once the above random ‘detection’ ability of the classifier ends. If the selection system were enhanced in the example, by improving the specificity (the ability to decide that a compliant client is in fact compliant) from 70% to 85% then the associated ROC curve would become:

**Figure 19: ROC chart: curve for 70% sensitivity, 85% specificity**

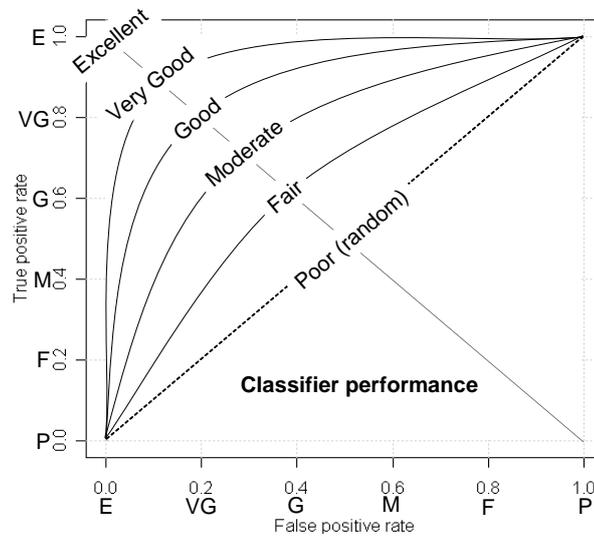


This simple example reveals one of the reasons why ROC curves have proved so useful. Rather than just calculating the probabilities at a particular point, the ROC

curve provides, when coupled with relative cost data, the information to decide the optimum trade-off point and what classifier performs better at which coverage point, across the entire selection threshold. It is also relatively robust to differences in prevalence and skew (Fawcett 2006).

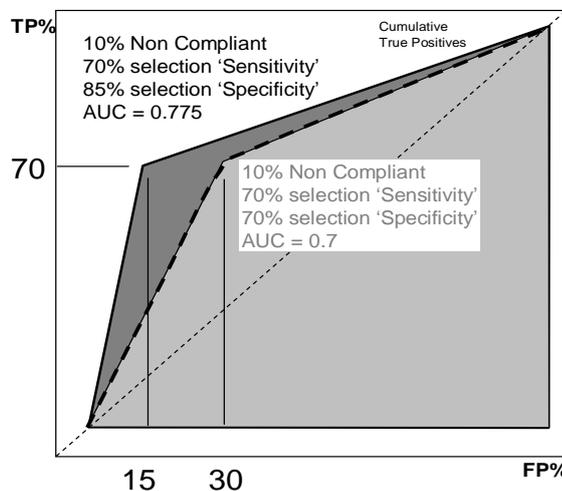
Better classifiers (that is, better case selection systems) have a larger ‘area under the curve’ (AUC), though technically the more accurate view of which classifier is better is the one further left and up at the point where the relative cost curve  $\$FP/\$FN \times (1 - P)/P$  is tangential to the ROC curve created.

**Figure 20: ROC chart: curves illustrating increasing classifier performance**



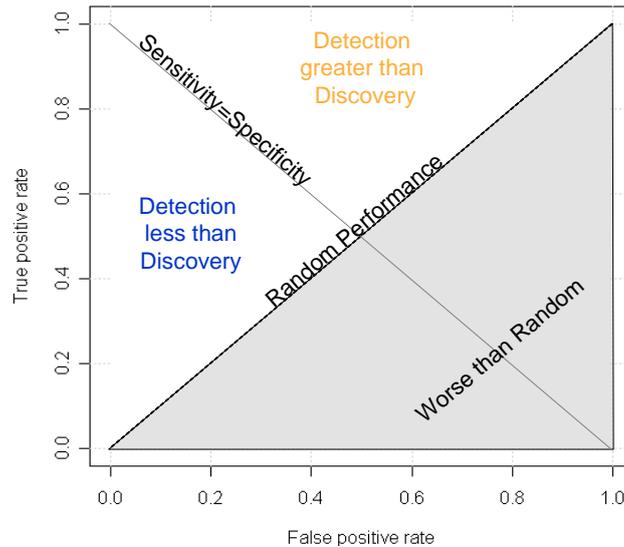
While the calculation of the area under the curve can be non-trivial for complex classifiers, for the simple model set out here, the AUC is simply  $1 - ((1 - Se) + (1 - Sp))/2$ . The AUC for a 70% sensitivity, 70% specificity classifier is  $1 - (30\% + 30\%)/2 = 0.7$  while the AUC for a 70% sensitivity, 85% specificity classifier is  $1 - (30\% + 15\%)/2 = 0.775$

**Figure 21: ROC chart: Area Under Curve (AUC) illustration**



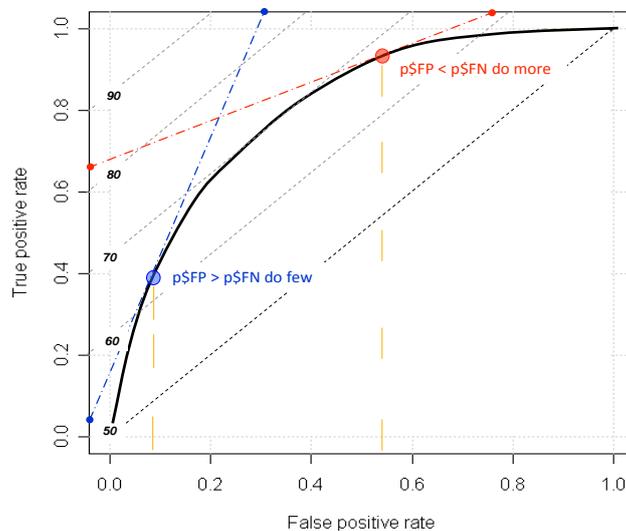
Technically the AUC is equivalent to the Mann-Whitney-Wilcoxon ‘sum of ranks’ test, which estimates probability that a randomly chosen positive (a non-compliant case in our discussion) for the classifier is ranked before a randomly chosen negative (a compliant case) for the classifier. ‘Bigger’ is statistically shown to be ‘better’. That is, a classifier with the larger area under the curve has a better overall accuracy of classification. (See Hanley & McNeil 1982 for further analysis.)

**Figure 22: ROC chart: detection versus discovery**



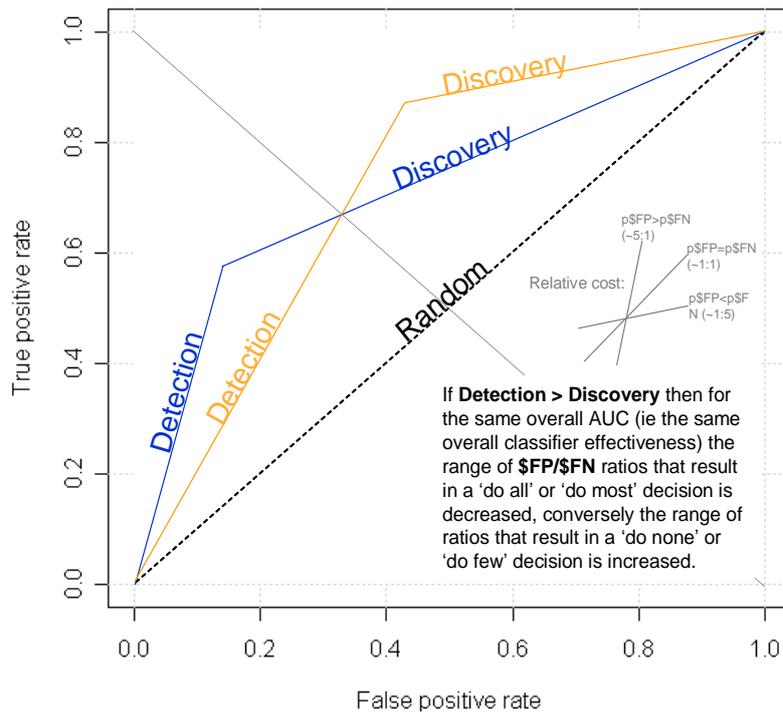
The ROC curve produced in the above model provides guidance on the optimal coverage for a regulatory agency when it is combined with a line representing the relative cost of a false alarm ( $p\$FP =$  a false positive) divided by the relative cost of a miss ( $p\$FN =$  a false negative) producing a line with a slope of  $\$FP/\$FN \times (1 - P)/P$ . The tangent point of this line with the classifiers ROC curve is the optimum coverage point in the system.

**Figure 23: ROC chart: optimum coverage point with varying \$FP and \$FN**



In the simple binary model illustrated in this paper one can see in Figure 24 that if the detection capability is very much less than discovery ( $Se < Sp$ ), then for the same area under the curve the range of values by which  $p\$FP/p\$FN$  suggests ‘do none’ is decreased, and the range of values where ‘do all’ is increased. That is the obvious result indicating that poor detection capability leads to doing significantly more cases than a situation with good detection. The reverse also holds if detection is greater than discovery.

**Figure 24: ROC chart: optimum coverage detection versus discovery**



### 3.6 Building the ROC chart

The simple binary ROC approach can be constructed from either a quantitative based risk flag based approach, or via a qualitative classification process. For example, Metz (1978) outlines a simple qualitative approach to classification that can be used to construct the ROC curve with more segments.

A step up from a binary ROC would be the addition of another class, for example, ‘must check’, ‘should check’, ‘could check’. Going further, Eng (2005) illustrates a reasonably simple six class qualitative approach: Positive, Negative each with a confidence rating of High, Moderate or Low.

### 3.7 Triangulating prevalence—mind the gap

Recall the earlier equations 2 and 4; if  $n \leq n^*$  where:

$$n^* = (N \times P \times Se) + (N \times (1 - P) \times (1 - Sp)), \text{ then the net compliance gap is:}$$

$$(N \times P \times Se \times \$TP) + (N \times P \times (1-Se) \times \$FN) - (N \times P \times Se \times \$TP) \times n/n^* \quad \text{Equation 2}$$

otherwise if  $n > n^*$ , the net compliance gap is:

$$(N \times P \times (1-Se) \times \$FN) - \$FN \times (n - n^*) \times FN^*/(TN^* + FN^*) \quad \text{Equation 4}$$

An astute reader has probably already spotted the issue in the equations for estimating the initial and residual compliance gap—what if  $P$  or  $Se$  or  $Sp$  (and hence  $n^*$ ) are unknown?

Before Global Positioning Systems existed, identifying a location in the field often took the form of multiple (often three – hence ‘triangulation’) bearings on known objects and then using back bearings to narrow down the location possibilities. Here we have a known population  $N$ , a coverage rate  $n$ , and a strike rate which is the outcome of only certain combinations of the unknowns:  $P$ ,  $Se$  and  $Sp$ .

Using this known data, plausible ranges for the unknowns  $P$ ,  $Se$  and  $Sp$  can be identified and used to derive estimates of the gross and net compliance gap.

The strike rate =  $TP/n$  where if  $n \leq (N \times P \times Se) + (N \times (1-P) \times (1-Sp))$  then  $TP/n = [(N \times P \times Se) \times n / ((N \times P \times Se) + (N \times (1-P) \times (1-Sp)))] / n$

else if  $n > [(N \times P \times Se) + (N \times (1-P) \times (1-Sp))]$  then  $TP/n =$

$$[(N \times P \times Se) + [n - ((N \times P \times Se) + (N \times (1-P) \times (1-Sp)))] \times (N \times P \times (1-Se)) / ((N \times P \times (1-Se) + (N \times (1-P) \times Sp))] / n$$

By substituting setting up a ROC chart and mapping the known strike rate for  $n$  and  $N$  as if it were the product of random selection the rest of the chart can be used to substitute in various possible values of  $P$ ,  $Se$  and  $Sp$ .

For example, if the ‘known’ strike rate was 21% we then chart the strike rate observed as if it were the product of random selection and it then becomes the far right prevalence band on the top right of the ROC chart.

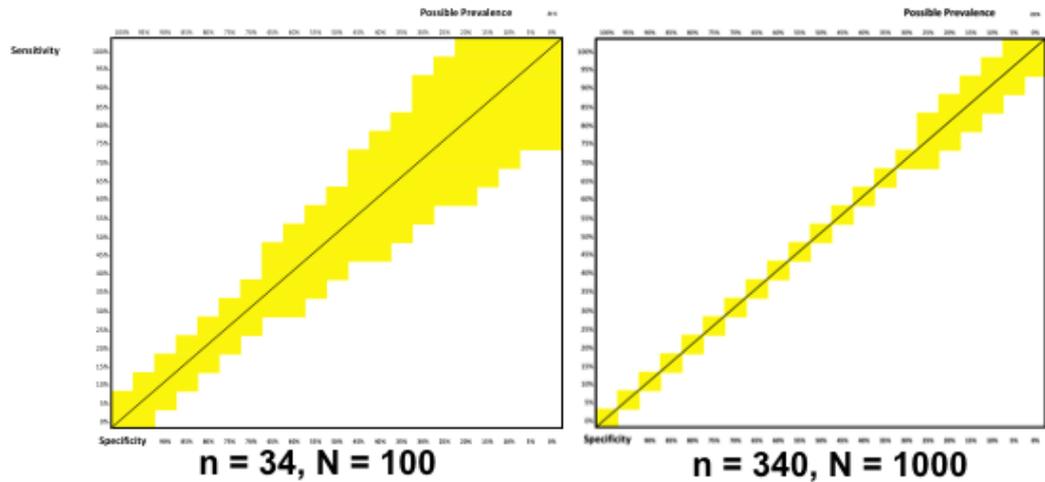
Possible prevalences  $P$  lower than this, which produce the observed strike rate, then form quite narrow bands<sup>8</sup> given by particular sensitivity and specificity combinations.

Only those combinations of  $Se$  and  $Sp$  produce the observed strike rate for a particular prevalence  $P$  of non-compliance in a population  $N$  with a sample size  $n$ . The coloured bands represent areas of  $P$ ,  $Se$  and  $Sp$  that could produce the observed strike rate. The light blue line represents all viable solutions for the sample  $n/N$  capable of producing the observed strike rate for various  $P$ .

For example, if the ‘known’ strike rate was 21% we then chart the strike rate observed as if it were the product of random selection and it then becomes the far right prevalence band (yellow) on the top right of the ROC chart.

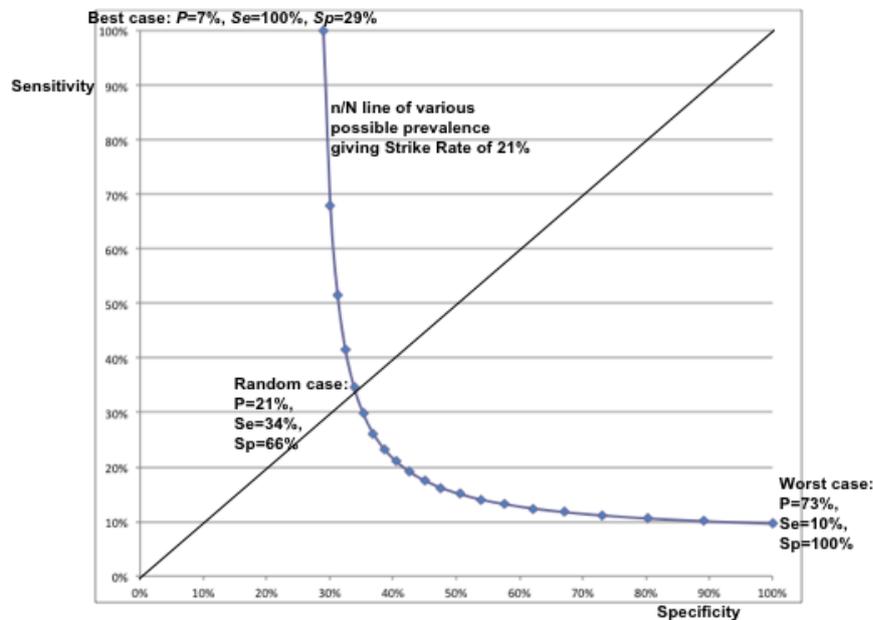
<sup>8</sup> The width of the band, the level of uncertainty in the strike rate, is inversely related to the square root of the sample size.

**Figure 25: Se and Sp combination bandwidth giving 21% strike rate for 21% Prevalence P.**



The width of the prevalence band depends on the sample size. The smaller the sample, the wider the confidence band. (These are mapped using the Wilson method).

**Figure 26: Line for n with population N producing 21% strike rate for various Prevalence P.**

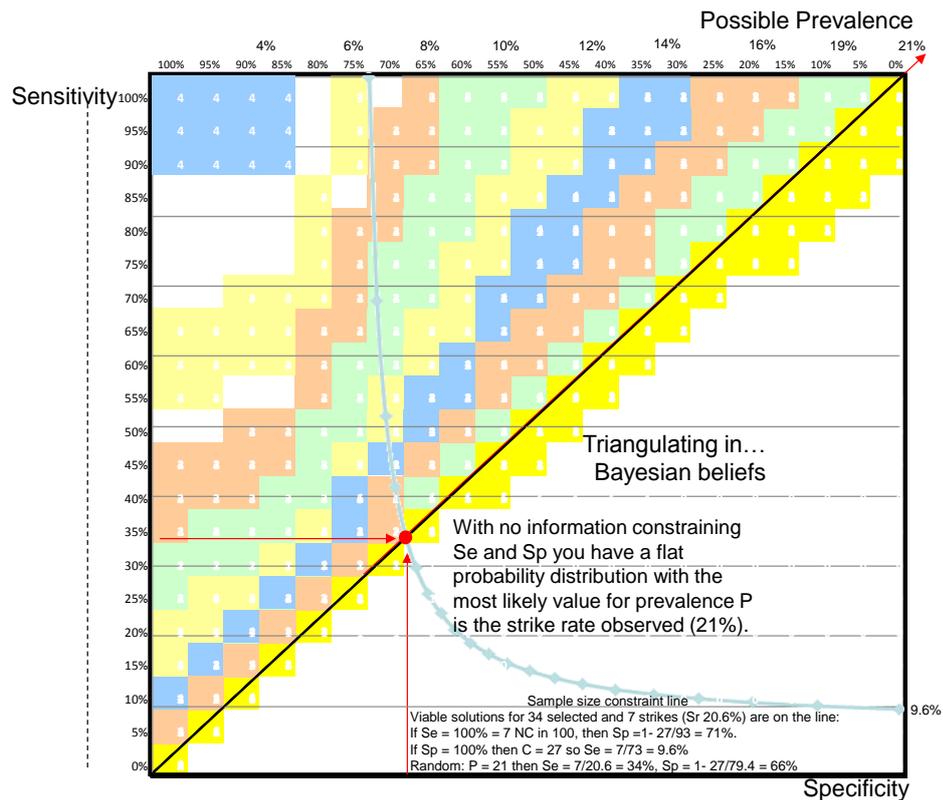


In this example the strike rate of 21% from a sample of 34 and a population of 100 would mean a best case scenario of an underlying prevalence of 7% with a selection sensitivity of 100% and Specificity of 71% (so all of the possible non compliant cases were selected from the population) and a worst case scenario of an underlying

prevalence of 73% with a selection sensitivity of 10% and Specificity of 100% (so all of the compliant cases were selected from the population).

Possible prevalences  $P$  lower than this, which produce the observed strike rate, then form narrow bands given by particular sensitivity and specificity combinations. Only those combinations of  $Se$  and  $Sp$  produce the observed strike rate for a particular prevalence  $P$  of non-compliance in a population  $N$  with a sample size  $n$ .

**Figure 27: Possible prevalence bands for given sensitivity / specificity**

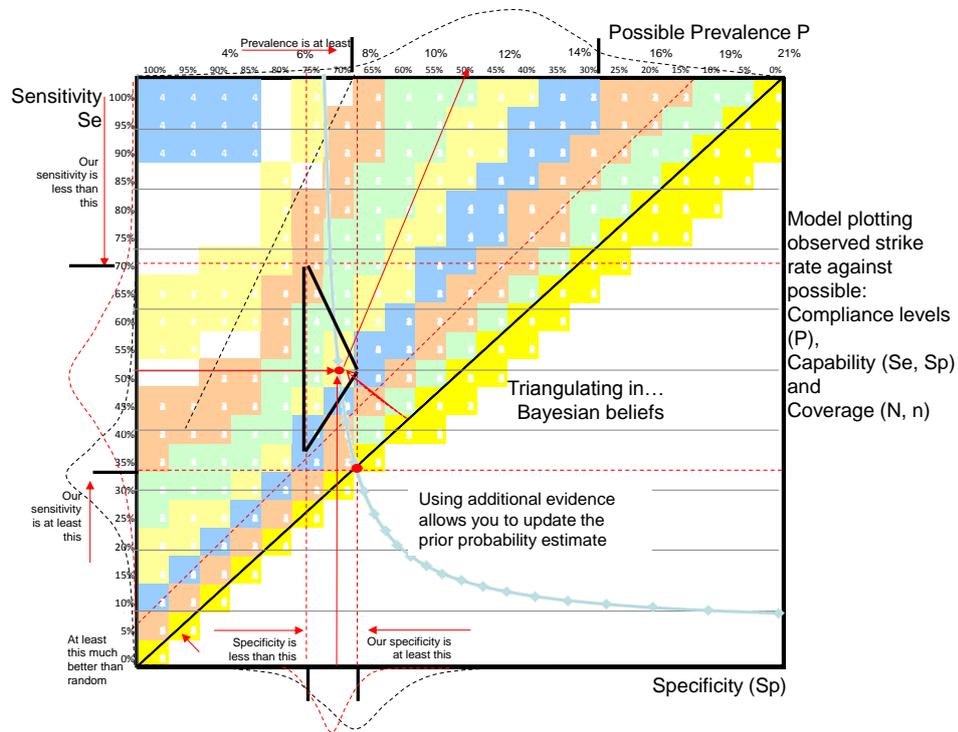


By restricting the viable space using for example a panel of evidence-based expert views, each providing a value for: *at least*, *most likely*, *at most*, for Sensitivity, Specificity and Prevalence, a range of probable underlying non-compliance can be derived.<sup>9</sup>

In the example given, based on knowing that selection system was better than random, but unlikely to be very good to excellent, a range of 8% to 14% emerges for  $P$  with a most likely value about ~10% to 12%.

<sup>9</sup> Formally we are estimating the probability of the unknowns ( $Se$ ,  $Sp$  and  $P$ ) having particular values given the knowns ( $N$ ,  $n$ , *Strike rate*). Bayesian techniques bring a well-tested mathematical logic to this. Only certain values of the unknowns work mathematically and the range of these is then updated using an experience / evidence-based Bayesian approach where  $p(B|E) = p(E|B) \cdot p(B) / p(E)$ , that is, for belief  $B$  and evidence  $E$  where  $p(B)$  is the initial or prior degree of belief (for example, random result);  $p(B|E)$  is the revised degree of belief taking into account the evidence; and  $p(E|B) / p(E)$  represents the degree of support the evidence provides for the belief. Bayesian approaches compute the degree to which a belief is supported by a body of evidence that the truth of the belief renders more probable.

**Figure 28: Updated view of prevalence using constrained values of  $P$ ,  $Se$  and  $Sp$ .**



This fairly rough triangulation could be updated with information from a small random selection of cases to provide additional intelligence and ascertain / check the robustness of the assumptions made. However, in the real world that is not always possible for a variety of reasons.

Alternatively more sophisticated Bayesian modelling (Joseph, Gyorkos & Coupal 1995) using Markov chain Monte Carlo methods (Hajian-Tilaki, Hanley, Joseph & Collet 1997) and probability distributions could be done, though the relative gain in confidence regarding the underlying prevalence would not be significant in most practical situations, particularly for a regulatory agency.

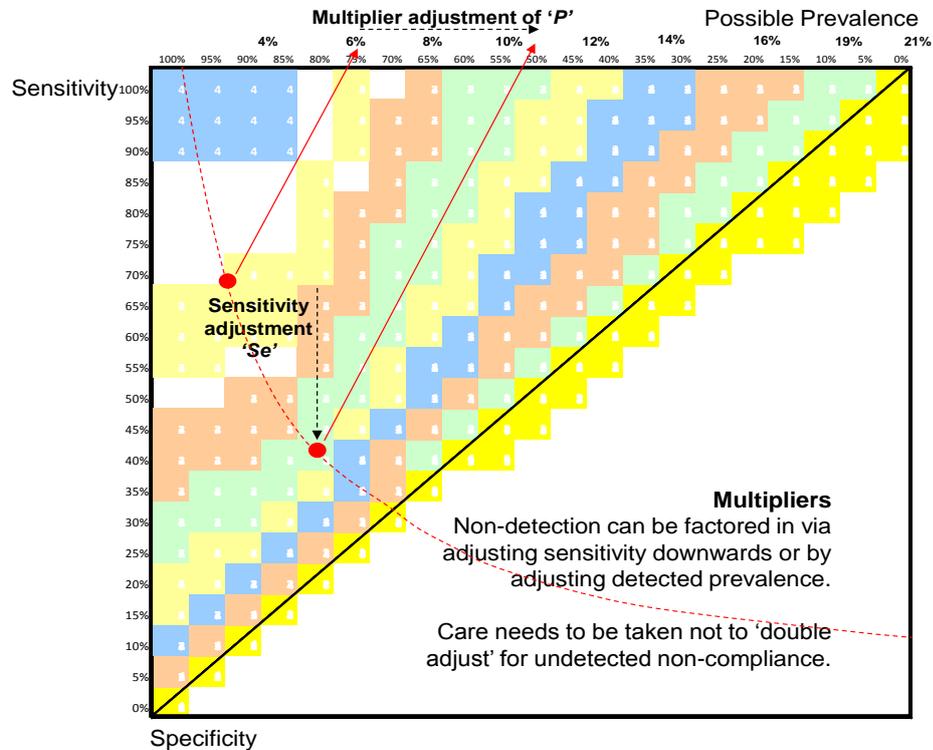
**3.8 Adjusting for an unreliable ‘gold standard’—the use of multipliers**

Bottom-up compliance gap estimation methods such as random audits, as well as the approach outlined in this paper, are known to miss some level of non-compliance. This can be compensated by using other information to estimate the ‘miss rate’ and then use this to adjust the detected rate (Feinstein 1990; Erard & Feinstein 2011). The problem of poor ‘gold standards’ is not confined to compliance estimates and in epidemiology Bayesian approaches are often used to estimate a range of likely underlying prevalence (Joseph, Gyorkos & Coupal 1995).

As the approach outlined in this paper explicitly allows for a level of undetected non-compliance care does need to be taken not to ‘double adjust’ for undetected non-

compliance via the inappropriate use of prevalence multipliers and sensitivity decreases. The following diagram illustrates the issue:

**Figure 29: Undetected non-compliance:  $P$  multiplication or  $Se$  reduction**



Essentially, if the implied prevalence  $P$  is adjusted by a multiplier to take into account undetected non-compliance when a review is undertaken, then the sensitivity of detection  $Se$  should not be reduced for the same reason.

### 3.9 Applying the approach to some real world data

Using a real world scenario, in the large market in Australia there are roughly 1,400 economic groups with a turnover of more than \$250 million.

Detecting non-compliance in the large market is particularly problematic. Large market tax data is very ‘noisy’. Taxpayers, even in a given industry, are often less alike than they are alike—so in the data another company in another industry will often be a closer match for an item than a company in the same industry.

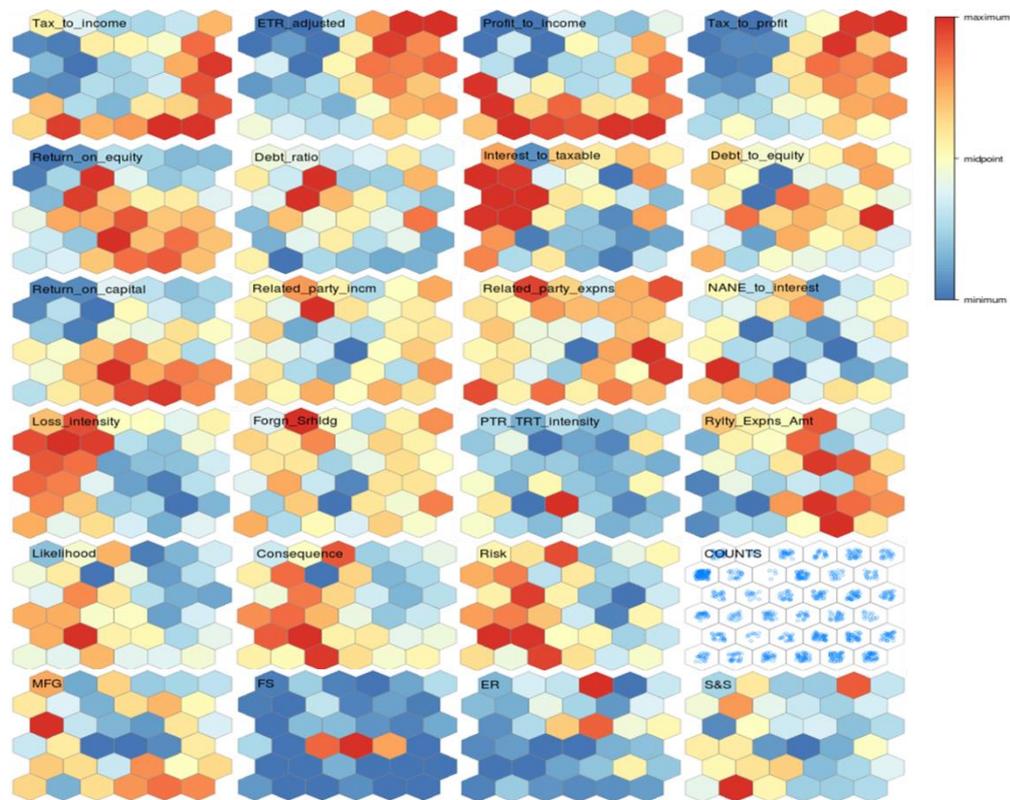
Industries in the large markets such as banking, mining or retail are often highly skewed and oligopolistic, where differently funded competitors carve out particular niches, generating wide differences in tax return data. In practice this makes ‘industry averages’ a rather poor guide to compliance case selection, apart from where specific industry law or practices exist. Where multiple business activities are ‘consolidated’ into a single return, such as diverse mining operations or banking and insurers, the divergence away from an ‘industry’ view is exacerbated.

In the highly heterogeneous, heteroscedastic large market, the size of the data set needed to build a robust parametric case selection model for a single risk type is generally much larger than our entire annual audit case load for the large market.

Typically a caseload for a particular risk will be less than fifty cases in a year; often it is about ten or so. Hence the views of subject matter experts are generally used for selection rather than those of more sophisticated data mining approaches, such as random forest or support vector models.

As a way of visualising the variation in the large market the ATO has used Self Organising Maps (SOM)—a descriptive data mining technique. These are sometimes called ‘heat maps’ of data.

**Figure 30: Heat-map of large market income tax label items for 2010 year data**



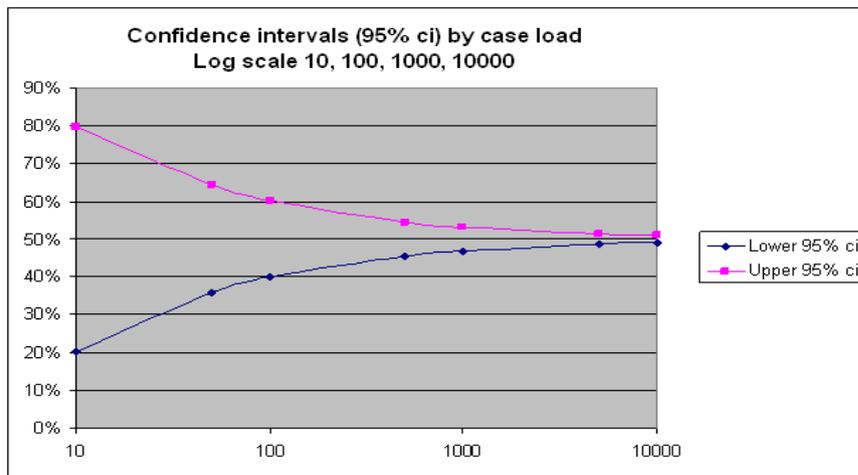
What the SOM technique does is to compute the distance or correlation between the various tax return label items for every taxpayer in our market and then computes who is the ‘nearest neighbour’ (closest match) to the taxpayer. It then places the neighbouring (more similar) taxpayers into cells and shows the relative values of the data items, highest to lowest.

Cells that look odd can be queried and see who is in them and seek to understand why the taxpayers so grouped might be similar and whether a degree of correlation exists with known tax compliance risks.

The small size of the case sample is associated with a degree of variability. Even if the underlying rate of population non-compliance has not changed, each time a sample is selected (for example, select a number of cases during a period of time) a degree of variation in the sample summary statistics (mode, median, mean, correlation, accuracy and so on) will naturally arise.

From basic statistics the degree of sample variation arising from this cause is related to the square root of sample size and will have a ‘Gaussian distribution’ around the true population value.

**Figure 31: Confidence intervals (95%) by sample size**



Because relatively high rates of false positives are likely to inevitably arise in highly compliant and highly variable populations such as the large market (where the law can be ‘grey’), it is quite important to have a good mechanism to efficiently extract them before too much time and effort is invested by all parties.

In the large market the use of questionnaires, risk workshops (a check of the case prior to commencing a risk review), and risk reviews aim to fulfil that purpose.

**Figure 32: Case selection, risk reviews and audits**



The more expensive and time-consuming audit process that gathers the evidence necessary to support an adjustment, and possible subsequent disputes and litigation, is reserved for those matters where the ATO believes that a material contentious issue exists.

From 2005 to 2010 the **mean** adjustment was about \$40m/case from an average of about 50 cases per annum, with the **modal** adjustment of ~\$12m/case, producing average aggregate adjustments of about \$2 billion, derived from an annual sample of about 300 reviews. This gives the average per annum strike rate from case selection as  $50/300 = 16.7\%$ .<sup>10</sup> (The aggregation of the data reduces sample size variability concerns somewhat.)

### 3.10 What kind of population compliance rate might give rise to these outcomes?

By testing various values for  $P$ ,  $Se$  and  $Sp$  it is possible to see what combinations produce the observed strike rate for the selected caseload  $n$  and population  $N$ ; various scenarios can be identified.

Three are illustrated and contrasted in the analysis that follows here:

- One solution, **A**, is for a population compliance rate of 85% ( $P = 15\%$ ), sensitivity of just 21% and specificity of 82%, producing a strike rate of 16.7%, *barely above* what a random selection process would provide (15%).

If the 'compliance gap' is a straight extrapolation of the average adjustment (\$40m/case) then the gross compliance gap would be about \$8.4b. If the undetected non-compliance was valued at the lower modal value (\$12m/case) then the compliance gap would have been about \$4b. The net compliance gap on this calculation basis is between \$6.4b ('high' at \$40m/case FN\$ average) and \$2b ('low' at \$12m/case FN\$ average).

- A second scenario, **B**, is for a population compliance rate of 90% ( $P = 10\%$ ), a relatively low sensitivity  $Se$  of 28%, allowing for the likelihood of significant non-detection (thus the use of an additional multiplier on  $P$  is considered unwarranted as this sensitivity setting of 28% is equivalent to a detection compliance multiplier of ~3.6), with a specificity of 90%.

The strike rate produced of 16.7% is roughly 1.5 times higher than what a random selection on this Prevalence would produce. The implied gross tax gap is between \$5.6b (at \$40m/case average) and \$3b (at \$12m/case FN\$ average) and the net gap is between \$3.6b and \$1.1b.

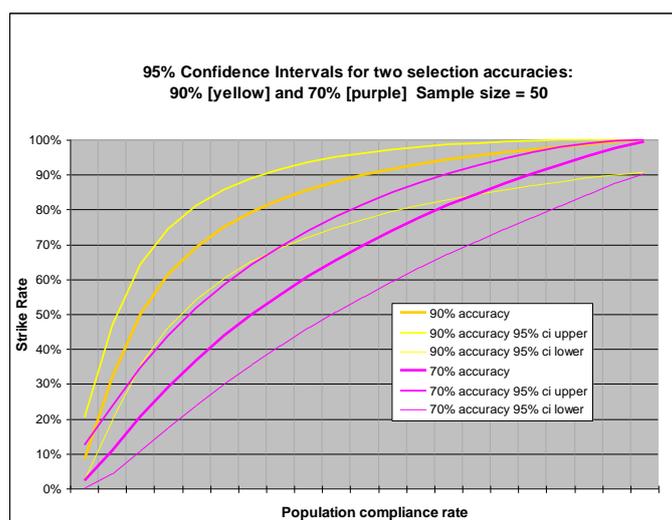
- A third solution, **C**, is for a population compliance rate of 95% ( $P = 5\%$ ) and a relatively high sensitivity of 67% and a high specificity of 95%. The strike rate produced of 16.7% is over three times what a random process would provide (5%). In scenario C the gross gap is between \$2.8b (at \$40m/case

<sup>10</sup> While this may seem very 'low' compared to figures cited for strike rates in the US IRS (for example, Brown and Mazur (2003) cite a strike rate of over 70%), the IRS figures cited are not those for the large market population. See IRS, 2012, Tax year 2006 tax gap estimate—summary of estimation methods, <[http://www.irs.gov/pub/newsroom/summary\\_of\\_methods\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/summary_of_methods_tax_gap_2006.pdf)>. It is noted that the cited US 70% strike rate with a non-compliance prevalence of 15% requires an extremely high case selection accuracy of 93% [ $70\% = (93\% \times 15\%) / ((93\% \times 15\%) + (7\% \times 85\%))$ ]. Such high strike rates in non-data matching situations are generally only possible with extremely low coverage levels, so that only the very highest ranked cases are reviewed. For an analysis of some of the issues involved, see TIGTA (2013, pp. 22–25). The use of extreme value approaches is discussed in some detail in Bloomquist, Hamilton, and Pope (2014). The UK HMRC estimates for the large business tax gap are also based on operational results rather than on an extrapolation from a random audit program (HMRC 2012, pp. 39, 40).



To form a judgement on which scenario was more likely, views were brought together regarding the efficacy of the case selection process.<sup>12</sup> These views took into account evidence from testing in 2010 of whether the system was ranking clients risk appropriately.<sup>13</sup> For example, the degree of overlap of various scenarios for overall case selection accuracy was tested against values for population non-compliance rates to see what was more likely ruled in or out by the data.

**Figure 34: 95% Confidence intervals for two case selection accuracy options**

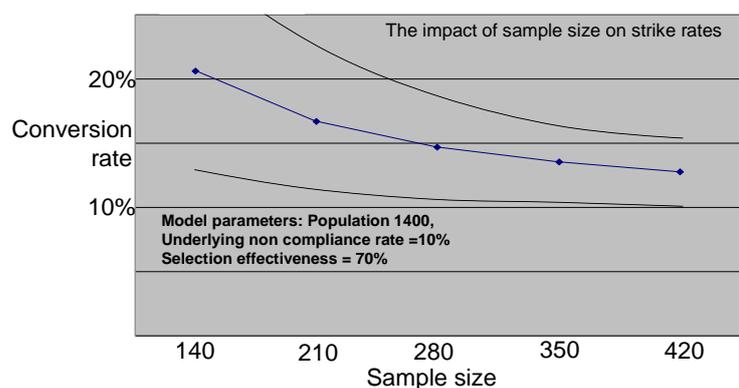


<sup>12</sup> In the highly heterogeneous, heteroscedastic large market, the size of the data set needed to build a robust parametric case selection model on an issue would generally be much larger than the ATO LB&I annual audit case load. So to identify particular compliance concerns in the large market, the ATO uses what it calls a 'risk engine', a set of over 100 algorithms largely designed from experience to compare taxpayers against their past, their peers and partners for various tax problems. See for example, the description of the profit shifting risk filter at: [http://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Large-market-income-tax-risk-filters/?page=3#Profit\\_shifting](http://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Large-market-income-tax-risk-filters/?page=3#Profit_shifting). The risk engine approach is discussed in some detail in IGT 2013. This 'expert rule' based system is supported by descriptive analytic techniques such as Self Organising Maps and Effective Tax Rate (tax to turnover, tax to profit, and tax to assets) analysis to identify possible new areas of concern/changing behaviour.

<sup>13</sup> In 2010 as part of a review of the efficacy of the risk ranking system the ATO conducted preliminary risk reviews of over 270 taxpayers categorised as 'lower risk' to test if the system had missed something obvious. No substantive contestable compliance concerns were identified. In the same year, for the 17 taxpayers identified as 'higher risk', some 15 of the 17 had substantive contestable concerns that were progressed to audit. A Chi-Square test of these results against a hypothesis that the selection system was no better than random (that is, with 17%  $P$  giving expected non-compliance in the lower risk grouping of 46 against 0 observed and for the higher risk grouping 3 non-compliant expected against 15 observed) was significant at the 99% confidence level. It can be concluded that the LB&I risk engine is considerably better than random at detecting potential non-compliance, even allowing for significant percentage of false negatives upon review. While not definitive, such analysis provides a high degree of support for a belief that the case selection system is significantly better than random. This evidence was used to form estimates (*at least, most likely, at most*) regarding the capability of correctly detecting perceived non-compliance (contestable tax positions) when present ( $Se$ ), and correctly identifying compliant taxpayers ( $Sp$ ). While higher sensitivity (for example, 70%) and hence lower prevalence rates (for example, 5% to 7%) were consistent with the data, a conservative view of the ATO detection capability was taken based on domestic and overseas experience / evidence. This uses a belief that the ATO only identifies about a half to a third of potentially contentious matters, but is significantly better at correctly identifying compliant taxpayers.

The impact of the sample size of case selection was also modelled and considered against the underlying strike rates obtained to form a view of the sensitivity and likelihood of changes expected in sample size variation (that is, noise) against a real signal.

**Figure 35: Strike rate confidence interval and changes against sample size**



Having settled on the middle scenario ‘B’, centred on a ~10% prevalence ( $P$ ) band ( $\pm$  ~2%) as a more likely view of the underlying prevalence of assessed contestable arrangements, what tax gap might plausibly be associated with such a prevalence rate?

The net tax gap for this level of ‘non-compliance’ varies according to the number of cases done ( $n$ ) and how their average value varies by caseload. If cases are prioritised by revenue, or generally, if taxpayers are prioritised for review by turnover (as tax is a percentage of profits and profits are a percentage of turnover), then as caseload increases, the average adjustment falls.

The high value scenario for the tax gap is if all unselected non-compliant cases are valued at the average (mean) of selected and adjusted cases: \$40m/case. This is likely to significantly overstate the tax gap. The low value for the tax gap is if all unselected non-compliant cases are at the modal value of selected and adjusted cases (\$12m/case). With relatively high coverage levels this is likely to understate the tax gap somewhat—as with a positively skewed distribution, there will be cases with values higher than the mode. With very low coverage rates the modal adjustment may overstate the assessed tax gap.

These simple ROC models of the tax gap could easily be recast as distributions, rather than fixed point estimates, with an Excel add-on such as Palisades’s @Risk. Much more sophisticated modelling approaches (Triangular, Log-normal, Weibull, Pareto etc) could be used throughout the process, though given the significant levels of uncertainty associated with tax gaps, the value-add is perhaps more of academic than of real practical interest. There is the ever present danger of being seduced by the sophistication of the modelling and ascribing higher levels of belief in the output.

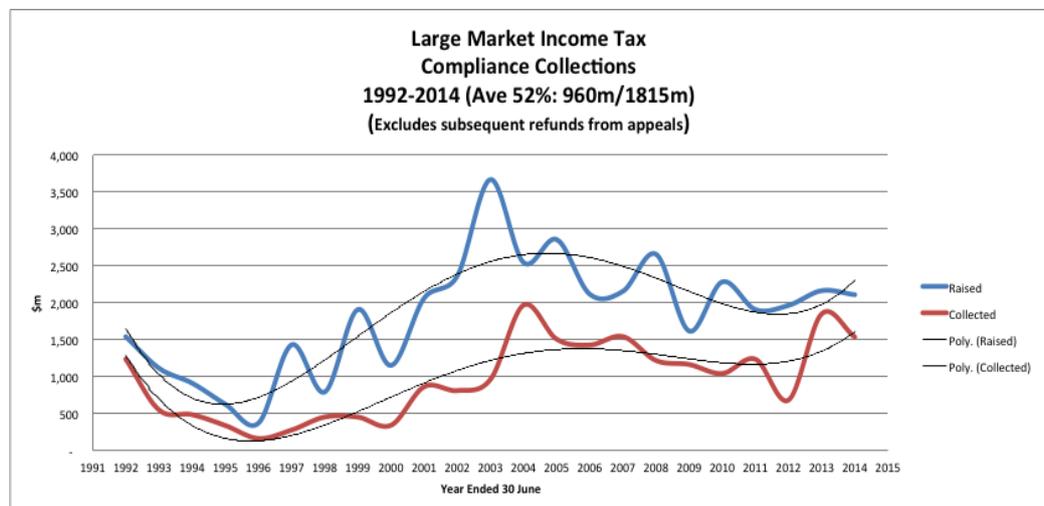
The mid value in the calculation here uses a weighted average (1:3) of the high and the low estimates for unselected non-compliant cases, some \$19m per case to give an initial assessed tax gap of \$3.7b and a residual assessed tax gap of \$1.7b.

This computation of the initial and residual assessed tax gap neglects considerations of how much of the adjusted taxes might be sustained in a dispute, or settled following negotiations. To the extent that audit adjustments are not sustained when disputed the estimate of the tax gap would need to be discounted.

Examining the data for collections arising from audit adjustments in the large market it is clear that only about half of the initial adjustment is sustained over time.

Even this overstates the final large market tax gap position as some amounts that are collected are subsequently refunded if the court case is lost. As examples of this, in July 2013 it was widely reported that NewsCorp received a refund of a \$623.8m adjustment made several years earlier (Chenoweth 2015), similarly BHP received a refund of \$542.6m in 2011 following a court decision (Wood 2011).

**Figure 36: Assessments to collections over time**

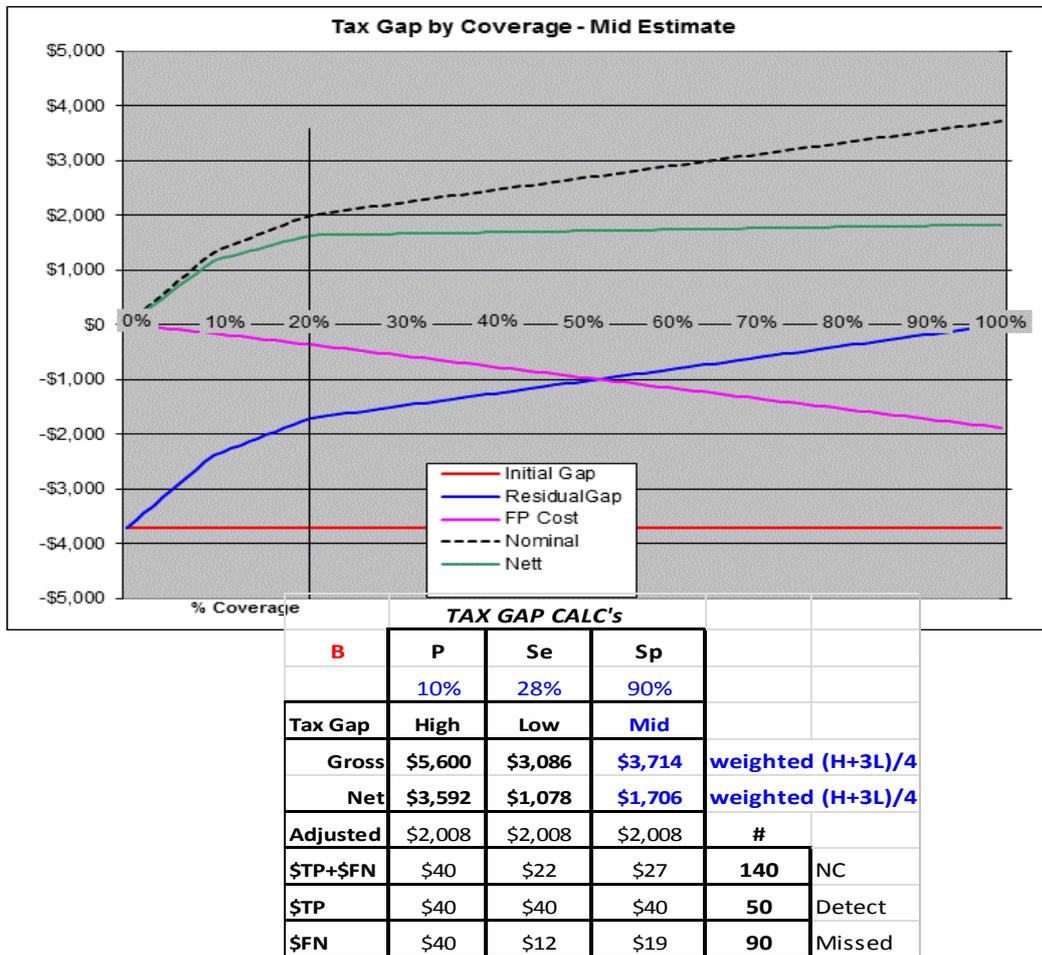


In the end these tax gap scenarios for the large market are all educated estimates, calculated Bayesian beliefs that are consistent with the observed data, rather than the classical certainty that might derive from large scale random sampling of something with high detection ability.

Graphically tax gap by caseload is as follows:

Mid-range scenario  $P = 10\%$ ,  $Se = 28\%$ ,  $Sp = 90\%$ .

**Figure 37: Large market per annum average income tax gap estimate 2005–10**



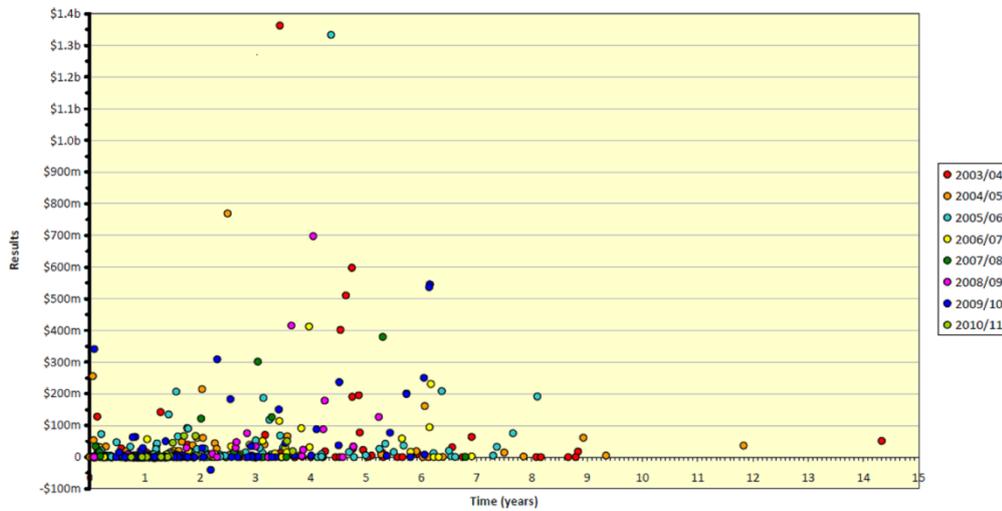
As indicated earlier, the high tax gap calculation values all non-compliant cases at the average (mean) case value of \$40m. The low tax gap estimate values missed cases at the model case value of \$12m per case. The mid estimate uses a weighted value per missed case of  $(\$40 + 3*\$12)/4 = \$19m$ .

This simple weighting procedure attempts to model the skew typically seen in compliance results.

**3.11 Volatility of outcomes**

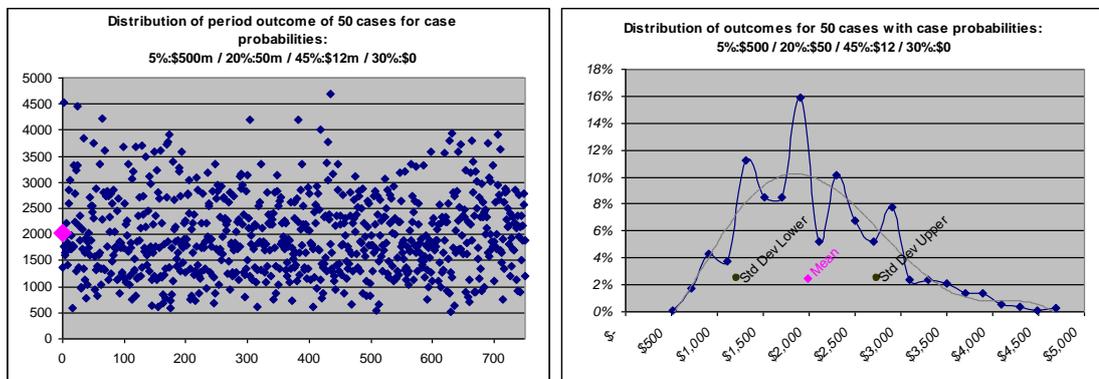
While the distribution of case results shown in Figure 38 produces an average adjusted amount of \$40m/case, there is obviously considerable annual variation associated with this average outcome.

**Figure 38: Large market income tax audits results 2003/4 to 2010/11**



This distribution of actual compliance results can be roughly simulated via a positively skewed distribution with a 5% probability of \$500m adjustment, 20% probability of a \$50m adjustment, a 45% probability of a \$12m adjustment and a 30% probability of a \$0 adjustment. Such a simulation of 750 periods produces the following set of outcomes:

**Figure 39: Simulation of annual aggregated large market case outcomes over time**



The skew of the large market, with the relatively small number of high value cases, produces a tax gap that is inevitably volatile over time even if the underlying probability distributions were invariant (and that is highly unlikely given changing economic conditions and laws). Accordingly, there is a significant and enduring degree of uncertainty (in the order of +/- \$1b) about the value that might be associated with the large market tax gap, in any particular year, from expected variability alone.

Against this backdrop it is probably unrealistic to expect to be able to ‘detect’ the signal of underlying annual shifts in the large market tax gap against expected volatility (background noise).

That said a significant and enduring shift or trend in the underlying large market prevalence ( $\Delta P$ ) might be detectable in the data over a period of several years using the techniques outlined in this paper.

### 3.12 Have compliance rates ( $\Delta P$ ) in the large market changed recently?

ATO conversion (risk review to audit) and strike rates (audit to adjustment) over the period 2008–2013 are represented in Table 10:

**Table 11: Large market income tax review and audit numbers and rates**

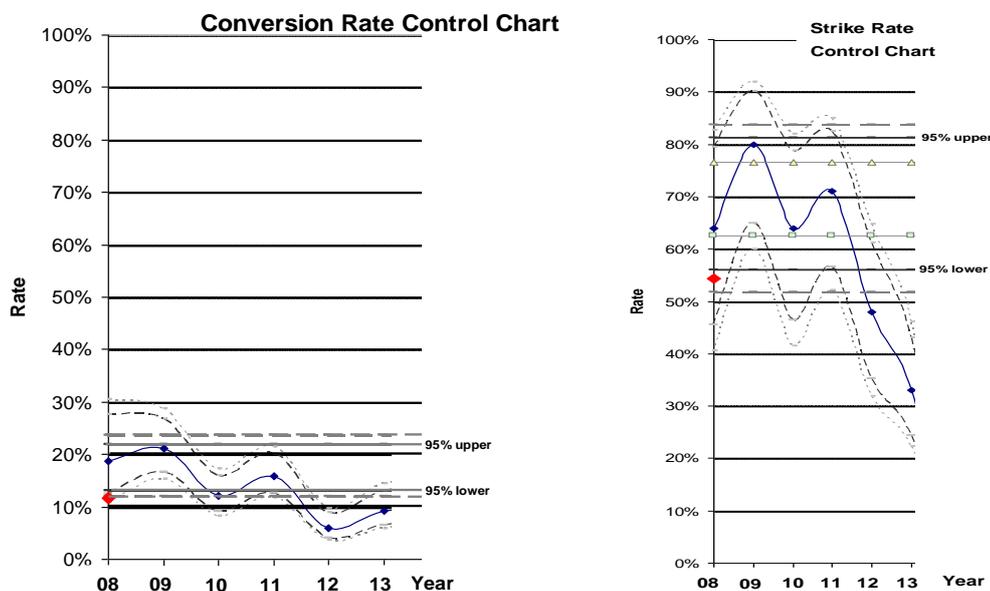
<u>Year</u>	<u>Risk Review</u>	<u>Conversion rate</u>	<u>Audit #</u>	<u>Strike rate</u>
2007/8	112	19%	33	64%
2008/9	260	21%	44	80%
2009/10	365	12%	36	64%
2010/11	396	16%	51	71%
2011/12	434	6%	61	48%
2012/13	328	9%	106	33%

It can be seen that the conversion and strike rates in 2011–2012 and 2012–2013 appear ‘significantly’ lower than for the four years prior. Are they though?

#### 3.12.1 Sample noise

A view that the apparent change is just an artefact of relatively small selection runs is likely ruled out as the variance is more than two standard deviations from the prior mean. Hence it appears more likely to be a ‘real’ decline and not just expected volatility or ‘noise’.

**Figure 40: Conversion and strike rate control charts with 95% confidence intervals**



### **3.13 What factors might explain the observed changes?**

#### *3.13.1 Coverage*

Changes in case selection mix, between prudential compliance work and targeted compliance work, could have merit in explaining most of the declines, as significant numbers of reviews were undertaken in the last two years to check compliance with consolidation exit requirements, and Secrecy and Low Tax Jurisdiction (SALT) reviews. For example, adding 100 prudential reviews to 300 risk targeted reviews with 90% compliance rate and 70% detection, the conversion rate would decline from 21% to 15%.

The increase in coverage from 120 to 400, even if risk focussed, could explain some of the decline from ~21% to ~15%, but is unlikely to explain all of the movement observed down to 9%. When combined with the inclusion of ~100 non-risk targeted reviews it could explain most of the movement observed, however it does appear more likely that compliance changes were also involved.

#### *3.13.2 Compliance—where the ‘line’ is drawn*

A view that the decline could be due to a change in where the ATO sees the compliance line drawn, following adverse court decisions (for example, the SNF and RCI cases) has some merit as approximately \$650m in projected adjustments were closed rather than proceeded with, and some \$500m in projected adjustments were delayed by about a year due to additional evidence gathering to support likely litigation. It is also evidenced by the decline in review conversion rates and audit strike rates happening simultaneously rather than being lagged, which would be expected if case selection alone were the dominant factor.

#### *3.13.3 Compliance—opportunity*

The hypothesis that the opportunity to take positions the ATO would challenge has reduced is somewhat supported as there has been a decline in Mergers and Acquisitions (in 2013 at their lowest level in five years) and these transactions typically are events that can be associated with opportunistic CGT tax planning that can be contestable.

#### *3.13.4 Compliance—propensity*

The argument that there has been a reduction in the propensity to take positions that the ATO would contest is anecdotally supported as taxpayers in Annual Compliance Agreements and Pre-lodgement Compliance Reviews are increasingly using rulings to obtain tax-planning certainty. The Risk Differentiation Framework process and ‘real time’ follow-up also appears to have influenced the level of disclosure and perhaps the perceived aggressiveness of arrangements. In addition, there is the impact of GFC-associated losses still flowing through the system, perhaps reducing the need to take more aggressive tax planning positions.

Modelling indicates that these possible changes in where the ‘compliance line’ is drawn, or in the opportunity or propensity for non-compliance, all have, at compliance levels of ~90%, about double the impact on conversion rates as changes in ‘detection and deal with’ capability. So a movement of 2%, from 90% to 92% compliance, has

the same conversion rate impact as a 5% change from 70% to 65% in detection capability.

### 3.14 Reasons that appear less favoured by the evidence examined

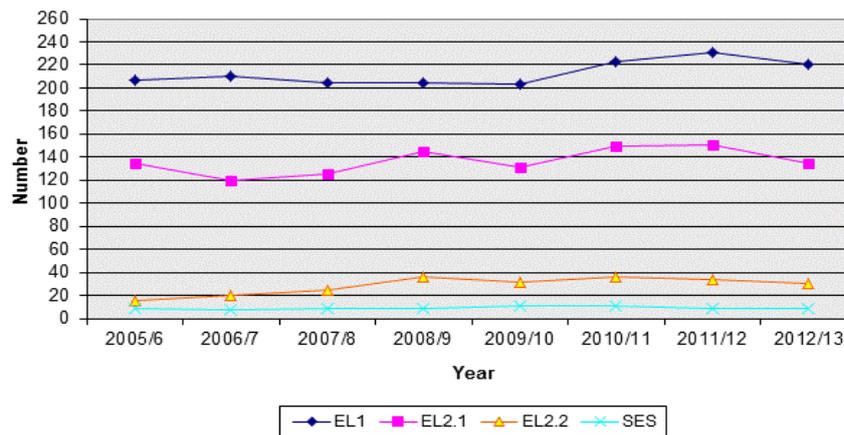
#### 3.14.1 Capability—selection

The view that the change is due to a decline in case selection efficacy appears likely ruled out as the risk filters used have not changed markedly.

#### 3.14.2 Capability—staff

The hypothesis that it is due to a decline in case capability is largely ruled out as there has not been a significant change in staff over the period. That is not to say that staff capability could not always be improved, just that it is not likely to be a significant causal factor in the decline in conversion and strike rates addressed here

**Figure 41: Large market income tax staff changes over time**



### 3.15 Summary of views on changes in large market strike rates

Overall it would appear more likely that some combination of coverage and compliance changes is the driver of the observed significant change in conversion and strike rates.

A sensitivity analysis indicates that a change in compliance levels (either through a reduction in the propensity to adopt a contestable position or the opportunity to adopt a contestable position or some mix of both) is more likely the dominant driver (about 2/3 of the change), with coverage changes being a secondary influence (about 1/3 of the change).

It appears less likely on the evidence that a change in capability (either selection or staff) has been the key driver, as these aspects appear to have been relatively constant.

#### 4. CONCLUSIONS

Evaluating (1) the effectiveness of case selection for compliance activities and (2) estimating the possible compliance gap are two interlinked and enduring issues for any regulatory agency.

Views of the level of compliance go to the heart of community trust in the regulatory agency's administration of the system and it is important to get an estimate of their potential magnitude – at a reasonable cost and ideally one that is not imposed upon compliant taxpayers merely to obtain 'a tax gap number' with significant uncertainty.

The current accepted 'gold standard' by which to estimate the non-compliance gap is a significant, and hence expensive, random audit process (Gemmell & Hasseldine 2012). This paper has outlined an innovative alternative or supplementary method by which a plausible compliance gap might be estimated from the signal of the regulator's known strike rates and coverage: efficiently, and at a fraction of the cost of a significant random audit program, or for those situations where a random audit program is not practical, such as for large market compliance.

The analysis applies Bayesian Signal Detection approaches, used in epidemiology for disease detection and prevalence, into the regulatory compliance domain. In so doing, it provides an innovative tool by which to model and analyse compliance results for improved meaning and understanding.

The analysis shows how strike rates are co-dependent on three key aspects:

1. Compliance rates – the underlying *Prevalence* of non-compliance ( $P$ ),
2. Capability – the *Sensitivity* and *Specificity* of detection approaches ( $Se$ ,  $Sp$ ), and
3. Coverage – the number of clients selected for review ( $n$ ,  $N$ ).

The approach outlined in this paper is likely to perform best in situations where the system is not functioning near its extremes:

- coverage rates are not insignificant (for example, >5%)
- underlying prevalence is relatively 'low' (for example, <20%) but not insignificant
- strike rates are not particularly high (for example, >70% which would generally imply an overall case selection efficacy of >90%).

In those countries with substantial review coverage of the large market, the approach also provides a method to calculate the extent and value of BEPS arrangements that are considered legal (so no adjustment is pursued) but not within the intent or spirit of the law. To enable this, the details of BEPS frequency and value would need to be captured within case management systems, even if no adjustment is made, to provide the operational data needed to use the ROC approach outlined in this paper.<sup>14</sup>

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<sup>14</sup> The recording of such operational data could also enable the use of the extreme value approach set out in Bloomquist, Hamilton and Pope (2014).

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