

# eJournal of Tax Research

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Atax is the tax school in the Faculty of Law at The University of New South Wales. We are the largest tax school in any university in Australia, bringing together a team of expert academic staff with backgrounds in law, commerce, tax, accounting and economics. At Atax, we're working towards building excellence in the tax profession, looking at tax from both a theoretical and practical perspective.



# **eJournal of Tax Research**

## **EDITOR'S NOTE**

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

## **SUBMISSION OF ORIGINAL MATERIAL**

Submission of original contributions on any topic of tax interest is welcomed, and should be sent as an email attachment to the Production Editor at <ejtr@unsw.edu.au>. Submission of a manuscript is taken to imply that it is an unpublished work and has not already been submitted for publication elsewhere. Potential authors are requested to follow the "Notes to Authors", which is available from the journal's website.



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# Editorial Announcement

**Binh Tran-Nam**

Rodney Fisher has resigned from Atax and from his position as coeditor of the eJournal of Tax Research to take up an appointment as Senior Manager, National Tax, with Ernst & Young, Australia. His many contributions to the eJournal of Tax Research, particularly in its planning phase, are gratefully acknowledged. We trust Rodney will not be lost to the academia entirely in that he will contribute to the eJournal in his new capacity as an author.

Associate Professor Michael Walpole has been appointed to be the new coeditor of the eJournal with effect from 6 August 2004.

I look forward to a long lasting and fruitful collaboration with Michael.

# The Cedric Sandford Medal

**Chris Evans, Binh Tran-Nam and Michael Walpole**

Cedric Sandford was a leading public finance economist in the UK. He made numerous outstanding contributions to different areas of taxation, particularly tax compliance costs, a field in which he was universally regarded as a world leader.

He was author of more than 30 books (the last—Why Tax Systems Differ—published in 2000) and well over 100 articles and reviews in the best scholarly journals. His relaxed style and clear thinking made him a sought after media commentator on tax matters. He was a key member of the Meade Committee (1976–78) which transformed the UK tax system and influenced tax systems throughout the world, and also served on many other international, national and regional committees and councils.

Professor Sandford also enjoyed a very close relationship with Australia. He was a consultant to many of Atax's research projects, supervised PhD candidates, and participated in many Australian conferences. Professor Sandford passed away in his home town, Bath, earlier this year at the age of 79.

The Cedric Sandford Medal has been established by Atax to commemorate Professor Sandford's contributions to taxation. It is to be awarded to the best paper submitted to the biennial International Tax Administration Conference, commencing in 2004. The independent judging panel will consist of three internationally recognised tax experts.

The 2004 judging panel consisted of Professor Robert Deutsch (Atax), Dr Ian Wallschutzky (formerly University of Newcastle) and Dr Simon James (University of Exeter, UK). The criteria they applied were:

- academic quality, including evidence of quality research;
- contribution to furthering scholarship or improvement of tax administration;
- clarity of communication of the written paper; and
- relevance to the current intellectual debates about tax administration and reform, with reference to, *inter alia*, the themes of the conference.

Based on these criteria, the panel unanimously awarded the inaugural Cedric Sandford Medal to Mr Adrian Sawyer (Senior Lecturer at University of Canterbury) for his paper entitled "An International Tax Organisation: A Step Forward for Rulings and APAs?".

The inaugural presentation of the Cedric Sandford Medal was made to Adrian Sawyer at a special ceremony at Atax on 1 July 2004. The engraved medal was presented by the Hon Sir Anthony Mason, former Chief Justice of the Federal High Court of Australia and former Chancellor of the UNSW. In awarding the medal, Sir Anthony recalled that in his opening address at the conference, he made a special mention of Adrian Sawyer's paper. Referring to the paper as 'fascinating', Sir Anthony said he

found Sawyer's suggestion that an international tax organisation might be an appropriate forum for administering binding rulings and advance pricing agreements an intriguing one.

The *ejournal* is delighted to feature a revised version of the winning paper in this edition.



(L to R) Chris Evans, Adrian Sawyer, Sir Anthony Mason, Binh Tran-Nam

# Is an International Tax Organisation an Appropriate Forum for Administering Binding Rulings and APAS?<sup>+</sup>

**Adrian Sawyer\***

## ***Abstract***

This paper presents the results of ongoing research into developing a World Tax Organisation for advancing tax policy and practice. Specifically it focuses on the driving forces for such a body, including that of harmonisation and globalisation, along with forces of resistance, including that of national sovereignty. The paper reviews the contributions of various scholars and seeks to build upon their efforts, focussing particularly upon areas that could form part of the scope of this international organisation, namely binding rulings and advance pricing agreements. The paper is far from the definitive analysis of the surrounding issues; rather it is part of the author's ongoing research, including eventually developing possible operational aspects of a possible World Tax Organisation.

## **INTRODUCTION**

With the increasing globalisation<sup>1</sup> of business activity, mobility of capital (and to a lesser degree individuals),<sup>2</sup> and the blurring of jurisdictional boundaries,<sup>3</sup> the setting of domestic tax policy has taken on an increasingly international application. As a consequence of this international dimension, tax policy and practice cannot, or at least should not, be developed by a country in isolation of the international implications.<sup>4</sup> Territorial tax competition, one potential outcome of international tax policies, has been criticised as an inefficient mechanism for economic activity when assessed from global perspective.<sup>5</sup> International economic cooperation and policy coordination has

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<sup>+</sup> This is work derived from part of my SJD dissertation.

\* Senior Lecturer, Department of Accountancy, Finance and Information Systems, University of Canterbury.

<sup>1</sup> Globalisation may be summarised as a metaphor for a way of describing a variety of non-linear processes of change on a global scale; see GORDON WALKER, *Introduction, to GLOBALIZATION AND SECURITIES REGULATION* (unpublished SJD thesis, Duke University, Draft 12/15/98), and Gordon Walker and Mark A. Fox, *Globalization: An Analytical Framework*, 3 IND. J. GLOBAL LEGAL STUD. 375 (1996).

<sup>2</sup> For a discussion on the implications of the mobility of capital, and to a lesser degree, of labour, see Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the State* 113 HARV. L. REV. 1573 (2000).

<sup>3</sup> See e.g. Jeffrey Owens, *Globalisation: The Implications for Tax Policies*, 14 FISCAL STUD. 21 (1993).

<sup>4</sup> Globalisation has become the latest concept to "grab the attention" of tax commentators. It has been recognised as having a significant impact on taxation. See e.g., Vito Tanzi, *The Impact of Economic Globalization on Taxation*, 52 BULL. FOR INT'L FISCAL DOC. 384 (1998) and Jeffrey Owens, *Taxation within a Context of Globalization*, 52 BULL. FOR INT'L FISCAL DOC. 290 (1998). See also ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *TAXING PROFITS IN A GLOBAL ECONOMY* 175-76 (1991). The Organisation for Economic Cooperation and Development is hereinafter referred to as the OECD.

<sup>5</sup> See OECD, *HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE* (1998). See also Jeffrey Owens, *Emerging Issues in Taxing Business in a Global Economy*, in *TAXING INTERNATIONAL BUSINESS; EMERGING TRENDS IN APEC AND OECD ECONOMIES* 25, 42-44, (Richard Vann ed., 1997).



been suggested as important in the operation of the international monetary system,<sup>6</sup> and with the growing internationalisation of business activities and investment,<sup>7</sup> cooperation and coordination should also be debated in the context of international tax policy.

The international tax environment is changing rapidly.<sup>8</sup> Social and economic conditions are changing almost constantly, along with a technological revolution that is challenging the traditional ways that tax systems operate to determine liability for tax. James<sup>9</sup> suggests application of the STEP analysis, where relevant social, technological, economic and political factors are each examined in turn. James<sup>10</sup> concludes that tax systems are likely to become more complex, that they will become increasingly global and more competitive.

Adopting international cooperation as the basis for setting tax policy is likely to produce benefits, and therefore international cooperation is an important theme throughout this paper.<sup>11</sup> Owens concludes with respect to the need for international cooperation<sup>12</sup>:

A more promising approach [than harmonizing tax systems] is to pursue multilateral convergence on three issues, with as many countries as possible involved in the process minimizing the number and size of measures in participating countries that are subject to deleterious spillover effects, agreeing on consistent and uniform responses to harmful measures elsewhere, and exploring more formal means of buttressing this understanding through international multilateral instruments.

The literature on international tax principles, globalisation, tax policy and international law within this context needs to be assimilated, synthesised and revisited in the light of developments in recent years, such as the growing importance of international transactions and derivation of income, and new challenges, such as the development of electronic commerce. Diverse views permeate throughout the pertinent literature, and some attempt at reconciliation, or at least revisiting in the context of the twenty-first century, seems warranted. This paper attempts to contribute to this enormous task to an observable degree with respect to binding rulings and advance pricing agreements (APAs). Nations are gradually moving away from their independence to forming interdependent relations with their neighbours, particularly their major trading partners.<sup>13</sup> Thus, this paper, as part of a broader study, is timely from this perspective

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<sup>6</sup> See e.g. Jocelyn Horne and Paul R. Masson, *Scope and Limits of International Economic Cooperation and Policy Coordination*, 35 IMF STAFF PAPERS 259 (1988).

<sup>7</sup> See e.g. John H. Dunning, *Introduction*, to GOVERNMENTS, GLOBALIZATION AND INTERNATIONAL BUSINESS 1, 1-28, (John H. Dunning ed., 1997).

<sup>8</sup> Simon James, *The Future International Tax Environment*, 29 INT'L TAX J. 1 (1999).

<sup>9</sup> *Id.* at 3.

<sup>10</sup> *Id.* at 9.

<sup>11</sup> International cooperation on a scale greater than that currently experienced is seen as crucial to solving the fiscal problems of the twenty-first century, including the development of more multilateral tax treaties. See e.g. Jeffrey Owens, *Emerging Issues in Tax Reform: The Perspective of an International Bureaucrat*, available in LEXIS NEXIS Library, 97 TNI 245-23 (December 22, 1997). Owens emphasises the need for continual updating of the OECD's model tax convention, a coordinated response to the global communications revolution and harmful competition, and possibly harmonization of tax systems (at paras 175-178). See also Charles E. McLure, Jr., *Tax Policies for the XXIST Century*, in VISIONS OF THE TAX SYSTEMS OF THE XXIST CENTURY, 50 CONG. INT'L FISCAL ASS'N 9 (1997).

<sup>12</sup> Owens, *supra* note 11, at para 178.

<sup>13</sup> Examples include the European Union (EU) (or European Community (EC)), the North American Free Trade Association (NAFTA), the Asia Pacific Economic Cooperative (APEC), the Association of South

and has the potential to make an important contribution to the literature and to the development of future international tax policy and practice. Development of a framework through the means of a best-fit response to key issues has the opportunity to facilitate future research and scholarship in this area.

Part of this framework necessarily involves some form of overarching international organisation to oversee and implement the proposals. In this paper, the organisation to undertake this role, a World Tax Organisation, is also used interchangeably with the title International Tax Organisation; both intended to represent the same proposed international body.

Furthermore, it is my contention that the phenomenon of cooperation has not evolved to a position whereby mutual considerations in devising, revising and implementing tax policy have been fully embraced, particularly on income that is derived across jurisdictional boundaries. A step down this path would be to include a mutually agreeable process in the areas of binding rulings and APAs that encompass business and income with cross-border implications. On the other hand, it could be argued that a mutual tax policy setting process in any area is a utopian ideal which in itself requires separate investigation and justification.<sup>14</sup> Beyond the OECD countries, there are an immense number of developing and transition nations experiencing the implications of globalisation.<sup>15</sup>

The remainder of this paper is structured as follows. The next section provides further background to events and developments influencing tax policy worldwide, including globalisation and harmonisation. It also identifies a number of key issues and limitations associated with these concepts, including national sovereignty. Section three outlines key aspects of binding rulings and APAs, two related areas that I will argue are prime candidates for inclusion within the scope of a World Tax Organisation. Section four then discusses the potential makeup of a World Tax Organisation/International Tax Organisation (ITO) from the perspective of other scholars, interspersed with my observations. Section five provides some concluding observations.

## GLOBALISATION AND INTERNATIONAL TAXATION POLICY AND PRACTICE

### Tax Policy Developments – Key Issues

OECD countries,<sup>16</sup> representing the world's major developed industrial nations and several developing nations, have experienced significant changes in tax policy over the past ten to fifteen years; in fact the changes have reflected a high degree of

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East Asian Nations (ASEAN), and Closer Economic Relations (CER), as between New Zealand and Australia.

<sup>14</sup> In this paper I argue that a mutual policy process is more than a utopian ideal although its chances of success when viewed realistically are not high in the current environment. However, Weiss and Molnar have argued that international cooperation is possible and they present some possible models; see Arnold H. Weiss and Ferenc E. Molnar, *International Cooperation is Possible*, in *TAX POLICY IN THE TWENTY-FIRST CENTURY* (Herbert Stein ed., 1988).

<sup>15</sup> For an excellent discussion of the issues and priorities for developing and transition countries in developing and refining their international tax policy, see Richard J. Vann, *International Aspects of Income Tax*, in *TAX LAW DESIGN AND DRAFTING* Vol. 2, 718, 808 (Victor Thuronyi ed., 1998).

<sup>16</sup> The 30 OECD member countries, as at the end of 1998, are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, (Republic of) Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

simultaneity in implementation.<sup>17</sup> However, in developing international tax policy, the United States is a major, if not dominant player, and has been so for decades.<sup>18</sup> Consequently developments in the tax policy literature in the United States should prove fruitful in exploring the processes of setting international tax policy and its application in practice.<sup>19</sup>

In looking to the tax systems of the twenty-first century, a number of difficult questions need to be answered, including<sup>20</sup>:

- What new problems do the future demographic and economic developments imply?
- What new tax bases will be available?
- What will happen with regard to existing main revenue sources – indirect taxes, labour taxation, capital taxation, and business taxation?
- What new means of control will tax administrations get and what new difficulties will they meet?
- Another commentator had observed with respect to tax policy in the twenty-first century<sup>21</sup>:

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<sup>17</sup> Martin Hallerberg and Scott Basinger, *Internationalization and changes in OECD countries: The Importance of Domestic Veto Players*, 31 COMP. POL. STUD. 321 (1998). Internationalisation is cited by the authors as a major force in the downward convergence of tax rates (p. 322). The results, according to Hallerberg and Basinger, suggest that capital is mobile, seeking after favourable tax treatment (the phenomenon of tax competition). See generally KEN MESSERE, *TAX POLICY IN OECD COUNTRIES* (1993).

<sup>18</sup> See e.g. Stanford G. Ross, *A Perspective on International Tax Policy*, 26 TAX NOTES 701 (February 18, 1985). In the context of advocating a United States tax regime that promotes consolidated worldwide income and taxes rather than focussing on nationalistic U.S. tax rules, see Stanford G. Ross, *US International Tax Policy: Where are we? Where should we be going?* 47 TAX NOTES 331 (April 16, 1990). For a more recent discussion by Ross on national versus international approaches to tax policy, see Stanford G. Ross, *National versus International Approaches to Cross-Border Tax Policy Issues*, 4 TAX NOTES INT'L 719 (April 8, 1992). Also, Ross provides a 20-year view of United States international tax; see Stanford G. Ross, *International Taxation: A 20-Year View*, 57 TAX NOTES 945 (November 12, 1992). Ross suggests that the United States international tax system is currently flawed (p. 946), and upon suggesting reforms, expresses his pessimism that reform will be achieved (p. 948). For an excellent discussion on the United States position on international taxation prior to the 1980s, see Charles I. Kingston, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1,151 (1981), and for more recent developments, see Peter R. Merrill, *International Tax and Competitiveness Aspects of Fundamental Tax Reform*, in UNITED STATES INDUSTRY: RESTRUCTURING AND RENEWAL: BORDERLINE CASE: INTERNATIONAL TAX POLICY, CORPORATE RESEARCH AND DEVELOPMENT, AND INVESTMENT (James M. Poterba ed., 1997). For recent discussion on investment in the United States, see PRACTISING LAW INSTITUTE, *TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES, BACKGROUND ISSUES RELATING TO THE TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES* (1990), and Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 24 TAX L. REV. 565 (1992). Furthermore, in the context of key questions that corporations must ask when they decide to “go global”, see William Zink, *Shrinking World Expands Relevance of International Tax Concepts*, 61 TAX’N FOR ACCT. 158 (1998).

<sup>19</sup> One important facet of sound tax policy according to one scholar, is returning to general principles to ensure that there is consistency in purpose an application of international tax rules, see Barbara R. Rollinson, *Guidelines for Taxing International Capital Flows: An Economic Perspective*, 46 NAT’L. TAX J. 309 (1993).

<sup>20</sup> See International Fiscal Association, *Symposium Outline*, in VISIONS OF THE TAX SYSTEMS OF THE XXIST CENTURY, 50 CONG. INT’L FISCAL ASS’N 3 (1997). See also Mervyn King, *Tax Systems in the XXIST Century*, in VISIONS OF THE TAX SYSTEMS OF THE XXIST CENTURY, 50 CONG. INT’L FISCAL ASS’N 53 (1997). For a comparative discussion on the agenda for tax policy in the 1990s, see *Future Directions of International Tax Policy*, available in LEXIS NEXIS Library, 90 TNI 18-8 (May 2, 1990).

A way to focus attention on the importance of reforming the taxation of international income is to consider what the world will be like in the 21st century. It seems unquestionable that increasingly markets will become global, national power will equate heavily with economic power, and technology will lead to a world of faster communication and more transactions. Present tax rules based on geographic residence of taxpayers, the geographic source of income, and physical location of assets will become increasingly irrelevant to real business and economic activities. Applying these rules undoubtedly will impose an increasingly deadweight cost on commerce unless reformed.

Newer methods and better ways for countries and taxpayers to establish the amount of income and the appropriate jurisdiction to tax it are needed. There are far too few innovations in tax policy being considered today to meet the challenges of a rapidly changing world.”

McIntyre<sup>22</sup> suggests six key guidelines for developing a coherent international income tax regime which would also be in the long-term interests of the United States. McIntyre’s guidelines may be summarised as:

- 1) employing worldwide taxation;
- 2) utilising source taxation;
- 3) allowing a foreign tax credit (or functional equivalent);
- 4) pursuing tax harmonisation;
- 5) adopting accrual taxation of foreign funds; and
- 6) employing formulary apportionment.<sup>23</sup>

This notion of some form of international tax organisation to facilitate binding ruling and APAs forms part of the underlying thesis of this paper, and to be effective requires increased levels of tax harmonisation and possibly (but not necessarily) in the future formulary apportionment rather than the current arm’s length approach. These components are critical to enable coherent and effective international tax policy and practice to be implemented in an era of globalisation.

The internationalisation of domestic tax policy<sup>24</sup> has serious ramifications for governments as they jealously guard and protect their sovereign rights to tax their

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<sup>21</sup> *Tax Policy Forum: US International Tax Policy: Where are we? Where should we be going?*, available in LEXIS NEXIS Library, 90 TNI 34-17 (1990). Emphasis added. The complexity of the international tax rules is in need of simplification, with a recent plea for action by multinationals to the Senate Finance Committee; see Tax Analysts, *Multinationals Beg Finance to Simplify International Laws*, TAX WIRE (March 11, 1999). Available at: < <http://www.tax.org/taxwire/taxwire.htm> >. (Visited March 12, 1999). For a discussion on forces that will shape tax policy in the twenty-first century, see also Vito Tanzi, *Forces that Shape Tax Policy*, in TAX POLICY IN THE 21<sup>ST</sup> CENTURY 266 (Herbert Stein ed., 1988).

<sup>22</sup> Michael J. McIntyre, *Guidelines for Taxing International Capital Flows: The Legal Perspective*, 46 NAT’L. TAX J. 315 (1993).

<sup>23</sup> *Id.* at 315-6.

<sup>24</sup> By domestic tax policy I am referring to tax policy developed for the purposes of a particular country in order to tax its residents and, to a lesser degree, non-residents on income sourced in that country, where that country is fully utilising its sovereign right to adopt its own tax system, such as a worldwide or territorial basis for ascertaining jurisdiction. For a discussion on territorial and worldwide tax systems, see ADRIAN OGLEY, *PRINCIPLES OF INTERNATIONAL TAX - A MULTINATIONAL PERSPECTIVE*, 22-25 (1993).

residents and income sourced in their jurisdiction<sup>25</sup> and, in some instances, their citizens.<sup>26</sup> These longstanding ideals are coming under greater pressure in the global effort by nations and tax administrations to secure the limited tax dollar.<sup>27</sup> In making this observation, the implications and spillover from the impact of globalisation, such as through moves to harmonise antitrust law<sup>28</sup> and commercial securities regulation by various international agencies<sup>29</sup> will play an important role as globalisation continues to have a profound impact upon taxation. Warren makes an important observation with respect to jurisdiction and taxation<sup>30</sup>:

In developing an orderly system of taxation, each nation must decide upon which base, if any, it will choose to levy taxes. This tax base defines the limits of the nation's tax jurisdiction. Modern tax theory recognizes four conceptually different types of tax jurisdiction. Jurisdiction based on the source of income enables a nation to tax all income sourced within its borders irrespective of the taxpayer's nationality or residence. Territorial jurisdiction gives a nation the power to tax income only within its territorial limits. Residence based jurisdiction subjects all income of nation's residents to taxation, regardless of the source from which such income is derived. Finally, jurisdiction based on citizenship permits a nation to tax its citizens on all income earned throughout the world.

Jurisdiction is also a pivotal factor in the debate over whether income is effectively connected to a particular country so as to enable that country to tax the resulting income or consumption.<sup>31</sup> Focusing on functional business tests and normative principles, rather than legal definitions, is advocated as the preferable manner to determine who is liable to pay United States taxes.<sup>32</sup>

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<sup>25</sup> For a discussion on jurisdiction, see Anthonie Knoseter, *TAXATION IN THE UNITED STATES AND EUROPE: THEORY AND PRACTICE*, 159-162 (Anthonie Knoseter ed., 1993).

<sup>26</sup> One example is the United States. Citizenship is advocated as important for simplifying the international jurisdiction issues associated with the United States transfer taxes, see Robert J. Misey, *Simplifying International Jurisdiction for United States Transfer Taxes: Retain Citizenship and Replace Domicile with the Green Card Test*, 76 MARQ. L. REV. 73 (1992).

<sup>27</sup> See e.g. Avi-Yonah, *supra* note 2.

<sup>28</sup> See Eleanor M. Fox, *Harmonization of Law and Procedures in a Globalised World: Why, What and How?*, 60 ANTITRUST L. J. 593 (1992).

<sup>29</sup> For a discussion of globalisation and its impact on securities regulation, see WALKER, *supra* note 1, and Walker and Fox, *supra* note 1.

<sup>30</sup> Ronald M. Warren, *Investment in United States Property by Controlled Foreign Corporations: A Proposal for Reform*, 19 RUTGERS L. J. 367, 368-9 (1988).

<sup>31</sup> For a discussion on importance of the force of attraction rules in the United States in order to ascertain whether income is effectively connected with a trade or business in the United States, see Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689 (1987). Dale provides an historical review and suggests (p. 749) three "modest" recommendations, including that the force of attraction principle be abolished from the Internal Revenue Code, that the new source rules be applied enabling use of the foreign tax credit, and for clarification of deductions, expenses and losses that are not sourced, but rather allocated or apportioned. For a discussion on valued-added tax (VAT) harmonisation and jurisdiction issues, see generally Craig A. Hart, *The European Community's Value-Added Tax System: Analysis of the New Transitional regime and Prospects for Further Harmonization*, 12 INT'L TAX & BUS. LAW. 1 (1994).

<sup>32</sup> See Yoseph M. Edrey, *Taxation of International Activity: FDAP, ECI and the Dual Capacity of an Employee as a Taxpayer*, 15 VA. TAX REV. 653, 670-1 (1996). Edrey proposes his approach in the context of 26 I.R.C. §871(a) (1986) for income from sources within the United States. For a discussion of the improved consistency and reflection of sound tax principles for the income source of isolated sales in 26 IRC §865 (1986), see Carlo Garbarino, *A Study of the International Tax Policy Process: Defining the Rules for Sourcing Income from Isolated Sales of Goods*, 29 HARV. INT'L L. J. 393 (1988). Several problems in application to non-residents are suggested by Garbarino.

Currently there are numerous other international policy issues which need to be resolved in the twenty-first century. For example, such issues encompass dealing with changes in demographics, which in itself creates a series of sub-issues, including inducing greater demand for increased user charges, emergence of an austerity environment, international factor mobility and the growing integration of the world economy, and virtual computerisation of all transactions.<sup>33</sup>

#### **Tax policy and international trade<sup>34</sup>**

A further approach to viewing international tax policy and its application is that of recasting it in parallel with the theory of international trade. Slemrod identifies two major advantages from this approach.<sup>35</sup> The first is that tax policy has at least as large an effect on the flow of goods across countries, the location of productive activity and the gains from trade as do trade policy instruments.<sup>36</sup> Secondly, reasoning applied in trade (free trade and costs of protectionism) is relatively non controversial among economists and therefore, argues Slemrod, should enable the debate to progress in the context of international taxation.<sup>37</sup>

#### **Tax policy and globalisation**

It is an opportune time to undertake a study that examines the impact that globalisation is having on domestic economies and the world economy. Such a study would be enormous to say the least, and thus only small portions can be handled at any one time.

Economic globalisation is a historical process, the result of human innovation and technological progress.<sup>38</sup> It refers to the increasing integration of economies around the world, particularly through trade and financial flows. The term sometimes also refers to the movement of people (labour) and knowledge (technology) across international borders. There are also broader cultural, political and environmental dimensions of globalisation that are not covered in this paper.

At its most basic, there is nothing mysterious about globalisation. The term has come into common usage since the 1980s, reflecting technological advances that have made it easier and quicker to complete international transactions - both trade and financial flows. It refers to an extension beyond national borders of the same market forces that have operated for centuries at all levels of human economic activity - village markets, urban industries, or financial centres.

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<sup>33</sup> See James M. Poterba, *Tax Policy in the Twenty-First Century*, in TAXATION TO 2000 AND BEYOND (Richard M. Bird and Jack M. Mintz eds., Canadian Tax Paper No. 93, 1992) and HERBERT STEIN (ed.), TAX POLICY IN THE TWENTY-FIRST CENTURY (1988).

<sup>34</sup> A detailed discussion on international trade is beyond the scope of this paper although institutions such as the World Trading Organisation will feature as part of the consideration of models for a world tax organisation.

<sup>35</sup> Joel B. Slemrod, *Free Trade and Protectionist Taxation*, available in LEXIS NEXIS Library, 94 TNI 63-28 (April 1, 1994). Slemrod concludes that the impact of international tax policy on the functioning of capital markets will increasingly arise as a central concern for policymakers. Slemrod also observes that harmonising of corporate tax rates via multilateral means should be pursued.

<sup>36</sup> *Id.* at 471.

<sup>37</sup> *Id.* at 471.

<sup>38</sup> International Monetary Fund, GLOBALIZATION: THREAT OR OPPORTUNITY? (April 12, 2000; Corrected January 2002). Available from <http://www.imf.org/external/np/exr/ib/2000/041200.htm#II> (visited 17 February 2004).

The concept or phenomena of globalisation<sup>39</sup> has implications not only in the context of its impact on trade and business, but also with respect to its impact on nation states and people, especially cultural groupings. One of the critical issues affecting international taxation currently is that globalisation has now become a tax problem rather than merely an issue for financial markets.<sup>40</sup>

Globalisation requires, or perhaps forces, a high degree of consensus policy and appropriate mechanisms to cater for the innovations that it has spawned, such as in the internationalisation of financial markets.<sup>41</sup> Globalisation clearly brings pressure to bear on traditional tax principles,<sup>42</sup> and is an issue that confronts tax policymakers for three principle reasons.<sup>43</sup> First, globalisation offers firms and businesses more freedom over where they locate. The improvement in capital mobility with globalisation of financial markets facilitates this freedom. With the ascendancy of residence-based taxation (or locale of a permanent establishment<sup>44</sup>), businesses can choose to operate from tax havens or countries with lower corporate tax rates with greater ease.<sup>45</sup>

Second, globalisation makes it hard to ascertain where a corporation or enterprise should pay tax, regardless of where it is based. This applies particularly to multinational enterprises that can exploit transfer pricing<sup>46</sup> rules to their advantage, subject to the vigilance of revenue authorities. Electronic commerce facilitates manipulation of this uncertainty by hampering the ability to verify the accuracy of profits and locale of sales.<sup>47</sup>

Third, globalisation has made it easier for individuals, especially skilled professionals, to take the benefit, for example, of earning consultancy income overseas and saving or investing their income on a global scale. In essence, globalisation increases the level of competition for what appears to be a potentially decreasing tax base in higher tax jurisdictions. Such competition may be dominated by the larger players through cooperative oligopolies (implemented by way of modified tax treaties) or through misuse of a dominant position, where powerful tax havens promote the benefits of their services to a larger group of potential clients.<sup>48</sup>

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<sup>39</sup> For the present purposes, globalisation is defined as a metaphor for a way of describing a variety of non-linear processes of change on a global scale; see WALKER, *supra* note 1 and Walker and Fox, *supra* note 1.

<sup>40</sup> See Avi-Yonah, *supra* note 2, Owens, *supra* note 3, and Tanzi, *supra* note 4.

<sup>41</sup> See generally WALKER, *supra* note 1. See generally, LORRAINE EDEN, *TAXING MULTATIONALS: TRANSFER PRICING AND CORPORATE INCOME TAXATION IN NORTH AMERICA* (1998) (globalisation in the context multinational enterprises and financial markets).

<sup>42</sup> See Joel Slemrod, *Tax Principles in our International Economy*, in *WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES* (Michael J. Boskin and Charles E. McLure, Jr. eds., 1990).

<sup>43</sup> See *Disappearing Taxes: The tap runs dry*, *ECONOMIST*, May 31, 1997, at 19-21.

<sup>44</sup> See generally ARVID A. SKAAR, *PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE* (1991).

<sup>45</sup> See *Disappearing Taxes: The tap runs dry*, *supra* note 43, at 19-21.

<sup>46</sup> Transfer pricing refers to the problem of allocating profits among the parts or members of a corporate group. It typically involves shifting income to lower tax jurisdictions to lower the tax burden for the group as a whole. See Richard J. Vann, *International Aspects of Income Tax*, in *TAX LAW DESIGN AND DRAFTING* Vol. 2, 718, 808 (Victor Thuronyi ed., 1998), at 781. See also JILL C. PAGAN AND J SCOTT WILKIE, *TRANSFER PRICING STRATEGY IN A GLOBAL ECONOMY* (1993).

<sup>47</sup> *Disappearing Taxes: The tap runs dry*, *supra* note 43, at 21.

<sup>48</sup> *Id.*

An appreciation of the implications of globalisation is vitally important to developing (international) tax policy.<sup>49</sup> Globalisation may be contrasted with the notions of internationalisation<sup>50</sup> and regionalisation,<sup>51</sup> both of which have received attention in the literature.<sup>52</sup>

### **Globalisation, Internationalisation or Regionalisation?**

Delbrück defines internationalisation as "... a means to enable nation-states to satisfy the national interest in areas where they are incapable of doing so on their own."<sup>53</sup> He also introduces the concept of renationalisation in the context of ethnic and religious conflict since the end of the Cold War. Delbrück also suggests renationalisation is present in the European Union.<sup>54</sup>

According to Stace<sup>55</sup> there are three waves of internationalisation that may be observed: the commodity exporter phase of the 1940s-1970s, the global opportunist phase of the 1980s (characterised by financial deregulation), and the exporter and insider phase of the 1990s (looking beyond national boundaries, and taking advantage of technology and utilising natural advantages). Stace goes on to contrast internationalisation and globalisation, in relation to firms, in the following manner<sup>56</sup>:

Internationalization: Cross national flows of goods and services effected by enterprises by either export/import or direct investments abroad involving operations in one or a number of countries. Globalisation: A more advanced form of internationalisation involving the increasing spread of economic activities across national and regional borders, characterized by global products, global innovation and global competition.

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<sup>49</sup> Luc Hinnekens, *Territoriality-Based Taxation in an Increasingly Common Market and Globalizing Economy: Nightmare and Challenge of International Taxation in this New Age*, E.C. TAX REV. 156 (1993).

<sup>50</sup> See e.g. Hallerberg and Basinger, *supra* note 17.

<sup>51</sup> See e.g. TAKATOSHI ITO AND ANNE O. KRUEGER, REGIONALISM VERSUS MULTILATERAL TRADE ARRANGEMENTS, (Takatoshi Ito and Anne O. Krueger eds., National Bureau of Economic Research Seminar on Economics, Vol 6, 1997), Allen J. Morrison and Kendall Roth, *The Regional Solution: An Alternative to Globalization*, 1 TRANSNAT'L CORP. 37 (1992), and KENICHI OHMAE, THE END OF THE NATION STATE: THE RISE OF REGIONAL ECONOMIES (1995).

<sup>52</sup> For a useful discussion of these terms, see WALKER, *supra* note 1.

<sup>53</sup> Jost Delbrück, *Globalization of Law, Politics and Markets – Implications for Domestic Law – A European Perspective*, 1 IND. J. GLOBAL LEGAL STUD. 9 (1993), at 11. This is part of a feature on globalisation, the outcome of a symposium held at Indiana University School of Law in 1993. The other papers presented and published in volume 1 of the *Indiana Journal of Global Legal Studies* on point are: Alfred C. Aman, Jr., *Introduction*, 1 IND. J. GLOBAL LEGAL STUD. 1 (1993); Martin Shapiro, *The Globalization of Law*, 1 IND. J. GLOBAL LEGAL STUD. 37 (1993); S. Tamer Cavusgil, *Globalization of Markets and its Impact on Domestic Institutions*, 1 IND. J. GLOBAL LEGAL STUD. 83 (1993); and William J. Davey, *European Integration: Reflections on its Limits and Effects*, 1 IND. J. GLOBAL LEGAL STUD. 185 (1993). See also David P. Fidler, *International Law and Global Public Health*, 48 U. KAN. L. REV. 1, 9 (1999) (discussing globalisation in the context of global public health and the World Health Organization). See also RAMESH MISHRA, GLOBALIZATION AND THE WELFARE STATE 15-16 (1999), at 3-4. With internationalisation, nation states remain the principal units for economic activity through international aspects of the economy, with trade and multinational enterprises of increasing importance to economic activity.

<sup>54</sup> Delbrück, *Id.* at 10-11. The European Union is hereafter the E.U.

<sup>55</sup> DOUG STACE, REACHING OUT FROM DOWN UNDER: BUILDING COMPETENCE FOR GLOBAL MARKETS, Ch. 1 (1997).

<sup>56</sup> *Id.* at 18. MISHRA, *supra* note 53, at 4, refers to globalisation proper as to a situation where distinct national economies cease to exist in that they are subsumed and rearticulated into the system by international processes and transactions. Mishra does not believe that the world is currently experiencing globalisation proper but rather internationalisation, although he uses the term globalisation to incorporate internationalisation; *Id.* at 4.



Globalisation may also be compared to nationalism, which can be seen as both a reaction against globalisation and is a product of globalisation.<sup>57</sup> In this regard Harris states<sup>58</sup>:

Globalisation forces a rethinking of the role of the nation state, its degree of autonomy in setting policies, and the degree to which national economics can usefully be analysed as separate units. It may well be that inter-national economics may become obsolete and be replaced by a focus on either the regional (time zone) economy or the global economy.

Regionalism involves a significant degree of geographical proximity and a high degree of economic interdependence to be successful. It involves a process of growing informal linkages and transactions derived primarily from economic activity but involving social and political interconnectedness.<sup>59</sup> Regionalism may involve a regional awareness or identity, interstate cooperation, state-promoted regional economic integration, or regional cohesion.<sup>60</sup> Regionalisation rather than full embracing of globalisation may be the preferable approach for United States Multi-National Enterprises (MNEs), although this recommendation was offered during the early period of financial globalisation, that is, the early 1990s.<sup>61</sup>

### **Globalisation and taxation generally**

As noted previously, globalisation has a far reaching impact beyond just financial instruments and commercial securities regulation; it extends to the taxation treatment of such instruments, and to the derivation of income and transactions involving goods and services.<sup>62</sup> As such, tax policy issues require resolution beyond the ability that any one nation has to conclude unilaterally, if global efficiency is to be maximised.<sup>63</sup>

Tanzi<sup>64</sup> observes that the connection between globalisation and taxation is particularly complex because of its interconnection with tax competition and because of the large number of actors involved. Globalisation increases the scope for tax competition because it provides countries with an opportunity to export part of their tax burden to other countries. Some countries will use or even abuse this opportunity. Tanzi also notes that tax competition may magnify the inevitable effects of globalisation.<sup>65</sup>

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<sup>57</sup> Nationalism is also an ideology, a movement, and is clearly related to international relations as the moral and normative basis for the system of states in justifying secession and territorial claims; see FRED HALLIDAY, *Nationalism*, in THE GLOBALIZATION OF WORLD POLITICS 15 (J. Bayliss and S. Smith eds. 1997). Halliday also questions whether we are moving into a post-nationalist age, and observes that nationalism has not disappeared; it fact it has benefited from globalisation as in part from resentment over globalization and through adjustment to continue to be relevant (*Id.* at 371-2).

<sup>58</sup> R. G. Harris, *Globalisation, trade and income*, 26 CAN. J. ECON. 773 (1993), cited in STACE, *supra* note 55, at 18.

<sup>59</sup> See FIONA BUTLER, *Regionalism and Integration*, in BAYLIS AND SMITH, *supra* note 57, at 410. For further discussion on regionalisation within the world economy, see JEFFREY A. FRANKEL (ED.), THE REGIONALIZATION OF THE WORLD ECONOMY, (1998).

<sup>60</sup> *Id.* at 410-11.

<sup>61</sup> See Morrison and Roth, *supra* n 51.

<sup>62</sup> For a discussion on the taxation of financial instruments and derivatives in particular, see Reuven S. Avi-Yonah and Linda Z. Swartz, *U.S. International Tax Treatment of Financial Derivatives*, 14 TAX NOTES INT'L 787 (1997).

<sup>63</sup> In addition to maximizing efficiency, other fundamental principles such as certainty, simplicity, equity, etc, should also be considered. The world economy has become the area of interest and focal point of activity rather than individual sovereign jurisdictions viewed in isolation.

<sup>64</sup> VITO TANZI, GLOBALIZATION, TAX COMPETITION AND THE FUTURE OF TAX SYSTEMS, 4 (IMF Working Paper WP/96/141, 1996), at 20.

<sup>65</sup> *Id.*

However, the complexity of the likely reactions of the countries makes the end result difficult to forecast.

Importantly, Tanzi contends that the fact that there is no world organization with the explicit responsibility to provide a sort of surveillance on the behaviour of countries in tax matters makes tax competition more likely.<sup>66</sup> Tanzi reiterates that tax competition is not always a good thing. In fact it may create difficulties for countries by<sup>67</sup>:

- eventually leading to lower tax revenue;
- by changing the structure of tax systems in directions not desired by policymakers; and
- by reducing the progressivity of tax systems thus making them less equitable.

### Harmonisation

Tax harmonisation may be viewed as one point on a continuum, which has total competition between nations to encourage investment in their jurisdiction at one extreme and complete harmonisation through identical tax systems (whether or not centrally administered) by all countries at the other extreme.<sup>68</sup> Countries may exhibit degrees of harmonisation or competition within their tax system. Harmonisation is a much debated issue, especially in the context of the E.U., where it has been fundamental to developing consistent indirect tax policy between member nations, but failed to gather any significant toehold for direct taxation.<sup>69</sup> One major factor in the reluctance for nations to harmonise taxes is that this impinges upon their sovereignty to set their own tax rates and base as considered necessary to meet the revenue needs and expenditure program set by the government.<sup>70</sup> This continuum is represented in Figure 1 below, which contains an example of each major point on the continuum currently in operation.

**Figure 1: Competition/Harmonisation Continuum**

<sup>66</sup> Tanzi has suggested elsewhere that a World Tax Organisation may be necessary. See Vito Tanzi, "Does the World Need a World Tax Organization?", paper presented at the 52nd Congress of the International Institute of Public Finance, Tel-Aviv, August 26-29, 1996. See also VITO TANZI, "Forces that Shape Tax Policy" in TAX POLICY IN THE XXI CENTURY, in Herbert Stein (ed.) (1988).

<sup>67</sup> Tanzi, *supra* n 64.

<sup>68</sup> For a definition of harmonisation, see e.g. Simon James and Lynne Oats, *Tax Harmonization and the Case of Corporate Taxation*, 8 REVENUE L. J. 36 (1998) and Simon James, *Tax Harmonization: What Does it Mean and What Form Should it Take?*, unpublished paper (1999). See also, Simon James, *Can we harmonise our views on European harmonisation?* 54 BULL. FOR INT'L FISCAL. DOC. 263 (2000).

<sup>69</sup> Part of the reason for the failure with direct tax harmonisation in the E.U. is the lack of a directive to do so in the Treaty of Rome forming the European Community; see TREATY OF ROME, Mar. 25, 1957, art. 99, 298 U.N.T.S. 11. Art. 99 mandates that signatories harmonise their indirect tax systems in order to achieve the free movement of goods and services within the common market. There is no equivalent article covering direct taxes although attempts have been made to find some basis for harmonising direct taxation in the E.U. The members of the unexpanded E.U. include Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. For a discussion on why taxes should be harmonised, in the context of the E.U., see Jeff Bowman, *Harmonisation of Direct Taxation within the European Community: Some implications for Australia*, 19 AUST. TAX REV. 256 (1990), at 256-8.

<sup>70</sup> Sovereignty is discussed in a later section of this paper; see section 2.7.

<i>Competition</i>		<i>Cooperation</i>		<i>Harmonisation</i>	
<i>Unregulated</i>	<i>Regulated</i>	<i>Regional or Partial</i>	<i>Global or Full</i>	<i>Regional or Partial</i>	<i>Global or Full</i>
Tax havens	Anti-trust Global trading of securities	OECD NAFTA APEC/ASEAN	GATT/WTO U.N.	E.U.	???

Tax competition may be defined as “competition between different tax jurisdictions to encourage businesses and individuals to locate in their areas.”<sup>71</sup> Debate continues over whether competition is desirable (it is certainly a fundamental concept underlying the free market system for global trading in goods and services and financial instruments), although a consensus has emerged in OECD nations at least, that competition, in the area of taxation at least, can be harmful and measures should be put into place to counter the distortions that arise.<sup>72</sup>

Tax cooperation, from an international perspective, represents a position lying between the extremes of this continuum, whereby nations work together for their mutual benefit but stop short of imposing obligations upon each other to operate identical tax systems. Cooperation is evident in the work of the OECD for its 30 member nations, and perhaps the most extreme form of cooperation (that falls short of harmonisation) currently is the E.U.’s direct taxation initiatives, especially in relation to corporate taxation.<sup>73</sup> The largest example of cooperation on an international scale to date is between the original 134 nations (now over 180 nations) that ratified the General Agreement on Trade and Tariffs of 1994<sup>74</sup> and the concurrent creation of the World Trade Organisation in 1995.<sup>75</sup> While harmonisation is not expected to progress significantly, the case for increased tax cooperation is clear.<sup>76</sup>

A further approach, tax unification, is discussed in the context of the E.U. by Hinnekens.<sup>77</sup> Tax unification is an advanced stage of tax harmonisation, which could be carried out in the E.U. through a supra-national European (Corporation) Tax. Such a proposal is dismissed by Hinnekens as falling outside the European Community’s

<sup>71</sup> See Simon James, *The Future International Tax Environment*, 29 INT’L TAX J. 1, 9 (1999) (defining competition).

<sup>72</sup> OECD, *HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE* (1998).

<sup>73</sup> See COMMISSION OF THE EUROPEAN COMMUNITIES, *REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION* (1992), [hereinafter the RUDING REPORT].

<sup>74</sup> Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Dec. 15, 1993, *LEGAL INSTRUMENTS –RESULTS OF THE URUGUAY ROUND* vol. 1 (1994), 33 I.L.M. 1 (1994). [Hereinafter referred to as the GATT].

<sup>75</sup> Marrakesh Agreement Establishing the World Trade Organization, *LEGAL INSTRUMENTS-RESULTS OF THE URUGUAY ROUND*, vol. 1 (1994) 33 I.L.M. 13 (1994). [Hereinafter referred to as the WTO.]

<sup>76</sup> James, *supra* note 71, at 9.

<sup>77</sup> Luc Hinnekens, *The Monti Report: The uphill task of harmonizing direct tax systems of EC member states*, 1 EC TAX REV 31 (1997), at 42-3. Hinnekens also uses tax coordination rather than tax cooperation and tax approximation (*Id.* at 43-45). See also RAMON J. JEFFERY, *THE IMPACT OF STATE SOVEREIGNTY ON GLOBAL TRADE AND INTERNATIONAL TAXATION: SERIES ON INTERNATIONAL TAXATION: NO 23*, (1999), at 133-168 (discussing the need for tax coordination in the E.U. and the rest of the (developed) world).

objectives and, in reality, is impossible to achieve in the context of the proposals I develop in this paper.

A hurdle in making further progress in the E.U. over direct tax harmonisation has been the absence of specific harmonisation requirements in the European Treaty.<sup>78</sup> A further frustration in some instances is the requirement for unanimous agreement.<sup>79</sup> In regional groupings which extend beyond one particular agreement, unanimity is more important than with only a single agreement that is left open for ratification and binding only on those that ratify<sup>80</sup> (assuming sufficient countries ratify the agreement to allow the agreement to be effective).<sup>81</sup> Some form of super-majority endorsement procedure<sup>82</sup> is recommended over a simple majority (greater than 50 percent) or a slow ratification approach (such as until unanimous ratification occurs).

Tax havens have been raised as an obstacle to establishing a unanimous agreement in the context of how they create unfair competition.<sup>83</sup> However, tax havens are extremely unlikely to be a party to any agreement in setting tax policy, given their reluctance to enter tax treaties in many instances.<sup>84</sup> However, certain OECD member countries that offer significant tax concessions, such as Ireland, Luxembourg and Sweden, are possible participants or signatories to the proposed international agreement.<sup>85</sup> Furthermore, it will be important to have transition and developing nations that are able to meet the criteria of an advanced and stable tax system, to be members of this international tax policy setting agreement.

### **Tax policy and coordination**

Markets promote efficiency through competition and the division of labour - the specialisation that allows people and economies to focus on what they do best. Global markets offer greater opportunity for people to tap into more and larger markets around the world. It means that they can have access to more capital flows, technology, cheaper imports, and larger export markets. But markets do not necessarily ensure that the benefits of increased efficiency are shared by all. Countries must be prepared to embrace the policies needed, and in the case of the poorest countries may need the support of the international community as they do so.

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<sup>78</sup> TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Feb. 7, 1992, O.J. (C 224) 1 (1992), [1992] 1 C.M.L.R. 573 (1992) [hereinafter referred to as the EC TREATY]. The EC TREATY, however, provides for indirect tax harmonization between member nations. See BEN TERRA AND PETER WATTEL, *EUROPEAN TAX LAW*, (2 ed., 1997). For a discussion of a recent recommendation for harmonisation of direct taxes within the E.U., see the RUDING REPORT, *supra* note 73.

<sup>79</sup> In the OECD this is overcome by members abstaining from voting rather than vetoing the arrangement, such as with the agreement over harmful competition; see OECD, *supra* note 5. In the E.U., the decision for several countries, including the United Kingdom, not to join, however, did not prevent monetary union from taking effect on January 1, 1999.

<sup>80</sup> For instance, the OECD's mutual assistance agreement; see OECD, *MULTILATERAL CONVENTION ON ADMINISTRATIVE ASSISTANCE IN TAX MATTERS* (1995).

<sup>81</sup> One instance of where this has been a "failure" within the OECD is the multilateral agreement on information sharing; see OECD, *id*; but relative success with the OECD's discussion paper on curbing harmful tax competition; see OECD, *supra* note 5.

<sup>82</sup> A majority vote in the range of 75 to 80 percent would be necessary for ratification.

<sup>83</sup> See OECD, *supra* note 5, on harmful tax competition.

<sup>84</sup> For a discussion on United States tax haven activity, see GARY C. HUFBAUER AND JOANNA M. VAN ROOIJ, *U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM*, ch. 3 (1992), at 152-6.

<sup>85</sup> For instance, Luxembourg and Switzerland abstained rather than voted against and therefore would prevent the release of the OECD's report on harmful competition; see OECD, *supra* note 5.

Commentators have also suggested that the current approach to handling international tax issues through bilateral treaties is outdated and inefficient,<sup>86</sup> reinforced by the philosophy behind the first League of Nations Model Treaty,<sup>87</sup> and as subsequently developed by the OECD. The OECD's contributions initially were in an era when the U.S. was a primarily an exporter of capital, preferring capital export neutrality and a residence-based taxation approach.<sup>88</sup>

Owens<sup>89</sup> considers the option of co-ordination or 'peaceful co-existence'. Here the objective is to have tax systems which are responsive to market forces, which can reflect the specific situation found in each country and which at the same time do not interact in ways which adversely affect the international allocation of resources. Co-ordination, argues Owens,<sup>90</sup> can play a useful role in preventing large countries taking unilateral actions which impose costs on other countries, particularly on small, open economies. Only by co-ordination, contends Owens,<sup>91</sup> can a certain degree of national autonomy be maintained in tax policy. The question is, can this be achieved and if so, how? Owens aptly suggests that any new initiatives should build upon the existing instruments and existing institutions, including the current large network of tax treaties.

Owens suggests that the following initiatives could be added to assist with coordination:<sup>92</sup>

- 1) *Developing guidelines for the use of tax incentives.* This would require agreement on what constitutes a tax incentive, how its cost should be measured, and its likely effects. The [New Independent States] (NIS), the eastern European countries, the EC and NAFTA countries - or more ambitiously the OECD countries - would be in a position to implement such agreements. A second option would be to encourage the development of internationally comparable tax expenditure accounts so that cross-country comparisons of the significance of deviations from the normal corporate tax regimes could be evaluated. Thirdly, countries could be encouraged to move from tax allowances and holidays towards tax credits since this would improve the transparency of the subsidies (although

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<sup>86</sup> See e.g. Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region* (Part 1 and 2), 45 BULL. INT'L FISCAL DOC. 99, 103 (1991), 45 BULL. INT'L FISCAL DOC. 151 (1991), and John Azzi, *Tackling Tax Treaty Tensions: Time to Think about an International Tax Court*, 52 BULL. INT'L FISCAL DOC. 344, 349-50 (1998).

<sup>87</sup> *Report Presented by the Comm. Of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C216 M.85 1927 II (1927), and see e.g. Michael J. Gratez and Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L. J. 1021 (1997), for a discussion of this treaty.

<sup>88</sup> For a discussion on capital export neutrality versus capital import neutrality, see GARY C. HUFBAUER AND JOANNA M. VAN ROOIJ, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM, ch. 3 (1992), and Daniel J. Frisch, *The Economies of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581 (1990). Capital export neutrality refers to a system where a resident of a country will be taxed at a given rate regardless of where the income is generated, see C. Neil Stephens, *A Progressive Analysis of the Efficiencies of Capital Import Neutrality*, 30 LAW & POL'Y INT'L BUS. 159, 161 (1998). This may be compared to capital import neutrality, which is a system where a resident of a country will not be taxed at a given rate regardless of where the income is generated. Taxpayers are taxed based on the source of their income, that is, only the country where the income is generated has taxing authority over the income, see Stephens, *Id.* at 163.

<sup>89</sup> Owens, *supra* n 3 at 41-44.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

cash grants would be even more transparent). Fourthly, the international community could try to develop common guidelines for the types of tax incentives which would be eligible for tax-sparing provisions in countries which do not have the exemption system in their tax treaties (although another solution would be to follow the United States approach which denies tax sparing altogether).

- 2) *Convergence of taxes on income and capital.* The OECD and other international organisations should encourage a gradual convergence of the income tax regimes in developed countries by:
  - a) Monitoring developments and trying to get agreement on the economic and other effects of different taxing techniques; and
  - b) Examining new developments, particularly in financial markets, with the aim of reaching an international consensus on how these developments should be treated for tax purposes and thereby pre-empting national legislation.
- 3) *New guidelines for allocating income and expenses within an MNE.* The implementation of the guidelines should be monitored and backed up by new forms of co-operation such as simultaneous examinations and advance transfer pricing agreements.
- 4) *Facilitating exchange of information.* A new framework should be put in place to facilitate the exchange of information and other assistance measures on a multilateral basis. In a global economy, even an extensive network of bilateral treaties is a second-best solution to a multilateral approach which provides a uniform application and interpretation of provisions.
- 5) *Compulsory arbitration.* The mutual agreement procedure set out in Article 25 of the OECD Model Tax Convention is time-consuming for both taxpayers and tax administrators and there are a very small number of cases where no agreement is reached. It is also unclear how far businesses avoid using this procedure because of these problems. Owens states that this raises the question of whether we can go beyond this article to establish a compulsory arbitration procedure and a multinational arbitration body (similar to the GATT panels).
- 6) *From bilateralism to multilateralism.* It is unlikely that countries would accept replacing the existing bilateral treaty network with a series of multilateral treaties. There are, however, a number of measures which could improve the operation of the existing bilateral treaty network, either by providing for more uniform provision or for a more uniform interpretation. These include:
  - encouraging OECD and other countries to follow more closely the provisions in the OECD model;
  - within regional groupings and also at the level of the OECD, developing the concept of multilateral pre-negotiating sessions for bilateral discussions;
  - examining the feasibility of putting certain Articles (e.g. non-discrimination) onto a multilateral basis;
  - buttressing the status of the OECD commentaries by giving them greater legal force;
  - examining ways of having a multilateral adaptation of treaties to changes in national legislation (e.g. multilateral exchanges of letters, protocols, etc.);

- bringing in non-member countries to the discussion of the OECD's Committee on Fiscal Affairs so that they obtain a better understanding of the interpretation of the OECD model and have an impact on its ongoing revision.
- 7) Developing effective mechanisms for taxing interest payments received by non-residents. These are two interrelated ways to approach this problem, according to Owens. The first is to develop an effective exchange of information programme encompassing all countries (and not just the OECD countries) which are major financial centres. The second approach would be to develop a generalised withholding tax regime that would apply to all interest payments to individuals.

Owens emphasises that the challenge that policymakers face in this new interdependent environment, both in the old and new democracies, is to design tax policies that will improve the allocation of capital, reinforce market-oriented behaviour and lead to higher living standards for all. An international framework exists to achieve this co-ordination but the existing institutions should be given a wider mandate to develop some of the instruments referred to above, to monitor their implementation, and in the case of the OECD to reach out to non-member countries, particularly the Asian and Latin American countries which are now major players in the world economy.<sup>93</sup> Owens notes that it remains unclear as to whether national governments are prepared to see this framework strengthened so that national policies are determined within a multilateral framework. Only with such coordination can small and not-so-small economies reap the benefits of a global market system but maintain a high degree of economic sovereignty.<sup>94</sup>

Owens concludes that to develop procedures for a co-existence of divergent tax systems is the challenge that faces tax policymakers in the twenty-first century. If they fail to respond to the challenge, they may find that a "little tax competition" is far more constraining than a "small amount of coordination".<sup>95</sup>

### **Tax policy and treaties**

Tax policy is determined by processes adapted to fit the aspirations of tax policymakers working under the delegated authority of government officials, usually with the interests of the sovereign nation foremost.<sup>96</sup> Only recently has some noticeable similarity in approach for devising and revising tax policy emerged, particularly in OECD countries through adoption of the OECD Model Tax Convention on Income and on Capital,<sup>97</sup> the OECD's Multilateral Convention on Administrative Assistance in Tax Matters,<sup>98</sup> and the OECD's Transfer Pricing Guidelines.<sup>99</sup> Similar convergence is arising in the E.U., especially in the area of consumption taxes.<sup>100</sup>

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<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> For a discussion on tax policy processes in several nations, see Adrian J. Sawyer, *Broadening the Scope of Consultation and Strategic Focus in Tax Policy Formulation: Some Recent Developments*, 2 N.Z. J. TAX'N L. & POL'Y 17 (1996).

<sup>97</sup> OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (1995) [hereinafter OECD MODEL TAX CONVENTION].

<sup>98</sup> COUNCIL OF EUROPE AND OECD, EXPLANATORY REPORT ON THE CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS, (1989). See also OECD, *supra* n 80.

<sup>99</sup> OECD, TRANSFER PRICING GUIDELINES FOR MULTILATERAL ENTERPRISES AND TAX ADMINISTRATIONS (1995).

<sup>100</sup> See various reports and commentaries on the results of the Ruding Committee Report (RUDING REPORT, *supra* n 73). Commentaries on this report include: Jens Blumenberg and Richard G. Minor,

Currently there are three major model tax convention models, namely the OECD's Model Tax Convention,<sup>101</sup> the United Nations Model Tax Convention<sup>102</sup> and the United States Model Tax Convention.<sup>103</sup> While this study focuses on international tax policy issues, it is also important to appreciate that international tax policy is traditionally a product of domestic tax policy processes and efforts to arrive at some degree of international cooperation and agreement.<sup>104</sup> Important concepts in international taxation policy development include residence,<sup>105</sup> source,<sup>106</sup> the taxation of residents compared to non-residents,<sup>107</sup> destination and origin as consumption tax principles relating to jurisdiction,<sup>108</sup> the importance of neutrality and other traditional tax principles.<sup>109</sup> Other fundamental concepts warranting further exposition include harmonisation, cooperation and competition,<sup>110</sup> and their impact upon sovereignty,<sup>111</sup> and the role of tax treaties in protecting and relaxing sovereignty in an attempt to

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*Ruding Committee Report Unveiled: New Measures Proposed for Company Taxes in EC*, 4 TAX NOTES INT'L 563 (March 23, 1992); Michael Daly, *Harmonization of Corporate Taxes in a Single European Market: Recent Developments and Prospects*, 40 CAN. TAX J. 1051 (1992); and Maarten J. Ellis, *Direct Taxation in the European Community: An Irresistible Force Meets an Immovable Object*, 28 WAKE FOREST L. REV. 51 (1993). See also in this regard, MALCOLM GAMMIE AND BILL ROBERTSON, *Beyond 1992: A European Tax System: Institute for Fiscal Studies' Commentary No. 13.*, in PROCEEDINGS OF THE FOURTH INSTITUTE FOR FISCAL STUDIES RESIDENTIAL CONFERENCE, (Malcolm Gammie and Bill Robertson eds., 1989).

<sup>101</sup> OECD MODEL TAX CONVENTION, *supra* note 97.

<sup>102</sup> U.N. DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES at 243, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.xvi.3 (1980) [hereinafter U.N. MODEL TAX CONVENTION].

<sup>103</sup> UNITED STATES MODEL INCOME TAX CONVENTION of September 20, 1996 [Hereinafter referred to as U.S. MODEL TAX CONVENTION]. See in particular, the commentary by RICHARD L. DOERNBERG AND KEES VAN RAAD, 1996 US INCOME TAX CONVENTION: ANALYSIS, COMMENTARY AND COMPARISON (1997).

<sup>104</sup> See e.g. Sawyer, *supra* note 96.

<sup>105</sup> See e.g., RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 19-20 (2d ed. 1993), at 19-20, and Vann, *supra* note 46, at 729.

<sup>106</sup> See Vann, *supra* note 46, at 734. See also Robert A. Green, *The Future of Source-Based Taxation of the Income of Multi-National Enterprises*, 79 CORNELL L. REV. 18 (1993), for a discussion on the future of source as a concept with application to MNEs. For a discussion on some of the problems in tax treaties relating to source, see John F. Avery Jones et al., *Tax Treaty Problems Relating to Source*, BRIT. TAX REV. 222 (1998).

<sup>107</sup> See e.g. DOERNBERG, *supra* note 105.

<sup>108</sup> See e.g. Luc Hinnekens, *The Challenges of Applying VAT and Income Tax Territoriality Concepts and Rules to International Electronic Commerce*, 26 INTERTAX 52 (1998) and Adrian Ogley, *VAT and Telecommunications Services in the European Union*, 14 TAX NOTES INT'L 1155 (April 7, 1997), discussing these concepts in the context of electronic commerce.

<sup>109</sup> For an excellent discussion on the role of source and residence principles and other important tax principles in international taxation for the twenty-first century, see Donald J.S. Brean, *Here or There? The Source and Residence Principles of International Tax*, in TAXATION TO 2000 AND BEYOND 303 (Richard M. Bird and Jack M. Mintz eds., Canadian Tax Paper No. 93, 1992).

<sup>110</sup> See James, *supra* note 8, for a discussion on what is meant by harmonisation, and cooperation, as compared to competition.

<sup>111</sup> Sovereignty has political and cultural connotations which are relevant to this paper. Politically, sovereignty holds that the exercise of political authority can only take place within clearly defined territorial boundaries and that the territorial integrity of the modern nation-state is untouchable; see Daniel Salée, *NAFTA, Quebec and the Boundaries of Cultural Sovereignty; The Challenge of Identity in the Era of Sovereignty*, in JOINING TOGETHER, STANDING APART: NATIONAL IDENTITIES AFTER NAFTA 73, 81, (Dorinda G. Dallmeyer ed., 1997). Cultural sovereignty may refer to groups of people within a nation-state or the nation-state itself (or a region), but this is increasingly becoming pluralistic; see *Id.* at 75.



arrive at a consensus between signatories.<sup>112</sup> Culture is a further variable requiring consideration.<sup>113</sup>

### **Sovereignty – A key inhibiting factor**

Crucial limitations or inhibitors to effectively implementing a multilateral agreement or treaty of the nature envisioned by this study exist, including a number of constitutional and jurisprudential concerns that could arise should a country be prepared to forgo or place restrictions on its sovereign rights to determine tax policy.<sup>114</sup> Furthermore, the traditionally held stance that tax policy may be utilised to implement national social policy goals restricts the willingness of nations to give up further control over their tax system.<sup>115</sup>

Sovereignty<sup>116</sup> has been raised in the context of international trade<sup>117</sup> and regionalism,<sup>118</sup> globalisation,<sup>119</sup> subsidiarity in the E.U.,<sup>120</sup> and taxation.<sup>121</sup> A related issue is that of how cultural differences between nations act as an inhibitor to closer harmonisation between nations.<sup>122</sup>

In relation to taxation, sovereignty may be viewed as "... the power of a sovereign to affect the rights of persons, whether by legislation, by executive decree, or by the judgment of a court...", and may be termed jurisdiction.<sup>123</sup> Sovereignty is the bundle of rights that go to make up the nation state, and is therefore analogous to statehood. The sovereign state is bound by its own constitution (internal dimension) and

<sup>112</sup> Bilateral tax treaties create numerous interpretation difficulties, a multilateral treaty is not dissimilar in this respect; see e.g. Russell K. Osgood, *Interpreting Tax Treaties in Canada, The United States and the United Kingdom*, 17 CORNELL INT'L L. J. 255 (1984). See also, PHILIP E. POSTLEWAITE, AND TAMARA L. FRANTZEN, *INTERNATIONAL TAXATION: UNITED STATES TAX TREATIES*, (1993), and Julie A. Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753 (1995).

<sup>113</sup> See e.g. Salée, *supra* n 111, and Grant Richardson and Roman Lanis, *Harmonizing Taxation Law within APEC: A Fiscal and Cultural Analysis*, 50 BULL. FOR INT'L FISCAL DOC. 430 (1996).

<sup>114</sup> For a discussion of how international organisations impact upon national sovereignty, see Lori Fisler Damrosch, "Sovereignty" and *International Organizations*, 3 U.C. DAVIS L. REV. 159 (1997).

<sup>115</sup> See e.g. H. David Rosenbloom, *Sovereignty and the Regulation of International Business in the Tax Area*, 20 CAN.-U.S. L. J. 267 (1994). In the context of the European Community, see RUDING REPORT, *supra* note 73.

<sup>116</sup> Here I am referring to sovereignty in the context of jurisdiction in disputes, where nations frequently assert national sovereignty over their territory, see Alan M. Simon and Spencer Weber Waller, Essay: *A Theory of Economic Sovereignty: An Alternative to Extraterritorial Jurisdictional Disputes*, 22 STAN. J. INT'L L. 337 (1986).

<sup>117</sup> See Horagio A. Gregeria-Naon, *Sovereignty and Regionalism*, 27 LAW. & POL'Y INT'L BUS. 1073 (1996), and Ivo Van Bael, *Comments on "Sovereignty and Regionalism"*, 27 LAW. & POL'Y INT'L BUS. 1181 (1996) and Gary N. Horlick, *Sovereignty and International Trade Regulation*, 20 CANADA-U.S. L. J. 57 (1994).

<sup>118</sup> See Gregeria-Naon, *supra* note 117.

<sup>119</sup> See Philip R. Trimble, *Globalization, International Institutions, and the Erosion of National Sovereignty and Democracy*, 95 MICH. L. REV. 1944 (1997).

<sup>120</sup> See e.g. Paul D. Marquardt, *Subsidiarity and Sovereignty in the European Union*, 18 FORDHAM INT'L L. J. 616 (1994) and B.H. Ter Kuile, *Legal aspects of fiscal sovereignty within the internal market*, INTERTAX 503 (1991).

<sup>121</sup> Rosenbloom, *supra* n 115.

<sup>122</sup> See Richardson and Lanis, *supra* n 113, and Grant Richardson, Roman Lanis and Frank Clarke, *Cultural Impediments to the Harmonization of National Taxation Systems: The European Union Experience*, unpublished paper (1998). See also Daniel Salée, *supra* note 111.

<sup>123</sup> Joseph H. Beale, *The Jurisdiction of a Sovereign State*, 26 HARV. L. REV. 241, 241 (1923). Beale only considers sovereignty and jurisdiction in the traditional physical realm, which at the time of his analysis, was the dominant perspective. While a sovereign's jurisdiction would be limited to its territory, it could extend beyond that with the agreement with the sovereign of the other territory.

international law (external dimension).<sup>124</sup> Jurisdiction, on the other hand, refers to a state's right of regulation manifested in its judicial, administrative and legislative competence. It is a subset of sovereignty and therefore increased jurisdiction cannot extend a nation's sovereignty.<sup>125</sup> Jurisdiction has both personal<sup>126</sup> and territorial<sup>127</sup> bases. The territorial basis was created in a geographical context of physical nation states, a concept which now fails to represent the new integrated or globalised economy.<sup>128</sup> Sovereignty in relation to the power to tax has been interpreted to mean that in the absence of an agreement or treaty arrangements, the courts of one country will not recognise or enforce revenue judgments or orders made by the courts of other countries.<sup>129</sup> This position is under considerable pressure and threat from the increasingly globalised economy and the Internet.

Sovereignty creates a puzzle in that the sovereignty of a nation-state on the one hand figures importantly in the descriptions of, and prescriptions for, global political change.<sup>130</sup> By way of contrast, sovereignty, as a result of the contemporary realities of global affairs has, according to Lee, become irrelevant, an anachronistic notion. Global economic integration is the most significant factor that has restricted or perhaps rendered nonexistent the sovereignty of states.<sup>131</sup> Nevertheless, Lee attempts to solve the puzzle how sovereignty can be both continually important and increasingly irrelevant to an understanding of world affairs. In the course of his argument, Lee presents sovereignty as four types of power, which are represented in Figure 2 below<sup>132</sup>:

**Figure 2: Mode of Power (or Sovereignty)**

Locus of power (or sovereignty)	<i>De jure</i>	<i>De facto</i>
Officials	Legal power (sovereignty)	Coercive power (sovereignty)
Populace	Electoral power (sovereignty)	Civil power (sovereignty)

One interesting issue raised by another scholar in this area is that even if sovereignty is lost by a nation, is it necessarily lost irrevocably because someone else gains it?<sup>133</sup>

<sup>124</sup> Dale Pinto, *Globalisation and the Twilight of Fiscal Sovereignty: Is it the End of the Nation State?*, PROCEEDINGS OF THE 10TH ANNUAL AUSTRALASIAN TAX TEACHERS ASSOCIATION CONFERENCE (Sydney: Aust, Monash U., Feb. 2000), at 7. This study has since been published and updated; see Dale Pinto, *Through the World's Eye: Governance in a Globalised World*, 9(3) MURDOCH U. ELEC. J. L. (September 2002).

<sup>125</sup> *Id.* at 7.

<sup>126</sup> Nationality or domicile of person, which forms the basis of residence in taxation.

<sup>127</sup> Traditionally regulation over persons and things within the geographical (or legal) boundaries of a state; the source basis of taxation.

<sup>128</sup> Pinto, *supra* note 124, at 8-9.

<sup>129</sup> *Id.* at 12. See generally Adrian J. Sawyer, *Enforcing New Zealand's Tax Laws via International Tax Recovery Agreements*, 54 BULL. FOR INT'L FISCAL DOC. 34 (2000).

<sup>130</sup> Stephen Lee, *A Puzzle of Sovereignty*, 27 CAL. W. INT'L L. J. 241 (1997).

<sup>131</sup> See *Id.* at 241-2.

<sup>132</sup> *Id.* at 250.

<sup>133</sup> See Neil MacCormick, *Beyond the Sovereign State*, 56 MOD. L. REV. 1, 11 (1993).

Sovereignty is not a universally defined concept, a fact which contributes to the debate over the impact that globalisation is having on sovereignty, especially within its legal and political dimensions.<sup>134</sup> It can be argued that no sovereign states remain any more in Western Europe (the E.U. in particular), but this does not mean there is a sovereign European Community in their place.<sup>135</sup> The implication of this argument for rethinking jurisprudence and legal philosophy, however, is beyond the scope of this paper. Notwithstanding the argument that sovereign states no longer exist, sovereignty, or what is left of it, is jealously guarded (or raised in opposition to proposals for change), for example, by the European Member states when it comes to direct tax harmonisation<sup>136</sup> and to jurisdiction.<sup>137</sup> Therefore sovereignty remains a hurdle to be overcome if the proposed international tax policy setting and dispute resolution process is ever to become a practical reality.

In relation to the social impact of globalisation, there is a necessary trade-off between globalisation and sovereignty, which Rugman has illustrated by the following matrix, as set out in Figure 3<sup>138</sup>:

**Figure 3: Globalisation and Sovereignty**

		Sovereignty	
		Low	High
Globalisation	High	1	3
	Low	2	4

Progress towards instigating some form of mutual policy process and international tax organisation will be challenged by obstacles and enhanced through various facilitating factors. To gain an appreciation of these obstacles requires a comprehensive review of

<sup>134</sup> See generally, *Id.*

<sup>135</sup> See *Id.* at 16.

<sup>136</sup> For instance, proposals for harmonizing direct taxation in the E.U. were largely rejected by the European Commission; for a discussion of the recommendations for change and accompanying comments, see RUDING REPORT, *supra* note 73. See also, M. Daly, *Annex 9A: Tax Coordination and Competition in Canada: Some Lessons for the European Community*, in the RUDING REPORT, at 383; P. Thalmann, *Annex 9B: Tax Coordination and Competition in Switzerland*, in the RUDING REPORT, at 397; Joann E. Weiner, *Annex 9C: Tax Coordination and Competition in the United States of America*, in the RUDING REPORT, at 417; Albert J. Rädler, *Annex 10A: Harmonization of Corporate Income Tax Systems within the European Community*, in the RUDING REPORT, at 439; and K. Messere, *Annex 10B: Dissenting View on the EC Corporation Tax System as Proposed in Annex 10A*, in the RUDING REPORT, at 461.

<sup>137</sup> See JEFFERY, *supra* note 77, at 25-60 (discussing sovereignty, jurisdiction and their interaction under international law, including fiscal jurisdiction;) see also *Id.* at 117-131, (discussing extraterritorial enforcement of revenue laws, such as by way of tax recovery agreements).

<sup>138</sup> ALAN M. RUGMAN, *Drawing the Border for a Multinational Enterprise and a Nation-State*, in LORRAINE EDEN AND EVAN H. POTTER (eds.), *MULTINATIONALS IN THE GLOBAL POLITICAL ECONOMY* 84-100, 86 (1993), at 89-91. The shaded area in quadrant 3 represents the current area where the problems of globalisation and sovereignty co-exist.

the general constitutional, jurisprudential and in particular, the sovereignty environment, predominantly in OECD countries. A comprehensive analysis is beyond the scope of this paper. Jurisdictional preferences currently provided through national revenue statutes will need to be accommodated for in some manner if they are not to be an insurmountable hurdle to developing policy that maximises global revenue from an efficiency perspective.<sup>139</sup>

It is anticipated that any recommendations culminating in a mutual tax policy setting process and appropriate form(s) of institution to resolve disputes associated with this process are expected to be contentious. To fully develop the proposals the necessary form of regulation or scope of a collective authority that is appropriate to facilitating a mutual approach, in the context of globalisation, need to be investigated. Furthermore, development of any policy and organisation is anticipated to require treaty modifications.<sup>140</sup> Not surprisingly, tax treaties and their interpretation will be a major factor in developing aspect of this study further, including multilateral treaties and the problems associated with arriving at an agreement.<sup>141</sup>

Determining a consistent tax base for application of tax policy is also important, (but beyond the scope of this paper), although consistency in tax policy, I would argue, extends beyond merely having a consistent tax base, to areas such as information disclosure and sharing, and employing fundamental principles consistently, such a taxation on a source or a residence basis. One further issue is whether any policy should have retroactive effect in particular defined circumstances.<sup>142</sup>

### **Importance of globalisation for international tax policy**

Lessard and Gagnon state:<sup>143</sup>

The accelerated pace of globalisation of the world's economy is certainly the single most important factor explaining the rise in the importance afforded to

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<sup>139</sup> See *Id.* for a further discussion of taxation as a social expenditure and revenue raising instrument and national sovereignty.

<sup>140</sup> See Julie A. Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753 (1995). One area in which revision may currently be required is the non-discrimination rules; see Robert A. Green, *The Troubled Rule of Non-discrimination in Taxing Foreign Direct Investment*, 26 LAW & POL'Y INT'L BUS. 113 (1994). See also, H. David Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL'Y 77 (1991). One further advantage with a multilateral agreement is that treaty-shopping for the most favourable tax treatment should be reduced; see Mimi E. Gild, *Tax Treaty Shopping: Changes in U.S. Approach to Limitation on Benefits Provisions in Developing Country Treaties*, 30 VA. J. INT'L L. 553 (1990). Placing too much weight on tax treaties as they are currently employed can be futile – instances of domestic legislative override abound where inconsistent legislation is enacted after a treaty has been negotiated and ratified; the U.S. is especially “guilty” of this practice. See e.g. Committee on U.S. Activities of Foreign Taxpayers and Foreign Activities of U.S. Taxpayers of the New York State Bar Association Section of Taxation, *Legislative Overrides of Tax Treaties*, 37 TAX NOTES 931 (November 30, 1987), reprinted in TAX ANALYSTS, SELECTED READINGS ON TAX POLICY: 25 YEARS OF TAX NOTES, 434 (1997).

<sup>141</sup> Several approaches have been applied to investigating how agreements may be arrived at or how disputes may arise, including the prisoners' dilemma, brinkmanship, and political grandstanding. For an example of the first, see the discussion in Robert D. Cooter, Symposium: *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA L. REV. 1643 (1986).

<sup>142</sup> For a discussion of the impact of retroactive taxation from an Australian and New Zealand perspective, see Warwick W. Anderson and Adrian J. Sawyer, *Legislative Complexity: The Need for Appropriate Variables and Some Likely Candidates*, 3 N.Z. J. TAX'N L. & POL'Y, 3 (1997) (providing a New Zealand comparative analysis to a prior Australian study).

<sup>143</sup> PIERRE A. LESSARD AND CHARLES C. GAGNON, *International Tax Compliance*, PROCEEDINGS OF THE 48TH TAX CONFERENCE (Can. Tax Foundation) 39:1-34, 1 (1996).

international tax compliance issues. Rapid globalisation affects tax compliance issues in a number of ways. Multinational corporations are enlarging their web of subsidiaries and have increasingly complex international structures, while small and medium-sized businesses are becoming more import- and export-oriented in order to survive in the highly competitive global marketplace. Entrepreneurs, professionals, and highly skilled employees are increasingly receptive to opportunities offered to them abroad and are therefore more mobile than ever before. The foregoing has led to an increase in the proportion of corporate and individual taxpayers having an international exposure and, hence, access to international tax-planning opportunities to reduce their overall tax burden.

Globalisation has been facilitated by rapid technological changes which are rendering traditional fiscal sourcing rules obsolete. Online sales and marketing activities are diminishing the need for a permanent local sales work force, and reducing the number of circumstances where firms must maintain permanent establishments. Improvements made to telecommunications have undermined the importance of physical location for financial intermediaries. This has led to the establishment of international financial centres in places which would have simply been unthinkable in the past (such as Ireland and Barbados) in order to benefit from the fiscal advantages offered by those jurisdictions.”

Tanzi examines the impact of globalisation on taxation, including the growth in tax competition and how this may impact upon the future of taxation<sup>144</sup>:

The benefits from the process of globalisation are many and some are obvious:

- a) world resources are better allocated; thus, output and standards of living rise;
- b) because of the greater access to foreign goods, individuals enjoy a greater range of choice in goods and services;
- c) because the cost of travel has fallen significantly (in time and money), many individuals are able to visit far away places;
- d) the amount and range of information available to individuals has increased enormously while the cost of getting information has fallen dramatically.

Tanzi goes on to observe<sup>145</sup>:

The significance of these benefits [from the process of globalisation] can be easily appreciated. But, as is often the case, these developments also bring some negative aspects. Globalisation can create or aggravate, potential problems. It is, thus, important to control these negative developments so that they are prevented from becoming large enough to cast a bad light on the process of globalisation and to provoke policies aimed at reversing the recent trends. ...

Globalisation implies that many national policies come to have effects beyond a country's borders. It, thus, tends to create frictions between the developments described above and traditional, national policies or institutions which, to a large extent, still reflect the closed-economy environment and thinking that existed when they were first developed or created. ...

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<sup>144</sup> Tanzi, *supra* n 64, at 4.

<sup>145</sup> *Id.* at 4. Emphasis added.

The tax systems of many countries came into existence or developed at a time when trade among countries was greatly controlled and limited and when large capital movements were almost non-existent. ...

In the environment described above the application of what is sometimes called the “territoriality principle,” which gives a country the right to tax all incomes and activities within its territory, did not cause conflict or difficulty. Tax policies by any one country could be pursued without much concern or much thought about how they would affect other countries. Equally, the tax policies of other countries were of only marginal, if any, interest to a country’s policymakers because they did not affect the behaviour of its citizens. ...

Globalisation and the progressive integration of world economies have been changing all this. In the present environment the actions of many governments have come to be greatly constrained or influenced by the actions of other governments, and spillover-effects across frontiers generated by taxation have become common and important.”

Tanzi concludes his study by stating<sup>146</sup>:

The connection between globalisation and taxation is particularly complex because of its interconnection with tax competition and because of the large number of actors. Globalisation increases the scope for tax competition because it provides countries with an opportunity to export part of their tax burden to other countries. Some countries will use or even abuse this opportunity. Tax competition may magnify the inevitable effects of globalisation. However, the complexity of the likely reactions of the countries makes the end result difficult to forecast. The fact that there is no world organization with the explicit responsibility to provide a sort of surveillance on the behaviour of countries in tax matters makes tax competition more likely.

The world is waking up to the realization that tax competition is not always a good thing. In fact it may create difficulties for countries by (a) eventually leading to lower tax revenue; (b) by changing the structure of tax systems in directions not desired by policymakers; and (c) by reducing the progressivity of tax systems thus making them less equitable.

...The limited evidence available indicates that so far the effect of globalisation and tax competition on total<sup>147</sup> tax revenue has been limited. However, the impact on tax structures<sup>148</sup> is more evident. This impact is likely to accelerate with the passing of time. It is only a question of time before the level of taxation begins to reflect the forces at work.

Globalisation is clearly highlighting the debate over the desirability of tax competition. Avi-Yonah argues, in this regard, that<sup>149</sup>:

[t]he mobility of capital is linked to tax competition, in which sovereign countries lower their tax rates on income earned by foreigners within their

<sup>146</sup> *Id.* at 20-21. Emphasis added. The issue of the absence of a world organization to undertake surveillance of countries with respect to tax competition is revisited by Tanzi. *See also*, VITO TANZI, *Is there a Need for a World Tax Organization?*, in ASSAF RAZIN AND EFRAIM SAKA (EDS.), *THE ECONOMICS OF GLOBALIZATION: POLICY PERSPECTIVES FROM PUBLIC ECONOMICS* 173 (1999) (discussing the possible role of a General Agreement on Trade, Tariffs and Taxes (GATT) as part of the WTO).

<sup>147</sup> Emphasis in original.

<sup>148</sup> Emphasis in original.

<sup>149</sup> Avi-Yonah, *supra* note 2, at 1. Emphasis added.

borders in order to attract both portfolio and direct investment. ... Thus, globalisation and tax competition lead to a fiscal crisis for countries that wish to continue to provide social insurance to their citizens at the same time that demographic factors and the increased income inequality, job insecurity, and income volatility that result from globalisation render such social insurance more necessary. The result is increasing pressure to limit globalisation (e.g., by re-introducing exchange controls) which risks reducing world welfare.

Avi-Yonah argues that if both globalisation and social insurance are to be maintained, it is necessary to cut the intermediate link by limiting tax competition in a way that is congruent with maintaining the ability of democratic states to determine the desirable size of their government.<sup>150</sup>

Pinto observes, in relation to the impact that globalisation is having on taxation policy, that<sup>151</sup>:

Leaving considerations of intensified tax competition aside, the sheer speed and borderless mobility of transactions in the globalise economy has called into question the ability to apply traditional transactional analysis inherent in transfer pricing laws. With no national borders, work on the same project can be undertaken in several countries, with intranets allowing the sharing of information. These new collaborative opportunities produce many challenges in applying traditional methods underlying transfer pricing rules. While globalisation and electronic commerce may not necessarily present any unique problems for transfer pricing, the growth of electronic commerce will be likely to make some of the transfer pricing problems more common.

Tax treaty concepts (such as permanent establishment) are also challenged by globalisation and new technologies. The combination of the Internet and globalisation has allowed taxpayers to operate internationally for low cost, 24 hours a day, 7 days a week. Global communication systems will see an increase in cross-border activities and may dispense with the need for businesses to maintain a sales force or distribution network to do business in a country. In a business sense, this means that simple and cheap access to global markets will be available and the barriers of distance and location have disappeared. In a legal sense, this puts pressure on concepts such as 'permanent establishment' contained in most double tax agreements that Australia has entered into.

In relation to the jurisdiction to tax, jurisdiction has traditionally been based on geographical territorial connections. Generally, therefore, entities or individuals need to be geographically located (resident) or the source of income needs to be located in a country for jurisdiction to be asserted. Practical jurisdiction depends on an identified taxpayer (and also assets) being located in a jurisdiction. While it may be argued that jurisdictional rules have always been a problem for revenue authorities, they have been relatively contained, but now even smaller organisations can trade and bank globally, and location and identity become more difficult to determine.

Pinto goes on to observe<sup>152</sup>:

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<sup>150</sup> *Id.* at 1.

<sup>151</sup> Pinto, *supra* note 124, at 14. Emphasis added.

<sup>152</sup> *Id.* at 15-16. Emphasis added. Footnote references omitted. For further discussion on the implications of electronic commerce for governments and revenue authorities, and the administration of the tax

In sum, the absence of borders and the lack of border controls undermines the jurisdictional rules of source and residency as they are currently formulated and applied. This is because transactions on the Internet occur everywhere, but nowhere in particular, or as one writer has put it ‘the trouble with cyberspace ... is that there’s no “there” there.

A related problem posed by globalisation and the Internet is the anonymity it offers and the difficulty of isolating where a transaction occurs.

...More pressure is brought to bear on tax laws by the intangible nature of many goods and services that can be delivered via the Internet. This challenges traditional rules relating to the characterisation of income as it blurs distinctions between the sale of goods, provision of services and royalties. This in turn impacts on source rules underlying various taxation regimes.

... Apart from differences between tax rates and tax bases that may produce distortions in the patterns of production and trade, the integration of the world economy produces other problems. One problem is that it becomes more difficult to determine which country is entitled to tax a particular transaction and a related difficulty is that practical enforcement can also be problematic, especially if an entity has no physical presence or assets in a jurisdiction in which it transacts its business.

...In conclusion, it may be stated that current tax systems of many countries reflect a period (before, during and immediately after the Second World War) when economies were closed and capital movements were much more limited. Today, the assumption of a closed economy has become increasingly anachronistic.

The Internet’s capacity to transform the world into global communities may see the displacement of some national law, as technology reduces the significance of sovereignty.

Electronic commerce is difficult to contain within geographically defined trade areas and frontier-based regulatory regimes. In a period of economic nationalism, laws were *prima facie* territorial and this reflected the general correspondence between physical space and law space. That is, geographical borders make sense in a physical world. In an integrated economy, however, territorial-based laws come under pressure, as geographical borders have little significance.

Globalisation has also created greater interdependency which in turn will have profound implications for tax systems. Owens identifies three key implications of this interdependency, namely<sup>153</sup>:

- The base for taxes on income and wealth will become more geographically mobile and therefore more sensitive to tax differentials. This, in turn, will lead to a greater danger of tax competition between countries, with each country trying to attract a larger share of the global tax base.
- It will become more difficult to determine and to collect taxes on activities which take place outside a country’s tax jurisdiction. This is not

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system, see generally Adrian J. Sawyer, *Electronic Commerce: International Policy Implications for Revenue Authorities and Governments*, 19 VA TAX REV. 74 (1999).

<sup>153</sup> Owens, *supra* n 3, at 23. Emphasis added. Owens then examines the impact of international tax competition and mobile resources, competition for the tax base (the arm’s length price versus apportionment debate), and then outlines some options for governments.



just a question of the volume of cross-border transactions increasing, but of their changing nature.

- The ways in which tax administrations carry out their 'business' will change. New technologies open up new ways of assessing and collecting taxes, and for co-operation between tax authorities in different countries.

Owens outlines his recommended options for governments to deal with the impact of globalisation of taxation policy and revenues, emphasising three key choices: entering into a process of full harmonisation of tax systems; allowing competitive forces to determine the design of each country's tax system; or undertaking greater coordination between the tax policies followed by countries.<sup>154</sup>

Writing more recently, Owens is optimistic about the likelihood of a positive outcome from globalisation, although he identifies risks that such an outcome may not materialise.<sup>155</sup> For instance<sup>156</sup>:

- *globalisation could lose its momentum* (such as the recent setback in Seattle [for the recent round of GATT talks]), particularly if the United States and Europe fail to provide the required leadership;
- *new barriers*, some of which may be tax barriers, *may be erected between financial markets*, increasing the cost of capital or denying access to innovative financial products;
- *regional blocks will become inward-looking*, leading to a rise in tensions between them;
- *citizens and government will revolt against the dominance of big business*; and
- *the nation state will be strengthened*.

The implications for tax administrations, from Owens' perspective, assuming governments accept the challenges of globalisation, are<sup>157</sup>:

- the rules that were developed in the physical economy may be seen as inappropriate for the virtual economy;
- governments would need to decide how to share the international tax base associated with the increasing number of very large multinational enterprises that dominate the world economy;
- at the other extreme governments would also have to deal with the increase in the number of small and medium-sized enterprises engaged in international electronic trade;
- as consumers increasingly engage in cross-border electronic commerce, governments would find themselves having to adapt their consumption tax systems to this new global market place;
- tax administrations and policymakers would have to accept that many of the traditional concepts embedded in their tax systems are undermined by financial innovations (distinctions between debt and equity, between different sources of income);
- the new global environment may force countries to compete aggressively for investment that is increasingly footloose;

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<sup>154</sup> *Id.* at 39.

<sup>155</sup> Jeffrey Owens, *Tax Administrations in the New Millennium*, 20 TAX NOTES INT'L 95 (Jan. 3, 2000). Emphasis added.

<sup>156</sup> *Id.* at 97.

<sup>157</sup> *Id.* at 97. Emphasis added.

- individuals and corporations would exploit easier access to tax havens;
- governments may have to confront aggressive global tax planning on the part of corporations and individuals; tax minimization becomes just another entrepreneurial activity;
- highly paid wealth creators demand favourable personal income tax regimes before they are prepared to locate in a country; as executives become more mobile, issues arise on the tax treatment of their pensions; and
- issues would also arise on how to coordinate the interaction between European Union Value-added tax (VAT) systems, non-European Union VAT systems, and sales tax systems so as to avoid international double taxation or non-taxation.

Owens also identifies other emerging issues arising from globalisation, including the debate over transfer pricing or formulary apportionment,<sup>158</sup> global asymmetries arising from open financial markets, challenges to tax treaties and competent authority procedures,<sup>159</sup> ethical issues (such as harmful tax competition), the implications of taxation in cyberspace which require international consensus, and greater levels of international tax information exchanges.<sup>160</sup>

Globalisation presents opportunities and challenges for global tax planning.<sup>161</sup> In particular it necessitates consideration of finance costs (such as location of debt), capital structures (use of cross-border entities), provision of services (such as managerial and technical services provided cross-border) and product flows (inter-company sale and purchase transactions between high and low tax jurisdictions).

Thus globalisation, in conjunction with the growth in the internationalisation of financial markets and MNEs, requires tax authorities and governments to find new ways to balance the maintenance of their national tax revenues and their unwillingness to harm the international competitiveness of their domestic business systems.<sup>162</sup> In the United States at least, reform of the current approach towards international tax policy is needed.<sup>163</sup>

International tax policy must be revisited in the light of the impact that financial globalisation, in particular, is having on income generation and consumption. Furthermore, the international aspects of domestic tax policy must also be revisited. Wilkinson observes in relation to the impact of globalisation on tax policy that<sup>164</sup>:

[i]n essence, the suggestion is that it is becoming progressively difficult for individual nations to pursue tax strategies without due reference to the implications of such policies in an international context. This is not to say

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<sup>158</sup> A detailed discussion of this debate is beyond the scope of this paper. However, see section 2.9 of the paper for a summary of some of the key issues of the debate.

<sup>159</sup> This could include the possibility of a model OECD VAT treaty and the emergence of multilateral rather than the current tax treaties.

<sup>160</sup> Owens, *supra* note 155, at 97-104.

<sup>161</sup> Allan R. Lanthier, *Taxation: Global Planning*, 131 CA MAG. 32 (Nov. 1998).

<sup>162</sup> ASSAF RAZIN AND JOEL SLEMROD, *Introduction*, in ASSAF RAZIN AND JOEL SLEMROD (EDS), *TAXATION IN THE GLOBAL ECONOMY* 1-10 (1990).

<sup>163</sup> HUGH J AULT AND DAVID F. BRADFORD, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises*, in *Id.* at 11-54.

<sup>164</sup> Brett Wilkinson, *Dividend Imputation in the Context of Globalisation: Extension of the New Zealand Foreign Investor Tax Credit Regime to Non-Resident Direct Investors*, 51 BULL. FOR INT'L FISCAL DOC. 363, 364 (1997). Emphasis added.

that anything like an appropriate level of attention has been paid to international tax issues in the past. On the contrary, as pointed out by Ault and Bradford (1990)<sup>165</sup> in respect of the US situation, all too frequently: “International tax policy has been something of a stepchild in the tax legislative process. The international aspects of domestic tax changes are often considered only late in the day and without full examination.

Even beyond the need for countries to pay appropriate attention to the international implications of their tax policies is the fact that globalisation is progressively curtailing national fiscal sovereignty. Choice over tax policy alternatives is essentially being eroded. A discussion of tax reform issues at a symposium of OECD and non-OECD countries on tax reform was reported by Anderson (1990)<sup>166</sup> as indicating that:

While many of the recent reforms can be explained by domestic considerations, participants generally attached considerable importance to international factors. Tax distortions can be tolerated for much longer periods in a purely domestic context, perhaps because governments find the costs acceptable compared with the costs and disruption associated with reforms. However, with increasing internationalisation of economies and greater capital mobility, countries have also become more fiscally interdependent.

In a similar vein, Bird (1989)<sup>167</sup> has stated: “the existence of important capital flows, and their apparent sensitivity to national budgetary policy, inevitably constrains to some extent the freedom of national policy-makers to decide their own tax system.

Both Australia and New Zealand are facing the fiscal policy pressures brought about by globalisation along with many other OECD member nations. Therefore, what should be the role of international tax policy in the context of globalisation? It is well known that “The Art of Taxation consists of plucking the goose to obtain the largest number of feathers but with the minimum of hissing.”<sup>168</sup> In the context of electronic commerce, Pinto<sup>169</sup> refines this adage by stating: “In a globalised economy, the problem lies not in obtaining the greatest amount of feathers, but in getting hold of any at all, for the goose is more elusive than ever.”

According to Spence,<sup>170</sup> the first role of international tax policy should be to protect national tax revenues (via adequately taxing profits once and allocating that tax in a sensible manner to each revenue authority), while the second should be not to get in the way of the operation of the world economy based on open markets (a tax system which is fiscally neutral and which minimises distortions).<sup>171</sup> As far as the international tax system is performing, in Spence’s view,<sup>172</sup> it has a reasonable track record in the light of its history. However, the international tax system is a product of

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<sup>165</sup> AULT AND BRADFORD, *supra* note 163, at 11. Emphasis added.

<sup>166</sup> P. ANDERSON, *Overview of discussion on tax reform*, in OECD, TAXATION AND INTERNATIONAL CAPITAL FLOWS: A SYMPOSIUM OF OECD AND NON-OECD COUNTRIES 27-32, at 28 (1990), cited in Wilkson, *supra* note 164.

<sup>167</sup> RICHARD M. BIRD, *International aspects of tax reform in Australia*, in JOHN G. HEAD (ED.), AUSTRALIAN TAX REFORM IN RETROSPECT AND PROSPECT 161-183 (1989), cited in Wilkson, *supra* note 164.

<sup>168</sup> Attributed to Louis XIV’s treasurer, and cited as Colbert’s definition of taxation.

<sup>169</sup> Pinto, *supra* note 124, at 16.

<sup>170</sup> Ian Spence, *Globalization of Transnational Business: The Challenge for International Tax Policy*, 25 INTERTAX 143 (1997).

<sup>171</sup> *Id.* at 143.

<sup>172</sup> *Id.* at 144.

history, where tax policy and laws generally commenced from the proposition of dealing with domestic corporations and income, and then were modified to deal with the international implications, albeit with the appearance of an afterthought.<sup>173</sup> Spence's prescription for the only practical way forward is to<sup>174</sup>:

... build on the existing international framework. A step-by-step approach, which develops the current international standards on the principles which should apply to the taxation of international business, and which increases the effectiveness with which those international standards are applied in practice, by working through the essential detail, by adapting the rules to match up with commercial and business developments, and by getting tax authorities worldwide to apply the rules in a reasonably consistent fashion.

A blending of national and international tax policies is considered the most appropriate way to deal with the implications of globalisation, with national policies requiring increased modification to take account of changing international conditions.<sup>175</sup> Writing in early 1992, Ross<sup>176</sup> provides support for greater multilateral approaches to international tax relations, with measures similar to GATT considered to be necessary to deal with cross border issues, perhaps building upon OECD and E.U. initiatives such as the Convention for Mutual Administrative Assistance in Tax Matters.<sup>177</sup>

Is national tax policy viable in the face of globalisation? This is the question that Mintz<sup>178</sup> seeks to answer in relation to how nation states may respond to globalisation. Mintz acknowledges that globalisation can make it more difficult to impose taxes on income and value-added taxes (VATs) with the difficulties in determining source and place of income for cross-border transactions.<sup>179</sup> Globalisation is identified to raise numerous implications for tax policy, including base erosion for very mobile tax bases facing high tax rates, preferences taxing industries with high economic rents, determining where mobile income is earned, the place where VAT transactions occur, reductions in withholding taxes on interest, royalties and fees, significant cross-border movement of employees, the taxation of financial services and the growth in electronic commerce.<sup>180</sup>

This situation, in Mintz's view, necessitates some form of coordinated action from governments to reduce inefficiencies arising from tax exportation (setting too high

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<sup>173</sup> See also TANZI, *supra* note 146, at 20-21.

<sup>174</sup> Spence, *supra* note 170, at 146. Emphasis added. Spence, while not going as far as advocating an international organisation to undertake this task, however, in my view, overly endorses the OECD's involvement in creating international standards that have proved tolerably robust and that the OECD has brought about a consensus in its transfer pricing guidelines. The arm's length approach is far from settled in terms of the ongoing debate with formula apportionment, and that there are significant nations outside of the OECD that do not adhere to the OECD's standards, such as China and Russia (former U.S.S.R.).

<sup>175</sup> Stanford G. Ross, *National versus International Approaches to Cross-Border Tax Issues*, 54 TAX NOTES 589 (1992).

<sup>176</sup> *Id.* at 593.

<sup>177</sup> COUNCIL OF EUROPE AND OECD, EXPLANATORY REPORT ON THE CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS, (STRASBOURG: Germany, Council of Europe, 1989).

<sup>178</sup> Jack M. Mintz, *Is National Tax Policy Viable in the Face of Global Competition?*, 19 TAX NOTES INT'L 99 (1999).

<sup>179</sup> *Id.* at 100.

<sup>180</sup> *Id.* at 100-101.

taxes, affecting primarily non-residents) and tax competition (movement of income and taxpayers to other jurisdictions with lower rates).<sup>181</sup>

Mintz sets out five possible responses for governments to approach the effects of globalisation on tax policy<sup>182</sup>:

- 1) Stop globalisation - the 'Island' mentality - an approach which countries are unlikely to take and is extremely risky for their future economic productivity;
- 2) Reduce the size of Government - a step back to the past. This is expected to occur if tax policies are not coordinated internationally through governments improving their efficiency and cutting back public services in response to lower tax revenues.
- 3) Change the tax mix, through greater reliance on less mobile tax bases (such as consumption and labour).
- 4) Globalise taxes with major trading partners through greater international coordination or harmonization, including possibly a global tax base and allocation process.<sup>183</sup>
- 5) Creating a national advantage in global markets, such as through a coordinated national action plan, more competition, and a level playing field for the private sector.

One major effect of globalisation, in conjunction with liberalisation, is that while there may be improved resource allocation and prosperity around most of the world, the opportunities for tax evasion and avoidance have widened. This is particularly noticeable for income derived from profits, interest and dividends, which reflect a particularly mobile tax base, namely capital.<sup>184</sup> Globalisation has also changed the approach for tax advisers in providing advice to their clients, with the emphasis moving from the generalist to the extremely specialist with regard to international taxation.<sup>185</sup>

### Other issues

Other prominent issues that arise in the context of international tax policy and some form of international body include the importance of distinguishing between commitments between nations to maintain taxes at a certain level or to raise (or lower) taxes (or to alter an existing tax system),<sup>186</sup> and available methods of allocating tax

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<sup>181</sup> *Id.* at 101.

<sup>182</sup> *Id.* at 102-105. Emphasis added.

<sup>183</sup> This issue forms part of the intended role for an international organisation to monitor and implement international tax policy and for dispute resolution.

<sup>184</sup> See Steven Clarke and Flip de Kam, *OECD taxes revisited*, 214 OECD OBSERVER 28 (1998). See also Sven Steinmo, *The End of Redistribution? International Pressures and Domestic Tax Policy Choices*, 37 CHALLENGE 9 (1994), referring to the situation created by globalisation whereby the ease and availability of the exit option for those with large incomes and capital resources has dramatically increased, necessitating changes in tax structures and the level of intervention by governments. However, contrary to this view, Swank provides empirical evidence in his econometric study that there is little evidence to support the traditional view and that the direct effects of globalisation of capital markets are associated with slightly higher business taxes and a diminution of tax policy responsiveness to the conditions that underpin investment; see Duane Swank, *Funding the Welfare State: Globalization and the Taxation of Business in Advanced Market Economies*, 46 POL. STUD. 671, 690-1 (1998). There is no evidence of any need to retrench social spending and public good provision; see *Id.* at 671.

<sup>185</sup> See Walter F. O'Connor, *Editor's Note*, 21 INT'L TAX J. iii (1995).

<sup>186</sup> Important in this respect are the directives on indirect tax in the E.U.; for a general discussion, see Barbara Crutchfield George et al., *The Dilemma of the European Union: Balancing the Power of the*

revenues.<sup>187</sup> In regard to allocating tax revenues between jurisdictions,<sup>188</sup> two contrasting approaches should be examined (which have attracted widespread controversy and divided tax scholars and commentators<sup>189</sup>), namely the current arm's length price (typically used in transfer pricing<sup>190</sup>) and the unitary/formulary apportionment model (adopted by most states in the United States<sup>191</sup> and in the Canadian provinces<sup>192</sup>).<sup>193</sup> Unitary taxation has been promoted by at least one commentator as the key to international tax harmony.<sup>194</sup> Issues that require resolution in adopting an international formulary apportionment can draw upon the existing experience of using unitary taxation.<sup>195</sup> The debate over which approach to

*Supranational EU Entity Against the Sovereignty of its Independent Member Nations*, 9 PACE INT'L L. REV. 111 (1997), Sijbren Cnossen, *Company Taxes in the European Union: Criteria and Options for Reform*, 17 FISCAL STUD. 67 (1996), and Joann M. Weiner, *Company Tax Reform Efforts in the European Union*, 90 NAT'L TAX ASS'N CONF. 163 (1998).

<sup>187</sup> See e.g. Weiner, *supra* note 186.

<sup>188</sup> The argument I refer to here is that cooperation is preferable to competition in ascertaining allocation of revenue between nations as it is expected to produce overall higher levels of revenue that may be allocated between more nations than when left to competitive forces. See e.g. Alex Easson, *The Tax Competition Controversy*, 18 TAX NOTES INT'L 371 (1999) and Ravi Kanbur and Michael Keen, *Jeux Sans Frontières: Tax Competition and Tax Coordination when Countries Differ in Size*, 83 AM. ECON. REV. 877 (1993).

<sup>189</sup> See e.g. Mark B. Baker, *Redefining Taxation of International Entities: The Unitary Controversy (A Constitutional Approach)*, 14 DEN. J INT'L L. & POL'Y 35 (1985). This controversy has continued for the last twenty to twenty-five years.

<sup>190</sup> See e.g. Frances M. Horner, *International Cooperation and Understanding: What's New About the OECD's Transfer Pricing Guidelines*, 50 U. MIAMI L. REV. 577 (1996) and Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89 (1995). See also JILL C. PAGAN AND J SCOTT WILKIE, *TRANSFER PRICING STRATEGY IN A GLOBAL ECONOMY* (1993), and Carl F. Steiss and Luc Blanchette, *The International Transfer-Pricing Debate*, 43 CAN. TAX J. 1566 (1995).

<sup>191</sup> See e.g. Reuven S. Avi-Yonah, *Slicing the Shadow: A Proposal for Updating United States International Taxation*, 58 TAX NOTES 1511 (March 15, 1993). Avi-Yonah's suggestion is to solely use the sales component of the formula applying for state allocation of tax revenues. One unanswered question is whether this could be applied to a case study subject, such as electronic commerce. See also, Richard L. Doernberg, *Electronic Commerce and International Tax Sharing*, 16 TAX NOTES INT'L 1013 (March 30, 1998). With respect to formulary apportionment, see also Kevin K. Leung, *Taxing Global Trading: An Appropriate Testing Ground for Apportionment?*, 1 MINN. J. GLOBAL TRADE 201 (1992). For further discussion on the unitary method, see Frank Church and Richard D. Pomp, *The Unitary Method: Thirteen Questions and Answers*, 10 TAX NOTES 891 (June 16, 1980), reprinted in TAX ANALYSTS, *SELECTED READINGS ON TAX POLICY: 25 YEARS OF TAX NOTES*, 407 (1997). One further variation in apportionment is application of the national tax base theory to dividing the world tax base. This approach is proposed by Palmer, see Robert L. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L. J. 1 (1989). For a study on proposals for dealing with the implications of electronic commerce, including that of multilateral agreements, see Pinto, *supra* n 124.

<sup>192</sup> See e.g. M. Daly, *Annex 9A: Tax Coordination and Competition in Canada: Some Lessons for the European Community*, in COMMISSION OF THE EUROPEAN COMMUNITIES, *REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION* 383, (1992).

<sup>193</sup> See e.g. Richard M. Hammer, *Will the Arm's Length Standard Stand the Test of Time? The Specter of Apportionment*, in *ESSAYS ON INTERNATIONAL TAXATION* 201-212 (Herbert H. Alpert and Kees van Raad eds., 1993). See also Michael J. McIntyre, *Contrasting Methodologies: A Systematic Presentation of the Differences between an Arm's Length/Source-Rule System and a Combined-Reporting/Formulary-Apportionment System*, in 87 NAT'L TAX ASS'N CONF. 226 (Frederick D. Stocker and Janet L. Staton eds., 1995), and Richard D. Pomp and Michael J. McIntyre, *Double Trouble: Double Taxation Aspects of Formulary Apportionment in the International Context*, in 87 NAT'L TAX ASS'N CONF. 236 (Frederick D. Stocker and Janet L. Staton eds., 1995).

<sup>194</sup> Lance C. Tyson, *Unitary Apportioning: A Key to Global Tax Harmony*, 22 INT'L TAX J. 35 (1996).

<sup>195</sup> Joann M. Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level*, 14 TAX NOTES INT'L 2113 (1996). In addition, the national tax

determining allocation of income is beyond the scope of this paper – rather it is assumed that the arm's length price approach is to be maintained for the indefinite future.

### Importance of the subject matter

I have outlined above in summary form the impact that globalisation is having on trade and business, and that the internationalisation of the world has changed the manner in which business is conducted. I also argued that investments are now made on an international scale, where national or territorial limits are no longer a dominant factor. Global trading<sup>196</sup> and the growth in multinational corporations<sup>197</sup> have in combination blurred the traditional tax concept of jurisdiction as it relates in particular to the source of income and residence of the taxpayer.<sup>198</sup> Competition for the tax dollar has the potential to accelerate the “race to the bottom”<sup>199</sup> in terms of lower tax rates and on occasions increased exclusions of income from the tax base or greater deferral (and provision for more deductions and allocations), especially for highly mobile capital and the growing numbers of upwardly mobile and highly skilled labour.<sup>200</sup>

Traditional concepts and principles have changed in other fields such as finance, with global trading and efforts towards implementing multilateral agreements,<sup>201</sup> and trade, with the conclusion of the General Agreement on Trade and Tariffs (GATT)<sup>202</sup> in 1994, along with the establishment of the World Trade Organisation (WTO) in 1995<sup>203</sup> to determine and resolve disputes over international trade in goods and services. Scholars have recognised the need for not only the United States international tax system to be reformed, but that internationally tax systems must face the challenges of the twenty-first century and beyond.<sup>204</sup>

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base theory developed by Palmer will be evaluated as a further alternative; see Robert Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L. J. 1 (1989).

<sup>196</sup> See OECD, *THE TAXATION OF GLOBAL TRADING OF FINANCIAL INSTRUMENTS* (1998), and Charles Thelen Plambeck, *The Taxation Implications of Global Trading*, 48 TAX NOTES 1143 (1990).

<sup>197</sup> See e.g. MARTIN FELDSTEIN ET AL., *THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS* 153-177, (Martin Feldstein et al. eds., National Bureau of Economic Research Project Report, 1995).

<sup>198</sup> For a discussion on source and residence principles, see e.g. DOERNBERG, *supra* n 105.

<sup>199</sup> The race to the bottom concept comes from corporation law, with the typical example being the state of Delaware providing the most flexible corporate incorporation statute in the United States, attracting a disproportionate number of corporate officials choosing this state for incorporation. “Race to the bottom” in the tax area is represented in the outcome of competition between countries (or states within a country, such as in the United States) whereby tax rates are driven lower in an effort to attract more capital investment and skilled labour. See e.g. ERNST AND YOUNG, *THE FUTURE OF CORPORATE TAX IN THE EUROPEAN COMMUNITY* 41-44, (1991), and the RUDING REPORT, *supra* note 73.

<sup>200</sup> See generally AVI-YONAH, *supra* note 2.

<sup>201</sup> See OECD, *THE TAXATION OF GLOBAL TRADING OF FINANCIAL INSTRUMENTS* (1998).

<sup>202</sup> Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Dec. 15, 1993, LEGAL INSTRUMENTS –RESULTS OF THE URUGUAY ROUND vol. 1 (1994), 33 I.L.M. 1 (1994). [hereinafter referred to as the GATT].

<sup>203</sup> Marrakesh Agreement Establishing the World Trade Organization, LEGAL INSTRUMENTS-RESULTS OF THE URUGUAY ROUND, vol. 1 (1994) 33 I.L.M. 13 (1994). [hereinafter referred to as the WTO.]

<sup>204</sup> See Stanford G. Ross, *A Perspective on International Tax Policy*, 26 TAX NOTES 701 (1985); In the context of advocating a United States tax regime that promotes consolidated worldwide income and taxes rather than focussing on nationalistic U.S. tax rules, see Stanford G. Ross, *US International Tax Policy: Where are we? Where should we be going?* 47 TAX NOTES 331 (1990). For a more recent discussion by Ross on national versus international approaches to tax policy, see Stanford G. Ross, *National versus International Approaches to Cross-Border Tax Policy Issues*, 4 TAX NOTES INT'L 719 (1992). Also, Ross also provides a 20-year view of United States international tax; see Stanford G. Ross, *International Taxation: A 20-Year View*, 57 TAX NOTES 945 (1992). Ross suggests that the United States international tax system is currently flawed (p. 946), and upon suggesting reforms, expresses his

In recognising the impact of globalisation on economic and social activity, another related development is the technological advances brought about through the Internet<sup>205</sup> and electronic commerce.<sup>206</sup> These social, technological, economic, and political developments, forming part of James' STEP analysis,<sup>207</sup> create new tax challenges which must be addressed.<sup>208</sup> This paper examines in part these developments and the challenges they create, and in doing so, develops possible approaches, in the context of binding rulings and advance pricing agreements, to formulating an international tax policy setting and enforcement mechanism for the twenty-first century where the global marketplace is the focus.

## BINDING RULINGS AND ADVANCE PRICING AGREEMENTS (APAS)

### Binding Rulings

Taxpayers frequently desire foreknowledge of the tax consequences of transactions either before the associated arrangements become unconditional, or at least before a tax return is filed and a tax position is taken concerning the arrangement. Such a system may enhance efficiency of business operations within a complex tax system, provide greater certainty for taxpayers and improve the administrative processes of government.<sup>209</sup>

Binding rulings normally have as the provisions of greater certainty to taxpayers and businesses as one of their major purposes rather than acting as some form of legislative power to the tax authorities that issue them. A growing number of countries have introduced or formalised their rulings systems rather than relying on administrative processes operated at the discretion of the tax authority. Essentially a

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pessimism that reform will be achieved (p. 948). For an excellent discussion on the United States position on international taxation prior to the 1908s, see Charles I. Kingston, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1,151 (1981), and for more recent developments, see Peter R. Merrill, *International Tax and Competitiveness Aspects of Fundamental Tax Reform*, in UNITED STATES INDUSTRY: RESTRUCTURING AND RENEWAL: BORDERLINE CASE: INTERNATIONAL TAX POLICY, CORPORATE RESEARCH AND DEVELOPMENT, AND INVESTMENT (James M. Poterba ed., 1997). For recent discussion on investment in the United States, see PRACTISING LAW INSTITUTE, TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES, BACKGROUND ISSUES RELATING TO THE TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES (1990), and Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 24 TAX L. REV. 565 (1992). Furthermore, in the context of key questions that corporations must ask when they decide to "go global", see William Zink, *Shrinking World Expands Relevance of International Tax Concepts*, 61 TAX'N FOR ACCT. 158 (1998).

<sup>205</sup> The Internet is a global information system [initially developed in the United States] that is logically linked together using TCP/IP protocols. The Internet provides electronic communication between users and access to gateways to other networks. There are three methods to access hosts over the Internet: they are telnet, FTP [File Transfer Protocol] and HTTP [Hypertext Transfer Protocol]. The Internet consists of thousands of independent, interconnected networks that span the globe. It is a global "network of networks" that connects more than 3 million computers. The Internet is a virtual space in which users send and receive e-mail, log on to remote computer (telnet), browse databases of information, World wide web, and send and receive files (FTP); see Ian W. Wallschutzky, *The Implications of Electronic Commerce for the Australian Income Tax System*, in TAX ADMINISTRATION: FACING THE CHALLENGES OF THE FUTURE 33, 50 (Chris Evans & Abe Greenbaum eds., 1998).

<sup>206</sup> A comprehensive exposition of the tax implications of electronic commerce arising from this new technology ushered in by the Internet, see RICHARD L. DOERNBERG AND LUC HINNEKENS, *ELECTRONIC COMMERCE AND INTERNATIONAL TAXATION* (1999).

<sup>207</sup> See James, *supra* note 8, at 3.

<sup>208</sup> For an excellent early overview of the implications of globalisation on tax policies, see Owens, *supra* note 3.

<sup>209</sup> See ADRIAN SAWYER, *Binding Rulings: A Comparative Perspective* in THE INTERNATIONAL TAXATION SYSTEM 291-315 (Andy Lymer and John Hasseldine eds. 2002).



binding ruling is a statement of the revenue authority's interpretation and application of tax laws to an arrangement, which is binding on the revenue authority in terms of the future application of the tax laws but not normally on the applicant.<sup>210</sup>

The purpose of the New Zealand binding rulings regime is encapsulated in the legislation, a feature of the new philosophy behind New Zealand's legislative drafting style in the 1990s. Other countries that have developed binding rulings regimes have done so for similar reasons, along with recognising the benefits from following approaches taken overseas. Binding rulings in New Zealand are intended to provide taxpayers with certainty about the way that the Commissioner will apply taxation laws.<sup>211</sup> In the discussion document that initially outlined the Government's proposals, two categories of certainty were identified: transaction certainty and compliance certainty.<sup>212</sup> Transaction certainty was described as the form of business certainty that arises when taxpayers know in advance the tax treatment of their proposed transactions. Compliance certainty is the reassurance given to taxpayers that the arrangement will not be subject to a higher tax liability provided the terms of the arrangement are no different to that contemplated by the ruling. The second major purpose behind introducing binding rulings in New Zealand was to assist taxpayers in meeting their obligations under the law.<sup>213</sup>

The purpose of this paper is not to provide an exhaustive analysis of binding rulings regimes; there is a considerable and growing literature on the topic.<sup>214</sup> However, one aspect of binding rulings analysis that is highly relevant to this study is the results from comparative analyses of binding rulings regimes, such that the resulting similarities and differences will be an indicator of the level of effort required to gain a degree of harmonisation of binding rulings and advance pricing agreement practices.<sup>215</sup>

In a study conducted by Sawyer in 2001<sup>216</sup> a brief comparative analysis of private rulings systems in twenty seven nations is provided,<sup>217</sup> with the private rulings systems in Australia, Canada, Sweden, United Kingdom and United States the main focus of comparison with the New Zealand regime. Sawyer concludes that there is surprisingly little in common between the regimes reviewed, apart from instances of one

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<sup>210</sup> *Id.*

<sup>211</sup> See section 91A Tax Administration Act 1994 (New Zealand).

<sup>212</sup> NEW ZEALAND GOVERNMENT, *BINDING RULINGS ON TAXATION: A DISCUSSION DOCUMENT ON THE PROPOSED REGIME*, (1994).

<sup>213</sup> *Id.* at 5.

<sup>214</sup> In relation to New Zealand and Australia, see e.g., Wayne Mapp, *Binding Rulings*, 2 N.Z. J. TAX'N L. & POL'Y 139 (1996); Adrian J Sawyer, *Binding Tax Rulings: The New Zealand Experience*, 26 AUST. TAX REV. 11 (1997); Adrian J Sawyer, *What are the Lessons for Australia from New Zealand's First Comprehensive Remedial Review of its Binding Rulings Regime?* 29 AUST. TAX REV. 133 (2000); and ADRIAN J. SAWYER, *AN INTERNATIONAL COMPARISON OF BINDING RULINGS REGIMES: A REPORT FOR THE ADJUDICATION AND RULINGS DIVISION OF THE INLAND REVENUE DEPARTMENT* (2001) (Hereinafter referred to as IRD Study).

<sup>215</sup> See Sawyer, *supra* n 209.

<sup>216</sup> See IRD Study, *supra* n 214.

<sup>217</sup> *Group One:* Australia, Canada, New Zealand, Sweden, United Kingdom and United States - the six major regimes, forming the first tier for analysis. *Group Two:* Belgium, Denmark, Finland, France, Hong Kong, India, (Republic of South) Korea, Mexico, the Netherlands and South Africa. These ten countries formed the second tier for analysis. *Group Three:* Germany, Hungary, Iceland, Ireland, Israel, Italy, Pakistan, the Philippines, Portugal, Spain and Switzerland. Interesting features of the regimes in these eleven countries formed the third tier for analysis.

country/jurisdiction modelling its regime on that of another and adopting some of its features, or from mere coincidence.<sup>218</sup>

The reason for such differences in regimes is frequently a side effect of historical practice, or merely a result of the freedom of choice or national sovereignty that each nation has to run its tax system.<sup>219</sup> However, such differences have implications for individuals and businesses that conduct business domestically, and more importantly, internationally, where the forces of globalisation are encouraging (or perhaps pressuring) convergence in many areas of business law, trade, and in various aspects of taxation law. Major differences in binding rulings regimes will create uncertainty when undertaking business activity.

A major hurdle to having an international system for recognising and developing rulings across borders is for consistency in domestic rulings systems. A majority of the regimes that were reviewed by Sawyer<sup>220</sup> had a formal binding ruling regime in place as compared to a non-binding (or administrative) regime. However, those in Group One and Group Two were both split 1:1, with a clear majority of 2:1 having a formal system in Group Three jurisdictions.<sup>221</sup>

In a subsequent study, Sawyer concludes<sup>222</sup>:

From the analysis undertaken by the International Report<sup>223</sup> it could be argued that if there were no costs incurred as part of the trade-off with a comprehensive rulings model, then an expanded ruling system drawing upon the favourable aspects of the Australian and New Zealand systems (the former providing a comprehensive, free, ruling system with a full range of appeal options in the case of an adverse ruling, the latter a comprehensive, efficient user pays system without any access to an appeal facility for unfavourable rulings), might be a model for consideration for any country seeking to implement a new regime or overhaul its existing regime. Key considerations in any trade-off include the risks to the revenue, the level of resourcing required, and the need to maintain consistency in dealing with all applications for rulings. However, models in other countries also offer interesting features that could be considered in the New Zealand and Australian contexts.

Thus a major hurdle to be overcome is an improvement in the level of harmonisation of domestic regimes such that it is feasible to develop consistent application of binding rulings across jurisdictions. While this would require considerable effort and persuasion for nations to modify their systems, it is a necessary path to be followed if the proposals in this paper are to come to fruition. Hence, the above comment by Sawyer<sup>224</sup> could be extended to suggest that the Australian and New Zealand binding rulings regimes could form the basis for harmonising other regimes.

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<sup>218</sup> See IRD Study, *supra* n 214.

<sup>219</sup> Refer to section 2.7 of this paper for a discussion on the issues surrounding sovereignty.

<sup>220</sup> See IRD Study, *supra* n 214.

<sup>221</sup> *Id.* For a brief description of these groups, see note 217 above.

<sup>222</sup> Adrian J. Sawyer, *Comparing New Zealand's Private Rulings System and its Features with a Selection of International Private Rulings Systems – What is There in Common?*, 5 J. AUST. TAX'N 440, 463-4 (2002).

<sup>223</sup> See IRD Study, *supra* n 214.

<sup>224</sup> Sawyer, *supra* n 222, at 463.

Romano suggests that a centralisation of certain functions of the national rulings authorities in the E.U. with respect to advance tax rulings of relevance to European Community tax law would be a positive step.<sup>225</sup> Romano further suggests that such a central body could function as a supervisory body on rulings policy, a collector of certain types of rulings requests and as a distribution centre of these requests amongst the competent offices. He also raises the possibility of a two-tier rulings procedure for certain European Community tax law issues of general interest for European investors, with a national authority of first instance and a central European authority as second instance.<sup>226</sup> While this would be regional (i.e. the E.U.), the proposal has merit and could be considered in more broad terms such as for OECD members or wider still, such as to all U.N. members.

Romano concludes<sup>227</sup>:

From the analysis of advance tax rulings systems conducted throughout this dissertation, it would seem highly beneficial to have a harmonized advance tax rulings system at a domestic level throughout the European Union. Whether or not this would be politically acceptable is something that warrants further investigation.

- From a legal point of view, the advantages of a harmonization of advance tax rulings systems in the EU Member States are the following:
- to obtain a higher degree of certainty in the interpretation and application of tax law provisions;
- to have greater consistency and uniformity in the application and interpretation of the law;
- to enhance the transparency of the decision-making process of the tax authorities in such a way as to improve the perception of the fairness of the tax obligations by taxpayers and thus tax compliance;
- to foster compliance with tax law and administrative practice;
- to improve the functioning of the self-assessment and self-reporting systems;
- to reduce tax litigation;
- to give the tax administrations the possibility to gather information from taxpayers; and
- to avoid harmful tax competition regimes and practices.

With further moves towards harmonising the E.U.'s corporate income taxes, Romano argues that it is necessary to ascertain the feasibility and opportunity to set up an advance tax rulings system, initially at the E.U. level.<sup>228</sup>

### **Advance Pricing Agreements (APAs) and transfer pricing**

An advance pricing agreement (APA) is an advance agreement on transfer pricing methodologies entered into between a multinational taxpayer and at least one

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<sup>225</sup> CARLO ROMANO, ADVANCE TAX RULINGS AND PRINCIPLES OF LAW: TOWARDS A EUROPEAN TAX RULINGS SYSTEM? 4 IBFD Doctoral Series (2002), at 471-2. Romano also defines what is meant by an advance ruling for his study (see p 485).

<sup>226</sup> *Id.* at 470-2.

<sup>227</sup> *Id.* at 499.

<sup>228</sup> *Id.* at 499.

government's tax administration.<sup>229</sup> In the case of the United States, an APA is essentially a contract with the Internal Revenue Service (IRS) which sets forth a methodology for evaluating whether transfer prices are arms length and will, therefore, be respected by the IRS. The heart of the APA request is the proposed transfer pricing method. This is the method the taxpayer proposes to determine an arm's length pricing that is consistent with the legislative requirements.<sup>230</sup>

Importantly, an APA is an agreement by the interested parties (related taxpayers and tax authorities) in usually at least two different countries, which commits both sides to a particular transfer pricing methodology. It assures that, barring unforeseen circumstances or a misrepresentation of the facts, the tax authorities will not subsequently challenge the positions taken.<sup>231</sup>

APAs can be unilateral, bilateral or multilateral. Only bilateral and multilateral APAs (where two or more countries are involved) can provide legal certainty as to how the tax authorities of countries involved consider the taxpayer-specific application of a transfer pricing method.<sup>232</sup> In the case of a bilateral or multilateral APA, a second agreement is made between the competent authorities of countries which are affected by the covered transaction. This second agreement is normally based on the mutual agreement provision of tax treaties between the jurisdictions.

Several complicating factors arise when there are unilaterally issued APAs, namely on what basis, under what requirements, and with what effect APAs can be requested and issued. In this respect, it is necessary to differentiate between an APA issued "unilaterally" by one tax authorities or through bilateral cooperation with foreign tax authorities.<sup>233</sup>

A further complicating factor with APAs generally is the discrepancy between business-world transfer pricing and tax-world transfer pricing. Business-world transfer pricing is a multi-entity issue where many routine and non-routine functions are performed in several jurisdictions along the value chain of the multinational. Tax-world transfer pricing in the form of the OECD Model Tax Convention,<sup>234</sup> the OECD Transfer Pricing Guidelines,<sup>235</sup> and the country-specific treaties and regulations is based on a simplified concept where two controlled entities exchange goods or services between two countries.

Durst<sup>236</sup> argues that APAs are useful primarily for taxpayers with transfer pricing issues that already have come to the attention of government authorities, or are very likely to do so in the future. APAs are also useful for taxpayers with a special need for financial statement certainty. Because APAs can offer revenue authorities savings as well as taxpayers, some countries have been particularly keen to grant APAs in the more complex areas of transfer pricing. Durst observes that bilateral APAs between

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<sup>229</sup> Kenneth W. Gideon, Bryan Stone, Robert B Stack and David J Charles, *Advance Pricing Agreements*, 8 INT'L TAX REV. 9 (1996).

<sup>230</sup> *Id.* at 10.

<sup>231</sup> See Frans W. Blok, *The Netherlands*, 9 INT'L TAX REV. 53 (1997).

<sup>232</sup> See Alexander Voegelé and Markus Brem, *Do APAs prevent disputes?* 14 INT'L TAX REV. 35 (2002/3).

<sup>233</sup> Rosemarie Portner, *Advance pricing agreements: Domestic Aspects and treaty issues*, 36 EUR. TAX'N 50 (1996).

<sup>234</sup> OECD, *supra* n 97.

<sup>235</sup> OECD, *supra* n 99.

<sup>236</sup> Mike Durst, *APAs: A personal view*, 26 TAX PLAN. REV. 9 (1999).

the US and Canada are becoming increasingly commonplace and both fiscal authorities have been pushing for their use.<sup>237</sup>

The ultimate goal of the APA process is to arrive at an agreement over three things<sup>238</sup>:

- inter-company transactions and businesses of the multinational taxpayer (affiliated parties involved, transactions, functions, risks, assets);
- most appropriate TPM to these transactions; and
- type of arm's-length results expected after applying the agreement.

Thus APAs aim to reduce uncertainty through enhancing the predictability of the tax treatment of international transactions.

In terms of the steps in obtaining an APA, for the United States APA process these are the pre-filling conference (an informal meeting with the IRS to discuss transfer pricing issues), the APA request itself, the transfer pricing methodologies sought, and negotiation with the IRS.<sup>239</sup> With respect to the United Kingdom, there have been recent developments expanding the APA procedure.<sup>240</sup>

The major components of a request for an APA in the United States are<sup>241</sup>:

- general background;
- factual content;
- legal content;
- current apportionment method;
- base of proposed apportionment method;
- explanation of proposed apportionment method;
- conformity with "clear reflection" and "arm's length" method;
- cost sharing arrangements;
- coordination with domestic law;
- coordination with treaty countries;
- term and assumptions;
- perjury statement;

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<sup>237</sup> *Id.*

<sup>238</sup> See Voge and Brem, *supra* n 232.

<sup>239</sup> See Gideon *et al.*, *supra* n 229. For an early survey on various countries employing the APAS procedure, see Nathan Boidman, *The Effect of the APA and other US Transfer Pricing Initiatives in Canada and Other Countries*, 44 TAX EXEC. 254 (1992), discussing Canada, Australia, France, Germany, Italy, Japan, Netherlands, the United Kingdom and the United States. See also Nathan Boidman, *The Roles of Advance Rulings in International Transfer Pricing*, 39 CAN. TAX J. 1563 (1991). For a discussion on the limited Finnish provisions, see Eric Sandelin and Mikko Palmu, *Finland*, 10 INT'L TAX REV. 55 (2002).

<sup>240</sup> Fiona Bayliss, *Advance Pricing Agreements: What will they offer?*, 40 EUR. TAX'N 229 (2000). Bayliss discusses the United Kingdom's new advance pricing agreement (APA) regime in general, looks at how the Inland Revenue intends to conduct the APA process, and considers whether various concerns expressed during the consultation period have been addressed. With increasingly complex transfer pricing legislation to comply with, businesses will surely welcome the offer of the new United Kingdom APA regime and the opportunity to plan their tax compliance with greater certainty. The United Kingdom has expanded into the provision of APAs in more recent times.

<sup>241</sup> Nathan Boidman, *Canadian Perspective on IRS Proposal for Inter-company Rulings*, 19 TAX MGMT INT'L REV. 355, 359 (1990).

- signatures;
- copies and mailing;
- user fees; and
- notification to the field.

Gramlich and Moller outline some of the factors that managers of a multinational firm should consider when deciding whether or not to request an APA.<sup>242</sup> The process by which a taxpayer requests an APA is described. The authors then present a model for deciding whether or not to obtain an APA, including undertaking a cost-benefit analysis. Various situations are discussed in which taxpayers should and should not consider obtaining an APA. Factors supporting obtaining an APA include: producing a lower tax liability, reducing firm (and shareholder) risk, obtaining the benefit of a competitor's recently defended transfer pricing method, reducing tension during an audit when the transfer pricing method is stalemated, or exercising control over the transfer pricing method discussion.<sup>243</sup>

Two other possible avenues that the APA mechanism could be extended to cover, and which in the case of the second would fit well within an international tax organisation, is resolving domestic transfer pricing issues (that is, pricing within one jurisdiction) and resolution of the existence or otherwise of a permanent establishment.<sup>244</sup>

### **Binding (Advance) Rulings v APAs**

While advance rulings on transfer pricing are essentially the same creature as an advanced pricing agreement on transfer pricing, there are some differences. Romano provides a succinct summary of the key similarities and differences between APAs and advance rulings<sup>245</sup>:

An advance pricing agreement (APA), being an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time, is to be distinguished from advance tax rulings for many aspects.

An APA providing taxpayers with certainty about how transfer pricing rules apply to future transactions may be unilateral, bilateral or multilateral. In contrast, advance tax rulings are unilateral in nature, and they are, therefore, generally granted without informing or involving other interested jurisdictions. ... In addition, advance rulings and APAs differ in their legal nature. APAs are generally regarded as agreements between one or more tax authorities and taxpayers, whereas advance rulings should be considered as one-sided statements by the tax administrations. Although in an APA a taxpayer is also not always seen as a party to the procedure, his agreement is required. No APA may be implemented without the approval of the taxpayer, whereas advance rulings are valid regardless of the consent of the applicant. Apart from a few procedural guarantees (conferences, etc.), mainly based on the right of the taxpayers to be heard, the participation of

<sup>242</sup> Jeffrey D. Gramlich and Ulrik Gorm Moller, *The Decision to Request an APA*, 24 TAX MGMT INT'L REV. 13 (1997).

<sup>243</sup> *Id.* at 15-17.

<sup>244</sup> See Sean F. Foley and Paul B. Burns, *The APA Program as a Model for Successful Alternative Dispute Resolution*, 32 TAX MGMT INT'L REV. 451 (2003). For a discussion on permanent establishment, see SKAAR, *supra* n 44.

<sup>245</sup> Romano, *supra* n 225, at 486.

the taxpayer in an advance rulings procedure is often limited to the initial phase of the process.

Finally, as a consequence of their different legal nature, APAs may also be distinguished from advance rulings on the basis of their effects. APAs are generally binding on the tax authorities, and sometimes on taxpayers, whereas advance rulings may have binding effects on tax authorities but rarely on taxpayers. Moreover, an APA, whether unilateral, bilateral or multilateral, differs from an advance ruling principally because it deals with factual matters more than it deals with the interpretation and application of the law and is aimed at resolving all the transactions or categories of transactions related to the taxpayer in cross-border situations. Conversely, an advance ruling request normally refers to one or more specific transactions.

Thus, while there are a number of differences between binding rulings and APAs, both have a high degree of similarity, justifying their joint consideration for inclusion within the scope of a World Tax Organisation.

## AN INTERNATIONAL (WORLD) TAX ORGANISATION

Prior to undertaking a discussion on the possible composition, powers and scope of such an organisation, a first step that has been proposed by a number of scholars is some form of multilateral tax agreement or convention.

### Multilateral Tax Agreement/Convention

McIntyre<sup>246</sup> argues that the point of a model tax convention is to promote cooperation and coordination among sovereign states with respect to certain fiscal matters. He acknowledges that some people may object to such cooperation and coordination, believing that governments should engage in a high level of tax competition and should eschew most cooperative efforts. The principle issue addressed by McIntyre is how to promote greater intergovernmental cooperation and coordination on the assumption that these twin goals are worthy ones for governments to pursue.

In promoting the notion of a multilateral treaty, it might be considered:

- a) As a full or partial replacement for the series of bilateral treaties now used by many countries, or
- b) As a mechanism for amending (updating) existing bilateral treaties to reflect changes in or additions to the OECD Model Tax Convention<sup>247</sup> or UN Model Treaty<sup>248</sup> (or some other model), as approved by the body in charge of that particular model.

McIntyre<sup>249</sup> argues that political feasibility of a multilateral tax treaty as a replacement for bilateral treaties may depend significantly on the size of the group of countries that conclude such a treaty. For a small group of countries with similar tax systems (for example, the Nordic countries<sup>250</sup>), a multilateral treaty seems to be more feasible than a multilateral treaty applicable to all countries in the world that have tax treaties.

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<sup>246</sup> Michael J. McIntyre, *Options for Greater International Coordination and Cooperation in the Tax Treaty Area*, 56 BULL. FOR INT'L FISCAL DOC. 250 (2002).

<sup>247</sup> OECD MODEL TAX Convention, *supra* n 97.

<sup>248</sup> UN MODEL Treaty, *supra* n 102.

<sup>249</sup> McIntyre, *supra* n 246, at 251.

<sup>250</sup> Odd Hengsie, *The Nordic Multilateral Tax Treaties – for the Avoidance of Double Taxation and on Mutual Assistance*, 55 BULL. FOR INT'L FISCAL DOC. 371 (2002).

A multilateral tax treaty that is limited in scope also may be more acceptable politically. It may be possible, for example, to have a multilateral treaty that deals with many issues arising in a tax treaty but leaves a small number of sensitive issues for bilateral negotiations. A multilateral treaty among a small number of countries with closely integrated economies might also permit greater experimentation.

Some of the possible advantages of a multilateral tax treaty presented by McIntyre are<sup>251</sup>:

- a) *Mechanism for revising treaties promptly.* If a multilateral tax treaty is developed by an international organization, that organization could make periodical revisions of the treaty to deal with the inevitable emerging issues and the inevitable tax avoidance schemes. Presumably, some procedure would have to be established for ratifying the revised treaty because most countries would not forfeit their right to reject a revised treaty. ...
- b) *Simplification.* A uniform tax treaty applicable to many countries may be easier to interpret and apply than the current non-uniform bilateral treaties. There is also likely to be increased consistency in interpretation and increased certainty in application. In some cases, novel rules inserted into a bilateral treaty can give rise to interpretation and/or application problems. In theory, the same degree of uniformity might be achieved through a series of identical bilateral treaties.
- c) *Solving triangular issues.* Some triangular issues that may arise as a result of the strict bilateral approach of the existing (bilateral) treaties can be solved more effectively by a multilateral treaty.
- d) *Reduced negotiating time.* Bilateral treaties take a year or more to negotiate. A multilateral treaty offers the prospect of avoiding the need for separate negotiations with each country. This advantage is of particular importance to small countries that do not have an abundance of resources.
- e) *Reduced treaty shopping.* A multilateral treaty would provide for uniform treatment of all residents of the participating states. Treaty shopping to get the best deal among the applicable treaties would be eliminated. Of course, the problem of persons from non-treaty states improperly obtaining benefits would not be solved merely by having a multilateral treaty.

Some of the possible disadvantages of a multilateral treaty are<sup>252</sup>:

- a) *Special provisions.* In some cases, a country may not be willing to enter into a multilateral treaty unless it retains the right to make special arrangements with some of its important trading partners. The simplification gains that might be obtained from a uniform multilateral treaty might be lost if many countries entered into side arrangements. Indeed, it is possible that a multilateral treaty, after its adornment with many side arrangements, could be more complex to interpret than the current set of bilateral treaties.
- b) *Ossification.* A multilateral treaty, in practice, may become difficult to amend. Bilateral treaties are already difficult to amend, and they involve only two parties. If a multilateral treaty ossifies, it is likely to do more harm than good.
- c) *Reduced flexibility.* By its nature, a multilateral treaty is less flexible in dealing with the particular circumstances of countries than a bilateral treaty. For example,

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<sup>251</sup> McIntyre, *supra* n 246, at 256-7. Emphasis added.

<sup>252</sup> *Id.* at 257. Emphasis added.



it seems unlikely that a multilateral treaty could be used to define the taxes of particular countries which qualify as creditable income taxes for treaty purposes.

- d) *Capture by powerful countries or special interests.* There is an increased risk that a multilateral treaty would be written to protect the interests of the powerful - powerful countries or powerful interest groups - at the expense of others. Such a capture of an international tax treaty by the powerful may not be inevitable, but serious steps would need to be taken to prevent it from happening.

#### **A consensus approach**

Avi-Yonah has had the following to say with respect to consensus on tax policy<sup>253</sup>:

The case for reaching consensus on the enforcement of residence-based taxation and determination of the source for active income is at least as strong today as the case for consensus on the general structure in 1923 [with the formation of the League of Nations]. Compared with 1923, the world's economy is much more integrated, international capital flows much larger, and MNEs make a much up a much higher proportion of world GDP. Moreover, consensus is necessary to avoid serious under-taxation of individuals (in the case of backup withholding of portfolio income) and MNEs (in the case of allocating active income to its source). Both developed and developing countries have much to gain and little to lose from reaching agreement, and significant revenue is lost by all concerned from failing to do so.

A consensus approach is desirable, and further discussion and debate over a mutual tax policy process is worthwhile and should be productive.<sup>254</sup> The best-fit response recommended by this study is that a consistent policy setting approach will be conducive to a more equitable and efficient outcome in both absolute and relative terms, along with satisfying many of the other key principles of evaluating tax policy.<sup>255</sup>

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<sup>253</sup> Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1350 (1996). Avi-Yonah briefly discusses how such a consensus may be reached, drawing upon the recent international trade talks as an example (i.e. the GATT). Then he explores how simplification of the international tax regime may occur once a consensus is reached.

<sup>254</sup> However, it has been argued that harmonisation may be futile, at least in the context of commercial law. Nevertheless, it is quite a different issue as to whether harmonisation of tax policy development is feasible. It is reasonable to debate whether this argument could be extended to income taxation; see Paul B. Stephan, *The Futility of Unification and Harmonization in International Commercial Law*, 39 VA. J. INT'L L. 743 (1999).

<sup>255</sup> Equity (or fairness) is traditionally presented as representing two dimensions, although this is not universally accepted by scholars. Horizontal equity is measured by whether everyone with the same ability to pay tax, pays the same amount of tax. Vertical equity occurs when those with a greater ability to pay, pay proportionally more tax, preferably on a progressive scale. Certainty refers to taxpayers being able to ascertain their liability to a tax clearly and unambiguously, and administrators and policy-makers being able to predict revenue flows with a high degree of accuracy. Convenience is related to simplicity in that it is argued that taxes should be assessed, levied and paid in the simplest manner. Economy in operation (administrative efficiency) places an obligation on both government and tax administrations to facilitate a tax collection process that enables taxes to be both cost effective to collect and not impose a heavy compliance obligation on taxpayers (with administrative costs kept to a minimum). For further discussion of these principles, see e.g. SALLY M. JONES & RAY. M. SOMMERFELD, *FEDERAL TAXES AND MANAGEMENT DECISIONS* 11 (1995).

The core concept of neutrality involves setting tax policy that neither favours or disfavors a particular form of business activity or method for concluding a transaction, such that resources are not allocated in a manner other than that which will enable their most efficient utilization. Economically similar transactions should be treated similarly so as not to interfere with choice. See also, Douglas A. Kahn, *The Two Faces of Tax Neutrality: Do they Interact or are they Mutually Exclusive?*, 18 N. KY. L. REV. 1

In particular, my proposed international agreement could be extended beyond binding rulings and APAs to encompass an agreed process for ascertaining jurisdiction and allocation of revenue (possibly even incorporating a variation on the formulary apportionment concept and unitary taxation with respect to multinational enterprises), as well as a limited consensus on maintaining the essential characteristics of income taxes on corporations and international income of mobile individuals (with respect to the tax base determination), and consumption taxation (especially VAT and GST). Freedom to vary rates on individuals' income (and to a much lesser degree on the income of corporations), is permitted to reflect the realities of retaining a 'thread' of sovereignty in this globalised environment, although economic theory would suggest complete harmonisation of base and rates in appropriate circumstances is optimal.<sup>256</sup>

Furthermore, new taxes which have a measurable international impact, I would argue, should be carefully debated before they are implemented, preferably with at least some international discussion and possible consensus on their application. It would be helpful in this respect to undertake a review of the similarities in tax policy reform in recent years.

Any model or mutual approach to developing international tax policy and dispute resolution should borrow from existing models for international policy setting and dispute resolution in other domains (with appropriate modifications), such as trade, along with recognising how they have gained a level of consensus and yet restrict or impinge upon national sovereignty.<sup>257</sup> Restrictions or impositions upon national sovereignty are worthy of debate in situations where such restrictions promote the greater interest of all countries concerned, when viewed from a global rather than an individualistic national perspective.<sup>258</sup> For instance, restrictions occur in the context of global trade in goods and services through the General Agreement on Tariffs and Trade (GATT)<sup>259</sup> and the General Agreement on Trade in Services (GATS).<sup>260</sup>

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(1990) for a discussion on neutrality, and Julie A. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 VA. L. REV. 919 (1989).

Another scholar argues that efficiency, in the context of anti-deferral reform, should be the key principle for reforming the taxation of Foreign Personal Holding Companies; See John McDonald, *Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 N.W. J. INT'L L. & BUS. 248, 283 (1995). See also, Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the United States International Income Tax Rules*, 51 U. MIAMI L. REV. 975 (1997), and two commentaries, the first by David R. Tillinghast, *Comments on Professor Peroni's paper on Reform of the United States International Income Tax Rules*, 51 U. MIAMI L. REV. 1013 (1997), and Stanley I. Langbein, *The Future of Capital Export Neutrality: A Comment on Robert Peroni's Path to Progressive Reform of the United States International Tax Rules*, 51 U. MIAMI L. REV. 1019 (1997).

One further possible solution worthy of further exploration is whether greater fairness in international taxation will arise through inter-nation equity, using economic allegiance theory; see Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 202 (1998). The original proponents of inter-nation equity were Richard A. Musgrave and Peggy B. Musgrave, *Inter-nation equity*, in ESSAYS IN HONOR OF CARL S. SHOUP (Richard M. Bird and John G. Head eds., 1972).

<sup>256</sup> See e.g. Michael Keen, *The Welfare Economics of Tax Co-ordination in the European Community: A Survey*, 14 FISCAL STUD. 15 (1993), and Michael Devereux, *The Ruling Committee Report: An Economic Assessment*, 13 FISCAL STUD. 96 (1992). See also Alan M. Simon and Spencer Weber Waller, *Essay: A Theory of Economic Sovereignty: An Alternative to Extraterritorial Jurisdictional Disputes*, 22 STAN. J. INT'L L. 337 (1986).

<sup>257</sup> See the discussion on sovereignty in section 2.7 of this paper.

<sup>258</sup> See e.g. VITO TANZI, *TAXING IN AN INTEGRATING WORLD*, ch. 2 (1994), Preface.

<sup>259</sup> GATT, *supra* note 202.

Furthermore, there are sovereignty restrictions in certain regional trading blocs, such as the current movement towards harmonisation of tax policy, monetary policy and social policies in the E.U., and in North America, through the North American Free Trade Agreement.<sup>261</sup> Other examples include development of further multilateral tax conventions, particularly those by the OECD,<sup>262</sup> the Nordic countries,<sup>263</sup> and the Caribbean Community.<sup>264</sup>

When an international agreement is concluded, it is vital that there be an effective enforcement mechanism in place and a process by which to resolve disputes; an agreement is only effective to the extent that it is enforceable (by legal or informal means).<sup>265</sup> An argument can be made that in borrowing from existing enforcement models, the costs associated with “reinventing the wheel” may be avoided. Enforcement models in the literature which may prove valuable as precedents include the World Trade Organisation (WTO),<sup>266</sup> the Organisation for Economic Cooperation

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<sup>260</sup> General Agreement on Trade in Services, Dec. 15, 1993, Marrakesh Agreement Establishing the World Trade Organization, Annex 1x, LEGAL INSTRUMENTS-RESULTS OF THE URUGUAY ROUND, vol. 1 (1994) 33 I.L.M. 44 (1994). [hereinafter referred to as the GATS].

<sup>261</sup> North American Free Trade Agreement, Dec. 8-17, 32 I.L.M. 289, 32 I.L.M. 605 [hereinafter referred to as NAFTA]. See e.g. Arthur J. Cockfield, *Tax Integration under NAFTA: Resolving the Conflict between Economic and Sovereign Interests*, 34 STAN. J. INT'L L. 39 (1998); Brian J. Arnold and Neil H. Harris, *NAFTA and the Taxation of Corporate Investment: A View from within NAFTA*, 49 TAX L. REV. 529 (1994); H. David Rosenbloom, *Commentary: What's Trade got to do with it?*, 49 TAX L. REV. 593 (1994); Alvin C. Warren, Jr., *Commentary: Alternatives for International Corporate Tax Reform*, 49 TAX L. REV. 599 (1994); Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 TAX L. REV. 691 (1994); Richard M. Bird, *Commentary: A View from the North*, 49 TAX L. REV. 745 (1994); John S. Brown, *Commentary: Formulary Taxation and NAFTA*, 49 TAX L. REV. 759 (1994); Michael J. McIntyre, *Commentary: The Design of Tax Rules for the North American Free Trade Alliance*, 49 TAX L. REV. 769 (1994); and Richard D. Pomp, *Commentary: Issues in the Design of Formulary Apportionment in the Context of NAFTA*, 49 TAX L. REV. 795 (1994).

<sup>262</sup> Such as the OECD's convention on information sharing (mutual assistance); see OECD, *supra* n 177, and the proposed OECD agreement on investment, OECD – DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS, THE MAI NEGOTIATING TEXT (AS AT 24 APRIL, 1998) (1998). Available at < <http://www.oecd.org> >. OECD - DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS, COMMENTARY ON THE MAI NEGOTIATING TEXT (1998). Available at < <http://www.oecd.org> >. (Visited 24 April, 1998).

<sup>263</sup> CONVENTION BETWEEN THE NORDIC COUNTRIES FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (Denmark, Faroe Islands, Finland, Iceland, Norway, Sweden: 1996). Hereinafter referred to as CONVENTION BETWEEN THE NORDIC COUNTRIES. For a discussion of the agreement see Peter Birch Sørensen, *From the Global Income Tax to the Dual Income Tax: Recent Tax Reforms in the Nordic Countries*, 1 INT'L TAX & PUB. FIN. 57 (1994). See also Hengsie, *supra* n 250.

<sup>264</sup> AGREEMENT AMONG THE GOVERNMENTS OF THE MEMBER STATES OF THE CARIBBEAN COMMUNITY FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, PROFITS OR GAINS AND CAPITAL GAINS AND FOR THE ENCOURAGEMENT OF REGIONAL TRADE AND INVESTMENT (1994). Hereinafter referred to as the CARICOM CONVENTION. For a discussion of the agreement, see Hubb M. M. Bierlaagh, *The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation?*, 54 BULL. FOR INT'L FISCAL DOC. 99 (2000).

<sup>265</sup> See e.g. Gustaf Lindencrona, *How to resolve international tax disputes? New approaches to an old problem*, INTERTAX 266 (1990). The analysis will consider proceedings between two or more states and between state(s) and private individuals and organizations.

<sup>266</sup> See WORLD TRADE ORGANIZATION, THE WTO DISPUTE SETTLEMENT PROCEDURES; A COLLECTION OF THE LEGAL TEXTS (1995). See also Robert A. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT'L L. 79 (1998). [Hereinafter referred to as Antilegalistic Approaches]. In the context of the WTO and its disputes settlement role, see e.g. Robert E. Hudec, *The New WTO Dispute Settlement Procedure: An Overview of the First Three Years*, 8 MINN. J. GLOBAL TRADE 1 (1999). See also General Agreement on Tariffs and Trade – Multilateral Trade Negotiations (The Uruguay Round) Understanding on Rules and

and Development (OECD),<sup>267</sup> the United Nations (U.N.),<sup>268</sup> the International Monetary Fund (IMF),<sup>269</sup> and the North American Free Trade Agreement (NAFTA) body.<sup>270</sup> However, several other options have been proposed by commentators, including an International Tax Court<sup>271</sup> and of most importance to this study, Tanzi's World Tax Organisation.<sup>272</sup> A World or International Tax Organisation is a critical part of the thesis of this paper.

Yet another avenue may be to develop a General Agreement on Trade, Tariffs and Taxes (GATTT), an addition to the current GATT.<sup>273</sup> One particularly promising approach for dispute resolution in Europe has been arbitration, although this approach is less conducive to dispute resolution than negotiation facilitated by way of mediation.<sup>274</sup> International arbitration models also need to be considered further in the development of such a body. The proposal advanced by this paper is for a World Tax Organisation that would eventually extend upon Tanzi's proposals,<sup>275</sup> as well as draw upon aspects of the WTO, and incorporate policy setting and dispute resolution (with both adversarial and arbitration components) mechanisms. However, this paper only develops this concept to the extent of such an organisation having a degree of responsibility and oversight for binding rulings and APAs.

One further contributing factor to securing international consensus or agreement on tax policy is striving for greater cohesion between the financial accounting and tax accounting systems in participating members or signatories to such an agreement. Major difference exist between continental Europe, where financial and tax accounting are closely related, and the Anglo-American situation where differences

Procedures Governing the Settlement of Disputes, Dec. 15, 1993, LEGAL INSTRUMENTS-RESULTS OF THE URUGUAY ROUND, vol. 1 (1994) 33 I.L.M. 112 (1994).

<sup>267</sup> The OECD has been suggested due to its proactive role in developing international model agreements in the area of taxation, although this only extends to its 30 members and the OECD does not have a formal dispute resolution mechanism since it is based upon member cooperation and consensus.

<sup>268</sup> The United Nations offers the widest coverage in terms of membership and as the successor to the League of Nations, has been involved in international tax treaty efforts (see U.N. MODEL TAX CONVENTION, *supra* note 102).

<sup>269</sup> The International Monetary Fund is hereinafter referred to as the IMF. For a discussion on the role of the IMF in the context of globalisation, see MICHEL CAMDESSUS, *THE IMF AND THE CHALLENGES OF GLOBALIZATION: THREE ADDRESSES* (1995).

<sup>270</sup> The North American Free Trade Agreement body is hereinafter referred to as NAFTA.

<sup>271</sup> See John Azzi, *Tackling Tax Treaty Tensions: Time to Think about an International Tax Court*, 52 BULL. FOR INT'L FISCAL DOC. 344, 349-50 (1998).

<sup>272</sup> See e.g. Tanzi, *supra* note 4. See also Vito Tanzi, *Is there a Need for a World Tax Organization?*, in Assaf Razin and Efraim Saka (eds.), *THE ECONOMICS OF GLOBALIZATION: POLICY PERSPECTIVES FROM PUBLIC ECONOMICS* 173 (1999). With an organisation such as the World Tax Organisation, this body would require a basis to manage transnational litigation, mediation and arbitration; for a discussion of some of the issues, see Tomas Kennedy-Grant, *Transnational Litigation and Arbitration*, N.Z. L. J. 7 (1998). In the context of developing a new world order and its implications for taxation, see Richard M. Bird, *Shaping a New International Tax Order*, 42 BULL. FOR INT'L FISCAL DOC. 292 (1988). For a response to Bird, see Leif Mutén, *A New International Tax Order?*, 42 BULL. FOR INT'L FISCAL DOC. 471 (1988).

<sup>273</sup> See e.g. CHARLES M. MCLURE, JR., *INTERNATIONAL ASPECTS OF TAX POLICY FOR THE 21<sup>ST</sup> CENTURY* (mimeograph, 1990), cited in RICHARD M. BIRD AND JACK M. MINTZ, *TAXATION TO 2000 AND BEYOND* 11 (Richard M. Bird and Jack M. Mintz eds., Canadian Tax Paper No. 93, 1992).

<sup>274</sup> See Luc Hinnekens, *Legal Sources and Interpretation of European Tax Arbitration Convention and its Recognition of the Taxpayer*, 47 CONG. INT'L FISCAL ASS'N 11 (1995), William W. Park, *Control Mechanisms in International Tax Arbitration*, 47 CONG. INT'L FISCAL ASS'N 35 (1995), and International Chamber of Commerce, *The Resolution of International Tax Conflicts*, 47 CONG. INT'L FISCAL ASS'N 97 (1995).

<sup>275</sup> See e.g. Tanzi, *supra* note 4, and Tanzi, *supra* note 272.

are much more noticeable.<sup>276</sup> The OECD conducted a review of accounting standard harmonisation in the mid 1980s,<sup>277</sup> although little has come of this, except for a growing role for the International Federation of Accountants and the International Accounting Standards Committee's efforts.<sup>278</sup> The move to adoption of International Financial Accounting Standards from 2007 (with early adoption from 2005) will have a significant impact on this issue.<sup>279</sup>

The extent of informal collective processes for determining tax policy that currently exist is minimal to say the least.<sup>280</sup> Such informal collective processes could form the basis upon which a more formalised tax policy process may be developed<sup>281</sup> as nations adapt to the changes "forced" upon them from globalisation. Much of this informal process occurs between diplomats and key political and official personnel, with the processes involved normally not formally documented.<sup>282</sup>

### Possible 'test cases' for a world (international) tax organisation

The breadth and success (or otherwise) of multilateral agreements that have a direct or indirect impact on taxation needs some level of consideration. Notable examples from the OECD include its agreement on information sharing by tax administrations,<sup>283</sup> the now failed attempt for an agreement on investment,<sup>284</sup> and transfer pricing guidelines for multinational enterprises and tax administrations.<sup>285</sup> However, of particular interest

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<sup>276</sup> See Thomas M. Porcano et al., *Alignment of Taxable Income with Accounting Profit*, 10 AUST. TAX FORUM 475 (1993), Thomas M. Porcano and Alfred V. Tran, *Relationship of Tax and Financial Accounting Rules in Anglo-Saxon Countries*, 33 INT'L J. ACCT. 433 (1998), Shahrokh M. Saudagaran and Joselito G. Diga, *Accounting Harmonization in ASEAN: Benefits, Models and Policy Issues*, 7 J. INT'L ACCT. AUD. & TAX'N 21 (1998), and Leo G. van der Tas, *European Accounting Harmonization: Achievements, Prospects and Tax Implications*, EC TAX REV. 178 (1992). For an international comparison of income taxation, including the role of financial accounting, see HUGH J. AULT (ed.), *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* (1997).

<sup>277</sup> OECD, *HARMONIZATION OF ACCOUNTING STANDARDS* (1986), and OECD, *ACCOUNTING STANDARDS HARMONIZATION: THE RELATIONSHIP BETWEEN TAXATION AND FINANCIAL REPORTING – INCOME TAX ACCOUNTING* (1987).

<sup>278</sup> See Saudagaran and Diga, *supra* note 272, at 22, 25, 33-34.

<sup>279</sup> See feature in the July 2003 issue of the *Chartered Accountants Journal* (NZ), and in particular, Liz Hickey, John Spencer, Tony van Zijl and Joanna Perry, *Adoption of IFRS – Background and Process*, 82 CHARTERED ACCTS. J. 4 (2003).

<sup>280</sup> See e.g. CHRISTOPHER C. FINDLAY, *CONFLICT AND COOPERATION IN INTERNATIONAL TAX POLICY: AUSTRALIA'S REFORM PROPOSALS*, (ASEAN-Australia Economic Papers No. 28, 1987).

<sup>281</sup> Such as an extension to the activities of the OECD or use of the U.N. model for debating and implementing proposed resolutions.

<sup>282</sup> The OECD member nations work on a consensus basis with the Secretariat seeking to produce agreements that are acceptable to all members as a result of extensive discussions. The U.N. utilises a permanent committee of influential nations, along with rotating memberships for other nations, with consensus sought but veto powers available to permanent members. Other regional groupings of nations are gradually formalizing their processes; for example consider APEC (see generally Lyuba Zarsky, *The Asia-Pacific Economic Cooperation Environment: Regional Environmental Governance in the Age of Economic Globalization*, 8 COLO. J. INT'L ENVTL. L. & POL'Y 323 (1997)) and ASEAN (see e.g. MARIA LOURDES ARANAL-SERENO AND JOSEPH SEDFREY SANTIAGO, *THE ASEAN: THIRTY YEARS AND BEYOND* (Maria Lourdes Aranal-Sereno and Joseph Sedfrey Santiago eds., 1997)). The 18 economies represented in APEC are Australia, Brunei, Canada, Chile, China, Chinese Taipei, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, South Korea, Thailand, and the United States. There is an overlap between the 10 ASEAN members and 18 APEC to the extent that Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand are members of both.

<sup>283</sup> OECD, *supra* n 177.

<sup>284</sup> OECD, *supra* n 262.

<sup>285</sup> OECD *supra* note 97.

and specifically in relation to tax, are the agreements between the Nordic Countries with respect to income tax,<sup>286</sup> the Caribbean Community,<sup>287</sup> and the E.U. members with respect to indirect taxation.<sup>288</sup> Various trading blocs and regional organizations of nations could become the basis for a multilateral (or regional) agreement with respect to taxation should an international tax organisation not eventuate.<sup>289</sup>

Underlying the arguments of this paper are the arguments surrounding the development of the best-fit international tax policy response to globalisation and how it can be accommodated within (international) tax policy concepts and principles. This can be divided into two major areas, the first concerns the degrees of harmonisation of taxation policy,<sup>290</sup> including the debate over whether limited cooperation, competition<sup>291</sup> or (complete) harmonisation is appropriate.<sup>292</sup> The second concerns whether an international agreement to maintain or raise taxes, and allocation of the jurisdiction (or the right to tax certain income or consumption), should be developed.<sup>293</sup> The context for establishing such agreements is normally applied by commentators to income tax (for both corporations and to a lesser degree, highly mobile and skilled individuals with significant international income derived beyond their country of residence), and to consumption taxes (in particular, the value-added tax and goods and services tax).<sup>294</sup>

Part of the motivation for this study is to investigate my *a priori* contention that a mutual tax policy setting, enforcement and dispute resolution process is both desirable and feasible in the current political and bureaucratic environment, and further, to determine the conditions conducive to facilitating such a process. The level of integration of policy,<sup>295</sup> including the harmonisation verses competition of tax policy debate, needs to be analysed.<sup>296</sup> Specific examples of types of taxation which are

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<sup>286</sup> CONVENTION BETWEEN THE NORDIC COUNTRIES, *supra* note 263.

<sup>287</sup> CARICOM Convention, *supra* note 264.

<sup>288</sup> For a discussion on the E.U.'s indirect tax harmonisation, see e.g. Michel Aujean and Ken Lennan, *The Community Internal Market: Direct and Indirect Taxation Issues*, in PROCEEDINGS OF CONFERENCE HELD BY THE CONFEDERATION OF EUROPEAN ASSOCIATIONS IN 1989, 8-22, (George Winckler ed., 1992) and Stephen Smith, 'Subsidiarity' and the Co-ordination of Indirect Taxes in the European Community, 9 OXFORD REV. ECON. POL'Y 67 (1993).

<sup>289</sup> These include the European Union (EU), the North American Free Trade Association (NAFTA), the Asia Pacific Economic Cooperative (APEC), the Association of South East Asian Nations (ASEAN), African Economic Community (AEC), and Closer Economic Relations (CER), as between New Zealand and Australia.

<sup>290</sup> See e.g. James and Oats, *supra* n 68 (examining the degrees of harmonisation) and James, *supra* n 68. See also the discussion in sections 2.4 and 2.5 of this paper.

<sup>291</sup> The OECD has been responsive to dealing with what is considered to be "harmful competition"; see OECD, *supra* note 5.

<sup>292</sup> For a discussion on the relative merits of harmonisation and competition, see Hans-Werner Sinn, *Tax Harmonization and Tax Competition in Europe*, 34 EUR. ECON. REV. 489 (1990).

<sup>293</sup> Agreements to maintain, raise or lower taxes will necessarily have greater restrictions in scope and contain more nation-state freedoms than the process of determining appropriate jurisdiction allocation and sharing of tax revenue, owing to the larger inroads to national sovereignty and culture that the former type of agreement will need to accommodate. See also the discussion earlier in this section of the paper.

<sup>294</sup> Hereinafter the value-added tax is referred to as VAT and goods and services tax as GST.

<sup>295</sup> See Tanzi, *supra* n 258. For a comment on Tanzi's proposals, see Joel Slemrod, *Comments*, in TAXING IN AN INTEGRATING WORLD, ch. 2 (appendix) (1994). Slemrod is sympathetic to the views and approach of Tanzi, but he anticipates the move to such a proposal to be slow and not explicit (this is particularly in the case of a global income tax more than for a world tax organisation); see pp 145-6.

<sup>296</sup> See Tracy A. Kaye, *European Tax Harmonization and the Implications for U.S. Tax Policy*, 19 B. C. INT'L & COMP. L. REV. 109 (1996), and Stephen G. Utz, *Tax Harmonization and Coordination in*

candidates for integration of policies are income tax levied on corporations<sup>297</sup> and individuals, and consumption taxes. While there are suggestions by some commentators that the United States income tax could be replaced by some form of a consumption tax, for the purposes of this study it is assumed that the income tax will continue in the United States and in all OECD member countries, along with the majority of developing and transition nations.<sup>298</sup> For this study the focus is narrowed to consider the related areas of binding rulings and advanced pricing agreements relating to issues of income tax.

### **Developing an international (world) tax organization, The United Nations' proposal**

The most recent and probably first non-academic discussion suggesting an International Tax Organisation (ITO) was that mooted by a panel of independent financial experts appointed by U.N. Secretary-General Kofi Annan and chaired by former Mexican President Ernesto Zedillo in 2001.<sup>299</sup> The proposal was to create an International Tax Organisation (ITO) that would be administered by the U.N. In essence this organisation would help nations collect and disseminate information on tax policies and, opponents insist, assess its own taxes, help governments' tax emigrant citizens working in other countries and even compel member states to share tax data. The ITO would be perceived as potentially taking a leading role in restraining tax competition which is designed to attract MNEs.<sup>300</sup>

Specifically, in their June 2001 report, presented as independent input to intergovernmental discussions, the Zedillo panel suggested that serious consideration be given to developing this new organisation.<sup>301</sup> The ITO might take on functions that would include offering technical assistance, providing a forum for the development of international tax norms, maintaining surveillance of tax developments in a manner similar to IMF review of national macroeconomic policies, restraining unwise tax competition designed to attract multinationals and arbitrating international disputes on tax matters.<sup>302</sup> It was also suggested by panel members that such an organisation might look into securing international agreement on a formula for unitary taxation of

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*Europe and America*, 9 CONN. J. INT'L L. 767 (1994). However, such harmonisation should not be sweeping in its effect, argues Vogel; see Klaus Vogel, *The Search for Compatible Tax Systems*, in TAX POLICY IN THE TWENTY-FIRST CENTURY (Herbert Stein ed., 1988). See also Alvin C. Warren Jr., *Alternatives for International Tax Reform*, 49 TAX L. REV. 599 (1994). See also the discussion in sections 2.4 and 2.5 of this paper.

<sup>297</sup> There have been calls for the United States to integrate its corporate and individual income tax regimes as part of this reform; see e.g., Glenn E. Coven, *Corporate Tax Policy for the Twenty-first Century: Integration and Redeeming Social Value*, 50 WASH. & LEE L. REV. 495 (1993).

<sup>298</sup> For a discussion on the proposed replacements for the income tax (National Retail Sales Tax, USA Tax, and the Flat Tax) and their international implications, see Stephen E. Shay and Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029 (1997) and several commentaries that accompanied this paper; George Mindstock, *Comment: What's on Second?*, 51 U. MIAMI L. REV. 1079 (1997), Reuven S. Avi-Yonah, *Comment on Shay and Summers: Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1085 (1997), and Michael J. Graetz, *International Aspects of Fundamental Tax Restructuring: Practice or Principle?*, 51 U. MIAMI L. REV. 1093 (1997).

<sup>299</sup> United Nations, *Media Kit: Halting a Global Tax*, available at: <http://www.un.org/esa/ffd/ffdconf/article89.htm> (visited 17 February 2004).

<sup>300</sup> See CATO INSTITUTE, CATO HANDBOOK FOR CONGRESS, POLICY RECOMMENDATIONS FOR THE 108<sup>TH</sup> CONGRESS, Washington DC, (2002).

<sup>301</sup> See United Nations, *supra* n 299.

<sup>302</sup> A considerable amount of this activity is already undertaken by the OECD.

multinationals,<sup>303</sup> as well as the establishment of principals for equitable collection of taxes from emigrants. However, this proposal was put to the Preparatory Committee, where it did not find favour as being implementable in the near future.<sup>304</sup>

In a briefing note from the University of Barcelona's Observatory of Globalisation (UBOG),<sup>305</sup> it is observed that at the very least, an organisation such as the ITO could compile statistics, identify trends and problems, present reports, offer technical assistance, and provide a forum for the exchange of ideas and the development of norms for tax policy and tax administration. It could engage in surveillance of tax developments in the same way that the IMF maintains surveillance of macroeconomic policies.

Going further, the UBOG<sup>306</sup> contends that the ITO might engage in negotiations with tax havens to persuade them to desist from harmful tax competition. Similarly, it could take a lead role in restraining the tax competition designed to attract multinationals - competition that, as noted earlier in this paper, often results in the lion's share of the benefits of FDI accruing to the foreign investor. Slightly more ambitiously, an ITO might develop procedures for arbitration when frictions develop between countries on tax questions. Even more ambitiously, the UBOG suggests that it could sponsor a mechanism for multilateral sharing of tax information, like that already in place within the OECD, so as to curb the scope for evasion of taxes on investment income earned abroad. Perhaps most ambitious of all, argues the UBOG, it might in due course seek to develop and secure international agreement on a formula for the unitary taxation of multinationals. Another task that might fall to an ITO would be the development, negotiation, and operation of international arrangements for the taxation of emigrants.<sup>307</sup>

If an ITO were successful in curbing tax evasion and tax competition, there would be two consequences, in the UBOG's view.<sup>308</sup> One would be an increase in the proportion of a given volume of taxes paid by dishonest taxpayers and by mobile factors of production (like capital). Most people would consider this an unambiguous gain. The other would be an increase in tax revenue for a given tax rate. Governments could take advantage of the increased revenue by increasing public expenditure, improving the fiscal balance, or cutting tax rates. The latitude to increase public spending would be welcomed by some but deplored by others, who may for that reason oppose the proposal.<sup>309</sup>

However, this proposal is unlikely to make any significant progress for some time, since it has been the subject of considerable criticism.<sup>310</sup> For instance the proposal is

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<sup>303</sup> Reference to the debate on unitary taxation through some form of formulary apportionment is a very emotive and controversial area quite apart from an ITO.

<sup>304</sup> See United Nations, *supra* n 299.

<sup>305</sup> Observatory of Globalisation of the University of Barcelona, *Briefing Notes; Chapter 4: An International Tax Organisation* (2003), available at: <http://www.ub.es/obsglob/itogen2.html>, (visited 17 February 2004).

<sup>306</sup> *Id.*

<sup>307</sup> *Id.*

<sup>308</sup> *Id.*

<sup>309</sup> *Id.*

<sup>310</sup> See e.g. Daniel J Mitchell, *Radical UN Tax Target*, WASH. TIMES, 22 December (2003); and Refet Kaplan, *Critics Slam Proposed UN Tax Authority*, FOX NEWS, 18 January (2002).



seen as creating something of an international tax cartel that would keep world taxes high.<sup>311</sup>

### **Scholarly contributions to the processes for developing an international tax organisation**

Avi-Yonah,<sup>312</sup> in his examination of globalisation and tax competition, observes that relying on the OECD to restrict tax competition ultimately suffers from two significant drawbacks. First, it can be envisaged that in the longer run significant markets for both portfolio investment and retail sales will develop outside the OECD. When this situation arises, solutions that rely on OECD enforcement will lose their effectiveness unless those emerging markets were to join the OECD. While several developing countries have joined the OECD recently (for example, Czech Republic, Hungary, Korea (Republic of), Mexico and the Slovak Republic), Avi-Yonah finds it difficult to imagine China or India doing so in the near future.

Secondly, and more importantly, Avi-Yonah contends that relying on the OECD to implement solutions to the tax competition problem, even if those solutions are tailored to benefit developing countries, may not be acceptable to those countries.<sup>313</sup> He supports this view by observing that the effort by the OECD to develop a multilateral agreement on investments (MAI)<sup>314</sup> foundered precisely because developing countries and “left-leaning” non-governmental organisations coordinated a campaign against it as representing the interests of the rich countries and “their” MNEs.

Avi-Yonah’s proposal for restricting tax competition is via a multilateral body that includes developing countries. While no such body currently exists, he acknowledges that several scholars have already proposed setting one up.<sup>315</sup> However, in Avi-Yonah’s view, there is a natural candidate for the job which already is in place: the World Trade Organisation (WTO).<sup>316</sup>

The WTO, argues Avi-Yonah, is the natural candidate to be the “World Tax Organisation.” In fact, he argues that it is hard to see how the WTO can fulfil its role of ensuring the free flow of trade and reducing non-tariff barriers without having jurisdiction over tax matters. In addition, the fact that the WTO includes representatives from almost all the developing countries gives it an obvious advantage over the OECD even if the solutions it implements are exactly the same as the OECD-based ones proposed above.<sup>317</sup>

Avi-Yonah observes that there are several serious objections to including tax matters in the jurisdiction of the WTO. First, it has been argued that the WTO lacks sufficient

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<sup>311</sup> See Kaplan, *Id.*

<sup>312</sup> Avi-Yonah, *supra* n 2.

<sup>313</sup> *Id.*, at 1670-5.

<sup>314</sup> See OECD, *supra* n 262.

<sup>315</sup> See TANZI, *supra* note 258, at 140; Bird, *supra* note 272, at 297-99; John K. Sweet, Comment, *Formulating International Tax Laws in the Age of Electronic Commerce*, 146 U. PA. L. REV. 1949 (1998); Kenneth J. Vandeveld, *The Political Economy of a Bilateral Investment Treaty*, 92 AM. J. INT’L L. 621, 641 (1998).

<sup>316</sup> Avi-Yonah, *supra* n 2.

<sup>317</sup> *Id.* at 1670-5.

tax expertise.<sup>318</sup> However, that problem, argues Avi-Yonah, can be remedied by hiring a sufficient number of tax experts to sit on the WTO's panels. In fact, as the WTO has expanded its jurisdiction to non-tariff matters, its staff already includes tax experts who also understand trade issues.<sup>319</sup>

Green has advanced a more serious objection arguing that the costs of imposing the WTO's legalistic dispute-resolution mechanism outweigh any benefits.<sup>320</sup> Green argues that the need for the WTO to resolve trade disputes legalistically is based on two features that are typically lacking in the tax context: retaliation and lack of transparency.<sup>321</sup> In the context of tax competition, Avi-Yonah acknowledges that both retaliation and lack of information appear to be serious problems.

Avi-Yonah acknowledges that Green<sup>322</sup> also raises another objection to giving the WTO authority over taxes which in practice is likely to be far more potent: the problem of sovereignty. This issue has been discussed earlier in this paper.<sup>323</sup> Countries are wary of giving up their sovereignty over tax matters which lies at the heart of their ability to exercise national power. Green argues that if the WTO dispute resolution mechanism were given authority over tax issues, this may lead to widespread non-compliance especially given the perception that the WTO is non-transparent and lacks democratic legitimacy.<sup>324</sup>

Avi-Yonah counteracts these problems through presenting a solution to this problem as well.<sup>325</sup> Under the GATT regime, all decisions had to be reached by consensus, i.e., with the agreement of the party whose regime is at stake. Under the WTO rules, on the other hand, all dispute settlement rulings are binding unless there is a consensus not to implement them; that is, even when the complaining party agrees to refrain from action. Avi-Yonah argues that the former rule is more appropriate for tax matters than the latter because it gives the loser a veto if it feels that its sovereignty is truly at stake.<sup>326</sup> Similar rules exist for tax matters in both the E.U. and the OECD. However, in practice a country will typically reserve its veto power only to those cases in which the adverse result is truly perceived as a severe limit on its sovereignty. In other cases, the stigma of disapproval is sufficient to ensure cooperation.

Pinto makes an important observation on the limits of sovereignty<sup>327</sup>:

However, absolute sovereignty is largely illusory and this is illustrated well by what has come to be known as 'Hobbes' paradox'. According to

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<sup>318</sup> See Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443 (1988); Antilegalistic Approaches, *supra* n 266, at 123; William M. Considine, *The DISC Legislation: An Evaluation*, 7 N. Y. U. J. INT'L L. & POL'Y 217 (1974).

<sup>319</sup> Avi-Yonah, *supra* n 2.

<sup>320</sup> See *Antilegalistic Approaches*, *supra* note 266.

<sup>321</sup> See further Avi-Yonah, *supra* n 2, for a discussion on these issues.

<sup>322</sup> See *Antilegalistic Approaches*, *supra* note 266.

<sup>323</sup> Refer to section 2.7 of the paper.

<sup>324</sup> See *Antilegalistic Approaches*, *supra* note 307, at 426. See also Joel P. Trachtman, *The Domain of WTO Dispute Resolution*, 40 HARV. INT'L L. J. 333 (1999) (describing factors to be weighed in choosing between rules and standards in the WTO context). But it should be noted that the WTO already has exercised jurisdiction over matters such as food safety, intellectual property, and similar issues that also involve sensitive sovereignty issues.

<sup>325</sup> Avi-Yonah, *supra* n 2, at 1674-5.

<sup>326</sup> *Id.* at 1674-5.

<sup>327</sup> Dale Pinto, *A Proposal to Create a World Tax Organisation*, 9 N. Z. J. TAX'N L. POL'Y 145 (2003), at 157.

Hobbes,<sup>328</sup> if men were to hold on to all their rights and liberties and be able to do as they wish (i.e. exercise absolute sovereignty), this would necessarily imply the right to invade other men's rights leading to a state of anarchy or war. In reality, equilibrium or peace can only be achieved when there is a mutual laying down of rights for mutual benefit. Hobbes paradoxically therefore asserts that in fact giving up sovereignty can lead to empowerment (by harnessing mutual benefits), while retaining it can actually lead to disempowerment.

One can extrapolate Hobbes' paradox to the establishment of a World Tax Organisation; that is, if nation states are to achieve mutual benefits and adapt to the challenges presented by electronic commerce in an increasingly integrated economy, there can be no room for the exercise of absolute sovereignty. Rather, the mutual laying down of rights by nation states, by means of cession or restriction of sovereignty, should be undertaken in a manner which is tailored to the new global forces so that the harnessing of mutual benefits can be maximised. Consistent with this is the assertion that nation states can give up or cede sovereign rights if they are able to secure mutual advantages for their citizens; that is, their decision to give up sovereignty would be guided by the benefits that accrue to the individuals making up the nation state.

Tanzi<sup>329</sup> contends with justification that the route of pursuing international agreements in tax matters is unlikely to be a productive one as the experience, over the past two decades, of the E.U. shows. Countries are not likely to abandon their national objectives and to agree to arrangements that they may see as less beneficial to them than the alternative of going it alone. Also, countries with different political agendas will find it difficult to agree on a given tax structure. Even in the restricted area of the E.U. the progress towards tax harmonisation has been limited, although improving with time. Tanzi observes that the experience with negotiating tax treaties indicates that tax agreements, even between two countries, are, at times, difficult to reach and are very demanding in time and effort. In any case there is no institutional set-up that facilitates the discussion of issues and the negotiation of agreements on a world basis, and this situation lies at the heart of the problem.<sup>330</sup>

This situation leaves the alternative of creating an international organisation which would systematically deal with tax matters or alternatively, of giving a specific mandate to an existing institution. As has been noted previously, there is a world organisation that deals with trade matters (WTO); one that deals with macroeconomic stability and balance of payment equilibrium (International Monetary Fund - IMF); one that deals with economic development (International Bank for Reconstruction and Development - IBRD); and many others that deal with other objectives. The IMF, in particular, focuses on transnational implications of domestic macroeconomic policies. Yet, there is no organisation at the world level that supervises, or attempts to influence, tax developments with transnational implications.<sup>331</sup>

Tanzi<sup>332</sup> suggests that this situation can be considered unusual because countries are competing less and less through the use of tariffs and quantitative restrictions on trade and through changes in exchange rates and more and more through the use of tax

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<sup>328</sup> T HOBBS, *LEVIATHAN* 92 (1991).

<sup>329</sup> Tanzi, *supra* n 4, at 341-3.

<sup>330</sup> *Id.*, at 342.

<sup>331</sup> *Id.*, at 342.

<sup>332</sup> *Id.*, at 342.

incentives, adjustments in tax rates, changes in administrative treatment of some incomes and so forth. This, Tanzi suggests, is the process that in the view of many tax experts is leading to “tax degradation”.<sup>333</sup> As trade is liberalised further and as capital becomes freer to move, the advantages to some countries of engaging in tax competition, and the temptation to do so, will increase. The world tax base will become one of the “commons” to be exploited.

Thus, a case can then be made for the establishment of a World Tax Organisation. Tanzi asks the question: what would be the mandate for such an organisation? There are many possibilities, with Tanzi mentioning some of them.<sup>334</sup> At the outset, its mandate would depend on how much power the member countries would want to give to it. It would also depend on how representative it would be of the whole world community. Because the levying of taxes is one of the most political of all governmental actions, it is unlikely that, at this juncture in time, the countries’ governments would want to assign to the World Tax Organisation the power to tax. There is still no example of a supranational organisation that has been given this power, since even the European Commission does not have such power.<sup>335</sup>

Tanzi then refers to James Tobin’s idea of an international tax on cross-countries’ financial transactions, an idea that has been adopted by other writers who have proposed international taxes on bases such as airline tickets, financial transactions, or other bases, to finance the U.N.<sup>336</sup> The collection of such a tax or some version of it, could be assigned to the World Tax Organisation, in Tanzi’s view.<sup>337</sup>

However, Tanzi recognises that it is unlikely that the countries of the world are ready for such a step or for similar steps even though such taxes could provide financing for the activities of some of the international organisations and would remove the decision to finance established institutions such as the U.N. from the frequent political debate within countries.<sup>338</sup> Nevertheless, Tanzi suggests that the World Tax Organisation could be given responsibilities other than tax collection, with some of the main activities of such an organisation being<sup>339</sup>:

- 1) The identification of main tax trends and problems at the international level.
- 2) The compilation and/or generation of relevant tax statistics and tax information for as many countries as possible.
- 3) On the basis of the above information, preparing a (yearly?) *World Tax Development Report* presenting statistics, describing main trends (both statistical

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<sup>333</sup> *Id.*, at 342.

<sup>334</sup> *Id.*, at 342.

<sup>335</sup> Tanzi wrote in 1988: “It is conceivable that the day may come when the countries [of the world] create an ‘International Revenue Services’ to collect taxes that could not be collected by separate governments and to allocate them either to the provision of international public goods or back to the countries.” See Vito Tanzi, *Forces that Shape Tax Policy*, in *TAX POLICY IN THE TWENTY FIRST CENTURY* (Herbert Stein, ed., 1988), at 277.

<sup>336</sup> The Tobin tax was first proposed by James Tobin, *A Proposal for International Monetary Reform*, 4 *EUR. ECON. J.* (1978), at 153-59. It has been much studied recently. See *inter alia*. B Spahn, *International Financial Flows and Transactions Taxes: Survey and Options*, IMF Working Paper, WP/95/60 (June 1995); and Peter Shame and Janet Stotsky, *Financial Transaction Taxes*, IMF Working Paper, WP/195/7 (August 1995).

<sup>337</sup> Tanzi, *supra* n 4, at 342.

<sup>338</sup> See comments and reaction to the U.N.’s 2001 announcement of a proposed WTO; see United Nations, *supra* n 299.

<sup>339</sup> Tanzi, *supra* n 4, at 343.

and in terms of policy developments), identifying problems, and, perhaps, pointing toward feasible solutions to these problems. Countries' best practices could be identified and made known to other countries. Emerging problems could be highlighted and solutions to them could be studied.

- 4) Providing some technical assistance to countries in tax policy and tax administration always keeping in mind that changes recommended should make the tax system of the country receiving the assistance better coordinated or harmonised with the systems of other countries. Furthermore, the goal of the technical assistance provided by the new organisation would be to make the tax systems more compatible.
- 5) Developing basic norms for tax policy and tax administration. This is an area where little progress has been made.
- 6) Providing a world forum in which countries' policy makers and experts can exchange ideas on tax matters.
- 7) Providing a world forum for tax arbitration when frictions or conflict between countries or among groups of countries arise. Once again, no such forum exists now.
- 8) Providing surveillance over tax developments in the same way as the IMF provides surveillance on macroeconomic developments. Such a process of surveillance could be conducted: (a) at the country level; (b) at the regional level; and (c) at a world level. The modus operandi of the IMF could provide a useful guide for the new organisation.

Thus, Tanzi concludes that the World Tax Organisation would identify tax developments that create cross-national spillover effects and would bring these to the attention of a board of directors representing all the countries.<sup>340</sup> The board would recommend changes in those areas where the tax behaviour of a country has clearly negative implications for other countries. For example, it would recommend changes in countries that are obviously raiding the world tax base. This organisation would not get involved in tax issues that do not have significant cross-border spillovers. Furthermore, the World Tax Organisation would only recommend changes and not force them. While these would be the major activities of such an organisation, Tanzi recognises that more detailed and specific terms of reference might include other activities.<sup>341</sup>

Do we need an International (or World) Tax Organisation? Horner<sup>342</sup> argues that a new global institution in taxation policy will make a significant, non-redundant contribution to global governance if - and only if - it gives a full and true voice to the fiscal concerns and needs of developing countries. That objective cannot be realised with a one-dimensional focus on tax cooperation. For the developing countries of the world, taxation policy and the development agenda are inseparable.<sup>343</sup>

In Horner's view, the U.N. seems to be the best contender for the job of convening an international tax body, and it is clearly positioning itself to become globally what the OECD has become for its interest group. The U.N.'s International Tax Organisation (ITO) proposal<sup>344</sup> is a commitment by heads of state to "[e]xplore, including through a

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<sup>340</sup> *Id.* at 343.

<sup>341</sup> See the companion paper by Tanzi; Tanzi, *supra* n 64.

<sup>342</sup> Frances M. Horner, *Do we need an International Tax Organisation?*, 24 TAX NOTES INT'L 179 (2001).

<sup>343</sup> *Id.* at 179.

<sup>344</sup> United Nations, *supra* n 299.

global network of tax authorities, the potential benefits and optimal design of an International Tax Organization or other tax cooperation forum, taking into account previous efforts in this regard as well as the special needs of developing countries and countries with economies in transition.”<sup>345</sup> It also underscores the need for “strengthening the representation and participation of developing countries in all global economic decision making and norm setting bodies. . . .”<sup>346</sup> If these ambitions can be realised, the ITO will have an excellent basis for success and a legitimate claim that the new international tax body is not redundant.

Horner then presents several conditions which are considered vital for an international cooperation agreement, this being a necessary component for an effective ITO<sup>347</sup>:

- 1) *Condition One: No Gag Rules*: All issues must be eligible for discussion at the forum;
- 2) *Condition Two: Fair Share*: Attention should be given to profit allocation rules;
- 3) *Condition Three: Link to Official Development Assistance*: Development issues should be relevant in formulating tax policy;
- 4) *Condition Four: Tax Administration Efficiency*: Developed countries should assist developing countries in improving tax administration; and
- 5) *Condition Five: Governance*: Developing countries should have a meaningful voice in any world tax body or tax cooperation arrangement.

#### **A previously suggested application of a world tax organisation model: The cyber-entity**

The literature to date is scant on specific areas that a World Tax Organisation/International Tax Organisation (ITO) could be applied to. One area that has received some attention is that of electronic commerce policy and its ensuing taxation implications. One proposal has been offered by Oats and Fernandez,<sup>348</sup> namely a Cyber Entity combined with a World Tax Authority (WTA).

Oats and Fernandez suggest that this new global corporation should be called the Cyber-Entity and should be defined as any entity that sells goods or services through the internet.<sup>349</sup> The Cyber-Entity will be an artificially created entity, similar to a corporation, but it will be global. Thus, instead of a corporation being incorporated in a particular jurisdiction, the cyber-entity will be born by registration with a WTA.<sup>350</sup>

The WTA, suggest the authors, will be created by representatives from each country that has agreed, by way of multilateral agreement, to be members of the WTA. The WTA will be given the jurisdiction to register and tax cyber-entities; that is, entities that deal with the internet trade. The WTA will be responsible for the incorporation of the artificially created Cyber-Entity, with its own legal personality, separate from its participators. The personality will be defined by rules that govern its behaviour from its conception before its birth, to the funeral after its death.<sup>351</sup>

<sup>345</sup> Horner, *supra* n 342, at 188.

<sup>346</sup> Draft Outcome Prepared by the FfD Facilitator (September 2001) para 54, available at: [http://www.un.org/esa/ffd/0901/Facilitator\\_text.htm](http://www.un.org/esa/ffd/0901/Facilitator_text.htm). (Visited 17 February 2004).

<sup>347</sup> See Horner, *supra* n 342, at 192-4.

<sup>348</sup> Lynn Oats and Prafula Fernandez, *Creation of a Cyber Entity*, 5 N. Z. J. TAX’N L POL’Y 96 (1999).

<sup>349</sup> *Id.* at 105-6.

<sup>350</sup> *Id.* at 105-6.

<sup>351</sup> *Id.* at 104-7.

Furthermore, each participating country will need to pass legislation in their jurisdiction implementing the scheme, and will have to forgo any right or jurisdiction over the cyber-entity. Each country may be a watchdog for the WTA and liaise with the WTA as to any breaches of WTA law by the Cyber-Entity.

The authors go on to discuss their proposed structure of the Cyber-Entity and its taxation. They then present several advantages and disadvantages of their proposal.<sup>352</sup> The advantages of their proposed structure are suggested to be that there will be no incentive for an organisation to artificially split its electronic commerce into various jurisdictions. Since accounting for the organisation will be done on a unitary basis, the tax will be at a uniform rate and in a uniform currency.<sup>353</sup> This will remove tax barriers, resolve the problems of bilateral or multilateral treaties, and promote global economic growth. However, the major disadvantage of economic integration is that it will limit national sovereignty.<sup>354</sup> Countries will have to give up rights over this Cyber-Entity. However, it may well be worth giving up national sovereignty for economic growth and prosperity. The major problem to be addressed is how to deal with countries that do not want to be part of this scheme. The authors conclude<sup>355</sup>:

What is needed is a new paradigm to trigger a change in the international tax order. The cyber-entity concept may seem "way out", but then who would have guessed what the internet itself would have looked like only 5 or 10 years ago. Anything is possible.

### **Approaches for progressing towards a World Tax Organisation**

Two scholars have made inroads into the possible structure of some form of international tax organisation. Their proposals are discussed in turn.

#### **Thuronyi**

Thuronyi argues in favour of international tax cooperation, a multilateral treaty, and most importantly, an international tax organisation.<sup>356</sup> Thuronyi reviews the problems with the existing international tax system and the problems with the existing treaty network. He identifies the follow issues<sup>357</sup>:

- 1) The existing framework limits unilateral action;
- 2) Bilateral networks are inconsistent with multinational business structures;
- 3) Bilateral networks represent a fragmented approach;
- 4) Triangular cases are difficult or impossible to handle bilaterally;
- 5) There is incomplete coverage of countries;
- 6) There are problems with interpretation and amendment;
- 7) There is incomplete coverage of taxes;
- 8) Inflexibility; and
- 9) Treaty shopping.

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<sup>352</sup> *Id.*, at 107.

<sup>353</sup> For discussion on the implications of unitary taxation, see section 2.9 of this paper.

<sup>354</sup> For a discussion on sovereignty issues, see section 2.7 of the paper.

<sup>355</sup> Oats and Fernandez, *supra* n 348, at 107.

<sup>356</sup> Victor Thuronyi, *In Defense of International Tax Cooperation and a Multilateral Tax Treaty*, 22 TAX NOTES INT'L 1291 (2001).

<sup>357</sup> *Id.* at 1294-7.

Thuronyi argues convincingly that many of these problems could be overcome with a multilateral treaty framework, and he then presents a proposed structure for a multilateral treaty.<sup>358</sup> The proposed multilateral treaty would replace the existing network of tax treaties with a single multipart treaty. The existing treaties would remain in force during a transition period. Thuronyi then advances his proposal in five main parts<sup>359</sup>:

- 1) The first part would be a common template for bilateral treaties, initially based on the OECD model.
- 2) The second part would be a multilateral treaty, based on the template in part one, but adjusted to take account of its multilateral nature. This part would not be subscribed to by all countries, at least initially.
- 3) The third part, which could evolve over time, would contain general undertakings for cooperation in international taxation (for example, non-discrimination, refraining from unfair tax competition, or agreements on information sharing).
- 4) *The fourth part of the treaty would be institutional, providing for an international organization to administer the treaty and for procedures.*
- 5) Finally, derogations and transitional arrangements would provide a bridge between the existing treaty networks and part one of the agreement. There would also be a common text based on the OECD Model, a unilateral version of the common text, general and undertakings.

Finally Thuronyi presents his proposal for the structure of an international organisation to administer this treaty.<sup>360</sup>

### **Membership and structure**

The multilateral treaty should designate an organisation charged with enforcing, promoting, and interpreting the treaty, proposing amendments, and, more generally, promoting intergovernmental cooperation in taxation. While the OECD currently plays this role to some extent, it is not ideally suited for it, given its limited membership.

Given the political nature of the question, Thuronyi<sup>361</sup> does not believe that it is useful to discuss extensively what existing or new agency might be entrusted with this task. If sufficient international consensus develops to negotiate a multilateral tax treaty and countries entrust its administration to an appropriate agency, whichever agency is chosen will be an outcome of the negotiation process.

Whatever body is chosen (an existing body or a new body), Thuronyi suggests<sup>362</sup> that membership should eventually be nearly universal, but should be conditioned on the satisfaction of specified criteria, as well of course as adherence to the treaty. Not all countries will wish to cooperate by becoming members.

Because each country has a sovereign right to tax, Thuronyi proposes<sup>363</sup> that each country should have a representative in this world body. The appropriate representative would be the highest official in charge of tax policy or tax administration - typically the finance minister or the minister in charge of the tax

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<sup>358</sup> *Id.* at 1297.

<sup>359</sup> *Id.* at 1297-8. Emphasis added.

<sup>360</sup> *Id.* at 1299-1300. The following discussion in section 4.6.1.1 draws upon Thuronyi's proposal.

<sup>361</sup> *Id.* at 1299-1300.

<sup>362</sup> *Id.* at 1299-1300.

<sup>363</sup> *Id.* at 1299-1300.



administration in countries in which there is a separate ministry. A one-country one-vote arrangement seems to have worked, for example, for the WTO. Such a rule is consistent with each country's sovereignty. An additional supermajority requirement on the basis of weighted voting could be layered on top of this.

Thuronyi recognises<sup>364</sup> that the tax staff of the organisation should be international in character. Staff should be drawn from tax experts of all countries, and it would be desirable for a substantial portion to be drawn from the ministries of finance and tax administrations of the member countries. While there should be a permanent staff to provide some continuity, it would be important to provide a rotating element for the staff in order to maintain the cooperative character of the organisation. Thus, Thuronyi contends that the staff would benefit from an immediate knowledge of practices in the tax administrations of their own countries.

### Functions

Thuronyi suggests that the organisation should be a general forum for discussion of the operation of the international tax system - the system for taxing international transactions.<sup>365</sup> Its staff should conduct studies, including statistical studies, on how the system is working, and propose solutions.

The organisation should, in Thuronyi's view,<sup>366</sup> have the power to issue interpretations of the treaty that would have general legal effect (specific disputes would have to be resolved separately). This would be an important improvement over the existing situation with the OECD commentary, because the interpretation would be legally binding. The organisation would provide a forum for continuous review of experience with the treaty. It would encourage the renegotiation of existing agreements to bring them into line with the treaty, including serving as a forum for multilateral negotiations (a country could renegotiate simultaneously a set of existing treaties with other countries). It would deal with problems of interpretation and application of the treaty and would attempt to find solutions by way of issuing reports, issuing formal interpretations of the treaty, and proposing amendments to the treaty text for ratification by the members.

While the primary focus of the organisation would be, in Thuronyi's view,<sup>367</sup> to facilitate the *operation of the international tax system*, it should also deal more broadly with taxation, including some purely domestic issues. On purely domestic taxation, however, the organisation should be more of an observer and technical advisor rather than interfering in countries' decisions on tax policy and thereby impinging on their sovereignty. The organisation should gather information on how the tax systems of its member countries operate, including data of a statistical, economic, and legal nature. It should provide technical assistance to its member countries upon request.

The organisation should, argues Thuronyi,<sup>368</sup> become a leader in comparative tax law and policy analysis. It should collect and publish the tax legislation of member countries and lead the effort in improving this legislation at a technical level. As part of its task of interpreting and evaluating the multilateral treaty, it should collect and publish judicial decisions and scholarly writings on tax treaty interpretation.

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<sup>364</sup> *Id.* at 1299-1300.

<sup>365</sup> *Id.* at 1299-1300. The following discussion in section 4.6.1.2 draws upon Thuronyi's proposal.

<sup>366</sup> *Id.* at 1299-1300.

<sup>367</sup> *Id.* at 1299-1300. Emphasis added.

<sup>368</sup> *Id.* at 1299-1300.

In addition to providing technical assistance in improving domestic tax administration to those of its member countries with weaker administrative capacities, the organisation should, argues Thuronyi, become a *centre for international cooperation* in tax administration.<sup>369</sup> It should actively facilitate the cooperation of administrations in areas such as information exchange, joint audits, resolution of transfer pricing cases, and other cooperative efforts to stem tax avoidance and evasion, particularly where international transactions are involved. In so doing, the organisation should work closely with regional groupings of tax administrators, providing support to them as appropriate.

The organisation could, suggests Thuronyi,<sup>370</sup> also become a forum for formal resolution of disputes among countries, as is the WTO for trade disputes. Thuronyi cautiously suggests that a dispute-resolution role should not be included in an original draft of a multilateral treaty, for fear of being too ambitious at the beginning. An alternative would be to provide for limited dispute resolution by agreement.

Thuronyi then contends that the process of negotiating a unified tax treaty template would presumably encourage countries to rationalise their bilateral treaty relationships and therefore to minimise the amount of derogation.<sup>371</sup> While there would not be complete uniformity, the extent of differences could be substantially reduced. Replacement of the network of bilateral treaties with a multilateral treaty, therefore, does not require all countries to effectively scrap all provisions of their bilateral treaties. While it would be desirable to achieve as great a harmonisation of bilateral agreements as possible, the multilateral treaty can be designed in such a manner that each signatory can enter reservations.<sup>372</sup>

Thuronyi proposes that during a transition period, existing treaties should remain in effect.<sup>373</sup> This would give negotiators time to review existing treaties and determine to what extent the texts can be brought into conformity with the uniform text. Countries would commit to negotiate any new treaties on the basis of the uniform text. This does not mean that there cannot be differences, but that the treaties must take the form of agreement to the uniform text subject to specified deviations. Eventually, all tax treaties would be brought into this format.

Thuronyi concludes<sup>374</sup> his proposal by suggesting that multilateral action is needed to establish an international organisation for cooperation in taxation and a multilateral treaty to replace the current bilateral tax treaty network. While Thuronyi is confident that the arguments in support of these steps are robust, he recognises that the road will not be an easy one, given that people tend to be 'wedded to old ways.'<sup>375</sup>

Thuronyi offers a potentially more palatable route, namely that it would not be necessary for all of the elements described in this article to be implemented precisely as envisaged here. For example, an international agency for cooperation in taxation could be established separately, even without an international treaty. This agency could grow into a formal international organisation, and it could provide a forum for negotiation of a multilateral treaty. This notion is essential to the argument in this

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<sup>369</sup> *Id.* at 1299-1300. Emphasis added.

<sup>370</sup> *Id.* at 1299-1300.

<sup>371</sup> *Id.* at 1299-1300.

<sup>372</sup> *Id.* at 1299-1300.

<sup>373</sup> *Id.* at 1299-1300.

<sup>374</sup> *Id.* at 1301.

<sup>375</sup> *Id.* at 1301.

paper for developing binding rulings and APAs as a potential area for this organisation to be involved with.<sup>376</sup>

### Pinto

Pinto<sup>377</sup> contends that consideration should be given to broaden the extent of international tax cooperation so that it truly becomes multilateral through the establishment of a World Tax Organisation. The role of such an organisation, in Pinto's view, would not be to impose tax or to collect tax, but be a forum where emerging problems that are caused by developments, such as electronic commerce and harmful tax competition, can be discussed in a coordinated and inclusive multilateral way that would extend beyond just OECD countries.

Pinto examines the mandate, scope and role of a World Tax Organisation for tax (including a review of previous proposed models for such an organisation), the feasibility of establishing such an organisation (including issues of governance, sovereignty, and multilateral cooperation).<sup>378</sup>

Pinto concludes<sup>379</sup> that based on his analysis, a World Tax Organisation is a desirable initiative that could achieve a more coordinated development of international tax policy than existing mechanisms. Pinto also argues that such an organisation could feasibly be established if created initially with modest powers that could be extended and expanded as it gains acceptance. A graduated process is certainly likely to be more palatable, and again it raises the question of what powers such an organisation should have to commence with. In this regard, Mintz has suggested that "a smaller group of countries could provide leadership to encourage the development of multilateral discussions that [could] ultimately lead to new arrangements for tax coordination."<sup>380</sup>

Pinto's incremental approach,<sup>381</sup> an approach with which I concur with, could see the organisation's powers initially restricted to facilitating multilateral cooperation in the development of international tax policy through the distribution of information and the creation of a global forum for discussion in areas of current and emerging international significance, such as electronic commerce, harmful tax competition, and also in my view, transfer pricing. Furthermore, such an organisation could also assume a monitoring role, to keep abreast of new developments in areas such as electronic commerce. Binding rulings and APAs would be suitable areas for initial inclusion with respect to information exchange and development of coordinated application of tax policy, particularly with respect to transfer pricing and the arm's-length approach that is currently applied.

However, Pinto suggests<sup>382</sup> that when the organisation is originally established, it should not aim to assume responsibilities in the areas of either tax collection or

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<sup>376</sup> *Id.* at 1301.

<sup>377</sup> Pinto, *supra* n 327.

<sup>378</sup> *Id.* at 151-159.

<sup>379</sup> *Id.* at 159-160.

<sup>380</sup> See JM Mintz, *The Role of Allocation in a Globalised Corporate Income Tax*, IMF Working Paper 98/134 (1998), p 36 (further suggesting that this process could be "facilitated by G-7 countries, which account for a significant share of multilateral trade, to initiate discussions and develop a broad set of criteria for multilateral negotiations among developed and developing countries"). Vann has suggested a similar approach could be undertaken in the context of a regional model: see RICHARD VANN ed, *TAXING INTERNATIONAL BUSINESS; EMERGING TRENDS IN APEC AND OECD ECONOMIES* 100 (1997).

<sup>381</sup> Pinto, *supra* n 327, at 159-160.

<sup>382</sup> *Id.* at 160.

imposition, as it is considered unlikely in the short- to medium-term that such responsibilities would be internationally accepted by many countries. Nevertheless, over time, such an organisation may ultimately assume these roles. In my view, to make the organisation effective in the area of binding rulings and APAs, a degree of negotiation, imposition and enforcement of binding rulings and APAs across borders is necessary to achieve the advantages from such international cooperation. Pinto's immediate desire is that the organisation's main short-term objective should be the establishment and acceptance of such a fundamental change in the way international tax policy is formulated.<sup>383</sup>

Created in this incremental way, Pinto argues convincingly<sup>384</sup> that a World Tax Organisation will not only bridge gaps in international tax policy created by the limited scope of unilateral measures such as the Controlled Foreign Company (CFC) rules (and also I would argue transfer pricing), but could also serve as an important and effective coordinating mechanism to determine future tax policy in an increasingly globalised world. With the rapid integration of world economies, combined with the transnational activities of global businesses, in Pinto's view a World Tax Organisation may in the not too distant future be a necessary, rather than a desirable, foundation of international tax policy. Thus it is a question of when rather than if, such an organisation becomes a reality.

#### **BINDING RULINGS AND APAS IN A WORLD TAX ORGANISATION: PART OF A GRADUATED APPROACH?**

The approaches to a transition from the current predominantly nationally-focussed tax policy approach to my proposed new internationally-focussed best-fit response need to be considered. In arriving at a best-fit response (ultimately, in my view, a multilateral agreement on developing tax policy, including allocation of taxes, jurisdiction determination and a general commitment with regard to maintaining existing taxes is needed, but for the purposes of this study this is restricted to binding rulings and APAs as a first step), the transition process from the current environment to one that fully recognises globalisation's impact on tax policy is vital. Frequently, this process is neglected or left to lawyers and other officials to develop after the new policy is finalised.<sup>385</sup> Various options to arriving at a best-fit response include gradualism (which implies some form of dual system) and going "cold-turkey". Concurrent with ascertaining the most prudent approach for implementing a new policy process, the cost/benefit considerations must be considered.

A further option is to implement changes on a regional (as opposed to global) scale in coordinating international tax policy, such as in the E.U.<sup>386</sup> One scholar has suggested that a suitable test case, in the context of a multilateral tax treaty, could be the APEC nations.<sup>387</sup> In this paper I pursue the international application of a mutual tax policy

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<sup>383</sup> *Id.* at 160.

<sup>384</sup> *Id.* at 160.

<sup>385</sup> In the context of moving to a consumption tax in the United States, see Ronald A. Pearlman, *Transition Issues in Moving to a Consumption Tax*, A.B.A. SEC. ON TAX'N (1996).

<sup>386</sup> In the context of corporate taxation in the E.U., see generally Sijbren Cnossen, *Company Taxes in the European Union: Criteria and Options for Reform*, 17 FISCAL STUD. 67 (1996).

<sup>387</sup> Vann, *supra* note 15. See OECD, *ELECTRONIC COMMERCE: THE CHALLENGES TO TAX AUTHORITIES AND TAXPAYERS* (1997) and Owens, *supra* note 3. One example of a model multilateral income tax treaty in operation is that which applies to the Nordic Countries; see *CONVENTION BETWEEN THE NORDIC COUNTRIES*, *supra* note 263. A further example is the treaty that applies for eleven of the fourteen members of the Caribbean Community; see *CARICOM CONVENTION*, *supra* note 264.

setting and development process for a particular issue (binding rulings and APAs) rather than tax policy in wider terms on a regional basis.

While a greater level of harmonisation from a regional perspective is a desirable (and achievable) goal,<sup>388</sup> widespread application via extensive ratification<sup>389</sup> is crucial in an environment of globalisation. Nevertheless, international tax policy may not be fully recognisable until after draft legislation (or a draft policy process) is prepared and subsequently ratified. The drafting process necessarily follows the initial heads of agreement concerning the underlying policies, and normally involves several previous iterations prior to the final draft agreement.<sup>390</sup> This also applies in the context of developing an international tax organisation, following the approach suggested in the earlier discussion.

## CONCLUDING OBSERVATIONS

This paper, like that of Pinto<sup>391</sup> and Thuronyi,<sup>392</sup> focuses on the policy rather than the detailed operational issues of a World Tax Organisation. However, this paper extends upon Pinto<sup>393</sup> through suggesting an area that a WTO would be a positive development, namely binding rulings and APAs with cross-border effects. Furthermore, the approach proposed in this paper largely endorses that proffered by Thuronyi.<sup>394</sup>

With respect to binding rulings and APAs, multilateral agreements are far superior to unilateral or even a series of bilateral agreements. Administering such an agreement would be greatly facilitated by an international organisation, such as the World Tax Organisation that has been proposed in this paper. Furthermore, binding rulings and APAs would, in my view, be a less contentious subject area for sufficient nations to relent a degree of their tax policy sovereignty to a suitably developed and organised international body. However, a greater degree of harmonisation of APA processes, and more particularly binding rulings regimes, is needed to facilitate any form of international cooperation in this area.<sup>395</sup> This in itself would represent a significant achievement as a first step. Thus to answer the question posed in the title to this paper, an International or World Tax Organisation would be an appropriate forum for administering binding rulings and APAs.

However, should such an organisation be considered desirable by a large number of nations, then further work and research will need to be conducted in many areas, including the need to take a closer look at the detailed structure of the World Tax Organisation model, the need to undertake further investigation in relation to the

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<sup>388</sup> An example of practical implementation of harmonisation has occurred in the European Union with respect to indirect taxes.

<sup>389</sup> Such as ratification by the original 134 member nations to GATT and the WTO (now over 180 members, including China).

<sup>390</sup> For a useful discussion on the general tax legislative process, see Richard K. Gordon and Victor Thuronyi, *Tax Legislative Process*, in *TAX LAW DESIGN AND DRAFTING* Vol. 1, 10-14 (Victor Thuronyi ed., 1996). However, the approach for taxing electronic commerce may not necessarily utilise the same policies as may apply to other areas of tax allocation. For example, is a proposal to allocate income tax revenues by some formulaic apportionment method (such as sales, Avi-Yonah, *supra* note 2), applicable for electronic commerce?

<sup>391</sup> Pinto, *supra* n 327.

<sup>392</sup> Thuronyi, *supra* n 356.

<sup>393</sup> Pinto, *supra* n 327.

<sup>394</sup> *Id.*

<sup>395</sup> See the earlier discussion comparing binding rulings internationally by Sawyer, see IRD study, *supra* n 214.

possible obstacles of establishing a World Tax Organisation, and finally, consideration will need to be given to the development of a potential framework towards developing a workable World Tax Organisation. These issues form part of my on-going research.

# Aligning Taxable Profits and Accounting Profits: Accounting standards, legislators and judges<sup>+</sup>

Judith Freedman\*

## Abstract

There has been an uneasy relationship between taxable business profits and accounting profits for many years. The radical changes currently taking place in the content and objectives of accounting standards, spurred on by the move towards International Accounting Standards, could be seen as an impetus for reviewing the tax position. These developments might be seen by some as an opportunity to use global accounting standards as a step towards harmonising the tax base, especially within the European Union. It is argued here, however, that the objectives of accounting standards are moving away from those of the tax system, making complete alignment between taxable and accounting profits inappropriate and identification of tax principles all the more important. It is widely agreed that, whilst the commercial accounts are a starting point for calculating taxable profits, there is a continuing role for tax legislation in providing for modifications in some cases to meet specific tax objectives. This article argues that, contrary to the views of many in the UK at present, there is also a multi-layered and ongoing role for the courts in the process of defining taxable profits.

## I. INTRODUCTION

In Australia, as in the UK, there has been a longstanding debate about the wisdom and extent of alignment of taxable business profits and accounting profits.<sup>1</sup> Systems differ markedly across jurisdictions. In Europe, countries have tended to divide between those where there is dependence (meaning either that the commercial accounts follow the tax rules or that tax follows the commercial accounts) and those where there is independence (where there are different rules for accounting and tax).<sup>2</sup>

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<sup>+</sup> The author would like to thank the participants at conferences organised by the Cambridge Centre for Tax Law in January 2004, the Anton Philips Fund Center for Company Law at Tilburg University in April 2004 and the European Association of Tax Law Professors at the Sorbonne in June 2004 for their comments on earlier versions of this paper and general discussions of this topic. She also thanks the anonymous referee, Maurice Parry-Wingfield and Edwin Simpson for their comments on this article. Any errors and the views expressed remain hers alone.

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<sup>1</sup> On Australia see Aldrin De Silva (2003) 'The Alignment of Tax and Financial Accounting Rules: Is it Feasible?' 18 *Australian Tax Forum* 264. On the UK, for just some examples see Judith Freedman (1995) 'Defining Taxable Profit in a Changing Environment' [1995] *British Tax Review* 434 and the many earlier articles cited at footnote 1 thereof; Geoffrey Whittington, 'Tax Policy and Accounting Standards' [1995] *British Tax Review* 452; Graeme Macdonald (2002) *The Taxation of Business Income: Aligning Taxable Income with Accounting Income*, TLRC Discussion Paper No. 2, Institute for Fiscal Studies, London (hereafter Macdonald (2002)); Christopher Nobes (2003) *A Conceptual Framework for the Taxable Income of Businesses, and How to Apply it under the IFRS*, ACCA, London (hereafter Nobes (2003)).

<sup>2</sup> Martin N. Hoogendoorn (1996) 'Accounting and Taxation in Europe- A Comparative Overview', *The European Accounting Review Vol.5 Supplement* 783 (hereafter Hoogendoorn (1996)). The importance of the relationship between accounting and tax principles outside Europe has been underlined recently by the publication of a special issue of the Asia-Pacific Tax Bulletin on the topic *IBFD 8 Asia-Pacific*

The differences are significant and generally lead to lower taxable profits in those dependence countries where commercial accounts follow tax rules, although the tax collected need not be lower, of course, since the rates may be higher to compensate.

Although systems vary, it is important not to draw too sharp a dividing line between different approaches or to be over-simplistic in the characterisation of these systems. In 1996, in a comparative study, Hoogendoorn reported a 'clear recent development towards more independence between accounting and taxation' especially in Scandinavian and Eastern European countries.<sup>3</sup> Even in Germany, considered to be home to a strong form of dependence<sup>4</sup>, there has been a recent tendency towards special tax rules which deviate from commercial accounts, for example on valuation, often in an effort to increase revenue.<sup>5</sup> At the same time, in the UK, frequently described as a prime example of a jurisdiction where the approach is one of independence, there has always been some element of alignment, recently strengthened through judicial and legislative developments. In truth, the stereotypes do not seem ever to have been entirely accurate and are becoming less so.

It seems likely that the complexity of accountings standards, and their globalisation, will lead to an appraisal of the appropriateness of dependence in many jurisdictions, whatever their starting point. In countries where there is strong culture of dependence there may well be a temptation to limit the adoption of the new accounting standards to consolidated accounts so that single company accounts, which are used for tax purposes, remain unaffected. At the same time, the work that is being done by the accounting bodies to achieve agreement in especially difficult areas may tempt tax policy makers to 'piggy-back' on these efforts both at domestic and international levels by using accounting standards as a basis for taxation. In which direction these conflicting pressures will lead us for tax purposes is not yet entirely clear.

Some argue that globalisation of accounting standards is the cue to *disassociate* tax and accounting. Not only will governments be reluctant to hand over control of their tax base to the International Accounting Standards Board (IASB)<sup>6</sup> but, crucially, the theory behind International Accounting Standards (IAS), and particularly its emphasis on fair value accounting, is departing from the central principles that have always been

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*Tax Bulletin* May/June 2002 (Special issue on the Relationship between Accounting and Taxation Principles).

<sup>3</sup> Hoogendoorn (1996), *ibid*.

<sup>4</sup> The German *Massgeblichkeitsprinzip* is conveniently described in English by N. Herzig (1996), 'Tax versus Commercial Accounting in Germany' in IFA 50<sup>th</sup> Congress Seminar Proceedings, *The Influence of Corporate Law and Accounting Principles in Determining Taxable Income*, Kluwer, The Hague.

<sup>5</sup> K. Ebling (ed) *Blumich Kommentar* (2003) (76<sup>th</sup> edn) Verlag Franz Vahlen Munich, § 5. The author is grateful to Oktavia Weidmann, Oxford University BCL student, for this reference. These moves are also a reaction to pressure to change accounting standards and to adjudicate on them at a European level: see W. Schoen, 'International Accounting Standards- a 'Starting Point' for a Common European Tax Base?', Presentation given to the Annual Conference of the European Association of Tax Law Professors, Paris, 5<sup>th</sup> June 2004.

<sup>6</sup> Alvin D. Knott and Jacob D. Rosenfeld (2003) 'Book and Tax: A Selective Exploration of Two Parallel Universes' (Parts I and II) *Tax Notes* May 12 and May 19<sup>th</sup>. The IASB is a not for profit Delaware corporation, not under any governmental control. Constitutional concerns are also a problem for many European jurisdictions as became clear at the conference of the European Association of Tax Law Professor, Paris, 5<sup>th</sup> June 2004.



thought of as suitable for taxation purposes in the past, the key one of which is the traditional concept of realisation.<sup>7</sup>

So, in an EU Commission staff working paper in 2001, globalisation of accounting standards is seen as a catalyst for the development of harmonised, but independent, tax accounting principles. The paper states<sup>8</sup>

Generally, it is clear that there is no prospect of fully matching tax and financial accounting in the future...To the extent that tax accounting will develop independently from financial accounting, Member States will be obliged to find autonomous rules for tax accounting purposes. In looking for such rules there is an opening for co-ordination and co-operation to start with common base rules, instead of each of the Member States trying to pursue individual solutions.

The EU Commission has, however, subsequently developed a modified view, that globalisation of accounting standards is an opportunity for finding a common base for tax across the EU, with a starting point in accounting profits.<sup>9</sup> This is no doubt in part on pragmatic grounds in the hope of reaching some measure of agreement within a reasonable time. Even so, the Commission recognises that this is only a starting point and that some deviation is likely to be necessary. What is important is to define those areas of deviation.<sup>10</sup> It is necessary to focus on whether there are any tax principles that can be agreed as a basis for the variations from accounting standards, both at a domestic and European level. In Europe, Australia and elsewhere, many companies are preparing to adopt IAS by 2005. Thus this is a debate which is topical and urgent, both in jurisdictions where there is currently alignment between accounting standards and tax accounts and those where the relationship is weaker, since that relationship needs re-examination in the light of the introduction of IAS.<sup>11</sup>

<sup>7</sup> Allister Wilson (2001) 'Financial Reporting and taxation: marriage is out of the question' *British Tax Review* 86; Ron Paterson, 'A taxing problem', (2002) *Accountancy* November 94.

<sup>8</sup> EU Commission staff working paper (2001) *Company Taxation in the Internal Market* [http://europa.eu.int/comm/taxation\\_customs/publications/official\\_doc/IP/ip1468/company\\_tax\\_study\\_en.pdf](http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip1468/company_tax_study_en.pdf) at p.324.

<sup>9</sup> For example the European Commission in its proposals for a consolidated tax base: see European Commission Consultation Document, 'The application of International Accounting Standards in 2005 and the implications for the introduction of a consolidated tax base for companies' EU-wide activities' (2003) and European Commission, *Summary report on results of consultation*, (2003) both to be found on [http://www.europa.eu.int/comm/taxation\\_customs/taxation/consultations/ias.htm](http://www.europa.eu.int/comm/taxation_customs/taxation/consultations/ias.htm).

<sup>10</sup> Communication from EU Commission (2003) (COM 2003 726 final) *An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges*, [http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003\\_0726en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0726en01.pdf). See also Matthias Mors of the European Commission, unpublished paper at the European Association of Tax Law Professors Conference, Paris June 5<sup>th</sup> 2004. As this article was being finalised, the Commission published a 'non-paper' for the informal Ecofin Council to be held on 10<sup>th</sup> and 11<sup>th</sup> September, proposing the use of IAS as a tool for designing a common consolidated tax base but stressing that the discussions should be guided by 'appropriate tax principles' and that any such base, once established, would not be systematically linked to accounting standards as any further development would need to be driven by tax and not accounting needs: see [http://europa.eu.int/comm/taxation\\_customs/taxation/company\\_tax/docs/Non-Paper\\_CCBT\\_EN.pdf](http://europa.eu.int/comm/taxation_customs/taxation/company_tax/docs/Non-Paper_CCBT_EN.pdf).

<sup>11</sup> Use of IAS will be mandatory for the consolidated accounts of all listed companies in Europe by 2005: see *Regulation (EC) No 1606/2002 on the application of international accounting standards* (July 2002). In the UK, publicly traded companies and others will be permitted to use IAS for not only their consolidated accounts but also their individual accounts from the same date: DTI Press Release P/2003/406, 17<sup>th</sup> July 2003; DTI- *Modernisation of Accounting Directive/IAS Infrastructure*, March 2004. Australia plans to adopt IAS by 2005 (Bulletin of the Financial Reporting Council 2002/4 - 3 July

In Part II of this article the debate on the relationship between taxable and accounting profits is outlined. Part III discusses the way in which this relationship is changing and being managed in the UK. In Part IV the role of the judiciary in this relationship is scrutinised and it is suggested that, contrary to some views expressed, there is a continuing role for the courts and this role will remain despite increasingly detailed and comprehensive accounting standards. Part V comments briefly on the interaction between the tax and accounting systems in this context, and Part VI concludes that a role will remain for the judiciary.

## II. THE ESSENCE OF THE DEBATE

The essence of the debate is whether the taxable profits of a business, or more specifically in a UK context, a trade or profession, should deviate from accounting profits.<sup>12</sup> Since TVM has now been rejected, Australians can return to the more general debate. Clearly, there are strong arguments for a move away from profit as the tax base altogether and the discussion about alignment of taxable and accounting profit only serves to show profit to be an artificial and problematic concept.<sup>13</sup> Since the taxation of business profits is pervasive and unlikely to disappear in the near future, however, this article will not examine alternative tax bases, but will focus on the need under current systems of business tax worldwide to find a sensible and workable definition of the concept of business profit which is fit for tax purposes.

### **Arguments for alignment of taxable profits and accounting profits**

The case for alignment is simple and *prima facie* attractive. It is based on the view that alignment would bring simplicity, cut compliance costs and reduce avoidance. The argument runs as follows. Companies must all make up commercial accounts following accounting standards so why not use these for tax purposes also? This simplification would save compliance costs, since only one set of accounts would be needed. It would also help to increase transparency and prevent avoidance. Since most companies, at least quoted companies, want to keep their commercial profits high, they would not wish to enter into tax schemes that reduce these profits if the same figure had to be used for both purposes. Transactions should be entered into for commercial and not for tax reasons and consistency in the accounts might help to achieve this.<sup>14</sup> Both those setting accounting standards and the tax authorities are aiming at the same figure - the 'true' economic profit.<sup>15</sup> The tax authorities should be

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2002). Japan has decided to follow this trend (*Japan Today*, February 17<sup>th</sup> 2004). It is also likely that domestic standards will be heavily influenced by IAS and that ultimately there will be convergence, as is proposed in the UK: DTI (2004) *Modernisation of Accounting Directive/IAS Infrastructure*, Department of Trade and Industry, London.

<sup>12</sup> In Australia this debate seems to have been side-tracked for a while due to discussions about a move to the Tax Value Method (TVM). De Zilva has explained why the TVM proposal is entirely different from the question of the extent of alignment of tax and accounting profits under a standard tax on business profits: see De Zilva above, Appendix 1.

<sup>13</sup> There are many discussions of alternative bases, such as a cash flow or expenditure tax approach. For a leading UK example, see the Meade Committee Report (1978) *The Structure and Reform of Direct Taxation*, Institute for Fiscal Studies, London and for an excellent overview of cash flow taxes see David F. Bradford, (1986) *Untangling the Income Tax*, Harvard University Press, Cambridge, Mass.

<sup>14</sup> This seems to be the assumption of the UK Government in their consultation papers on Corporation Tax Reform, supporting alignment: Inland Revenue and H.M. Treasury (2002) *Reform of Corporation Tax* (London); Inland Revenue and H.M. Treasury (2003) *Reform of Corporation Tax*, London.

<sup>15</sup> This assumes an ideal of a comprehensive income tax, rarely achieved in practice but accepted as a goal in most tax literature (the Haig-Simons model: R.M. Haig (1921) *The Federal Income Tax*, New York:

able to tax the same profit as is enjoyed by the owners. There is no need to have two sets of rules and no justification for it. At an international level, the expert work done to harmonise accounting standards could be utilised in the tax field without having to duplicate effort. Accountants have expertise in defining profit that lawyers do not have and this should be recognised.

### **Arguments for divergence of accounting and taxable profits**

The counter arguments are less immediately obvious but are nevertheless well known. It is argued here that they are stronger than the arguments for alignment. This view is based on the differing objectives of calculating taxable profits on the one hand and presenting financial accounts on the other and the need to keep each system true to its objectives and robust against any pollution by considerations more relevant to the other system.

Alignment is only helpful if it simplifies the process of preparing accounts, thus reducing compliance costs. Major simplification may not be possible because in practice complete alignment is neither achievable nor desirable. Commercial accounts and tax accounts have different objectives. Tax must raise revenue and do so equitably and efficiently as between taxpayers. This points to reasonably objective rules that take account of taxable capacity and administrative efficiency. Tax avoidance opportunities must be blocked. Financial accounts must give relevant and reliable information and prevent businesses from hiding the substance of their position. In each case these objectives are perfectly valid, but the functions performed by the accounts for these two purposes may dictate some differences although there will be a central core of similarity. In addition to the above objectives of a tax system, governments wish to use the tax system to provide economic incentives and disincentives. Whilst many economists would argue against such a use of taxation, it appears to be inevitable and universal, making complete alignment an illusory goal.

Accountants would agree that there is no one true profit figure but that a range of figures is necessary to paint a picture of what is happening in a company.<sup>16</sup> The application of accounting standards requires the use of discretion. Commercial accounts cater for many stakeholders, although primarily for the shareholders. What are needed for this purpose are forward looking figures involving judgment and valuations. The single figure in the accounts will often be backed up or explained by notes and further figures. International accounting standards do not give the profit and loss account primacy but the balance sheet. In fact, the profit and loss account looks set to disappear altogether.<sup>17</sup> Tax, on the other hand, is historical: that is it must be based on an artificial period already completed and is concerned with the profit or loss in that limited period. It may be possible to carry losses or other allowances forwards and back from one period to another, but essentially each period is taken in isolation because taxation is an artificial structure and needs to operate in this way to be manageable. The tax system must arrive at one figure on which to base an assessment.

In addition, to operate fairly and efficiently, it is often argued that a tax system must recognise ability to pay and subject the taxpayer to tax when it is most convenient to

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Columbia University Press; H.C. Simons (1938) *Personal Income Taxation*, Chicago University of Chicago Press).

<sup>16</sup> W.T. Baxter, Correspondence, [1978] *British Tax Review* 67.

<sup>17</sup> See Wilson, n. 7 above.

pay the tax.<sup>18</sup> These concepts are sometimes linked to the realisation principle, since without liquid assets there is an obvious difficulty in paying taxes. Whilst in a perfect market this problem of liquidity might be met by borrowing by the taxpayer against unrealised profits, in practice financing taxes in this way not only creates transaction costs but can also be risky as the value of the security for the borrowing may fall. For this reason, the realisation principle seems more important for tax purposes than it is for accounting purposes, particularly as we move towards fair value accounting.<sup>19</sup> The volatility inherent in fair value accounting reflects volatility in the market and so, arguably,<sup>20</sup> should be reflected in the commercial accounts. It is less clear, both from the point of view of the taxpayer and the government, that it is sensible to tax on the basis of volatile accounts.

Generally, the different objectives of tax and financial accounts make it desirable that the rules for each one are not unduly influenced by the rules for the other. At present international accounting standard setters pay little regard to tax implications and would be unlikely to take kindly to the suggestions that they needed to add tax to the list of considerations and pressure they must take on board already.<sup>21</sup> Commercial accounting considerations could be distorted by tax pressures. This is not to say that tax and financial accounting should operate in isolation from each other and some mutual awareness and cross referencing will no doubt be valuable, but there should be clear differences, although these do need to be made explicit and based on some established principles.

Alignment of taxable and accounting profits to prevent abuse has been the subject of considerable debate in the USA recently following the Enron and WorldCom scandals.<sup>22</sup> Currently in the USA, tax and commercial accounts can differ significantly. This has led to a Wall Street columnist calling for conformity between book (accounting) and tax income to combat tax shelters; a call that attracted some support, but now appears to have been rejected largely for the reasons discussed above.<sup>23</sup> The suggestion that has emerged most strongly from the ensuing debate is that public disclosure of tax accounts should be required, or that there should be more and better information provided on the book/tax reconciliation forms that exist already.<sup>24</sup> Both the Securities and Exchange Commission and the US Treasury, to

<sup>18</sup> For example, Adam Smith's Canons of Taxation, Adam Smith, *The Nature & Causes of the Wealth of Nations*, Book V, Chap. 11, Part II "Of Taxes", paras. 1-7.

<sup>19</sup> In an interesting unpublished paper presented to the NYU School of Law Colloquium on Tax Policy and Public Finance (Spring 2004, Number 12), 'An Economic Analysis of the Realization Rule', Deborah Schenk argues that the justifications for the realization rule are not as persuasive as has been thought, but even she agrees that there are valuation and political difficulties in taxing paper gains, making it difficult to abandon realization as a basis for taxation.

<sup>20</sup> This is not uncontroversial in relation to commercial accounting either. There is strong resistance to IAS 39 in Europe for this reason, spearheaded by French banks: Roger Murray and Larissa Clark (2003) 'IAS 39, cash flow hedges and tax' 8 *Financial Instruments Tax and Accounting Review* 1; Andrew Parker (2003) 'Compliance costs soar for new IAS rules' *Financial Times* November 24<sup>th</sup>.

<sup>21</sup> Wilson, n. 7 above; Nobes (2003) n. 1 above, p.38.

<sup>22</sup> It is not necessarily tax regulation that is at fault here: it may be commercial accounts that require the modification, see George Plesko and Lillian Mills (2003) 'Bridging the Reporting Gap: A Proposal for more Informative Reconciling of Book and Tax Income' 56 *National Tax Journal* 4. Plesko and Mills cite the *Wall Street Journal* (January 29<sup>th</sup> 2003) as stating that 'Profits reported to the IRS, where firms have less discretion in making calculations, are considered to be closer to the truth...'

<sup>23</sup> Knott and Rosenfeld n. 6 above.

<sup>24</sup> Knott and Rosenfeld n. 6 above (Part II) document the history of the Wall Street Journal article and follow up and they also discuss the issues of publication of tax returns and the Schedule M-1

whom the idea of public disclosure of tax accounts was put, doubted the value of disclosure of the entire voluminous tax accounts, largely on the grounds that the complexity and length of them made them of limited value to the authorities, although potentially useful to competitors. Rather more useful is specific information that can be requested by the SEC if necessary. There does seem to be a consensus, however, that the book-tax reconciliation information already required should be improved upon.<sup>25</sup> It should also be noted that one of the characteristics that makes a transaction in the USA subject to stringent tax rules on disclosure is a large difference between book and tax results.<sup>26</sup> The use of book-tax differences in this targeted way seems likely to be a more valuable way of tackling abuses than does conformity, with all the problems and disadvantages that would entail.

### III. MANAGING DIVERGENCE- AN EXAMINATION OF THE UK LEGISLATIVE/CASE LAW BALANCE

On the basis of the above arguments it would seem that complete alignment is neither possible, nor desirable. Nevertheless, in any tax system based on profit, the commercial accounts and tax accounts will almost certainly have the same starting place, so the interesting question becomes one of the degree to which there should be divergence rather than whether there should be divergence at all. In addition, to the extent that there is divergence, who should be the final arbiter of taxable profits in any given case? The matter could be one for the legislature, the courts or the accounting profession or, most probably, some combination of the three, but the relationship between these sources of definition will need management and regulation.

These are the central issues arising in every tax system struggling with this issue. In Australia, the position has been well summarised by D'Ascenzo and England:

...the real reform issue ...is probably not whether accounting profit and loss should form the starting point for tax purposes. It already does in practice to some extent. The real issue might be how to best structure and draft income tax law so as to use accounting concepts where it is sensible to do so, and to clearly identify where there are differences from accounting outcomes. The way forward seems to be a careful and pragmatic review of the situations of divergence between accounting concepts and tax rules. As far as I know, such a review is not on the drawing board.<sup>27</sup>

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reconciliation of book and tax accounts. See also Gil B. Manzon and George Plesko (2002), 'The Relation Between Financial and Tax Reporting Measures of Income' 55 *Tax Law Review* 175; Plesko and Mills n 15 above; David Lenter, Joel Slemrod and Douglas Shackelford (2003) 'Public Disclosure of Corporate Tax Return Information: Accounting, Economics and Legal Perspectives' 56 *National Tax Journal* 803.

<sup>25</sup> Knott and Rosenfeld n. 6 above, note the calls of Senator Grassley (Chair of the Senate Finance Committee) for such improvements and how these have been supported by the academic community. See Gary McGill and Edmund Outslay (2002) 'Did Enron pay taxes?: Using Accounting Information to Decipher Tax Status' *Tax Notes* August 19, 1125.

<sup>26</sup> Erika Nijenhuis, David Chung and Maxim Kulikov, (2002) 'The New Disclosure and Listing Regulations for Tax Shelters' *Tax Notes* November 18, 943.

<sup>27</sup> Michael D'Ascenzo and Andrew England (2003), 'The Tax and Accounting Interface', *Proceedings of the 15<sup>th</sup> Australasian Tax Teachers Association Conference* <http://pandora.nla.gov.au/pan/23524/20030305/Michael%20D%92Ascenzo.doc> (although their article was written in their personal capacity, both authors were senior staff of the Australian Tax Authority (ATO) and so in a position to know if any work was ongoing on this subject in the ATO).

In order to discuss this further, the current UK position will be examined. The positions in Australia and the UK are not identical<sup>28</sup> but there are significant parallels and interesting distinctions in the debate.<sup>29</sup>

Superficially, the position in the UK now seems to be clearer than it has been in the past. In part this is said to be due to case law developments, notably the case of *Gallagher v Jones*,<sup>30</sup> seen by many as cementing the trend towards dependence of taxable profits on account profits. Sir Thomas Bingham MR stated in that case that he found it

hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business.<sup>31</sup>

This was followed by legislative codification of this case law in section 42 of the Finance Act 1998. Section 42 stated that

...the profits of a trade, profession or vocation must be computed *on an accounting basis which gives a true and fair view*, subject to any adjustment required or authorised by law in computing profits for those purposes.

Section 42 was amended in 2002 so that the words *in accordance with generally accepted accounting practice* were substituted for the words in italics in the original. In the Finance Bill 2004 the definition of generally accepted accounting practice has been expanded to include generally accepted accounting practice with respect to accounts prepared in accordance with IAS where the taxpayer company or entity prepares its accounts using IAS.<sup>32</sup>

It may seem, then, that the position is now straightforward but, as we shall see, important questions remain undetermined regarding the extent to which the phrase ‘adjustments authorised by the law’ refers to case law as well as to overriding legislation. In addition, there may be occasions when the available accounting standards do not answer the questions arising for tax purposes conclusively or when tax law characterises a sum in such a way that accounting standards are held not to come into the picture at all. In such cases, there appears to be a continuing role remaining for the courts, but the extent of this is unclear.

<sup>28</sup> Justice D G Hill (2003), ‘The Interface Between Tax Law and Accounting Concepts And Practice As Seen By the Courts’ *Proceedings of the 15<sup>th</sup> Australasian Tax Teachers Association Conference* <http://pandora.nla.gov.au/pan/23524/20030305/Justice%20Hill.doc>

<sup>29</sup> The main difference between the UK and Australian case law seems to be in relation to losses and outgoings where in Australia the question arises whether they have been ‘incurred’, whilst in the UK the question remains the more general one of what is the taxpayer’s profit. This has led to a more jurisprudential approach in Australia than in the UK, see Hill, *ibid.* citing *CIR v Mitsubishi Motors New Zealand Ltd.* [1995] STC 989 (PC). On the introduction of international accounting standards in Australia see Greg Leyden and Brett Croft (2004), ‘International financial reporting standards and Australian income tax’, *The Tax Specialist* Vol. 7 198.

<sup>30</sup> [1993] STC 537.

<sup>31</sup> Discussed further below and see also Judith Freedman (1993) ‘Ordinary Principles of Commercial Accounting- Clear Guidance or a Mystery Tour?’ [1993] *British Tax Review* 468.

<sup>32</sup> Section 836A Income and Corporation Taxes Act 1988 and clause 50 of the Finance Bill 2004.

### Profit definition - the role of the courts prior to 1998

The meaning of the words 'annual profits or gains arising or accruing from a trade, profession or vocation' in the charging provision contained in the Taxes Acts,<sup>33</sup> was originally defined in case law only, to the extent that it was defined at all. Initially it was said that profit should be understood in its 'natural and proper sense - in a sense which no commercial man could misunderstand'.<sup>34</sup> Gradually this sense acquired a gloss from the case law. It was never entirely agreed whether that gloss carried the status of law or whether the question of definition of profit remained purely a question of fact, in the sense that precedent could have no bearing upon it and the higher courts could not review a decision.<sup>35</sup> It was clear, though, that profit was to be treated as a technical term upon which expert evidence was admissible.<sup>36</sup>

To the cynical, the law/ fact distinction is a circular issue.<sup>37</sup> The courts will find that there is a question of law if they wish to intervene. As Cross and Harris put it

...the question of whether a case will be treated as a precedent depends on the way in which future courts treat that case.<sup>38</sup>

This is not merely an academic view. The Rt. Hon. Sir John Laws, Lord Justice of Appeal agrees that the boundary between law and fact is not fixed.

Where there are reasonable choices to be made between one interpretation and another of a defining phrase in legislation....It depends on what the higher courts think ought to be a matter of law: or, more pointedly, what they think should be subject to judicial control.<sup>39</sup>

In the context of deciding upon taxable profits, one way of reconciling the positions was put forward by Pennycuik VC in *Odeon Associated Theatres Ltd v Jones*<sup>40</sup> at first instance:

The concern of the court in this connection is to ascertain the true profit of the taxpayer... In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word 'correct' deliberately. In order to ascertain what the correct principles are it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the

<sup>33</sup> Section 18 Income and Corporation Taxes Act 1988.

<sup>34</sup> *Gresham Life Assurance Soc. v Styles* 3 TC 165.

<sup>35</sup> See Judith Freedman (1987) 'Profit and Prophets- Law and Accountancy on the Timing of Receipts' (two parts)[1987] *British Tax Review* 61, 104 where the author argues that the word 'profits' had at that time acquired a legal meaning through the case law, relying on cases such as *Minister of National Revenue v Anaconda American Brass Ltd* [1956] AC 85; *Willingale v International Commercial Bank Ltd* [1978] 1 All. E.R and *Odeon Associated Theatres Ltd v Jones* [1971] 2 All E. R. 407.

<sup>36</sup> John Bell and George Engle (1995) *Cross on Statutory Interpretation*, (3<sup>rd</sup> ed.) Butterworths, London at p 61-'When it is agreed or contended that statutory words have a technical meaning, evidence with regard to that meaning is unquestionably admissible...'. This is normally an indication of a question of fact in itself.

<sup>37</sup> For further discussion of this difficult issue see Etienne Mureinik (1982) 'The Application of Rules: Law or Fact?' 98 *Law Quarterly Review* 587; Timothy Endicott (1998) 'Questions of Law' 114 *Law Quarterly Review* 292.

<sup>38</sup> Rupert Cross and J. W. Harris (1991) *Precedent in English Law*, (4<sup>th</sup> ed.) Clarendon, Oxford.

<sup>39</sup> The Rt. Hon. Sir John Laws (1999) 'Law and Fact' *British Tax Review* 159.

<sup>40</sup> *Odeon Associated Theatres Ltd v Jones* [1971] 2 All E. R. 407.



correct principles of commercial accountancy...At the end of the day the court must determine what is the correct principle to be applied.

In modern conditions, where accounting standards have been hammered out and agreed nationally and now even internationally so as to eliminate many disputes between accountants on different approaches, the first part of this process as described by Pennycuik VC, seems to have been elevated over the second as Bingham MR suggested in *Gallagher v Jones*. Accounting standards are so much more formalised and rigorous now than when the older cases were decided that the position is now completely different from that which prevailed in those earlier times. The issue of fact will normally determine the question of what is the correct principle of commercial accountancy. But it will be argued below that there will still be cases where the courts must decide, having taken this evidence, what is the correct principle to be applied in tax cases.

Given the changing nature of accounting practice this is of real significance. On the one hand it could be argued that to insist on following precedent, often based on outdated accounting practices, would stultify the development of tax law. On the other, it could be said that the courts have evolved some tax principles in the course of defining profit and should, at least in the absence of any general legislative tax principles on profit definition, continue to evolve and apply these. In this way the courts can reflect the objectives of the tax system in the way that developing accounting standards do not set out to do. In other words, this is an area where the issues should be subject to judicial control. The role of the courts is therefore at the heart of the debate.

It should be noted here that *Gallagher v Jones* and section 42 of the Finance Act 1998 did not mark a radical departure in the relationship between taxable profits and accounting profits. At no time was there complete independence of tax accounting and financial accounting in the UK, despite the statements suggesting otherwise in some of the books and commentaries comparing the UK with other jurisdictions.<sup>41</sup> The commercial accounts were always the starting point as a matter of case law,<sup>42</sup> but on relatively rare occasions, although a generally accepted accounting practice had been applied for commercial purposes, a different result was preferred for tax purposes. This was true in some cases on timing<sup>43</sup> and most noticeable where the issue was one

<sup>41</sup> See Hoogendoorn n.3 above; Margaret Lamb (1996) 'Accounting and Taxation in the UK' *The European Accounting Review* Vol. 5 Supplement 933.

<sup>42</sup> See Inland Revenue Guidance Note, Inland Revenue (2004) *International Accounting Standards- The UK Tax Implications* (hereafter 2004 Inland Revenue Guidance note) [http://www.inlandrevenue.gov.uk/practitioners/int\\_accounting.htm](http://www.inlandrevenue.gov.uk/practitioners/int_accounting.htm)

citing the 1926 case *Lothian Chemical Co Ltd v Rogers* 11 TC 508 and for the classic statement of the need to start with accounting practice see *Odeon Associated Theatres Ltd v Jones* [1971] 2 All E. R. 407.

<sup>43</sup> For example in *Minister of National Revenue v Anaconda American Brass Ltd* [1956] AC 85 and *Willingale v International Commercial Bank Ltd* [1978] 1 All. E.R. The dictum of Lord Reid in *Duple Motor Bodies v Ostone* [1961] 39TC 537 is often cited: 'it is a cardinal principle that profit shall not be taxed until realised'. Lord Reid himself recognised that this was not a rigid rule of law but did consider it to be a principle: *BSC Footwear v Ridgeway* [1972] 47 TC 495

'The application of the principles of commercial accounting is, however, subject to one well established though non- statutory principle. Neither profit nor loss may be anticipated..... But it is admitted that this matter is not governed by any rigid rule of law. It depends on general principles which have been elaborated by the courts for the purpose of ensuring that so far as practicable profits shall be attributed to the year in which they were truly earned'. But note that Lord Reid dissented in this case. Lord Nolan



of the capital/income distinction. In the capital/income area, Lord Denning's famous dictum in *Heather v PE Consulting Group*<sup>44</sup> expresses a widely shared view.<sup>45</sup>

The Courts have always been greatly assisted by the evidence of accountants. Their practice should be given due weight: but the Courts have never regarded themselves as being bound by it... The question of what is capital and what is revenue is a question of law for the Courts.

The revenue/capital distinction was one where the judges felt comfortable, having encountered it in various guises in the realm of property law and trusts, and where they would impose their own views. More recent cases have stressed the importance of the facts in cases where the capital/income distinction falls to be decided but the judges have nevertheless proceeded on the basis that they must apply precedent and identify indicia of capital payments, which appears to elevate this to a question of at least mixed law and fact.<sup>46</sup>

### **Profit definition - the role of the legislature**

In the UK there have always been areas of profit definition covered entirely by legislation, most notably depreciation, where a comprehensive legislative capital allowances regime continues to govern the position despite arguments from accountants for many years that commercial depreciation methods would be preferable.<sup>47</sup> There are further areas where the UK government has legislated, notably in the case of financial instruments, foreign exchange and intangibles, where the legislation is in each case largely based on accounting standards, but with some important deviations.<sup>48</sup> This legislation moves away from the traditional common law distinction between capital and income.

In recent reviews of the Corporation Tax regime,<sup>49</sup> the UK Government has expressed a desire to align commercial and tax accounts to a greater degree, for example by moving away from the capital/income distinction to follow accounting treatment for the taxation of profits and losses on capital assets, and using accounting depreciation instead of a capital allowances regime. On both these proposals there has been retrenchment in the light of comments and further consideration. The 2003 consultation document reiterates rather more strongly than before that it may not be appropriate for the tax base to follow the accounts in all respects. It is accepted that adjustments to the accounts may be needed for policy reasons, to provide incentives to address market failures, to ensure that the tax system is fair and to take account of practical issues.

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made it clear in *Gallagher v Jones* (n. 30 above) that the Courts will seek guidance from accounting practice as to whether or not a loss is anticipated.

<sup>44</sup> [1973] 1 All E.R. 843.

<sup>45</sup> Apparently also held in Australia, see Hill, n. 28 above.

<sup>46</sup> See the analysis of Dyson LJ in *IRC v John Lewis Properties* [2003] STC 117, for example, where he decided, based on careful consideration of the case law that a lump sum prepayment of rent was capital in nature. Contrast Arden LJ, dissenting in that case, who relied upon dicta of Lord Hoffmann's in *MacNiven v Westmoreland* [2001] STC 237 to the effect that income and capital are commercial and not juristic concepts and thought that the payments must take their capital/income colour from the rentals they represented, and were therefore income. See also Macdonald, n.1 above, at para. 4.12.

<sup>47</sup> Discussed in Lamb, n. 41 above.

<sup>48</sup> For example, corporate debt and currency accounting (Finance Act 1996 as amended by Finance Act 2002); derivatives (Schedule 26 Finance Act 2002); intangibles (Schedule 29 Finance Act 2002).

<sup>49</sup> Consultation documents on Corporation Tax Reform, 2002 and 2003, n. 14 above.

In the first category, provision of incentives, both Government and business taxpayers have come to the conclusion that they would prefer to retain the special capital allowances provisions rather than taking accounting depreciation as the basis for calculating profits in this respect.<sup>50</sup> The flexibility to provide incentives and the benefit from these incentives was too great to be foregone in the interests of possible simplification. The need to take account of practical issues seems to cover the suggestion that, even if there was a move towards commercial accounting treatment for investment properties, for example, fair value changes would not be brought into account for tax. To follow the relevant IAS (IAS 40) on this front, would mean taxing unrealised profits and ignoring problems of liquidity and cash flow, and the Government has drawn back from this.<sup>51</sup>

The imminent introduction of IAS 39, or a new UK accounting standard based largely on IAS 39, for UK companies in respect of financial instrument measurement has already resulted in the UK government introducing legislation and regulations in the Finance Bill 2004 permitting further deviations from accounting treatment.<sup>52</sup> Again, the UK government's intention to follow accounting standards is qualified by practical considerations: here the consequences in terms of volatility of following the provision for hedging in IAS 39, which are more restrictive than those currently in use in the UK, are now agreed by the industry and government to be unacceptable for tax purposes on the current state of the standard.<sup>53</sup>

Thus legislation will continue to permit deviations from accounting standards on pragmatic grounds, whatever the general rule on alignment. It is this willingness to deviate that may mark the UK out still as a jurisdiction which does not follow the dependency route, although it seems clear that jurisdictions which previously maintained a rule of closer dependency are now considering breaking these links in the light of changing accounting standards.<sup>54</sup> The Inland Revenue has described the categories in which departures from accounting may be permitted as covering public policy, transfer pricing, structural issues, avoidance, tax neutrality, capital/revenue divide, fiscal incentives, symmetry, realisability and tax capacity, and whether the commercial accounts are a 'true reflection'.<sup>55</sup> This mixed list based on pre-existing law, pragmatism and principle leaves considerable scope for divergence in the future.

### **The UK case law position following section 42 Finance Act 1998**

Section 42 was not intended to alter the definition of taxable profits of a trade but to codify existing law. It was a by-product of a move to prevent the professions from using the cash basis and the opportunity was taken to include trading profits within a general statutory definition. This intention was expressed in the Explanatory Note to the clause when it was introduced: 'the Government's view is that it does not effect any change in the law on the computation of profits of traders'.<sup>56</sup> It is nevertheless possible for an inadvertent change to have occurred and the Explanatory Notes would

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<sup>50</sup> Ibid; 2004 Budget Press Release PN 04 (<http://www.ir.gov.uk/budget2004/pn04.htm>).

<sup>51</sup> 2004 Inland Revenue Guidance Note, n. 42 above

<sup>52</sup> Schedule 10 to Finance Bill 2004 and draft regulations to be made thereunder- see 2004 Inland Revenue Guidance Note, n. 42 above.

<sup>53</sup> As mentioned above, the accounting standard is generally being criticised for this reason, and not only in connection with taxation (see n 18 above).

<sup>54</sup> W. Schoen, n. 5 above.

<sup>55</sup> 2004 Inland Revenue Guidance Note, n. 42 above.

<sup>56</sup> Explanatory Notes to clause 42 Finance (No 2) Bill 1998.

not be referred to by the courts in interpreting the legislation, so there is some speculation about this matter.

It is interesting to note that this ‘tidying up exercise’ had first been mooted by the Tax Law Rewrite Team<sup>57</sup> and the phrase ‘generally accepted accounting practice’ originally suggested by them for inclusion had met with some opposition. According to the summary of responses to the first consultation on this part of the rewrite, a substantial majority of respondents were in favour but, the team said,

we recognise that a significant number were opposed. They felt that profits could not be sufficiently defined or that references to accounting principles were not helpful- many of those who supported the change had reservations about the way the clause is currently framed.<sup>58</sup>

The question was then transferred from the rewrite team to be dealt with within the less restricted bounds of the Finance Act 1998. Nevertheless, presumably due to the comments from consultees, the 1998 legislation referred to a true and fair view, rather than generally accepted accounting practice (GAAP), to be quietly replaced by the reference to GAAP in 2002. In this way (GAAP) appeared in UK tax legislation for the first time without full consultation and somewhat by stealth, although arguably the reference to a ‘true and fair view’ came to much the same thing and the definition of generally accepted accounting practice refers to true and fair view.<sup>59</sup> ‘True and fair view’ is of course a key concept in accounting and company law, but its inclusion in a taxing statute might be thought to raise the possibility that the courts will one day be called upon to give an interpretation of it, and of the meaning of GAAP more generally, in a tax case.<sup>60</sup>

In giving the explanation that section 42 was not intended to change the law, the Explanatory Notes stated that

The computation of profit remains subject to adjustments permitted or required by tax law, for example, adjustments to ensure that neither a profit nor a loss is anticipated.

It is significant that the example given of an adjustment that may be required by law is not a legislative rule but one established by case law. Likewise, the latest draft legislation published by the Tax Law Rewrite team follows the section 42 wording and the draft Explanatory Note comments that

The general rule is expressly subject to any special rule of law (either expressed in statute or explained by the courts).<sup>61</sup>

A slight element of equivocation has crept into the Inland Revenue’s position in their 2004 guidance note on the UK implications of IAS, however, where they state that the

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<sup>57</sup> The UK rewrite of tax legislation is not intended to change the law, only the way in which it is drafted: Inland Revenue (1996) Tax Law Rewrite: The Way Forward, <http://www.inlandrevenue.gov.uk/rewrite/wayforward/tlrc1.htm>.

<sup>58</sup> <http://www.inlandrevenue.gov.uk/rewrite/exposure/first/response.htm>.

<sup>59</sup> Income and Corporation Taxes Act 1988, s. 836A (introduced by FA 2002, s.103(2)).

<sup>60</sup> David Hole (2002) ‘References to accounting practice and periods of account’ (Finance Act Note) British Tax Review 326.

<sup>61</sup> Inland Revenue, Tax Law Rewrite Draft Income Tax (Trading and Other Income) Bill, 2004. Any special rule of law can either have its origins in legislation or in judicial decisions and so the word ‘explained’ is not thought to be signalling any shift in the Inland Revenue’s position here.

words ‘adjustment required or authorised by law’ in section 42 is not necessarily limited to adjustments required by statute.

It may apply to adjustments authorised by case law *to the extent that such a departure is still possible*’ (author’s italics).<sup>62</sup>

This equivocation reflects a growing debate and exposes a central question. If we re-examine the two part procedure described in the *Odeon* case, outlined above, where first evidence is taken of GAAP and then the ‘correct’ accounting principles are applied, and then couple this with the dictum of Sir Thomas Bingham MR in *Gallagher*, as captured in legislation by section 42, what role is there left for the courts to decide that there should be an answer different from that based on accounting standards? It is argued here that Sir Thomas and the legislation have left considerable scope for the courts to play a role.

### **The judicial and legislative roles- development or exclusion?**

The uncertainty over whether accounting standards are subject to case law principles as well as legislative ones has resulted in calls for the legislature to give clearer guidance on the extent to which accounting standards should be followed. Even before recent developments, this author argued that since tax law and accounting principles did not, and should not, always conform, the divergence should be explicit and properly planned.<sup>63</sup> In his research undertaken for the Tax Law Review Committee of the Institute for Fiscal Studies, Macdonald has called for legislation setting out the accounting principles as they apply to taxation rather than leaving this to review by the courts on unspecified principles.<sup>64</sup> Subsequently, in a paper commissioned by The Association of Chartered Certified Accountants, Christopher Nobes, a Professor of Accounting, has proposed a conceptual framework for the taxable income of business, although his proposed high level criteria are so abstract as to be of little operational value (for example, collection of an equitable share of tax at minimum cost and efficiency).<sup>65</sup>

It seems that many of the so-called tax principles evolved in the case law, such as non-anticipation of profits,<sup>66</sup> have themselves evolved from the accounting principles of prudence and realisation. These accounting principles are now developing and changing so that what appear to be legal principles could be said to be merely outdated accounting principles. To this extent we can agree with Macdonald that, if there is to be variation from accounting standards, it would be helpful to have legislative guidance on when this should occur. For example, Macdonald suggests a legislative provision stating that gains or losses arising from the revaluation of assets and liabilities to a value not based on transaction consideration shall not be included as taxable gains or losses. Another of his proposed provisions is that

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<sup>62</sup> See n. 51 above.

<sup>63</sup> Freedman n. 35 above at p.133.

<sup>64</sup> Macdonald (2002), n. 1 above, chapter 5.

<sup>65</sup> Nobes (2003), n 1 above. Some of his detailed rules give results which deviate from the current position and would be unlikely to be acceptable, for example the suggestions that all provisions should be ignored for tax purposes, even if permitted for accounting purposes under FRS12 or IAS 37.

<sup>66</sup> See *Duple Motor Bodies*, n 43 above.

Gains from transactions shall be recognised in the accounting period in which they are regarded as realised in accordance with normal accounting practice.<sup>67</sup>

This is a suggestion that might well require further consideration, given the way in which accounting practice is moving away from realisation as a trigger for recognition. To some extent this is being achieved by a redefinition by accountants of realisation to include, for example, the results of marking to market as realised profits.<sup>68</sup> It is not clear how long the concept of realisation will continue to be important at all in financial accounting terms. In the UK it has been retained in Financial Reporting Standard (FRS) 18, *Accounting Policies*,<sup>69</sup> but only under sufferance because of protests from those concerned about the company law implications of the concept disappearing, whilst distributions are dependent on having realised profits.<sup>70</sup> In practice the UK Accounting Standards Board (ASB) considers the linking of prudence to realisation to be out of date and prefers to discuss the concept of prudence in terms of revenue recognition only where there is reasonable certainty that a gain exists and if it can be measured reliably.<sup>71</sup> IAS do not address the issue of realisation and the fact that a gain must be reported to accord with IAS does not necessarily imply that a gain would be realised or distributable under UK or any other national law.<sup>72</sup> It is not by reference to realisation, therefore, that we can expect to see the accounting rules on profit recognition evolving.

Given this, Macdonald's proposed provision may require modification. It may not be appropriate to try to use normal accounting practice to determine the time of realisation: some form of tax realisation principle may be required, possibly more closely linked to legal rights than revenue recognition will be in the future under accounting practice. So, discussion is needed on the appropriate legislative tax principles but it can be agreed that some sort of guidance is desirable. If there were to be legislation on such principles, the courts could examine the accounting standard in question and decide whether, as a matter of statutory construction, the application of the accounting standard would give a 'correct' result under the tax realisation principle.

If no such legislation is forthcoming, it may be necessary for the courts to evolve a concept of realisation of their own, based on earlier accounting approaches that were

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<sup>67</sup> Macdonald (2002) n 1 above at p 50.

<sup>68</sup> See Inland Revenue Guidance 2004, n. 42 above, citing the ICAEW Technical Release 7/03 on Realised Profits.

<sup>69</sup> Accounting Standards Board (December 2000).

<sup>70</sup> Article 31 of the EC Fourth Directive on Company Accounts, implemented in the UK by Schedule 4 to the Companies Act 1985, paragraph 12. Sections 262(3) of the Companies Act 1985 provides that references to realised profits are to be construed in accordance with GAAP so that this fundamental principle of company law is, arguably, in the hands of the accountants. See Judith Freedman (1996) 'The Role of Realisation: Accounting, Company Law and Taxation' in IFA 50<sup>th</sup> Congress Seminar Proceedings, *The Influence of Corporate Law and Accounting Principles in Determining Taxable Income*, Kluwer, The Hague. Within the EU there are now calls for the test for distributability to be a solvency test rather than one based on realised profits: see Jonathan Rickford (ed) (2004) *Reforming Capital*, Provisional Report of the Interdisciplinary Group on Capital Maintenance, (British Institute of International and Comparative Law, London); Communication of 21 May 2003, COM (2003) 284 final, *Modernising Company Law and Enhancing Corporate Governance- A Plan to Move Forward*.

<sup>71</sup> Appendix IV to FRS 18.

<sup>72</sup> Allister Wilson, Mike Davies, Matthew Curtis and Greg Wilkinson-Riddle (2001), *UK & International GAAP*, (7<sup>th</sup> ed.) Ernst & Young/Butterworths Tolley, London.

more suitable for tax purposes than those now developing (and thus taking in some of the old case law). This is not stultification of development but a proper application of the traditional two-stage process described in the *Odeon* case. There will remain a role for the courts in applying any relevant legislation and, whether there is legislation or not, in determining the correct accounting principles to be applied for tax purposes.

There will be those who argue that the courts are not equipped for this role. This is to confuse the proper *determination* of accounting standards on the one hand with their *interpretation* and *application* for tax purposes. *Determining* the content of accounting standards is of course beyond the expertise of the judiciary and this is a question for accountants and business owners and managers, as are many, though not all, questions of interpretation of standards. When it comes to *interpretation*, there has to be some adjudication process in case of dispute and the courts must provide that service, although always in the light of expert evidence. Although this will be a question of fact, it is one that could lead to the determination of general principles regarding the meaning of accounting standards that could become used as precedents and thus emerge as questions of law. Given this, it could be argued that it would be desirable for the manner in which accounting evidence is brought to the court to be formalised somewhat, since at present the court is dependent upon whatever accounting evidence is brought before it by the parties.<sup>73</sup> If a court's decision on the meaning of accounting standards may acquire status as a precedent then it is important for all issues to be aired. This is particularly so if a decision in a tax case could have implications in other areas of law such as company law, a problem which would be reduced by having distinct legislative tax principles. Furthermore, the accounting standards to be examined in future may be international accounting standards and it is desirable to have uniform interpretation of these across jurisdictions.

One solution to this might be for the courts to seek guidance from the Accounting Standards Board or International Accounting Standards Committee in cases of dispute over the correct interpretation of accounting standards. In Sweden, for example, the Supreme Administrative Court may consult the Swedish Accounting Standards Board. It is not bound to follow its interpretation but in recent years normally has done so.<sup>74</sup> It seems unlikely, however, that it would be practical to call upon the interpretation committee of the IASC to perform this role and they may well not welcome the additional burden.<sup>75</sup> The issue of different interpretations in different jurisdictions will be a general problem of interpretation of accounting standards at an international level and not merely a tax problem. Once IAS is a European standard, the relevant court to decide on interpretation in Europe will ultimately be the European Court of Justice (ECJ), raising further issues for domestic courts in a tax context.

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<sup>73</sup> Sometimes taxpayers can find it hard to find adequate expert evidence or choose not to do so as was the case in *Gallagher v Jones* (see Freedman n.31 above).

<sup>74</sup> Kristina Artsberg (1996) 'The link between commercial accounting and tax accounting in Sweden' *The European Accounting Review* Vol. 5 Supplement 795. Claes Norberg has pointed out, in correspondence with the author, that the court has referred only 10 tax cases between 1990 and 2003 and that in all of these cases it has followed the opinion of the accounting standards board.

<sup>75</sup> The International Financial Reporting Interpretations Committee (IFRIC) develops interpretations of IAS. Interpretations are exposed for public comments and then have to be approved by IFRIC and the Board so this will be a time consuming process, Interpretations then become part of the International Accounting Standards Board's (IASB's) authoritative literature (IAS 1).

Whilst it is right that the courts should look to expert evidence on the meaning of accounting standards, their *application* for tax purposes is bound to raise questions upon which the courts must and will adjudicate. In addition, where the interpretation relies on legal concepts it is proper for the courts to have a role. Further, they may have to choose between accounting practices where more than one is applicable. The courts can thus be seen to have a role in dealing with four categories of questions as follows.

- 1) Does the accounting standard apply to the transaction at all?
- 2) Does the accounting standard itself introduce questions of law?
- 3) Are there two or more accounting practices which could properly be applied, or no specific standard but only general accounting principles? If so, which practice or principles are preferable for tax purposes?
- 4) Is the accounting standard proposed by the accounting evidence applicable in a tax context?

These questions, which are explored in more detail below, are similar, although not identical, to the questions posed by Sir Thomas Bingham in *Gallagher v Jones*, set out above.<sup>76</sup> Although that case is often described as establishing the primacy of accounting standards, in fact it leaves plenty of scope for judicial interpretation in appropriate cases.

To accept an accounting standard as relevant to taxation without investigation of its objectives and effects and to accept accounting evidence on the *application* of that standard, without examining whether that has relied on an incorrect understanding of legal concepts comprised in the standard, would be an abdication of responsibility by the court.<sup>77</sup> The interaction between taxing legislation and principles and accounting standards will inevitably raise questions for the courts that are not questions to be answered purely on the accounting evidence. It can be agreed that there should be a legislative framework for divergence, but even Macdonald's and Nobes' models do not provide sufficient guidance to enable the role of the judges to disappear altogether. They have, and will continue to have, a role as gap fillers; a role which in this author's view will take them beyond mere adjudication on the facts and into the realm of developing legal rules for the application of accounting standards for tax purposes.

#### IV. THE JUDGES AS GAP FILLERS

Four areas of potential judicial involvement in deciding on the application for tax purposes of accounting standards have been identified above. These will now be examined in turn. This section of this article, supported by detailed examples taken from the UK case law, shows how courts will be inclined to involve themselves at various levels with decisions even where accounting standards exist. In each case the areas discussed are not covered by specific legislation.

##### **Does the accounting standard apply to the transaction at all?**

There may be prior questions for the court to decide, such as whether a sum is a trading receipt for tax purposes at all. It may be that the sum is a capital not a revenue receipt<sup>78</sup>, or that it does not have the characteristics of a trading receipt for some other

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<sup>76</sup> Text to n 31 above.

<sup>77</sup> Freedman (1993) n 31 above.

<sup>78</sup> *IRC v John Lewis Properties* [2003] STC 117.

reason.<sup>79</sup> If, as a matter of law, a receipt is not a trading receipt then it will not be included in the calculation of profit for income or corporation tax purposes, although it may be taxable as a capital gain.

As the Special Commissioners put it in *Tapemaze v Melliush*

...accountancy principles may tell us how big a sum ought to be, and in what year it should appear in the accounts, and whereabouts in those accounts it should appear, and what accountancy label should be attached to it. What those principles cannot tell us is what the sum, in income tax terms, actually is.<sup>80</sup>

A recent example of this approach can be seen in a case that came before the Special Commissioners, *Anise v Hammond*,<sup>81</sup> in which excess payments were received by banker's order from customers by the taxpayer in payment for brochures and booklets containing their advertising. These overpayments were retained<sup>82</sup> and written to the profit and loss account. Initially they were included in the taxable profits but subsequently the taxpayer companies changed their views and, although still including the sums in the profit and loss account, argued that they were not trading receipts and thus not taxable receipts. The sums were shown in both the commercial and corporation tax accounts as non-trading receipts. The taxpayers succeeded in their claim that the sums were not taxable trading profits. The Special Commissioners held that the sums were not received as trading receipts: seeking overpayments was not part of the trading activities of the company. Transferring them to the profit and loss account was purely an internal transaction and no trading asset was created.

The Special Commissioners, in their decision in *Anise*, kept closely to previous case law and did not discuss the case on the basis of accounting standards or accounting principles.<sup>83</sup> The whole case was argued 'as an old fashioned tax appeal concerned with basic principles' as the Commissioners put it themselves. The Commissioners relied on *Morley v Tattersall*,<sup>84</sup> a case in which it was decided that unclaimed balances of sale proceeds of racehorses were not trading receipts and did not become such as a result of being transferred to the partners of the firm. The Commissioners in *Anise* agreed that *Morley* established that it must be determined whether payments are or are not trading receipts at the time they are received. The overpayments were not trading receipts when received and did not become so as a result of internal transactions. Another case, *Jay's the Jewellers*,<sup>85</sup> was distinguished. Here, surpluses retained by a pawnbroker became his property after a certain time under a special statutory regime and were held taxable at that time, was distinguished. In the case of *Jays*, the accounting treatment had been to put the whole surplus into the profit and loss account on receipt and then debit two-fifths as a reserve for the amount that would be claimed, based on past experience. That this was good accounting practice was not questioned,

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<sup>79</sup> *Morley v Tattersall* [1938] 3 All ER 296, discussed further below.

<sup>80</sup> *Tapemaze Ltd v Melliush* [2000] STC 189 at 197h.

<sup>81</sup> [2003] STC (SCD) 258.

<sup>82</sup> No comment is made in the case or here on the propriety of these sums being retained in this way.

<sup>83</sup> The accountants took the view that these were non-trading receipts and so non-taxable, despite being in the profit and loss account. This was, of course, a tax judgment made by the accountants and not justified by reference to accounting standards, which do not appear to have been discussed in the case at all.

<sup>84</sup> (1937) 22 TC 51.

<sup>85</sup> (1947) 29 TC 274.



but it did not govern for tax purposes. Atkinson J decided that the receipts could not be trading receipts in the year of receipt.<sup>86</sup> When the special statute applied to terminate the claim against the broker after three years, however, a new asset came into existence, an asset which had arisen out of a trade transaction. In *Anise*, the Commissioners held, even once the Limitation Acts applied to make the overpayments unrecoverable, they would not have the nature of trading receipts, as they were not part of the trading transaction in the same way as the pawnbroker's retention of a surplus, which is the most profitable part of the pawn broking business. The legal reasoning in this case might be challenged on appeal,<sup>87</sup> but what is interesting for our purposes is that the reasoning was entirely based on case law and focused on the character of the receipts as a question of law. Accounting standards or practice were simply not discussed and the transfer of a payment to the profit and loss account was seen as 'a purely internal transaction'.<sup>88</sup>

In *Tapemaze v Melliush*,<sup>89</sup> where the issue was the tax treatment of advance payments retained after the sale of a business, more attention was paid to accounting practice and the judge was not convinced that the character of a receipt was stamped on it once and for all on receipt, but he did consider the question of the source of the profit to be the determining one and he treated this as a question for him to decide on the basis of the original receipt and an analysis of the terms of the sale agreement.

Whilst the courts may be reluctant to become engaged in questioning accounting standards and their application in a direct way, they will have no hesitation in considering the *nature* of payments in the light of contractual terms and legal obligations, seeing this as a prior question to those of timing and quantification which may be rather more the province of the accountants. In this way accounting practice and standards may be excluded from consideration altogether.

### **Does the accounting standard itself introduce questions of law?**

Sometimes accounting standards themselves refer to legal concepts or require analysis of a legal document, most often a contract. An accountant giving an opinion on a legal concept, or the proper construction of a contract, could not bind the court on that point. It is true that the principle that accounting standards should be followed might mean that in some circumstances a court would follow an accounting standard which applied commercial substance over legal form, but where a legal concept formed part of the standard, then that would have to be interpreted according to legal principles. Potentially, this could give rise to a complex interaction of accounting principles and legal concepts, which might make it very difficult to avoid judicial intervention. Simply stating that tax will follow accounting is then only a partial description of the process. There is a circularity here if accounting standards incorporate legal concepts.

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<sup>86</sup> He was much concerned by the fact that if the estimate turned out to be incorrect the accounts could not be re-opened, and, although this might work out year on year fairly enough in the end it would be a problem where, as in this case, there was an excess profits tax. *Sun Insurance Office Ltd. v Clark* [1912] 6TC 59, where such an estimate was permitted, was not cited in *Jays*. On advance payments see now application note G, discussed below, but the initial question of whether a receipt is a trading receipt remains.

<sup>87</sup> See *Tapemaze v Melliush* n. 80 above and below, not cited in *Anise*.

<sup>88</sup> In this case the Special Commissioners' application of the case law reached the same practical conclusion as the accountants had done on the tax payable but not because of any reliance on accounting principles by the accountants or the Commissioners.

<sup>89</sup> See n 80 above.

What is more, the fact that the issue arises in a tax case rather than, say, a company law case, could colour the outcome since the court will be considering the tax implications of its decision in the context of overall tax concepts such as realisability and taxable capacity, avoidance and objectivity. Whether a decision in a tax case could have more general import is a difficult question.

Prior to the establishment of accounting standards, it was nevertheless the practice to take expert advice on accounting practice. In *Peter Merchant v Stedeford*, where the issue was whether a provision should be permitted for tax purposes where a caterer was under a contractual obligation to replace utensils, an independent accountant considered that it was good accounting practice to make a provision annually, but the court found that a *legal* obligation existed only at the expiry of the contract and so permitted no deduction year on year.<sup>90</sup> Tucker LJ, having cited the cases law, such as *Sun Insurance Office v Clark*,<sup>91</sup> which stated that the question of what is a profit is primarily one of fact, went on to state that,

If, on analysis, it appears that the opinion expressed by the chartered accountant is based upon an erroneous interpretation of the obligations under this contract, of course the whole value of his evidence goes.

In modern circumstances the courts would be likely to be applying an accounting standard in such circumstances; in the case of provisions, FRS 12<sup>92</sup> (a UK standard very similar to IAS 37). This standard applies where an entity has a present obligation, either legal or constructive. This clearly goes beyond legal obligations and so does change the position from that when the *Stedeford* case was decided, but it must still be for the courts to decide if there is a legal obligation, which is defined by the standard as being an obligation that derives from a contract, legislation or other operation of law.

If a constructive obligation is relied upon then, by definition, this is intended to go further than a legal one. FRS 12 defines a constructive obligation as an obligation that derives from an entity's actions where

- a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities and
- b) as a result the entity has created a *valid* expectation on the part of those other parties that it will discharge those responsibilities.

Had this standard been in force at the time of the *Stedeford* case, the accountant's view would have assumed more importance and possibly the court's construction of the contract would not have been determinative, unless the accountant was still relying on the existence of an actual contract rather than a constructive obligation. Nevertheless, incorporated into this definition of when the standard applies is a legal concept on which clearly the court's decision would be authoritative. More problematic is the question of who would be the final arbiter of non-legal concepts, such as whether a valid expectation had been created or a past pattern had been established. The standard itself proceeds by way of examples but this can leave considerable room for

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<sup>90</sup> *Peter Merchant v Stedeford* 30 TC 496 at 509.

<sup>91</sup> 6 TC 59.

<sup>92</sup> Accounting Standards Board September 1998.

discussion.<sup>93</sup> It is hard to believe that the court would not consider the issue and the terms of the standard if a question on this became crucial for tax purposes. Initially this might be seen as a pure question on the facts but it is possible that such determinations would begin to build into guidance on the construction of the standard. At what point this would then become legal guidance, if at all, remains to be seen. If the issue were to arise in a tax case, there would be the additional consideration of whether the court would explicitly or impliedly take tax considerations into account.

Another example of an accounting standard which embodies legal concepts but goes further than those concepts, is FRS 5, which, together with Application Note G to that standard on revenue recognition,<sup>94</sup> is similar to IAS 18 and deals with some aspects of timing of particular importance in a tax context. FRS 5 is entitled 'Reporting the substance of transactions' so is clearly intended to go beyond legal rights and duties. Given this, it is significant to note the extent to which the application note is framed in terms of contractual obligations, rights and performance. Although it is intended to look at substance, its basis is certainly contract law and it quotes a leading legal textbook by Treitel<sup>95</sup> in support of the proposition that

The principle that a seller generates revenue by performing its contractual obligations to the customer is consistent with the idea of performance under the law of contract.

Thus, under G4, a seller recognises revenue under an exchange transaction with a customer when, and to the extent that, it obtains the right to consideration in exchange for performance. This is fully consistent with long-standing UK case law and is very legally based in tone.<sup>96</sup> Under G5, where a seller receives a payment in advance of performance it recognises a liability equal to the amount received, representing its obligation under the contract. It would be hard for a court to consider this without considering legal rights and duties. This is not to say that the outcome would be anything other than following the standard. The point here, though, is that questions of whether there was an obligation under the contract or a right to consideration would be issues on which the courts would not fear to engage and on which they would expect their determination to be final unless the standard made them subject to some overriding question of substance, which is not the case here. Thus, the case of *Elson v Price's Tailors*<sup>97</sup> (in which an unclaimed deposit was held taxable when received) would not be dealt with as a matter of pure law on the nature of a deposit as it was in 1962, but there would nevertheless need to be a discussion of whether there was a continuing obligation under the contract at the time when deposits were transferred to

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<sup>93</sup> Allister Wilson et al. n. 7 above at p. 1958 'The critical event that creates a constructive obligation tends to be elusive... That is not to say that we believe that only legal obligations deserve to be in the balance sheet, but we doubt if this particular approach is the best way of determining which additional items deserve to be there'.

<sup>94</sup> Accounting Standards Board, November 2003.

<sup>95</sup> Sir Günter Treitel, (1999) *The Law of Contract* (10<sup>th</sup> ed.) Sweet and Maxwell, London at p 697, cited in the note on development of the Application Note.

<sup>96</sup> *J.P. Hall & Co. Ltd v The Commissioners of Inland Revenue* [1921] 3KB 15. The case is a reminder of simpler times but the common sense of the judges accords with the latest sophisticated accounting guidance. See the delightfully brief judgment of Lord Atkin, who stated 'It seems to me that no person here trying to ascertain these profits on the principles of ordinary commercial trading would dream of including profits... which would not be made until the goods had actually been delivered in respect of some contract which was to run over a period of at least two years, and possibly more'.

<sup>97</sup> [1963] 1 All ER 231.

the unclaimed deposit account, in order to assess whether a balancing liability should be recognised.<sup>98</sup>

In practice the statement quoted from Treitel in the application note is merely a preface to an entire chapter discussing the issues around performance in more detail and many questions of law are involved which might be relevant to whether a contractual right to consideration has arisen. For example, certain contracts - entire contracts as opposed to severable ones - require complete performance before any right to consideration arises.<sup>99</sup> It is far from clear to what extent application note G intends to rely on contract law such as this and where it intends to override it.

The corresponding international standard, IAS 18 on revenue recognition is similarly intended to move away from purely legal obligations but incorporates them into its definitions nonetheless. This tendency to resort to legal concepts indicates the central role of legal thinking in the commercial world. It has been fashionable to reject legal form as not reflecting reality, but there are normally sound reasons why the concepts have arisen in the way they have done. IAS 18 refers to the transfer of the risks and rewards of ownership of goods and the ability to measure revenue reliably. The standard acknowledges that in most cases the transfer of the risks and rewards coincides with the transfer of legal title or possession although there may be differences. Once again this calls for an examination of legal issues, even if it is possible that the final determination may go beyond strict legal questions.

In similar vein, in relation to long-term contracts, Application Note G, paragraph 18 (elaborating on Statement of Standard Accounting Practice, (SSAP) 9, 'Stocks and long-term contracts' which continues to apply) requires that

A seller should recognise turnover in respect of its performance under a long-term contract when, and to the extent that, it obtains the right to consideration. This should be derived from an assessment of the fair value of the goods or services provided to its reporting date as a proportion of the total fair value of the contract.... The guiding principle is to consider the stage of completion of the contractual obligations, which reflects the extent to which the seller has obtained the right to consideration.

The definition of right to consideration at G3 makes it clear that the right to consideration is not linked to the contractual right to demand stage payments. To allow this would mean that revenue recognition would be distorted by the timing of payments. Instead there must be a relationship between actual performance of the obligations and the right to consideration. Performance is defined as fulfilment of the seller's contractual obligations to a customer through the supply of goods and services. This makes the tests to be applied a curious mix of contractual and non-contractual ones. There is an attempt to apply substance but at each point a return to contractual rights.

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<sup>98</sup> Contrast *Jays the Jewellers* n. 85 above, where there was no receipt.

<sup>99</sup> *Sumpter v Hedges* [1898] 1 QB 673. The courts are reluctant to construe contracts to perform services so as to require complete performance before any payment becomes due since this can lead to unjust enrichment: *Button v Thompson* (1869) L R 4 CP 330 at 342, cited in Treitel, n. 95 above. The question of whether a particular obligation is entire or severable is one of construction. This is separate from the issue of separation and linking of contractual arrangements also discussed in Application Note G.

It may be that the courts will refuse to enter into any debate over this and see it as a matter of accounting practice. Indeed we have already seen them take this approach in *Symons v Weeks*<sup>100</sup>, where the court accepted the application of a work in progress formula consistent with SSAP 9 in relation to recognition of profit by architects under a long-term contract. On the other hand, the contractual language of the Application Note does much to invite judicial intervention. The equivalent IAS, which deals with construction contracts, is rather less dependent on contractual terms, referring to contract revenue, which can be measured reliably, but the question of reliable estimates depends upon nevertheless judgments on various matters such as the enforceability of contracts. Thus we can see that many accounting standards will have legal elements which continue to require adjudication by the courts.

**Are there two or more accounting practices that could properly be applied, or no specific standard but only general accounting principles? If so, which practice or principles are preferable for tax purposes?**

It is well established, and was reiterated in *Gallagher v Jones*<sup>101</sup>, that where there are two or more rules which could be applied to a situation it will be for the court to choose between them for tax purposes.<sup>102</sup>

Sometimes where accounting standards have not given a clear answer the courts have chosen an approach which has been subsequently upheld by accounting developments,<sup>103</sup> whilst at other times judicial decisions have been effectively reversed by subsequent accounting standards, as in *Johnston v Britannia Airways Ltd.*<sup>104</sup> The increasingly comprehensive coverage by standards at a national and international level is likely to remove some of this choice from the courts, although the principles basis of standards will mean that detailed choices remain to be made by those applying the standards. At other times the accounting will give a very detailed answer, requiring a range of information and notes in the accounts,<sup>105</sup> whereas what is needed for tax law purposes is a more straightforward or binary answer: is this sum taxable or is it not?

<sup>100</sup> [1983] STC 195; see Freedman n 35 above for a detailed discussion of this case.

<sup>101</sup> n. 30 above.

<sup>102</sup> Where unlisted and individual UK companies will have a choice between IAS and UK GAAP after 2005 their tax treatment will follow whichever of these sets of standards they use (clause 50, Finance Bill 2004).

<sup>103</sup> *Herbert Smith v Honour* [1999] STC 173, consistent with the subsequently agreed FRS 12.

<sup>104</sup> [1994] STC 763

<sup>105</sup> See the comments of Lord Millet NPJ in *Commissioners v Inland Revenue v Secan Ltd.* 74 TC 1 at p 12- capitalised interest is a very weak indication of value so shareholders are entitled to a note showing how much in the balance sheet is so attributable. Generally Lord Millet's comments on accounting in *Secan* have come in for heavy criticism, revealing the danger to judges of commenting on these issues-see Tim Ambrose on the website of the Chartered Institute of Taxation (technical article 18/-9/02) <http://www.tax.org.uk/showarticle.pl?n&id=1328&p=1>; Maurice Parry-Wingfield, (2002) 'Depreciation in a Tangle' *The Tax Journal* 14 October 11; G. Macdonald (2003), 'Further Reflections on Secan Ltd' *The Tax Journal* 3 March 9. Despite this criticism (which did not affect the decision, only the reasoning) the Inland Revenue sought to rely on the reasoning in *Secan* in the *Mars* case, showing how judicial comment will be utilised by both sides of tax disputes and the attempt will be made to turn it into matter of value as a precedent.

### Is the accounting standard proposed by the accounting evidence applicable in a tax context?

This is the fundamental open issue - will the courts still permit themselves to ask this question? Following the decision in *Gallagher v Jones*, it is argued by some that 'statutory modification is the only limit to the application of accounting principles and practice'.<sup>106</sup> This is not what the case law states. Returning to the statement of Sir Thomas Bingham MR in *Gallagher*,<sup>107</sup> it is clear that the courts have left themselves a good deal of scope to intervene and to judge the applicability of the accounting standard to the 'true facts'. It is submitted that, whilst they are unlikely to refuse to follow an established accounting standard, they maintain a residual capacity to do so. Section 42 of the Finance Act 1998 quite expressly does nothing to change this.<sup>108</sup>

This view is supported by the Inland Revenue who, in their note on the introduction of IAS,<sup>109</sup> envisage the possibility of adjustments to accounting standards being made by case law and refer, for example, to the rule in *Sharkey v Wernher*<sup>110</sup> (self-supply to be shown in the books at market value for tax purposes). This 'rule' appears to have been decided contrary to accounting practice of the time<sup>111</sup> but it now seems to be accepted as established. Unfortunately, accounting evidence was not actually given in the case, but it was argued that a figure of cost should be brought into the books as a matter of good accounting practice.<sup>112</sup> There seems to have been some misunderstanding of accounting by the majority who could not understand why it had been admitted that any amount should be brought into the account as a receipt. Lord Oaksey, dissenting, understood that this was accounting practice, saying

It follows, in my opinion, that such expenses as have been incurred to produce an asset which is withdrawn from a trade cannot properly be deducted and must, therefore, be withdrawn from the account which can only be done in accordance with accounting practice by crediting the amount of the expenses

This insertion of a balancing figure was not, though, convincing to the rest of their Lordships. On the one hand, it must be possible that *Sharkey v Wernher* would now be decided differently on the basis of properly presented accounting evidence.<sup>113</sup> On the other, it is hard to see how such a long established and well known rule of case law could be easily overturned: it is more likely that it would be distinguished. Given that the Inland Revenue has more sophisticated legislative tools available to it now to

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<sup>106</sup> Macdonald, n 1 above, at p.46.

<sup>107</sup> See text to n 31 above.

<sup>108</sup> See text to n 56 above.

<sup>109</sup> See n. 42 above.

<sup>110</sup> [1955] 3 All ER 493.

<sup>111</sup> J. Tiley (2000) *Revenue Law* Hart Publishing, Oxford p439; H. Edey 'Valuation of Stock in Trade for Income Tax Purposes' [1956] BTR 23.

<sup>112</sup> See Lord Radcliffe.

<sup>113</sup> As, for example, in *Symons v Weeks*, n. 100 above, where *Elson v Prices Tailors*, n 97 above, was distinguished as containing no evidence on accountancy practice and having been argued and decided totally on the grounds of the legal character of receipts at a particular date. Warner J stated that no general principle could be derived from the case in these circumstances. But *Elson* did not lay down such a well established principle as does *Sharkey v Wernher*.

counteract the mischief being attacked in that case,<sup>114</sup> we may never learn the fate of this particular rule.

How the case law will develop more generally will depend in part on the way cases are presented to the courts, as with any litigation. As solicitors and barristers and ultimately judges become more familiar with the impact of increasingly sophisticated accounting standards on taxation issues, and as significant questions arise involving large sums of money, it is hard to believe that this question will not be tried and tested.

Indeed we can see a tendency to litigate around accounting standards in the recent case of *Mars UK Limited v Trevor William Small*,<sup>115</sup> said to be a case waited upon with great interest by many businesses.<sup>116</sup> The issue in that case was whether for the purposes of corporation tax, the gross amount of depreciation in stock was required to be added back in arriving at taxable profits, as the Inland Revenue argued, or whether only the net amount had to be so added back (after adjusting for depreciation included in opening and closing stock). The interesting point for our purposes was the approach of the Commissioners. They could simply have followed accounting practice, based on standards, to find for the taxpayers. Instead, although they did come to the same conclusion as the taxpayers' accountants, they engaged in their own more legal analysis to reach this end. This involved examining the capital/ income divide, applying section 74(1)(f) of the Income and Corporation Taxes Act 1988 and looking at the need to avoid a capital amount becoming chargeable to corporation tax on income. Whether their approach, which has been criticised by accountants,<sup>117</sup> will be upheld on appeal remains to be seen. It seems very likely that there will be an appeal and this will be fertile ground for further discussion of the role of the courts and the law in relation to the application of accounting standards.

It is in relation to the capital/income divide, unless it is removed by legislation, that the courts seem most likely to continue to consider they have a role to play and that the issue, unlike that of timing, is one of law.<sup>118</sup> An example of this can be seen in the area of leases, where notwithstanding that the accounting standard (SSAP 21) requires a proportion of rentals payments to be treated as capital, the rentals are agreed to remain in law revenue payments. This is confirmed by an Inland Revenue statement of practice (SP3/91) and was accepted in *Gallagher v Jones* itself without argument.<sup>119</sup> Thus it seems that SSAP 21 applies in so far as it refers to timing but not in so far as it

<sup>114</sup> See clause 30 of the Finance Bill 2004 (provision not at arm's length: transactions between UK taxpayers).

<sup>115</sup> [2004] SpC 408.

<sup>116</sup> Maurice Parry-Wingfield, 'Depreciation in Stock Again', *The Tax Journal*, 12 April 2004 and 17 May 2004.

<sup>117</sup> Ibid.

<sup>118</sup> See Lord Hoffmann in *CIR v New Zealand Forest Research Institute* [2000] STC 522 (PC); also the classic statement in *Heather v PE Consulting Group* [1973] 1 ALL ER 843

'The Courts have always been greatly assisted by the evidence of accountants. Their practice should be given due weight: but the Courts have never regarded themselves as being bound by it. ... The question of what is capital and what is revenue is a question of law for the Courts'. (Lord Denning MR). The Inland Revenue seem to agree: Inland Revenue Tax Bulletin (1999) 'Relationship Between Accountancy and Taxable Profits: Current Points of Interest' Issue 39 at p624.

<sup>119</sup> See n. 30 above at p544; SP3/91 states (para. 9) 'Notwithstanding that SSAP 21 requires a proportion of the rentals payable to be treated as capital repayment, the rentals remain in law revenue payments for the use of the asset, and for tax purposes the whole of the rentals should be allocated to the periods of account for which the asset is leased in accordance with the accruals concept'. (In practice commercial depreciation is normally accepted, but not always; paras. 10-12).

recharacterises the revenue payment as capital. The accounting standard is only partially applicable.

Whether the courts will ever intervene in timing issues in the future is a more difficult question. It seems more likely that legislation will be used to counter the more extreme effects of fair value accounting but, if fair value accounting is introduced without legislative variations, it is not impossible that the courts will revive the notion of the importance of realisation for tax purposes and endeavour to examine for themselves whether an accounting treatment amounts to anticipation of profits, especially if the accounting profession finally removes all references to realisation as we have known it previously from its standards.<sup>120</sup> This will truly raise the question of whether any tax principles remain which can override accounting standards.

As this analysis of decided cases has shown, though the courts will sometimes be content simply to follow accounting standards, this will not always resolve the issues. If there is a prior question concerning the legal character of a receipt or expenses, or if the courts perceive that a legal concept is relied upon for the propose of the application of a standard, they will have a tendency to adjudicate: that, after all, is the function of courts. Much will depend upon the way cases are presented and the confidence of the judiciary in their comprehension of standards but, as they become more used to dealing with accounting evidence under the formalised systems of standards now evolving, this confidence will grow. Taxpayers and their advisers will also begin to press issues relating to accounting standards before the courts when these are seen to involve important issues with a good deal of tax at stake and will become increasingly expert at arguing the case for analysing the legal aspects of standards when it suits their case.

It is contended here that the judiciary will be willing to decide whether a standard is applicable at all, to provide interpretations of legal concepts embodied in standards, and to choose between competing standards or practices where both are presented as acceptable but one has to be chosen for tax purposes. In some cases, for example where there is a long established legal rule such as the capital/income distinction or the rule in *Sharkey v Wernher*, they may even decide that a tax principle exists which means that an accounting standard is not the correct principle to be applied, either in whole or in part, for tax purposes. In sum, then, it cannot be stated that the advent of detailed and formally agreed accounting standards removes the judicial role completely in this area.

## V. THE INTERACTION OF SYSTEMS

The extent to which the courts will be prepared to go in interpreting accounting standards, and even deciding that they should not apply accounting standards for tax purposes, remains to be seen. It seems inevitable, however, that there will be a complex relationship between these two systems of law and accounting in this context, as in others.<sup>121</sup> Tax law will make reference to accounting standards, and in so doing will transform them into part of the legal system. In this process, there will be a tendency towards simplification of the accounting material to make it practical to use

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<sup>120</sup> See text to ns. 68- 72 above.

<sup>121</sup> The complexities of this interaction are discussed in Peter Miller and Michael Power (1992) 'Accounting, law and economic calculation' in *Accounting and the Law*, Michael Bromwich and Anthony Hopwood (eds) Prentice Hall/ICAEW, London.



it in legal decision-making, as we have seen in a number of decided cases.<sup>122</sup> Tax law requires binary decisions- is an amount taxable or is it not?- rather than disclosure of an array of information as is required for accounting. Similar problems are encountered when the law attempts to interact with other sources of expert knowledge such as science, where a complex evidence set needs to be made susceptible to use for a binary legal decision- guilty or not guilty.<sup>123</sup> As systems theory puts it,

Systems are unable to communicate directly with one another, for each system uses different criteria of validity, different forms of authority and different codes for deriving meaning from and assessing the value of information. Put in its simplest terms, they see things differently and there is no possibility of one system being able to internalise the world-view of another. All that it is able to achieve is an internalisation according to its own 'way of seeing' of what it understands from the communications of the other system.<sup>124</sup>

The outcome of litigation on whether an amount is taxable or not is ultimately one reached by the legal system, having absorbed the accounting information into itself. We can anticipate a continuing and creative interaction at a domestic level, and yet further complexities should issues of interpretation of IAS reach the ECJ as well they might once these have been adopted at European level.

## CONCLUSION

There is no denying the central relationship between taxable and commercial profits. Equally, there are clear differences in objective between the tax and financial reporting systems. Although the UK government is currently keen to move the taxable profits closer to accounting profits, the difficulties of doing this in a changing accounting environment are becoming apparent and we have seen some retrenchment from the original plans. Even where there is a starting point of following the accounts, the number of exceptions demanded by practicality and public policy is such that the simplicity of alignment is lost. The need to incorporate accounting standards into the legal system, which provides ultimate adjudication on tax matters, further complicates the extent and way in which accounting standards will actually be followed for tax purposes. The result is likely to be a dynamic interaction rather than a static relationship.

At the same time, jurisdictions which have traditionally pursued the path of total, or almost total, dependence are considering movement away from alignment. In countries such as Germany, alignment was achieved by the objectives of the commercial accounts being subordinated to those of the tax system. Once control over the accounting system is lost due to the advent of new international accounting standards, alignment is a less attractive option. The new accounting standards may be contained by restricting them to consolidated accounts not used for taxation, but the impact on German accounting standards is likely to be more pervasive than this. Ultimately it is hard to believe that IAS will not have an impact on domestic standards

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<sup>122</sup> For example, *Symons v Weeks* n 100 above; *Johnston v Britannia Airways Ltd* n 104 above.

<sup>123</sup> This analysis borrows from systems theory but does not purport to be an application with which systems theorists would necessarily agree. I am indebted to Richard Nobles of the LSE for discussions of this issue.

<sup>124</sup> M. King and C. Thornhill (2003), *Niklas Luhmann's Theory of Politics and Law*, Palgrave Macmillan, London at p.27.

and make it much more difficult for them to be tax driven. If this occurs, the pressure to increase the number of exceptions from the old dependence principle will continue to mount. The absorption of IAS will be seen as unconstitutional, too difficult to control and as having objectives too remote from those of the tax system which earlier governed the formulation of accounting standards. Dependence was a product of tax dominance and once this has gone, the arguments for dependence will follow.

At a European level, the Commission continues to argue for the use of IAS as a starting point for discussion of a common consolidated tax base, even if only for want of anything better. There are, however, many Member States opposed to the concept of such a common base. Most Member States are still considering the impact of IAS and are not at the stage of moving forward on this basis. There are also those who would raise constitutional objections to the use of IAS to determine tax policy and so a sophisticated and political process would be needed at Commission level for the adoption of such standards for tax purposes. Much work remains to be done to reach agreement on this within the EU.

Underlying all these debates there is a concern about the interpretation of accounting standards for tax purposes. At a European level, the relevant court would ultimately be the ECJ, already embroiled in many controversial tax decisions. The interaction between the ECJ and the IASB would almost certainly be dynamic and difficult to predict. This problem of interpretation also exists more generally in relation to accounting standards in a wider context than tax.

Even if IAS are to be the starting point for taxable profits, governments at a domestic and European level will need to consider the pragmatic and policy reasons for departure from the accounting standards.<sup>125</sup> It is suggested here that these focus largely around issues of realisation, certainty and volatility. Legal transactions may be easier to manipulate than other tests of economic substance, but they do have a basis in reality and there may be good reasons to use transactions based evidence and legal rights as opposed to estimates in a tax context. Legal concepts of capital and income may seem outdated but sometimes reflect common understandings that underlie consensus about tax systems. Neutrality of taxation may be a desideratum but Governments will not wish to give up the ability to use tax as an economic tool, however ineffective a tool it may be.

All these considerations need to be taken into account in formulating policy on the relationship between taxable and accounting profits. Preferably these differences should be embodied in legislation to give guidance. As the European Commission working paper put it,<sup>126</sup> to the extent that tax accounting is to develop independently from financial accounting, autonomous tax rules (or principles) are needed. But legislation will not, and probably cannot, provide all the answers across the range of issues that may arise. Given this it will not be entirely unexpected if the courts intervene where a residual possibility to do so remains, either by means of interpreting standards, by finding them not to be applicable, or even by deciding that they are not the correct accounting principles to be applied in a certain situation. Just how far the courts will be prepared to go in the face of sophisticated accounting standards remains

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<sup>125</sup> As the European Commission agrees: see the Commission non-paper referred to at n. 10 above.

<sup>126</sup> See n. 8 above.

to be seen but ultimately, after all the accounting evidence has been given, the judges will adjudicate and the final decision will be a legal one.<sup>127</sup>

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<sup>127</sup> Or, as Justice Hill (n. 28 above) puts it, ‘ultimately Judges will still be there’.

# Towards An Electronic Filing System: A Malaysian survey<sup>+</sup>

Ming-Ling Lai<sup>\*</sup>, Siti Normala Sheikh Obid<sup>†</sup> and Ahamed Kameel Meera<sup>‡</sup>

## *Abstract*

This paper examines the level of technology readiness of Malaysian tax practitioners and their usage intentions towards an electronic filing system. A questionnaire survey was administered to 572 tax practitioners. The survey indicates that 31.3% of the respondents are somewhat techno-ready and 9.4% are highly techno-ready. By and large, tax practitioners are optimistic in new technology and have strong usage intentions; nonetheless, they are wary of the security of Internet technology. Multiple regression analysis reveals that there is a significant positive relationship between the level of technology readiness and the usage intentions towards the e-filing system.

## INTRODUCTION

The Inland Revenue Board Malaysia (the IRB) is currently streamlining the tax filing process through the use of information and communication technology (ICT) and is working to reform tax administrative policies to embrace an electronic income tax filing system (MIA, 2000; SGATAR, 2001). The main objectives of the IRB in embracing an electronic filing (e-filing) system are to facilitate tax compliance and to provide improved taxpayer service through administrative improvement.

Basically, the e-filing system encompasses the use of Internet technology, the Worldwide Web and tax software for a wide range of tax administration and compliance purposes. The chief advantage of an e-filing system is that it integrates tax preparation, tax filing and tax payment. With the e-filing system, taxpayers and tax practitioners can file income tax returns electronically via the enabling technologies, rather than through mail or by physically visiting the tax office. This may eventually make the art of tax filing and tax payment easier. The e-filing system may offer potential benefits to improve administrative compliance efficiency, but the benefits gained may be obstructed by tax users' unwillingness to accept and use the available electronic services. Learning from the experience of overseas tax agencies, the move to embrace an e-filing system is not hassle free and is not well accepted by all parties. Worldwide, tax users' resistance and under utilization of the e-filing system remains a

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great concern and it still plagues various tax agencies who are embracing electronic tax administration systems (AccountingWeb, 2002; ETAAC, 2002).

Prior studies found that tax practitioners are an important third party in tax compliance settings, as tax practitioners have the acquired technical knowledge and professional experience in liaising with tax agencies relative to an ordinary taxpayer (Burnett, 1998; Newsberry, Reckers and Wyndelts, 1993). As a result, tax practitioners are able to exercise a strong and direct influence on the tax compliance and administration process (Erard, 1993). Particularly, in fear of penalty, many taxpayers turn to tax practitioners for help under the self-assessment regime (Kocakulah and Grower, 2000). For instance, in the United States, the tax authority is counting on tax practitioners to promote the e-filing system (ETAAC, 2002; Kahan, 1998). In a similar vein, the IRB is also counting on local tax practitioners to promote the e-filing system. Undoubtedly, an e-filing system can only work effectively with the assistance and cooperation of tax practitioners.

Even though the e-filing system is an inevitable progression in the Malaysian tax environment in the foreseeable future, there has been little scholarly research to date pertaining to the e-filing system related to Malaysian tax settings. It is unclear whether Malaysian tax practitioners are ready to embrace the e-filing system. Hence, the move by the IRB to embrace the e-filing system has motivated this study. This study aims to (i) examine the level of technology readiness of Malaysian tax practitioners, (ii) ascertain their usage intentions of the e-filing system, (iii) assess if there is any difference in technology readiness dimensions across gender and age groups and (iv) explore if there is a relationship between technology readiness and usage intentions towards the e-filing system.

## **LITERATURE REVIEW**

Previous studies found that a combination of positive and negative beliefs about technology underlies the domain of technology readiness (Dabholkar, 1994; Mick and Fournier, 1998). In particular, Dabholkar (1994) found that individuals simultaneously harbour positive (favourable) and negative (unfavourable) beliefs about technology. The positive beliefs propel individuals towards new technologies, while negative beliefs may hold them back.

Mick and Fournier (1998) highlighted eight “paradoxes” of technology with which IT consumers have to cope: control/chaos, freedom/enslavement, new/obsolete, competence/incompetence, efficiency/inefficiency, fulfilment/creation of needs, assimilation/isolation, and engagement/disengagement. All these paradoxes implied that technology might trigger both positive and negative beliefs. An individual can be a technology “innovator”, dare to experiment, but still be sceptical about the benefits of technology, or can believe strongly in technology but also be wary of its security (Parasuraman, 2000).

Parasuraman and Colby (2001, p.48) defined technology readiness (TR) as “people’s propensity to embrace and use new technologies at home and at the workplace”. They analysed the positive and negative belief about technology into four distinct technology readiness dimensions: (1) optimism, (2) innovativeness, (3) discomfort and (4) insecurity. The four TR dimensions are defined as follows:

- *Optimism*: The optimism facet is defined as a positive view of technology and beliefs in the benefits of technology in increasing job efficiency and enhancing people's lives at work and at home.
- *Innovativeness*: The innovativeness dimension refers to the extent to which a person believes that he or she is a thought leader, and at the forefront of trying out new technology-based products/services.
- *Discomfort*: Discomfort refers to a perceived lack of control over technology and a feeling of lack of confidence in using the new technologies properly.
- *Insecurity*: Insecurity is defined as distrust of technology-based transactions and scepticism about its ability to work effectively.

In the United States, during the period 1999/2000, a nationwide telephone survey was conducted on 1,001 American adults. The American National Technology Readiness Survey (NTRS) was based on a random sample of American adults (18 years or older). The survey reported that the mean score on a 5-point scale for each of the four TR dimensions were 3.8 for optimism, 3.2 for innovativeness, 3.5 for discomfort and 4.0 for insecurity perceptions (NTRS, 2000; Parasuraman, 2000). In the same survey, the results indicated that American adults were optimistic about new technology; nonetheless, they were also wary of Internet security. The findings further revealed that there were no significant differences in optimism and insecurity perceptions between genders; both male and female adults were positive about technology, and were concerned by the insecurity of Internet technology.

In addition, the results of the NTRS (2000) found that American males appeared to be more innovative than the females, and American females experienced greater discomfort with new technology as compared to the males<sup>1</sup>. The survey also found that older people tend to be less optimistic and less innovative about new technology as compared to younger participants. At the same time, older participants perceived more discomfort with new technology as compared to the younger ones. However, the views pertaining to insecurity varied little across age groups.

Parasuraman and Rockbridge Associates, Inc developed the Technology Readiness Index (TRI) to measure technology readiness. According to TRI, the combination of scores on the four TR dimensions represents a person's overall technology readiness. The first two TR dimensions, 'optimism' and 'innovativeness' are the 'contributors' that may increase an individual's technology readiness while the other two TR dimensions 'discomfort' and 'insecurity' are 'inhibitors' that may suppress technology readiness. Parasuraman (2000, p.317) stated that the TRI is "a multiple-item scale with sound psychometric properties that can be used to gain an in-depth understanding of the readiness of technology customers (both internal and external) to embrace and interact with technology, especially computer/internet-based technology".

Parasuraman (2000) and Parasuraman and Colby (2001) highlighted that technology readiness is an overall state of mind and not a measure of competency. In brief, there are three important components of technology readiness. First, technology readiness varies from one individual to another. Anyone can be a consumer of a technology, but

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<sup>1</sup> One plausible explanation for such a finding was attributed to the education system in United States. Traditionally, more male students were selected to pursue computer sciences and IT related courses than females (Parasuraman and Colby, 2001).

some may seek technology actively, whilst others may need special help or coaxing. Second, technology readiness is multifaceted. Third, technology readiness can be used to predict and explain consumers' responses towards new technologies.

Extant studies provide support that the TRI scale is capable of capturing the relationship between technology readiness and technology usage behaviours (NTRS, 2000; Parasuraman and Colby, 2001). Empirical findings indicate that technology readiness correlates with actual use and intention to use the technology-based products and services in varying degrees (Parasuraman and Colby, 2001). Notably, an individual with a higher level of technology readiness has higher usage intention and more experience in using the technology based products and services in varying degrees. Similarly, prior studies by Dabholkar (1994) and Mick and Fournier (1998) also demonstrated that information technology/information system (IT/IS) consumers with more positive beliefs are more receptive and ready to use the various new technologies.

Agrawal and Prasad (1999) found that individual differences influence an individual's beliefs and usage intention of the new ICT. Zmud (1979) defined individual differences as any dissimilarity across people, including differences in cognitive style, personality, and demographic variables. Meanwhile, Fishbein and Ajzen (1975) defined usage intention as a measure of the strength of one's intention to perform a specific behaviour. Sheppard, Hartwick, and Warshaw (1988) found individuals' actual behaviour could be predicted reasonably well from their intentions. Subsequently, several studies, for example Davis, Bagozzi, and Warshaw, (1989), Jackson, Chow, and Leith (1997) and Chau and Hu (2001), indicated that usage intentions of IT/IS are reasonable indicators of future system use.

## RESEARCH METHOD

A survey method was used in this study. The questionnaire comprised of four sections. Section A gathered background and demographic information about the respondents. Section B asked respondents to indicate their general perceptions towards new information and communication technology on the following dimensions: optimism, innovativeness, discomfort and insecurity<sup>2</sup>. Respondents were asked to indicate their opinion on a scale of 1 (strongly disagree) to 5 (strongly agree). Section C was designed to assess the respondents' usage intentions of the e-filing system on the 7-point Likert scale, anchored on 1 (strongly disagree) to 7 (strongly agree). Two questions were adapted from Davis (1989) to measure the usage intentions. Section D contained open ended-questions.

The questionnaire was subjected to two pre-tests. The questionnaire was pre-tested with 8 professionals, and the pilot test was carried out on 35 tax practitioners. Systematic sampling method was used and the sample was limited to tax practitioners who were public accountants authorised by or under written law to be an auditor or person in authority such as the tax partner, tax director or tax manager working in the audit firms registered with the Malaysian Institute of Accountants (MIA) as at 31 July 2002. The survey questionnaire was posted to 572 tax practitioners throughout Malaysia.

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<sup>2</sup> Note that the survey questionnaire, comprising the Technology Readiness Index (TRI), is copyrighted by A. Parasuraman and Rockbridge Associates, Inc., 1999, and is adapted with written permission.

Non-response bias may occur when potential respondents included in the sample failed to respond. Fowler (1993) indicated that when the mail survey method was employed, one way to reduce non-response bias is to do rigorous follow-ups to increase response rate. Accordingly, three weeks after the first mailing, one follow-up letter was sent to survey respondents, and for those who had e-mail addresses, an e-mail was sent. Subsequently, three weeks after the first follow-up mailing, a second follow-up letter with another copy of questionnaire plus a stamped self-addressed envelope was sent by post. In total, 192 completed questionnaires were received; hence, the response rate was about 34% (192/572). However, at the time of study, there has been no prior empirical study on Malaysian tax practitioners that can be relied on as a reference point. Therefore, in order to test for the potential non-response bias, the mean score for the research variables was compared, i.e., between the first early respondents and the last 30 respondents, based on guidelines provided in Armstrong and Overton (1977). The t test results show no significant differences between the early and later respondents at 5% significant level, indicating that non-response bias is not a serious problem in this study.

## DATA ANALYSIS AND DISCUSSION

The summated scale was used to compute the mean score of technology readiness dimension and usage intentions. The combination of scores on the four dimensions represents a person's overall technology readiness. The details of the survey results are presented next.

### The Respondents' Profiles

The respondents' profiles are presented in Table 1 and Table 2. As Table 1 shows, the respondents were located all over Malaysia. As expected, the majority of respondents were from Wilayah Persekutuan (34.8%) and Selangor Darul Ehsan (13.9%). These proportions reflect the reality in this country as these two states have the biggest number of registered audit firms in Malaysia (Lee, 2002).

**TABLE 1 THE RESPONDENTS' PROFILE BY STATE**

State	Percentage (%)
Wilayah Persekutuan (Kuala Lumpur only)	34.8
Selangor Darul Ehsan	13.9
Johor	11.8
Pulau Pinang	7.0
Sarawak	9.1
Perak	3.7
Sabah	8.6
Melaka	2.1
Kedah	2.1
Negeri Sembilan	2.1
Pahang	1.6
Terengganu	1.1
Kelantan	2.1

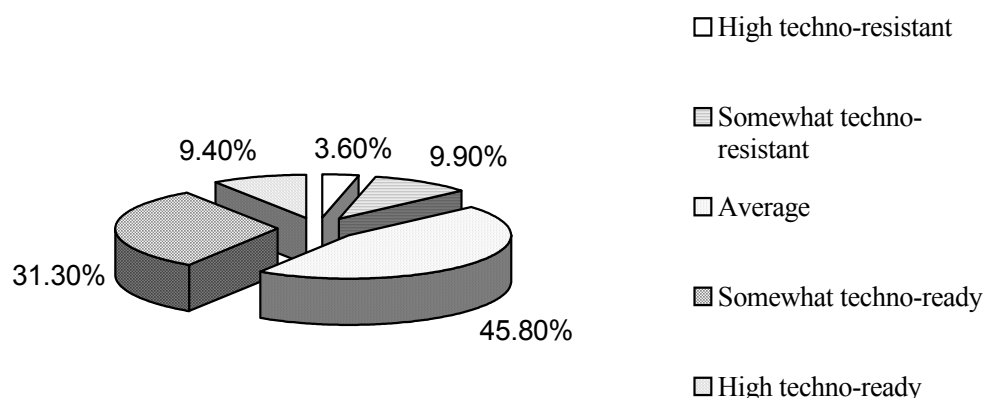
As Table 2 indicates, the respondents comprised tax proprietors/tax partners (80.2%), tax directors (5.3%), and tax managers (14.5%). A substantial majority of the respondents were Chinese (87.2%) and male (86%). The dominant proportion of



Chinese males in the respondents' group reflects the reality in Malaysia where Chinese males are the major players in accounting and tax practice. Approximately 22% of the respondents were aged below 35. The predominant education level was professional qualification and university degree. More than 91% of the respondents indicated that they were members of local professional bodies such as Malaysian Institute of Accountants (MIA), Malaysian Institute of Chartered Public Accountants (MICPA), and Malaysian Institute of Chartered Secretary and Administrators (MAICSA), and 48% were member of Malaysian Institute of Taxation (MIT). About 37% of the respondents were also members of foreign professional accounting bodies established in countries such as Australia, Canada, New Zealand and United Kingdom.

**TABLE 2 THE RESPONDENTS' PROFILES**

	Percentage (%)
Job Position	Proprietor/Tax Partner
	80.2
	Tax Director
Gender	5.2
	Tax Manager
	14.6
Age	Male
	85.9
Ethnicity	Female
	14.1
	25-34 years old
	21.9
Academic Background	35-44 years old
	34.9
	45-54 years old
	32.8
Professional Membership	55 and above
	10.4
	Chinese
	86.5
Technology Readiness and Technology Readiness Dimensions	Indian
	6.3
	Malay
	5.2
Based on the Technology Readiness Index, the survey results show that the respondents vary in their level of technology readiness. Figure 1 reports that about 3.6% were highly technology-resistant, 9.9% were somewhat techno-resistant, 45.8 % were in the average level, 31.3 % were somewhat techno-ready, and 9.4% were highly techno-ready.	Others
	2.0
	Professional Qualifications
	75.0
Figure 1	Bachelors' degree
	17.7
	Masters' degree
	6.3
31.3 %	Diploma
	1.0
	MIA/MICPA/MAICSA
	91.1
9.4%	MIT
	47.8
	Foreign professional bodies
	36.5
105	None
	1.6



Parasuraman and Colby (2001) found that those who have high level of technology readiness appear to be thought leaders with more technology savvy than those who have low technology readiness. In this vein, the survey results indicate that more than 40% of the respondents appear to be thought leaders. On top of this, the study of Rogers (1995) provided insights that thought leaders and early adopters should be identified and used as key change agents to facilitate the diffusion of the e-filing technology.

The mean score based on the data set for each technology readiness dimension and the *t*-statistics for equality of means for both gender and age groups is presented in Table 3. As Table 3 indicates, by and large, the respondents are highly optimistic towards new technologies with a mean score of 4.29 on the 5-point scale (significant at  $p < 0.001$ ), but they are less receptive to new technology with a mean innovativeness score of 2.86 on the 5-point scale. On the other hand, the discomfort dimension shows a mean score of 2.93 on a 5-point scale, thus indicating that the respondents experience lesser degrees of discomfort with new ICT. Furthermore, the results indicate that Malaysian tax practitioners as a group perceive a considerable level of technology anxiety, with a mean value of 3.6 on the 5-point scale on insecurity dimension (significant at  $p < 0.001$ ). In addition, *t*-statistics and the Mann-Whitney U test were used to test the influence of gender and age groups on the four technology readiness dimensions (see results in column 3 and 4 in Table 3 and Table 4 respectively).

**TABLE 3: MEAN SCORES AND T-TEST FOR EQUALITY OF MEANS ACROSS GENDER AND AGE GROUPS**

Technology Readiness Dimension	Items Mean (Std deviation)	Mean (Standard deviation)			Mean (Standard Deviation)		
		Male (N=165)	Female (N=27)	<i>t</i> -stats ( <i>p</i> -value)	Aged below 35 (N=42)	Aged above 35 (N=150)	<i>t</i> -stats ( <i>p</i> -value)
Optimism	4.2891* (0.5707)	4.2818 (0.5799)	4.3333 (0.5189)	-0.434 (0.665)	4.2619 (0.5548)	4.2967 (0.5767)	-0.348 (0.728)
Innovativeness	2.8576 (0.8865)	2.8545 (0.9004)	2.8765 (0.8120)	0.119 (0.905)	2.9444 (0.8739)	2.8333 (0.8914)	0.717 (0.474)
Discomfort	2.9323 (0.9396)	2.9727 (0.9423)	2.6852 (0.9003)	1.479 (0.141)	2.7381 (0.7092)	2.9867 (0.9898)	-1.521 (0.130)
Insecurity	3.5903* (0.9248)	3.5879 (0.9362)	3.6049 (0.8575)	-0.089 (0.929)	3.5873 (0.7644)	3.5911 (0.9656)	-0.024 (0.981)

All items were measured based on scale of 1 (Strongly disagree), 2 (Slightly disagree), 3 (Neutral), 4 (Slightly agree) and 5 (Strongly agree).

\* Significant at  $p < 0.001$

**TABLE 4: MANN-WHITNEY TEST FOR MEAN SCORE ON THE FOUR TR DIMENSION ACROSS GENDER AND AGE GROUPS**

TR Dimension	Gender	N	Mean Rank	Z score ( <i>p</i> -value)	Age	N	Mean Rank	Z score ( <i>p</i> -value)
Optimism	Male	165	96.03	-0.36 (0.971)	Below 35	42	62.52	-0.330 (0.741)
	Female	27	99.35		Above 35	150	65.06	
Innovativeness	Male	165	96.56	-0.294 (0.769)	Below 35	42	71.96	-1.214 (0.225)
	Female	27	96.13		Above 35	150	62.41	
Discomfort	Male	165	98.82	-1.256 (0.209)	Below 35	42	58.57	0.978 (0.328)
	Female	27	82.35		Above 35	150	66.16	
Insecurity	Male	165	96.42	-0.389 (0.697)	Below 35	42	58.05	-1.047 (0.295)
	Female	27	97.00		Above 35	150	66.31	

The results as presented in Table 3 and Table 4 show that there is no significant difference in technology readiness dimensions across gender and age groups. These results contrast with the NTRS 2000 survey in several aspects. Notably the NTRS survey reported that males appeared to be more innovative than females; females experienced greater discomfort with new ICT as compared to males; older people tended to be less optimistic and less innovative about new ICT, and older people experienced more discomfort with new ICT as compared to younger people.

There are a few plausible explanations for the insignificant results between mean score for each TR dimensions, when variables like gender and age are compared. Firstly, the sample size for gender and age groups were imbalanced or not comparable. Notably, there were 165 male respondents and 27 female respondents. The dominant proportion of males in the respondent group reflects the reality in Malaysia that males are the major players in the accounting and tax practice. In addition, 42 respondents were below 35 years old and 150 respondents were above that age. This indicates that the majority of tax practitioners surveyed are highly experienced professionals.

Secondly, the samples were collected from a homogeneous group; i.e. tax practitioners who were highly educated professionals. As qualified tax professionals, regardless of gender and age groups, all of them are frequently exposed to new technologies at work and at home nowadays; as such, their perceptions towards new ICT may not vary greatly despite gender and age differences. Nevertheless, it is important to note that data analysis using the Mann-Whitney U test, as presented in Table 4, did show some variations in the four TR dimensions across gender and age groups, which warrant further attention and study.

### **Usage Intentions of the E-filing System**

The respondents were asked to indicate their usage intentions of the e-filing system. The mean score observed was 5.7 on a 7-point scale (standard deviation=1.070), and the reliability test of the usage intention construct showed a Cronbach alpha of 0.90, indicating a very satisfactory measurement consistency (Nunnally, 1978). The result indicates that the majority of the respondents have high usage intentions of the e-filing system. However, the results may not be a precise measure and could be over reported, as it is a self-reported measure (Davis, 1993). At best, self-reported usage intention should serve as a relative indicator (Legris, Ingham, and Colletette, 2003). The following is an example of the difficulty with self reported measures (La Presse Montreal, Tuesday, 17 October 2000, cited in Legris et al., 2003, p.202):

“Observers in public washrooms in New Orleans, New York, Atlanta, Chicago and San Francisco noted that only 67% of the persons washed their hands after visiting the toilet cabinet. When 1,201 Americans, in a telephone survey, were asked if they washed their hands after going to the bathroom, 95% answered yes.”

Furthermore, it is noted that some of the respondents specifically expressed that they would only use the e-filing system if the IRB could assure them that the electronic filing system were safe and secure, and if the usability and reliability of the e-filing system were fully tested and well documented.

### **Technology Readiness and Its Impact on Usage Intentions of the E-filing System**

When we regressed usage intentions on the level of technology readiness (controlling for age and gender variables), the results of multiple regression showed that the level of technology readiness had a significant positive relationship on usage intention of the e-filing system ( $\beta = 0.39$ ,  $t=5.83$ ,  $p<0.001$ ); and about 16% of the variation in usage intention of the e-filing system can be explained by the level of technology readiness ( $r^2 = 0.157$ ,  $p<0.001$ ). This result appears to support the contention of Parasuraman and Colby (2001) that the level of technology correlates with intention to use the technology based products and services in varying degrees.

## **CONCLUSION**

The survey findings of this study have implications for tax policy makers and tax practice management. One implication is that the survey results report that tax practitioners are optimistic about new technology. Nonetheless, they are also wary of the security of the Internet technology, an outcome also identified in the UK where concerns about Internet security inhibited tax practitioner filing return online (AccountingWeb, 2003). In a similar vein, ‘perceived insecurity’ could be the ‘inhibitor’ in promoting the e-filing system among tax practitioners. Thus, it is imperative for the tax authority to address the fundamental risks associated with online tax transactions before implementing the e-filing system nationwide.

The results also report that the respondents have a moderate level of 'discomfort' and 'innovativeness' with regard to emerging technologies. These results imply that the tax authority needs to ensure that the e-filing system is very user-friendly, easy to gain access to and easy to use in the context of tax compliance. Pragmatically, the tax authority needs to provide courteous technical support online or set up physical service counters at various premises to assist tax practitioners and intended tax users.

Another implication of the study is concerned with technology readiness and usage intentions (and ultimate usage) of the e-filing system. The survey results show that there is a significant positive correlation between technology readiness level and usage intentions of the e-filing system. This finding appears to indicate that technology readiness is a force behind the motivation to embrace the e-filing system among tax practitioners. The survey finding provides an insight that an understanding of technology readiness can be used as a business strategy, supporting Rogers (1995) suggestion that thought leaders can be identified and used as change agents to accelerate the diffusion of new technology. Hence, intuitively, it is suggested that the tax authority and tax firms need (i) to study the technology readiness of their staff; (ii) to identify the thought leaders among the staff; and (iii) to choose the thought leaders to lead the e-filing project and use them as the change agents to accelerate the diffusion of e-filing technology. For maximum effectiveness, employees in charge of tech-support should be high on technology readiness (Parasuraman and Colby, 2001).

Admittedly, this paper provides only a snapshot of the empirical evidence collected from one major segment of tax user groups, i.e., the tax practitioners or tax preparers. Hence, future research could be conducted on other potential tax user populations (such as tax officers and taxpayers) to gain further insights. A clearer understanding of the technology readiness of the intended users may provide useful insights pertaining to the types of systems that are likely to be most appropriate; the pace at which the systems should/could be implemented; and the types of support needed to assist tax users in voluntary compliance. Essentially, paying explicit attention to intended tax users' technology readiness may assist the tax authority in formulating business and marketing strategy to accelerate the adoption of e-filing technology.

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# The Evolution of the Informal Economy and Tax Evasion in Croatia

**Katarina Ott\***

## *Abstract*

This paper presents the results of research on the size and evolution of the informal economy and tax evasion in Croatia. It compares the results of two large-scale surveys of the informal economy and tax evasion, one conducted in 1996, covering the first half of the 1990s, and another conducted in 2001, covering the 1996-2000 period. Before conducting the second survey we expected the size of the informal economy and the extent of tax evasion in Croatia to be declining in response to positive economic and political changes in Croatia and the region in the second half of the 1990s. Most of our measurement methods confirm this null hypothesis. In particular, the system of national accounts method indicates that the size of the informal economy in 2000 was equivalent to about 7% of GDP, compared with an estimated 37% in 1993. However, the monetary evaluation method and the electricity consumption method suggest that the size of the informal economy increased somewhat in the second half of the 1990s. Such discrepancies are also common in empirical work in other countries and we investigate some possible reasons for the contrasting results in the case of Croatia. The paper first presents the key results of our surveys on the size of the informal economy and the extent of tax evasion; then discusses other evidence supporting our main finding on the decline in the size of the informal economy, including the results of research on the socio-cultural dimensions of the informal economy in Croatia, and finally gives some conclusions and provides some policy recommendations.

## **I. INTRODUCTION**

This paper presents the results of research on the size and evolution of the informal economy and tax evasion in Croatia during the second half of the 1990s. It compares the results of two large-scale surveys of the informal economy and tax evasion, one conducted in 1996, covering the first half of the 1990s, and another conducted in 2001, covering the 1996-2000 period.<sup>1</sup> Before conducting the second survey we expected the size of informal economy and the extent of tax evasion in Croatia to be declining as a result of positive economic and political changes in Croatia and the region in the second half of the 1990s. Most methods of measurement confirm this null hypothesis. In particular, the system of national accounts method (SNA) indicates that the size of the informal economy in 2000 was equivalent to about 7% of GDP, compared with an estimated 37% in 1993. However, the monetary evaluation methods and the electricity consumption method suggest that the size of the informal economy increased somewhat in the second half of the 1990s. Such discrepancies are common in empirical work for other countries and we investigate some possible reasons for the

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<sup>1</sup> More about the 1996 project could be found in Bićanić and Ott (1997) and in Feige and Ott (1999). Besides, all the papers from 1996 project were presented at the conference The Importance of the Unofficial Economy in Economic Transition organized by the Institute of Public Finance in Zagreb, in May 1997 and are available on request from the author of this paper. A brief overview of the 2001 project can be found at Ott (2002), but all the papers from the 2001 project were presented at the conference Unofficial Activities in Transition Countries: Ten Years of Experience organized by the Institute of Public Finance and Friedrich Ebert Stiftung in Zagreb, in October 2002 and can be found at [<http://www.ijf.hr/eng/UE%202002/croatian.html>].

contrasting results in the case of Croatia. In particular, we consider the results of related research by sociologists from our team on the socio-cultural dimensions of the informal economy (see Štulhofer, 1999; Štulhofer and Rimac, 2002). This research indirectly provides convincing evidence of the decline in the size of the informal economy, which leads us to argue in the end in favour of the null hypothesis.

The remainder of this paper is divided in three sections. Key results of our surveys on the size of the informal economy and the extent of tax evasion are presented in Section 2. Section 3 discusses other evidence supporting our main finding on the declining size of the informal economy, including the results of research conducted by sociologists on the socio-cultural dimensions of the informal economy in Croatia. Section 4 concludes and provides some policy recommendations.

## II. ESTIMATES OF THE SIZE OF THE INFORMAL ECONOMY AND TAX EVASION

Figure 1 summarises seven different estimates of the size of the informal economy in Croatia during 1990-2000. The different methods are described below

### Box 1

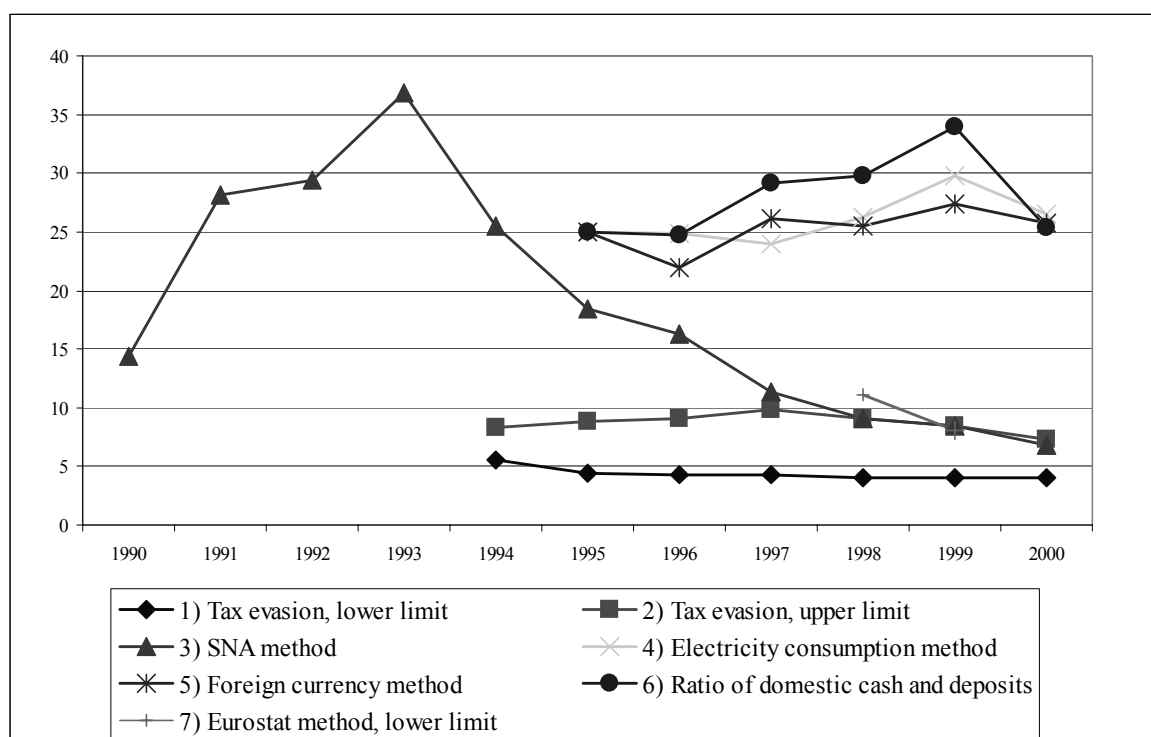
#### Methods of estimating the size of the informal economy and tax evasion

1. and 2. Tax evasion - Tax evasion refers to a legal economic activity that is not reported for the purpose of avoiding the payment of taxation. Method: estimating the gap between collected and potentially collected taxes. Madžarević-Šujster (2002); Blades (1982).
3. SNA - The informal economy is defined as the unrecorded economy. Method: independent sources of information (e.g. household budget surveys) are used to assess the level of GDP, which is usually higher according to the expenditure approach than according to the production or income approach. Results derive from the fact that individuals have fewer incentives to hide their real consumption in household budget questionnaires than income in tax files. The informal economy is thus interpreted from the difference in GDP calculations from two sources. Madžarević-Šujster and Mikulić (2002); Blades (1982).
4. Electricity consumption – the unofficial economy is estimated on the basis of electricity consumption. Under the unit elasticity condition a percentage change in electricity consumption changes total GDP (includes both official and unofficial economy) for the same percentage. Kaufmann and Kaliberda (1996), Šošić and Faulend (2002).
5. Foreign currency – the unofficial economy is approximated on the basis of the estimated amount of foreign currency cash, given the underlying hypothesis that says that foreign currency cash is mainly used for transactions in the unofficial economy. This method could be particularly interesting for dollarized/euroized economies. The only known source, Šošić and Faulend (2002).
6. Ratio of domestic cash and deposits – the unofficial economy is approximated on the basis of the estimated amount of domestic cash currency that is used in the unofficial economy, since the main idea is that transactions in the unofficial economy are conducted only in (domestic) cash. Gutmann (1977); Šošić and Faulend (2002).
7. Eurostat – data about employment from the official sources are compared with data derived from the household labour force survey and from other sources. Eurostat (1995); Lovrinčević, Mikulić and Nikšić-Paulić (2002).

We should first stress that empirical evidence for other countries also indicates wide discrepancies in the estimated size of the informal economy based on different methods. National accounts discrepancies methods usually give lower, while various monetary methods usually give higher results. Schneider and Enste (2000) compare results of various methods e.g. for Germany in the same period the discrepancy between expenditure and income resulted in an informal economy of 13 % GDP while the transactions approach resulted in 30%; for Italy in almost the same period the discrepancy between expenditure and income gave around 9%, while the cash-deposit ratio gave around 30%, and the transactions approach over 34% GDP.

In the case of our research in Croatia four of the seven methods indicate that the size of the informal economy continuously declined in the second half of the 1990s. The SNA method indicates the most significant reduction in the informal economy, from about 37% of GDP in 1993 to an estimated 7% of the GDP in 2000. The Eurostat method, which could be applied only to 1998 and 1999 because of the lack of data for other years, strongly coincides with the SNA method.

**FIGURE 1: ESTIMATES OF THE SIZE OF THE INFORMAL ECONOMY AND TAX EVASION IN CROATIA (% OF GDP)**



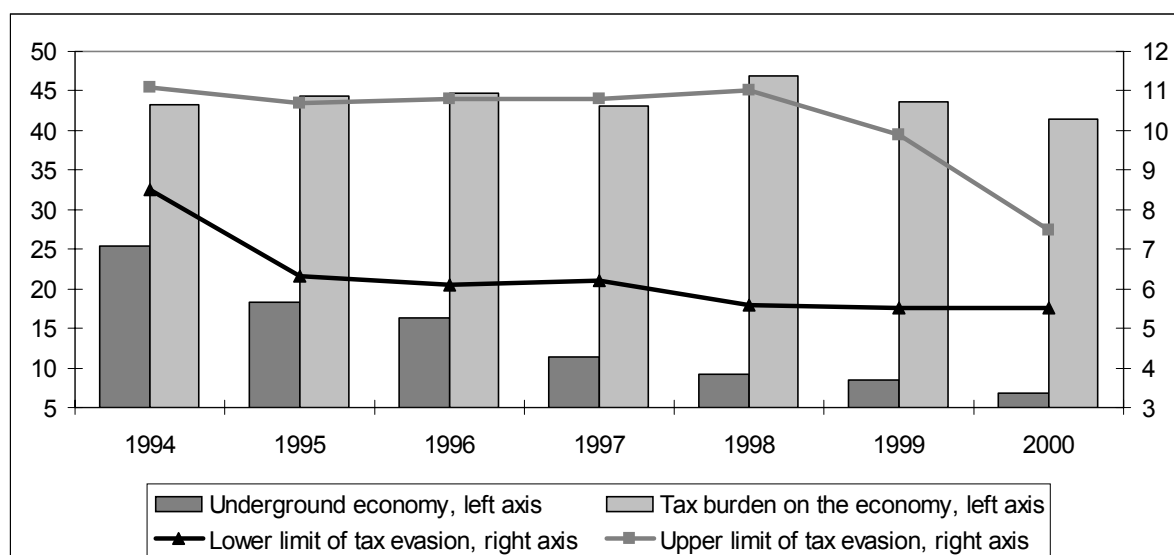
Source: Lovrinčević, Mikulić and Nikšić-Paulić (2002); Madžarević-Šujster (2002); Madžarević-Šujster and Mikulić (2002); Šošić and Faulend (2002).

Upper-and lower-bound estimates of the share of tax evasion in GDP provide evidence of the same trend, although they do not indicate such a large shrinkage of the informal economy as the former two methods. Nevertheless, these two estimates are particularly important because our survey indicates that labour not reported for the

sake of evading the payment of taxes<sup>2</sup> is a major source of the informal economy in Croatia (Lovrinčević, Mikulić and Nikšić-Paulić, 2002).

Figure 2 compares the upper- and lower-bound estimates of the share of tax evasion in GDP with two alternative indicators that are expected to be positively correlated with the size of the informal economy: the size of the tax burden on the economy, defined as total tax revenue of consolidated general government in official GDP; and the estimated size of the informal economy. The tax burden indicator is clearly highly correlated with the upper-bound estimate of the extent of tax evasion, while the estimated size of the informal economy is highly correlated with the lower-bound estimate, thus confirming the initial result. One should note, however, that the lower limit estimate of missed revenue in 2000 (8.6 billion kuna) is still very large - it is greater for instance than the deficit of consolidated general government in 2000 (7.7 billion kuna).

**FIGURE 2. COMPARISON OF TAX EVASION AND THE SHARE OF THE UE (% OF GDP)**



Source: Madžarević-Šujster (2002).

In summary, the SNA, Eurostat, and the (upper limit) tax evasion methods indicate that the informal economy in Croatia accounted for about 9% of GDP in 1998 and about 7% in 1999. The similarity of these estimates is in itself a remarkable result – that the three different methods yield almost identical estimates in two consecutive years would hardly seem to be a coincidence.

Yet measures of the informal economy using the ratio of domestic cash and deposits (C/M1), the so-called Gutmann method; the ratio of foreign cash in circulation and domestic monetary aggregate (FCC/M1); as well as the electricity consumption method suggest that the size of the informal economy increased more or less continuously from 1995 to 1999 and subsequently declined in 2000. Again, the three estimates are remarkably similar, but indicate that the informal economy was much

<sup>2</sup> Estimate of tax evasion was given on the basis of selected direct (personal income, surtax and social security contributions, corporate income) and indirect (value added, excise on tobacco) taxes.

larger in 2000, equivalent to about 25% of GDP. We must here stress that measurements with monetary methods in Croatia are in a way problematic because of the short time series and the unsatisfactory statistical basis (more about the shortcomings in Jankov, 1997 and Šošić and Faulend, 2002). Particularly important is that e.g. the Gutman method does not take into account the specific circumstances in a country like Croatia, i.e. experience of hyperinflation and frequent devaluations. As a consequence citizens are apt to turn their free resources into foreign currency and put them into short-term time deposits. This can not be considered real savings, rather delayed consumption stored in a currency that citizens trust more. If the share of cash in a somewhat wider monetary aggregate (between M1 and M4) had been used, i.e. if short-term time deposits were included, the results could have been different (the share of cash would probably have fallen). The electricity consumption estimates were criticized by Schneider and Enste (2000) because not all economic activities are equally electricity-intensive, while some service industries that are easier to conceal or switch into the informal economy are often labour intensive; technological advances that increase efficiency reduce the need for electricity, and electricity consumption elasticity compared with changes in GDP can change in some years. The method has also been criticized by Lacko (2003) and Eilat and Zinnes (2000).

### III. HAS THE SIZE OF THE INFORMAL ECONOMY REALLY DECLINED?

Can these two sets of contrasting evidence be reconciled? We address this issue in three steps. First we consider macroeconomic trends in the 1990s. Second, we discuss how various special factors identified in recent literature are likely to have influenced the evolution of the informal economy in Croatia during the 1990s. Third, we look at evidence from a related survey on the socio-cultural characteristics of the informal economy.

#### Macroeconomic trends

In general, one would expect the size of the informal economy to increase as macroeconomic circumstances - growth, inflation and unemployment - deteriorate. See e.g. Eilat and Zinnes (2000) and Feige (2002, 2003).

**TABLE 1: BASIC ECONOMIC INDICATORS IN CROATIA 1994-2000**

	1994	1995	1996	1997	1998	1999	2000
Rate of growth of GDP (in %)	5.9	6.8	6	6.5	2.5	-0.4	3.7
Rate of inflation (% change in retail prices)	-3.0	3.7	3.4	3.8	5.4	4.4	7.4
Average number of unemployed (in 000)	243	241	261	278	288	322	358
Rate of unemployment (International Labour Organisation)	9.4	9.1	10.0	9.9	11.6	14.5	17.0

Sources: Ministry of Finance and State Statistical Office.

If we look at the data in the *Table 1* we could argue the following:

- Strong economic growth in the mid-1990s and sharp slowdown in 1998-2000 would suggest a decline in the informal economy in the mid-1990s and its rise in the late 1990s. This conflicts with the evidence of the decline and supports the evidence of the growth of the informal economy.
- Inflation was relatively low in the mid-1990s and rose in 1998-2000, which again argues in favour of the evidence of the growth and contrary to the evidence of the decline in the size of the informal economy.
- Unemployment rose more or less continuously, which again speaks in favour of the evidence of growth of the informal economy.

In summary, macro evidence would at first sight seem to point to conditions for an increase in the size of the informal economy in the late 1990s. However, additional macroeconomic evidence is not inconsistent with the estimated decreasing trends in the informal economy. As argued by Madžarević-Šujster and Mikulić (2002), economic stabilisation in 1994 and the rise in personal incomes in 1997 clearly led to a reduction in the estimated size of the informal economy. Higher incomes in particular led to a change in the structure of personal spending – spending on consumer durables, mostly financed with loans (which automatically reduce the possibility of concealing transactions) rose significantly in 1997 as a result of higher personal incomes. The consolidation of large retail chains and the entry of foreign firms into Croatia in the second half of the 1990s reduced the market share of small and informal enterprises, leading to better statistical reporting. In 1998 a value added tax with broad coverage was introduced, which considerably improved the registering of transactions due to built-in incentives for keeping neat records. Finally, in 2000 the government paid off a large proportion of its debts to enterprises; the banking sector was further consolidated; and banks started to increase lending to small- and medium-sized enterprises, all of which increased the incentives for reporting transactions. Thus, on balance we can conclude that macroeconomic evidence with some reservations is basically consistent with a decline in the size of the informal economy in the late 1990s.

### **Transition-related factors influencing the informal economy**

The 1990-2000 periods in Croatia was marked by several specific factors that may have considerably influenced estimates of economic activity.

First, there were significant changes in the statistical system and many statistical series were discontinued. Second, high inflation in the early 1990s highly distorted the size of many economic variables. Third, numerous new business units were created that reported few if any data to the statistical office, while on the other hand large business systems with established statistical reporting procedures disappeared. The changes in the quality and scope of data between 1990-2000 therefore make it likely that the estimated size of the informal economy in the mid-1990s, when many of these changes were still occurring, was underestimated and that the estimated reduction in the size of the informal economy in the late 1990s reflects better coverage of the formal economy in the national accounts.

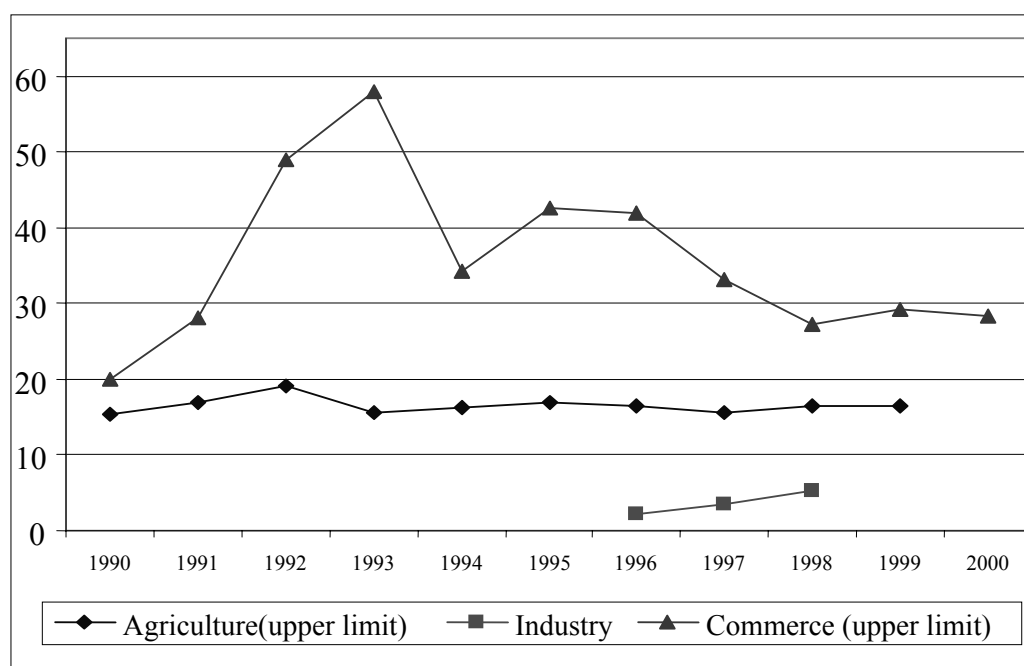
The literature somehow came to the understanding of some of the factors influencing informal activities in countries in transition. Political repression, inadequate legal system, institutional weaknesses, administrative control and discretionary decision-

making in the economy, high tax burdens and a non-payment culture are recognized by several authors Kaufman and Kaliberda (1996), North (1997), Vehovec (2001). All these factors became less pronounced in the late 1990s in Croatia and hence point to the decline in the size of the informal economy.

- Political repression certainly gradually started to phase out after the end of the war in the mid-1990s.
- The legal system has been constantly improving (even if still not fast enough) with the introduction of numerous new laws and amendments to the existing ones (e.g. bankruptcy law, criminal law and various tax related laws).
- Institutions improved during the time (e.g. tax and customs administrations were introduced, financial police established, central bank developed). Particularly influential was the privatisation of media and their liberalization, which played a great role in exposing the poor practices of the institutions.
- Administrative control and discretionary decision-making in the economy had to become less pronounced thanks to the liberalizations of markets, entrance to the WTO, and preparations for EU accession.
- As shown before in Figure 2 the high tax burden decreased and tax evasion paralleled it.
- Government started paying its liabilities, including arrears, which influenced the pro-payment culture.

In particular, several factors that affect the growth of the informal economy in economies in transition were present in Croatia as well.

The transition intensified sectoral and institutional restructuring. As can be seen from Figure 3 in three chosen industries, for the whole of the decade, the ratio among them was the same – the informal economy is greater in trade, smaller in agriculture, and smaller still in industry. The trends, however, are essentially different: the UE is reducing in trade, stagnating in agriculture, but rising in industry. The explanation might be fairly simple – the speed of the transition per sector, the development of a number of new, mainly small business units and the number of employees, the relative weakening of the importance of the big systems. In short, the transition was most rapid in trade, slowest in industry – hence this kind of result. In agriculture there was no transition, hence the stagnation.

**FIGURE 3. THE UE IN AGRICULTURE, INDUSTRY AND TRADE (% OF GDP)**

Source: Mikulić and Madžarević (2002).

Transition also created significant changes in the tax system. The majority of new tax laws were passed and new taxes were introduced during the early and mid-90s when Croatia simultaneously had to make the transition and carry on the war. Tax authorities had to cope with the new taxes and the increased numbers of taxpayers. Taxpayers took advantage of the opportunity of constant changes and lack of organized authorities. With the introduction of the tax administration, customs administration and financial police in the mid-90s situation had to improve in the direction of a diminution of informal activities.

Croatia's transition also had some specific features. The most significant was the break-up of the former country and the establishment of the new state. As a result, numerous "soft borders" between the former Yugoslav republics were created. The end of the war, the establishment of new and better functioning customs authorities at borders, the conclusions of bilateral agreements with neighbouring countries all made for a less friendly environment for informal activities.

The war that followed the break-up of former Yugoslavia had serious social consequences; in particular it created a huge number of displaced and disabled persons. It took some time for majority of them to settle and fit into the formal environment.

The non-transparent process of privatisation catering to various special interests (the so-called *clienteles*) delayed the establishment of competitive market conditions. With the growth of domestic economic entities, openings for foreign players in the privatisation game, the space for special domestic players narrowed.



### Socio-cultural factors

In addition to macroeconomic and transition-related factors, evidence from research conducted by sociologists from our team also points to conditions that are conducive to reduced role of the informal economy in the late 1990s. Štulhofer and Rimac (2002) start off from the theoretical assumption that the dynamics of social opportunism coincides with the dynamics of the informal economy: the rise in opportunism reduces the moral costs of engaging in informal economic activities, i.e. increases the readiness of individuals to get round or break the standards of economic behaviour. And if such informal activities go unpunished, they may sustain the expansion of opportunism on their own.

#### Box 2

##### Socio-cultural dimension of the informal economy

Using "World Values Survey 1995 and European Values Survey 1999 data for Croatia" the authors analyse the dynamics of opportunism and lack of trust in institutions regarding them to be socio-cultural proxies of (the acceptance and volume of) the informal economy, measuring:

- *opportunism*, defined by the extent to which respondents are ready to justify the payment of bribes and the evasion of taxes;
- *distrust in institutions* (the legal system and parliament);
- inclination towards *economic traditionalism* defined as preference for egalitarian distribution ("we need larger income differences as incentives for individual effort" vs. "incomes should be made more equal") and collective ownership, and preference for state paternalism ("people should take more responsibility to provide for themselves" vs. "the government should take more responsibility to ensure that everyone is provided for").

In this context, it is worthwhile to highlight the following findings of the two surveys on the socio-cultural dimensions of the informal economy and tax evasion in Croatia that were conducted in 1996 and 2001:

The diffusion and intensity of opportunism (see Box 1 for definitions) decreased from 72% in the mid-1990s to 48% in 2000.

- The number of respondents who think that tax evasion and bribing can never be justified doubled.
- Economic traditionalism ceased to be a relevant factor. Respondents were getting used to differences in wages and, as it seems, embraced the principle of individual responsibility.

One should note, however, that almost half of respondents were prepared to tolerate tax evasion and bribing phenomena in certain circumstances. Moreover, the distribution of opportunism according to age has remained unchanged, with the youngest age group still most apt to justify tax evasion and take bribes. This suggests that the phenomenon of opportunism might remain present in Croatia in the long term.

## IV. CONCLUDING REMARKS

The evidence presented in this paper suggests that, on balance, the size of the informal economy and the extent of tax evasion declined in Croatia in the second half of the 1990s. One should note, however, that changes in the quality and scope of statistics during the past ten years make it difficult to assess the trends in informal economic activity with much certainty. Further research will therefore be necessary to provide better insight into the scope and dynamics of informal activities.

One area that needs to be explored in particular is “moonlighting” i.e. the labour that is not registered for economic reasons (subjects are not registered, so-called T5 in accordance with OECD, 2001) which seems to be an important component of the informal economy according to Lovrinčević, Mikulić and Nikšić-Paulić (2002). As the process of transition goes on, we can expect a reduction of the share of “moonlighting” and an increase in the amount of underreporting. This fact could have serious implications both for policy makers and for further researchers.

Another potentially important policy implication is that the extent of informal activity seems to be inversely related to the speed of transition and privatisation in particular. Thus, in retail trade, where the transition to a market-based system is essentially completed, there is clear evidence that the extent of informal activities has diminished. Policymakers should be prepared for the fact that with the eventual progress in privatisation of the agriculture for example we could expect first the parallel growth of the informal activities in that sector and later their decline.

One finding in this paper that has a bearing on economic policy is the need to improve the statistical system and to reform the tax system. Of particular importance would be to simplify the tax system and to improve the efficacy of the tax authorities. Because of the many changes in the tax system in the last couple of years it is necessary to try to ensure a more neutral tax system that will to the least possible extent influence economic decision making and in which the tax bases will be as broad as possible, with as few exemptions and privileges as possible, with the tax system not being used to carry out governmental social, economic and development policies. This means no additional tax concessions, credits, and allowances for individual industries, regions or occupations. On the contrary, the aim should be to abolish the existing privileges. The tax system should be as stable as possible, the tax and regulatory burden as low as possible, together with an increase in the probability of tax evasion being detected and penalised, with a build up of an appropriate public spending structure and quality of public services, and a strengthening of the general awareness of the need to pay taxes. As stressed by Madžarević-Šujster (2002) it is easy to make a decision about going into the informal activity in an unstable environment while for getting out of it a number of positive reforms and a relatively long period of time are required. It is not enough just to introduce fines. Large penalties do reduce the attractiveness of getting into informal activities, but an increase of revenue from fines shows that the system is in a bad condition. *It is more important to obviate the causes than to penalize the consequences.* The institutional sphere is crucial – the relationship of the government and the economy, i.e. the speed with which the government redefines its role in the market.

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# New Modalities in Tax Decision-Making: Applying European experience to Australia

**Yuri Grbich\***

## ***Abstract***

This article criticizes the current situation in judicial decision making which it says is overly dominated by ‘old fashioned’ conservative legalistic analysis. It compares this with the UK’s experience of the European challenge to its Common Law. The article urges Australian jurisprudence to learn from the European civil law. By this means, it suggests, core public policy imperatives will be permitted to shape the tax decision making agenda. This would make Australian tax judges more accountable for the application of policies against tax avoidance, and other policies behind statutory rules. The article concludes by urging Australian tax teachers to contribute to the development of a culture of accountability by judges and to take the lead in criticizing the performance of judges in how they deal with policy and principles when making decisions.

## **GETTING TO THE NUB OF THE PROBLEM**

There is a well known story, now an iconic myth of the information economy. As the story has it, Bill Gates was slow in picking up the significance of the looming internet revolution. He thought the internet was a mere toy for computer geeks. When he discovered his error, all hell broke loose at Microsoft. To remedy his mistake, it is said that he transformed the most successful company in history overnight and the jobs of a large chunk of its staff.

Are such radical solutions needed to deal with our intractable problems in taxation? We have long running systemic problems in Australia. The tax system has not responded systematically, in depth, and with sufficient clarity to a log of genuinely tough problems that continue to accumulate. The length and complexity of tax legislation is out of hand, let alone the masses of subordinate documentation and other material. We have thrown prodigious resources at tax avoidance but the problems continue to fester. Key concepts are not evolving at pace to respond to rapidly changing commercial realities and to rapidly evolving globalization of the Australian economy.

What is the current bottleneck? What is the nub of the problem lying in the ‘too hard basket’? Decision making by judges? Tax judges have become increasingly marginalized in tax rule making. But the position of tax judges at the commanding heights of the Australian tax decision making structure makes them the dominant players in defining the day to day rules of engagement. As a result, and notwithstanding the rhetoric, much of the operational part of the Australian tax decision making apparatus *still* works according to modalities which are, essentially, governed by old-fashioned 1930s pedantic legalism. The high-water mark was the

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infamous 1930s House of Lords decision in *IRC v Duke of Westminster*.<sup>1</sup> Like typical expats, Australians cling to this fossil more faithfully than the ‘mother country’. To be fair, the High Court modified its articulations in *FCT v Spotless Services Ltd*<sup>2</sup> and the Federal Court is not quite the fundamentalist artifact of the 1930s and 1970s. But decisions like *Cooper Brookes (Wollongong) Pty Ltd v FCT*<sup>3</sup> and *Spotless and s15AA*<sup>4</sup> are thoroughly marginalized in resolving major corporate tax cases and there has recently been something of a retro revival of the ‘good old’ 1970s.

### Legalistic modalities at the nub of it

The tax system and the world in which it operates have gone through a revolution. But Australian tax judges, at least in the middle of the hierarchy which makes the lion’s share of the day to day tax decisions going to the courts, have modified their actual decision making behaviour only at the margins. Too often, judges do not look at construction of legislation as a means to an end: the effective articulation of core principles and the practical implementation of key legislative policy directives by delegated decision makers. Rather, it is treated as some disembodied, reified,<sup>5</sup> word game with little to do with practical tax outcomes. Too often, the ‘least dangerous branch of government’ compromises the coherence and practical workability of policy initiatives pursued in tax legislation. The consequent comfort such modalities give to tax avoidance, which is largely driven by exploitation of these very rigidities in the rules, is now familiar.

But, far more significant, such modalities generate tax decision making which is expensive and ponderous and not sufficiently coherent to respond intelligently to fundamental challenges. Judges are not contributing effectively enough, consistently enough to the development of coherent doctrines to drive a changing tax system. The challenges include technological change, globalization and the wholly new problems created by breathtaking innovation in the finance sector. It diverts resources and intellectual energy from the crucial job of, gradually and with a clear vision, remoulding underlying concepts to deal with fundamental challenges to the tax system.<sup>6</sup>

Those who have heard my papers in recent Tax Administration conferences<sup>7</sup> will be familiar with the analysis to back up these arguments and my detailed criticisms, in particular, of recent Federal Court tax decisions in major corporate tax avoidance and tax driven financing cases. At the core of the criticism is blinkered constructions of

<sup>1</sup> [1936] AC 1, 19: see Y Grbich, ‘The Duke of Westminster’s Graven Idol’ (1978) 9 *FLRev* 185.

<sup>2</sup> 96 ATC 5201

<sup>3</sup> (1981) 147 CLR 297 where the High Court ignored the literal words of a bungled anti-avoidance statute where the context made its meaning clear; see also *FCT v Gulland* 85 ATC 4765, *FCT v Myer Emporium Ltd* 87 ATC 4363, *Coles Myer Finance Ltd v FCT* 93 ATC 4214.

<sup>4</sup> *Income Tax Assessment Act 1936* Cth

<sup>5</sup> Reified is from the same root as deified, words are raised over and above their functions and are given a separate life of their own.

<sup>6</sup> I am talking about effective responses to avoidance and information hiding techniques, to new global arbitrage opportunities, to the shifted realities of emerging Asian economic dominance, particularly the time value of money, to the monkey that tax planners are making of the old tax and property law with derivatives and more sophisticated offshore in China.

<sup>7</sup> Y Grbich, After <sup>Bellinz</sup> and Ralph: A new focus for decision making in the Australian tax system, in M Walpole and C Evans (eds) *Tax Administration in the 21<sup>st</sup> Century* (Prospect, 2001); Y Grbich, Tax Decision-making at the Crossroads: Strategic directions in M Walpole and R Fisher (eds) 5<sup>th</sup> *International Conference on Tax Administration* (Timebase, 2003)

Australian tax legislation and tortured drafting to overcome them. This sets up a vicious circle of even more narrow construction and pedantic legislation.

Of course, Australian judges are quite capable of avoiding narrow, pedantic modes of reasoning and have done so in a number of cases.<sup>8</sup> The trouble is, they typically do so selectively and do not articulate the premise on which refusal to make such broad approaches is based. Crucial discretions exercised by judges in the routine course of tax decision making are not articulated. Judges are not properly accountable, outside the context of a convergent culture of fellow judges, for their exercise. There is not an adequate attempt to link the delegated rules created to legislative policy and to the wider context in which they operate.<sup>9</sup> Fundamental criticism of judges for their performance is, all too often, treated as an attack on the fundamental bulwarks of civilization.

This paper is a work in progress and an eclectic selection from a forthcoming book which integrates these ideas into a larger picture of tax rule making.<sup>10</sup> The paper takes some of my ideas from that book out for a spin. It runs through some insights gained from recent exposure to European tax institutions and uses a case study on the European doctrine of proportionality as a benchmark to assess Australian judicial performance in taxation.

#### NEW MODALITIES: THE EUROPEAN CHALLENGE TO COMMON LAW

Lord Hoffmann,<sup>11</sup> of the House of Lords, identified the dynamics:

...membership of the EU has required English judges to undergo a compulsory education in continental legal thinking. In having to deal with the European treaties and subordinate legislation, they have been exposed to statutory provisions which are abstract, general and open-textured; a style of legislation far from the finely tuned precision of [the UK] Parliamentary draftsman, but familiar enough to practitioners in a codified system of law. And with the continental style of legislation has come continental methods of construction, which allow a freedom to mould language almost sinful to puritan English sensibilities, and continental concepts such as good faith, proportionality and the rights of man.

European experience is valuable because the application of over-arching concepts, expressed as general principles, gives some hope of broad policy coherence. In contrast with much of the approach to similar legislative directives in Australia, judges and bureaucrats explicitly participate in shaping and tuning technical tax provisions to give operational form to the core statutory policy objectives. In contrast, the adversarial approach in Australian litigation process is carried over into the rule making work of tax judges who too often define their role as one of deconstruction of tax legislation. This process, retained as a protection of last resort to save us from tyranny, becomes a routine tool for pursuing unarticulated judicial agendas. These

<sup>8</sup> Judges were able to over-reach some of the literalist approaches in later cases in areas like the old s26(a) and artificial attempts to get round undistributed profits tax with schemes which were technically effective but not politically acceptable; and there have always been the odd case where judges do not stop a taxpayer by pedantic reliance on the form of transaction, where its substance is otherwise.

<sup>9</sup> See Y Grbich 'Is Economics any Use to Tax Lawyers?' (1980) 12 *MULR* 340.

<sup>10</sup> Y Grbich, 'Advance Tax Rulings in Wider Australian and International Tax Rule Making Perspective' (in draft)

<sup>11</sup> Foreword to N Foster, *German Legal System and Laws* (Blackstone Press, 2<sup>nd</sup> ed, 1996), v

propositions will be explored using a case study. It contrasts modalities in the operation of the choice principle in Australia and the EU proportionality principle.

Let me red flag a crucial point. It is *not* that Australian tax decisions do not have policy outcomes or that our tax judges are innocent of them. It is that, in their *formal* justification for decisions, judges *pretend* they are unaware of these outcomes or that they play no part in decisions. As a wise person once said, it is terrible that policy decisions are made by unelected officials. There is only one thing worse. The self delusion that such decisions are not routine in most tough delegated decisions.

The UK has adapted far more adroitly to the challenges than Australia but has still failed to adapt quickly or deeply enough. A growing crisis has emerged in the UK as recently as the late 1990s. The ECJ boldly, some would say carelessly, has over-ruled structural elements of the UK direct tax system which most believed were set in stone. The civil law modalities of a European Commission and European Court of Justice, driven by the boldness and brashness of a heady EU vision, are pushing the pace. EU success in VAT integration has been very influential.

But it is in direct tax we are now seeing the crucial battles. The UK courts, in accordance with the famous Sixth Directive,<sup>12</sup> must “construe domestic legislation ... so as to accord with the interpretation of that directive as laid down by the European Court”<sup>13</sup> and “the influence of European legislation with its broad principles, together with European methods of interpretation, is likely to increase in the UK courts”.<sup>14</sup> But it goes much further. EU members must draft their own legislation in accordance with the principles laid down in EU directives.<sup>15</sup> National legislation is demonstrably subservient to EU principles. The UK is rapidly transforming into, in all but its own nostalgic political rhetoric, a mere state (and not necessarily the most influential state) in a federated Europe. It has the final option of pulling out of the EU, but this will be increasingly costly. Australia is moving further and faster in the direction of subsuming its tax sovereignty to overarching transnational realities than most appreciate.

Let me make my argument crystal clear from the outset, so that the message is not confused. I am not asserting that the brave new world of tax in the EU is all good or all wise. In recent radical tax interventions, clearly the ECJ has acted like a bull in a china shop. Clearly the European performance on tax avoidance is not always a shining beacon. But the Europeans are setting the intellectual agenda. The US Supreme Court has operated with a more policy based orientation than our courts for many years. We must adapt with determination to the lessons of Europe, *both good and bad*. Unless Australian tax judges respond proactively to this ‘brave new world’ or we engineer changes to our decision making modalities in some other way, the challenges will escalate faster than our ponderous, legalistically shackled decision making can adapt and we will import the crises currently besetting the UK. Australia risks ending up high and dry on an intellectual Pacific no man’s land. Such a position will make Australian adaptation to entirely novel globalized environments, less than

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<sup>12</sup> Directive of the EC Council 77/388 (May 1977)

<sup>13</sup> Lord Keith in *Webb v EMO Air Cargo (UK) Ltd* [1992] 4 All ER 929, 939, though he did qualify it that this was so to the extent it did not distort domestic legislation, which is a bob each way.

<sup>14</sup> Ibid

<sup>15</sup> Acknowledgment to R Codara in a 2000 ATAX paper for emphasizing this point cited by James, who also points out that this leads to delays in finalizing disputes.



comfortable, particularly in the context of the recent US/Australia free trade agreement<sup>16</sup> and increased regional interdependence in Asia. It will become a threat to social stability as ‘the battlers’ get a renewed insight into how loaded the day to day application of tax rules has become in Australia.

### **Judicial Modalities: Judge’s role in civil law Germany**

In practice, the dominant modalities in Europe and the EU derive from German origins. Australia has traditionally tied its future to an English legal tradition, which is now an increasingly marginalized partner in a European momentum rooted in German traditions. The German Civil Code is the centre piece of all German civil law and “considered very abstract, very technical ... precise and consistent, especially in the use of legal concepts”<sup>17</sup> and in common with most continental European systems, is based on a Roman law tradition.<sup>18</sup> A Spanish academic, Gasparro Falsitta<sup>19</sup> referred to the famous German *Tax* Codification early in the twentieth century as “the mother of all tax codes in Europe and Latin America in the twentieth century”.

The issue is the extent to which Australia needs to understand and to better mine this German experience in the future development of Australian tax law. What follows in this section is an elaboration based on insights and case studies of the civil law systems and institutions which are the intellectual foundation of the EU. These might trigger creative thinking about options for change. If you like, this becomes an exercise in structured lateral thinking for Australian decision makers.

Start with this articulation of civil law basics by Vranken<sup>20</sup>

...the study of judicial “glosses” has always been essential for a proper understanding of the enacted laws in the civil law, even though it does not necessarily follow that case law can be put on the same pedestal as the common law. The perception in the civil law that court decisions do not constitute the law as such, but rather that they are applications –illustrations even – of the law as enacted by the legislature, is too deeply rooted for it to be different.

As Foster puts it, the “formal function of the judiciary which has developed in the German legal system is that judges simply apply the law and should not create it. [T]herefore the case law cannot ... have any general binding effect in other cases”.<sup>21</sup> Generally speaking, and with exceptions, there is no concept of precedent. Only the strength of the ideas and reputation of the judge command respect and conformity. Older decisions receive less respect than recent decisions. Of course, the influence of judges extends as “very important role interpreters and developers of law”.<sup>22</sup> The parallels are interesting. Paradoxically, the lack of formal stare decisis leads to greater

<sup>16</sup> Note that the current US participation in the North Atlantic Free Trade Agreement has already seen US higher Courts subject to judicial review by an international tribunal in a corporate contract case (Adam Liptak, New York Times, 18 April 2004). The analogy with EU process described below is obvious and similar concerns are being raised. Acknowledgment to Matthew Wallace of Atax for this.

<sup>17</sup> Foster at 229

<sup>18</sup> G Dannemann, *Introduction to German Civil Law and Commercial Law* (British Institute Int and Comparative Law, 1993)

<sup>19</sup> Falsitta at Bologna conference op cit

<sup>20</sup> M Vranken, *Fundamentals of European Civil Law* (Federation Press, 1997) 212

<sup>21</sup> Foster at 70

<sup>22</sup> Foster Ibid

attempts to generalize and adds power to the claims for the authority of judicial decisions and their contribution to doctrinal development.

There are in two parts to statutory construction in Germany. The objective rules, not altogether dissimilar to those in Australia, but with emphasis on “a contextual rule to interpret the provision in the context ... of the system of rules or the provision as a whole”.<sup>23</sup> This involves, says American Dickerson,<sup>24</sup> a search for the ‘cognitive’ meaning derived from a conscientious reading in context, as it would emerge for its intended audience’. The next, and distinct, process involves constructing meaning where none emerges. If objective rules do not give a clear answer, the judge resorts to ‘subjective rules’.<sup>25</sup>

It was clear that generalized tax principles, like a general prohibition on double tax of the same income, formed a key dynamic of civil law systems, and in particular that of Germany, in dealing with tax problems.<sup>26</sup> The Germans, Fischer asserts, have highly developed systems for demarcating the comparative expertise and roles of lawyers and politicians. They have elaborated these into principles which limit legal intervention and which apply them with consistency across the various taxes. The judges distinguish legal principles from political ideology and properly weigh the competing principles of certainty and the assertion of broader legal values. The German Constitutional Court intervenes to enforce general principles, based on well understood values, of equality in treatment and the need to articulate proper justifications for any particular exaction of taxation.

### Europeans reinvent decision making basics

Under pressure to coordinate the over-riding EU Treaty based rules<sup>27</sup> with the traditional laws and regulatory rules of member states, the EU has gone back to the drawing board and redefined the relationship of judges, administrators and the powerful European Commission. European modalities reinvent our wheel of policy and rule making. They largely eschew concepts ingrained in our system, like the separation of powers between the executive and bureaucracy and between the bureaucracy and judiciary. In the words of Raworth,<sup>28</sup> “a peculiar feature of the legal system of the EU is that no formal distinction is made between executive and legislative powers.” EU bodies, he elaborates, may have both an executive and legislative character in certain areas and procedures overlap. These differences provide a basis for lateral thinking for coherent thinking about how we get round our current road blocks.

A still embryonic confederation of autonomous states like the European Union has developed powerful tools to ensure judicial compliance with over-riding EU policy

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<sup>23</sup> Foster at 64

<sup>24</sup> R Dickerson, *The Interpretation and Application of Statutes* (Little Brown, 1975) in Brooks 117

<sup>25</sup> Described by Foster Ibid: Teleological rule to determine meaning in light of the purpose of provisions; Historical rule similar to our mischief rule; Comparative rule Introduces analogies and context from other provisions and nearby legal systems; Grundgesetz (article 20(3)) rule requiring judges to be bound by ‘law and justice’ and to range beyond literal interpretations of the Code. See *Princess Soraya* Case25, judges create a civil law right for the Shah’s ex-wife to sue for civil defamation where only a criminal statutory head for this action existed.

<sup>26</sup> P Fischer, op cit

<sup>27</sup> See history of Treaties in P Raworth, *Introduction to the Legal System of the EU* (Oceana publications, 2001), 26ff

<sup>28</sup> op cit 109

directives in member nations. It is paradoxical that a unified nation like Australia, federated for a century and enjoying much less social and political diversity or tensions, has much weaker levers to ensure compliance by its own *federal* judges with a core national policy priority: the raising of federal taxes in a fair and efficient manner. Do our fundamental rules need changing? Do we have to tackle the fossilized judicial rule making?

#### EUROPEAN DECISION MAKING MODALITIES: A SUBTLE IMPLEMENTATION STRATEGY

There is a fundamental tension between the idea of a European union and a decision-making structure drawing on constituent nations, acting according to sovereign self interest. How does Europe create coherence and focus in a confederation of opinionated, culturally diverse and self-serving states? The frequent paralysis in the UN shows how hard this task is.

This tension assumes added significance when, as earlier articulated, we appreciate that EU rules become part of domestic law in member states. The ECJ has held<sup>29</sup> that provisions of the European Treaties over-ride conflicting law of member states, when that law post dates a Treaty. Craig says<sup>30</sup> of the spillover impact of the ECJ on the courts of constituent states:<sup>31</sup>

It is axiomatic that in formal legal terms the ECJ's decisions will have no impact in cases where there is no Community law component. It is equally clear that this formal legal result may not reflect reality. Even if national courts are under no duty to apply EC law [and also the law of nations with which they have increasingly intimate contact] they may well consider it, particularly if they believe that it may be of assistance in developing domestic law.

Essentially, and in contrast with much of tax decision making in Australia, Europe has used the interaction of the bureaucratic and judicial process as a potent tool for responding to social and political challenges. According to Andersen and Eliassen,<sup>32</sup> echoed in an extensive literature, the 'EU represents a new type of complex, multi-level and loosely coupled decision-making and implementation [mechanism] .... It might be regarded as a new type of political structure.' Andersen and Eliassen analyze the EU<sup>33</sup> as a multi-layered, complex of competing and overlapping institutions which lack any obvious and clear authoritative centre. The institution emphasizes the importance of policy networks and decision *processes*.

The design of institutions, based on ideas which have germinated over many years, is central and important.<sup>34</sup> It is through an unusually thoughtful application of a "system of institutionalized, constitutional, precedential or otherwise standardized, patterned procedures which all actors commit themselves to use and respect."<sup>35</sup> The member states "are formally bound to comply with the procedures governing the operations

<sup>29</sup> *Van Gent en Loos v Nederlands Administratie der Belastingen* as cited in E Ellis and T Tridimas, *Public Law of the European Community; Text, materials and commentary* (Sweet and Maxwell, 1995), at 177

<sup>30</sup> P Craig 'Domestic Liability of Public Authorities in Damages: Lessons from the European Community' in J Beatson and T Tridimas, *New Directions in European Law* (Hart Publishing, 1998), 83

<sup>31</sup> Similar point already noted this in relation to legal formalism,

<sup>32</sup> SS Andersen and KA Eliassen 'Making Policy in Europe' (Sage Publications, 2<sup>nd</sup> ed, 2001), 3

<sup>33</sup> Ibid 15

<sup>34</sup> SS Andersen and KA Eliassen 'Making Policy in Europe' (Sage Publications, 2<sup>nd</sup> ed, 2001), 20

<sup>35</sup> D Puchala 'Of Blind Men, Elephants and International Integration' (1972) 10 *JCMS* 267, 279

and by the decisions taken by these institutions.”<sup>36</sup> But so are nations in other international and regional forums and they commonly get very little done.

The style of delegating decision making in Europe is to lay down a framework of general principles. These integrate and discipline the specific technical constructions of detailed tax provisions. The broad policy directives are king and judges generally apply them as the over-riding driver. In the application of these general purposes, not infrequently, judges go to the general purposes and context to override literal meanings of technical provisions and fill in gaps. This approach began with the individual civil law codes of Germany and France. It has achieved new significance in the EU, which has an elaborate framework to generate coherence and consistency over an increasing number of very disparate national interests and cultural traditions. Law and bureaucratic processes are at the very centre of this process. As Jean Paul Gaudin puts it:<sup>37</sup>

Through the multiplication of continuous interactions between actors in a situation of interdependence, [under modern European concepts of Governance] the state would eventually become “a collection of inter-organizational networks composed of governmental and social participants, without a sovereign actor in a position to direct” ... the [sum total of the] multiple configurations of social and political networks .... Scarcely had it emerged when this highly managerial, incremental and ultimately rather utilitarian aim appeared somewhat limited ... [than attempts were made] to improve them by situating them with respect to goals of greater magnitude.

...

The EU has little in the way of formal sanctions to bring recalcitrants into line. Some have described it “as no more than a highly institutionalized form of international relations”<sup>38</sup> but that belies its genius. They deal with intransigence and non-compliance, familiar in some members, by gradually asserting principles and marginalizing the behaviour. Chalmers articulates the following threads, partly overlapping and some times in tension, which have been identified as the basis of the cohesion of the EU:<sup>39</sup>

- By structuring debate and allocating roles to parties from individual states, they reconfigure power relations
- By lock-in to the EU they generate new expectations among the parties which make it difficult for any one party to deviate from established positions or norms
- The institutions socialize participants by getting individual actors from the constituent parts to engage with the beliefs and interests and commitment of others
- Institutions structure interactions and hence create a climate in which actors are less uncertain about how others might behave and hence facilitate deals which can set agendas and build coalitions

<sup>36</sup> D Chalmers, *European Union Law* (Dartmouth PCL, 1998), 83

<sup>37</sup> J-P Gaudin, ‘Modern Governance, Yesterday and Today: Some clarifications to be gained from French government policies’ in (1998) 155 *International Social Science Journal*, Governance issue, 47, 53, 54, 55 Quote within attributed to Rhodes. In relation to the last question, his view is the jury is out and pending public acceptance it is ‘only a managerial makeshift’.

<sup>38</sup> Chalmers at 330

<sup>39</sup> Ibid 84. This analysis is largely that of Chalmers but I have actively digested it to fit Australian vernacular and understandings.

- Under new ‘fusion theory’ states retain their own self-serving tendencies but the invisible guiding hand of self-interest, while refusing to comprehensively surrender sovereignty, gives them a structure in which to pursue that enlightened self-interest. As the institutions get more powerful, there is an incentive for states to increase their involvement to maximize their clout in the process and this in turn creates the spark of fusion and the convergence of interests and further strengthens the role of the central EU institutions.

To that should be added:

- The more general momentum to deregulating the world economies in the same time frame has led to an erosion of national economic controls on the cross-border movement of capital and technological developments, like the net and more efficient travel, made the shift of information and people so much easier.

It is a mistake to imagine that Europe represents a great, integrated design. The introduction of a German Civil Code a century earlier, and twenty years in the making, was one of the decisive steps in injecting national unity into the disparate kingdoms of Germany.<sup>40</sup> That experience, suitably modified, has served as the model for the broader systems of Europe. And what did Germany use to do the job? They imported, indeed gave rebirth to, an exotic Roman law model based on ‘absolutism and centralisation’.<sup>41</sup> No doubt, the unifying cement of a powerful set of norms enforced by a powerful central organ was a process well understood by the founders of the EU seeking to create a new federated Europe from the spectre of Hitler’s horrible abuse of centralized authority. Europe, instead of pulling the teeth out of its central institutions and the coherence out of its decision making process, boldly mobilizes these powers for different purposes. This is why human rights protections and an EU social vision are such key components, with economic liberalism, in the vision of a new Europe.

Much of the secret lies in the opportunism of Eurocrats, ‘skilful at turning’ the ‘multiple (and by no means coherent) provisions’ of the key treaties ‘into an expansion of their *competences*’.<sup>42</sup> Jean Paul Gaudin<sup>43</sup> argues that the claim of efficiency for these institutional modalities is not strong and ‘it can be seen from experience to be highly wasteful of time and energy’. But, in comparison with Australian tax decision making, at least the time and energy in those frustrating processes is focused on over-riding policy outcomes.

In short, Europe has powerful lessons for Australia and particularly the tax system in which the power of individual actors and pressure groups has not been properly defined in terms of wider national needs.

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<sup>40</sup> RC van Caenegem, *European Law in the Past and the Future* (2002, CUP), 90

<sup>41</sup> Ibid 97, also 4 significant in terms of the later history of Germany

<sup>42</sup> Liberally extracted from PC Schmitter ‘Imagining the Future of the Euro-polity with the Help of New Concepts’ in FW Scharpf in G Marks FW Scharpf, PC Schmitter & W Streeck, *Governance in the European Union* (Sage Publications, 1996), 127.

<sup>43</sup> J-P Gaudin, ‘Modern Governance, Yesterday and Today: Some clarifications to be gained from French government policies’ in (1998) 155 *International Social Science Journal*, Governance issue, 55

## BRIEF OVER-VIEW OF EU INSTITUTIONS

In the “classical summary of EU policy process – the Commission proposes, the European Parliament advises and the Council of Ministers decides.”<sup>44</sup> In the European Union ‘there is almost complete fusion of the two [executive and legislative] branches.’<sup>45</sup> Since the mid 1980s the European Commission has played an increasingly important role.

The European Parliament needs little comment. It is a directly elected assembly from the peoples in the states [the word in the Treaty]<sup>46</sup> who constitute the EU. It is based on universal suffrage. Representation is based on populations. The all important European Commission is politically responsible to Parliament.

The Council of Ministers, to use a rule of thumb, is the equivalent of the Australian Senate, a second chamber in a federal jurisdiction.<sup>47</sup> But according to Andersen and Eliassen,<sup>48</sup> this characterization understates its role as a decision maker and repository of legitimacy. As Jacobs and Karst put it: “In addition to its other powers, especially ... the Community budget, it is the Council which has the principal law-making power under the EEC Treaty.”<sup>49</sup> It represents the people of constituent nations indirectly through appointed members of national governments. It exercises more of a co-decision role with the European Parliament. It has a significant role in negotiating compromises on the tougher decisions and acts as a protector of ‘states rights’ through the consensual mode of its decision making. The relationship between these legislative bodies is more analogous to the Westminster system or the council of an international body<sup>50</sup> than the Senate in the US [and Australia federal] model.<sup>51</sup> This is so, notwithstanding that, on the US model, members of the Commission are not members of the European Parliament.

### European Commission: Practical dynamics of institutional coherence

A ‘Time’ European retrospective argued: “Success for Europe is the growing power of the European Commission and particularly its increasing boldness in exercising that power, thus silencing [nationalistic] obsessions.”<sup>52</sup> Its unique feature is its agenda setting and implementation structure. It spans political and bureaucratic policy making. The European Commission carries the most cogent EU lessons for Australian institutional reform.

The Commission “enjoys a dual role as the EU’s executive and bureaucracy”,<sup>53</sup> though it is primarily executive. This is, essentially, the super cabinet of the EU, with the institutional grunt of Prime Minister and Cabinet in Australia. As Jacobs and Karst

<sup>44</sup> SS Andersen and KA Eliassen ‘*Making Policy in Europe*’ (Sage Publications, 2<sup>nd</sup> ed, 2001), 21; for a convenient access to the main constituent documents see E Ellis & T Tridimas, *Public Law of the European Community: Text, materials and commentary* (Sweet and Maxwell, 1995), 49ff

<sup>45</sup> P Raworth, *Introduction to the Legal System of the EU* (Oceana Publications, 2001), 211

<sup>46</sup> Art 137 EC Treaty; They do not even have to change the name to evolve into a formal federal government!

<sup>47</sup> SS Andersen and KA Eliassen ‘*Making Policy in Europe*’ (Sage Publications, 2<sup>nd</sup> ed, 2001), 26

<sup>48</sup> op cit

<sup>49</sup> FG Jacobs & KL Karst, ‘The “Federal” Legal Order: The USA and Europe compared’ in Secombe and Weller, *Integration through law* (1986) 184 cited in E Ellis & T Tridimas, *Public Law of the European Community: Text, materials and commentary* (Sweet and Maxwell, 1995), 51

<sup>50</sup> FG Jacobs & KL Karst, op cit 51

<sup>51</sup> P Raworth, *Introduction to the Legal System of the EU* (Oceana Publications, 2001), 212

<sup>52</sup> *Time* (European ed, 18 Aug 2003), A38

<sup>53</sup> SS Andersen and KA Eliassen ‘*Making Policy in Europe*’ (Sage Publications, 2<sup>nd</sup> ed, 2001), 23

articulate it:<sup>54</sup> “The Commission, the institution at the heart of the entire Community structure, is a political institution but independent of the member states. ... Beyond its function in the administration of the Community and as an enforcement agency, and a unique role as guardian of the community ... the Commission participates in ... the Community law-making process.”

The European Commission has powers for “adopting implementing rules ... directly from the Treaty”<sup>55</sup> as well as specific delegations from the Council of Europe. It even has an inherent jurisdiction, ‘to adopt implementing rules in specific sectors where the Commission has not been bestowed with such power’<sup>56</sup>. But it has become much more dominant in EU processes than even this formulation indicates.<sup>57</sup> It is ‘guardian of the legal framework’ and the key driver of further European integration.<sup>58</sup> It shapes measures taken by the Council and the Parliament and initiates major policy directions.

The Commissioners are appointed from member countries; one commissioner from each member nation of the EU and two from larger players.<sup>59</sup> They are appointed for a renewable five years. But they are explicitly bound by the Treaties ‘to foreswear any national loyalties’<sup>60</sup> and to be ‘completely independent’<sup>61</sup>. In practice, Commissioners have identified with the culture and wider objectives of the EU. Though there are procedures for voting, they operate largely by consensus. Significantly, for our purposes, the Commission does not carry out its functions in the vast and complex continent of Europe but delegates them to the member states and the organs of member states are responsible for their implementation.<sup>62</sup>

### European law and European Court of Justice

Scharf<sup>63</sup> argues that the EU literature ‘focused too long only on aspects of intergovernmental negotiation while ignoring (or, at least, not taking seriously enough) the establishment by judge made law, of a European legal order that take precedence over national law.’ The European Court of Justice, subject to civil law modalities, has a role closely equivalent to the Australian High Court. Its 15 members are appointed by member states and can only be dismissed by their own colleagues.<sup>64</sup>

<sup>54</sup> FG Jacobs & KL Karst, ‘The “Federal” Legal Order: The USA and Europe compared’ in Secombe and Weller, *Integration Through Law* (1986) 187,190-1 cited in E Ellis and T Tridimas, *Public Law of the European Community; Text, materials and commentary* (Sweet and Maxwell, 1995), 53

<sup>55</sup> Ibanez, *The Administrative Supervision and Enforcement of EC Law* (Hart, 1999), 20 quoting arts 48(3)(d) and 91 of the EC Treaty

<sup>56</sup> Ibid

<sup>57</sup> For example, PC Schmitter and FW Scharpf in G Marks, FW Scharpf, PC Schmitter and W Streeck, *Governance in the European Union* (Sage Publications, 1996), 1 argue the unheralded and seemingly modest Single European Act, which created the momentum for the move from EC to EU and the subsequent Maastricht Treaty, was given ‘legs’ in the early 1990s by 282 directives drafted by the Commission and approved by the Council of Ministers.

<sup>58</sup> Ibid 23

<sup>59</sup> Ibid 86

<sup>60</sup> SS Andersen and KA Eliassen ‘*Making Policy in Europe*’ (Sage Publications, 2<sup>nd</sup> ed, 2001)

<sup>61</sup> Art 157 EEC Treaty

<sup>62</sup> Jacobs op cit

<sup>63</sup> FW Scharf in G Marks et al, *Governance in the EU* (Sage Publications, 1996), 15

<sup>64</sup> P Raworth, *Introduction to the Legal System of the EU* (Oceana Publications, 2001), 211

Significantly, judges are appointed for only six years. It does not publish dissenting judgments.<sup>65</sup>

The Court has been accused of activism. An MP in the United Kingdom, who tried to create a power to ensure its judgments did not apply in the UK, said it was a political court and had a bias to European integration.<sup>66</sup> As Vranken says: “The law making function of the courts in the civil law is not officially acknowledged. However, the various methods of statutory construction available to the courts have served as a guise to do precisely this. The European Court of Justice is no different from other civil law courts in this regard.”<sup>67</sup> Though not “bound by any formal doctrine of stare decisis, the Court very rarely reverses its own earlier decisions”.<sup>68</sup> The ECJ has been an important element in the evolution to a EU.

### **Tax integration in the EU**

The common market attempts, according to the ECJ,<sup>69</sup> “the elimination of all obstacles to intra-Community trade in order to merge the national markets into a single market.” From the very implementation of the EEC Treaty in 1958, taxation integration was seen as a major part of the job and the Commission spent much time on it. It gave very high priority to indirect taxes.<sup>70</sup> Tax integration varies from complete uniformity through harmonization and coordination to mere approximation or attempted removal of some differences in member states.<sup>71</sup> The tough job of direct tax harmonization in the EU has proved too much for the institution to date, with more promise than performance. This is a major challenge for the EU. To quote Williams:<sup>72</sup>

...the tax policies of the European Union have been both an outstanding success and an almost total failure. The Community Customs Code is ... remarkable,... not just for its content, but for its very existence as a code of law applying directly to ... eighteen or more sovereign states. At the other extreme, the attempts to produce a common corporate tax system have failed time and again.

There has been much progress on uniformity or harmonization of indirect tax measures. As well as customs duties it includes excises and turnover taxes<sup>73</sup>, which can act as substitutes for customs duties and, of course, VAT. Customs duties *between* EU states have largely gone. The EU wide adoption of VAT (and a European model which is less than perfect) has allowed VAT to replace a raft of confused individual national indirect taxes. This is of course an essential pre-requisite to an efficient single market in goods and services. EU directives have brought about steady removal of national differences in VAT<sup>74</sup> in favour of a move to Community wide standards.<sup>75</sup> These differences were quite marked in the original six states, in both system

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<sup>65</sup> Ibid 25

<sup>66</sup> Chalmers at 326-7

<sup>67</sup> M Vranken, *Fundamentals of European Civil* (Federation Press, 1997) 73

<sup>68</sup> AJ Easson, *Taxation in the European Community* (Althone Press, 1993) 65

<sup>69</sup> *Gaston Schul* [1982] ECR 1409

<sup>70</sup> P Farmer and R Lyall, *EC Tax Law* (Clarendon Press Oxford, 1994) 13

<sup>71</sup> Typology of D Williams, *EC Tax Law* (Longman, 1998), 35 drawing on confusions in EU texts.

<sup>72</sup> D Williams, *EC Tax Law* (Longman, 1998) 7

<sup>73</sup> AJ Easson, *Taxation in the European Community* (Althone Press, 1993) 84ff

<sup>74</sup> B Terra and P Wattel, *European Tax Law* (Kluwer, 3<sup>rd</sup> ed, 2001), 235 ff full discussion

<sup>75</sup> B Terra and P Wattel, *European Tax Law* (Kluwer, 3<sup>rd</sup> ed, 2001), 7



structures and exemptions. New initiatives as the time of writing were moving into harmonization of VAT, with particular reference to collection mechanisms.<sup>76</sup>

The wider political impact of these changes should not be missed. The “loss of boundary control”<sup>77</sup> over markets for capital, goods and services and labour, not political or military control, is the crucial step to creating transnational integration. In breaking down the economic boundaries of states, their sovereignty is weakened and they are subsumed into a larger collective. In contrast with Napoleon’s army and Britain’s navy, the rhetoric of competition, deregulated international markets and supra-national financial institutions, as much as its enormous military capacity, was the weapon of US international economic dominance until Japan and China learned their trick.

### **Direct tax harmonization stalled**

There has been only halting progress on integration of direct taxes.<sup>78</sup> In contrast to the many provisions on indirect taxes, the Treaties are silent on direct taxes<sup>79</sup> and recent attempts to introduce them in the new Constitution of the EU appear to have stalled.

The interactions of EU member states are now characterized by a very large degree of economic and monetary integration, with unhindered and untaxed movements of workers and capital across borders and hence the creation of businesses increasingly spanning all of Europe.<sup>80</sup> This raises, as William’s says,<sup>81</sup> a raft of practical issues of double tax and discrimination against migrant workers and the refusal of social welfare, including pensions and deductions, for which taxes have been collected. But, most important, it raises a large range of anomalies on corporate taxes and the taxation of saving and investment. This is the normal litany of problems with inconsistent corporate tax systems familiar to international tax experts and company tax theorists. The problems in accommodating cross-border transactions between tax jurisdictions with strikingly divergent company tax systems<sup>82</sup>, all the more immediate and pressing in an integrated market like Europe, are articulated in the Ruding report.<sup>83</sup> They include distortion of transactions, significant compliance costs in doing cross-border business and misallocation of resources. This imposes an excess burden on the cost of capital and opportunities for arbitrage and blatant tax avoidance.

Early attempts to harmonize individual income tax, in the 1962 Neumark Committee, were abandoned<sup>84</sup>, possibly because there was a focus on the more immediate problem of indirect taxes, and until recently there seemed no immediate prospect of revival.<sup>85</sup> In 1967 detailed measures for tax harmonization were prepared by the EU

<sup>76</sup> Analysis relies on interview with Jan De Goede, Director of R and D, IBFD and Professor at Lodz

<sup>77</sup> FW Scharpf in G Marks, FW Scharpf et al, *Governance in the European Union* (Sage Publications, 1996), 16; the analysis draws heavily on this source.

<sup>78</sup> Professor Augusto Fantossi Univerita La Sapienza di Roma at Bologna conference op cit

<sup>79</sup> AJ Easson, *Taxation in the European Community* (Althone Press, 1993) 179

<sup>80</sup> See excellent discussion in D Williams, *EC Tax Law* (Longman, 1998) 17 and the recent movements which remove impediments for companies operating in other EU countries: P Dryber, ‘Full Free Movement of Companies in the EC at Last’ (2003) 28 *European LR* 528

<sup>81</sup> op cit 99ff

<sup>82</sup> In Europe they involve fully classical, various mechanisms for partial integration of entity and member taxation and widely varying tax rates.

<sup>83</sup> Report of the Committee of Independent Experts on Company Taxation (EC commission, 1992), 196ff

<sup>84</sup> S Cnossen, *Tax Coordination in the EC* (Kluwyer, 1987), 41

<sup>85</sup> D Williams, *EC Tax Law* (Longman, 1998), 97

Commission, with an emphasis on free movement of capital across European borders, corporate structures and the achievement of an even playing field for competition.<sup>86</sup> In 1970 the van den Tempel report was commissioned on individual income tax, which covered issues of dividend tax in the hands of shareholders. 1969 meetings of European heads of state and a 1971 report proposing the development of the EU, again, identified the abolition of tax frontiers and taxes which influence the movement of capital as major issues. Stagnation followed.<sup>87</sup>

### **Direct tax harmonization: recent initiatives**

The most recent formal report at the time of writing, the 1992 Ruding Report<sup>88</sup> was set up to address the impact of taxation on investment and allocation of profits between EU states. It noted a large number of differences in corporate tax systems and the corporate tax base. The report was not warmly received and was criticized by Fantossi<sup>89</sup> as being too focused on difficulties rather than opportunities. Direct taxes raise very sensitive issues and nations like the UK are very reluctant to surrender sovereignty on core issues like their monetary and direct tax policy. One French speaker at the Bologna conference in 2003 asserted bluntly<sup>90</sup> that, while EU directives have supremacy and are *normally* applied by the French Council of State, tax is a domestic issue for France and their application is selective because the European Convention does not apply. This is the problem for analysis.

From about 2000 the European Commission became far more aggressive in its mobilization of the various tools at its disposal to force the pace of direct tax harmonization.<sup>91</sup> This involves both the prosecution of cases to the ECJ and the publication of Treaty interpretation provisions. This includes explicit articulations of the tax application and the limits of general norms in the Treaties with respect to tax competition. It has mobilized state aid investigations, which were not used in tax before, to combat tax provisions which provided a hidden subsidy to domestic business in a state to the relative disadvantage of other members of the EU. In another initiative litigation has been initiated to challenge the imposition of exit taxes on taxpayers leaving particular tax jurisdictions.

Having started these hares running and shifted the underlying norms, individual taxpayers have got the message and initiated actions in domestic courts of constituent nations based on the inconsistency of national tax laws with EU instruments. This has increased momentum and co-opted individual taxpayers, in effect, as an enforcement arm of the EU. This was particularly prevalent in the Netherlands and, to the consternation of tax lawyers, has recently been mushrooming in the UK. This has led to some controversy and calls for the abridgment of Commission powers but many consider it an implementation of the EU's core mission to remove barriers to trade. Significantly this development has led to attack on some forms of policy discrimination which is tolerated by the OECD model treaties. EU developments thus have wider international policy implications.

<sup>86</sup> P Farmer and R Lyall, *EC Tax Law* (Clarendon Press Oxford, 1994) 21

<sup>87</sup> P Farmer and R Lyall, *EC Tax Law* (Clarendon Press Oxford, 1994) 22

<sup>88</sup> Report of the Committee of Independent Experts on Company Taxation (EC Commission, 1992); chaired by Onno Ruding.

<sup>89</sup> Professor Augusto Fantossi Univerita La Sapienza di Roma at Bologna conference op cit

<sup>90</sup> Cyrill David at Facolta di Giurisprudenza, *Tax Law Principles in Europe* (16 September 2003, University of Bologna)

<sup>91</sup> Analysis relies on interview with Jan De Goede, Director of R&D, IBFD and Professor at Lodz.

The strategy is emerging from the fog. Having failed in open attempts at direct tax integration, the EU appears to be using a sledge hammer to attack any provision which discriminates against investors in other EU countries. This makes the status quo untenable. At the same time, by moving to attainable milestones which mesh the treatment of company tax, a momentum for full integration is created. Models, once in place, as we saw earlier, make it very difficult to halt the momentum to integration. It all makes Australian tax reform problems seem modest by comparison. But the model for institutional renewal offers valuable lessons for getting through road blocks.

The ECJ has reiterated that “although direct taxation falls within the competence of the Member States, the later must ... exercise that competence consistently with Community law.”<sup>92</sup> Under a calculated test case strategy, the European Commission, has used such tax articles as exist in the EC Treaty as a general source for deriving the concept of an intent to create free movement of capital and non-discrimination which carries through to tax. This injects into the tax analysis the familiar key pillars of the EU: the four freedoms for movement of goods, people, services and capital.<sup>93</sup>

In 2003, after many false starts, there have finally been some significant milestones in the move to corporate income tax integration. The new German corporate income tax has been designed on principles of neutrality of treatment across borders. This reform, largely driven by the need to remove distortions to cross border investment in EU states, drops imputation in favour of a different corporate tax model which will, no doubt, act as a precedent from the intellectual leader of the EU for the other members of the EU.

The long awaited directives on taxation and withholding taxes on savings have been issued. The over-riding objective, in the absence of coordination of national systems for savings, is to remove distortions to smooth cross border flows of capital between member states of the EU. The 2003 Directive on taxation of interest<sup>94</sup> removes intra-EU interest withholding tax and ensures that interest payments are taxable only in the country of residence of the taxpayer receiving the interest.<sup>95</sup> An allied Directive<sup>96</sup> covers withholding tax on interest and royalties between associated companies in EU states. The principles articulated<sup>97</sup> are that in a single EU market ‘having the characteristics of a domestic market, transactions between companies of different

<sup>92</sup> Terra and P Wattel, *European Tax Law* (Kluwer, 3<sup>rd</sup> ed, 2001), 29 and following for discussion of principles. The analysis here draws heavily on his rather longer discussion.

<sup>93</sup> Leads to a prohibition on discrimination by reason of nationality [analogy to state in Australia], free movement of goods and services across state borders, free movement of persons, capital and businesses across borders. But also includes wider doctrines like the ‘rule of reason’ applied to the movement of goods. This is analogous to the proportionality doctrine discussed in detail below. If the national tax rule is liable ‘to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty’ it must be ‘applied in a non-discriminatory manner’, justified by ‘imperative ... public interest’, ‘suitable for securing ... the objective’, ‘not go beyond what is necessary’ (Language from *Gebhard v Consiglio etc di Milano* [1995] ECR I-4165 cited in Terra & P Wattel, *European Tax Law* (Kluwer, 3<sup>rd</sup> ed, 2001), 33

<sup>94</sup> Council Directive 2003/48/EC on taxation of savings income in the form of interest payments. Operative 1 Jan 2004

<sup>95</sup> Art 1 op cit

<sup>96</sup> Council Directive 2003/49/EC on a common system of taxation of interest and royalty payments between associated companies of different EU states

<sup>97</sup> op cit preamble para (1)

member states should not be subject to less favourable tax conditions than those applicable to the same transactions carried out between [domestic companies]’.

### BEYOND THE UK COMFORT ZONE: FEEDBACK ON RADICAL EU TAX INTERVENTIONS

Corporate tax integration and the problems with it were the centre piece of the 2003 annual conference on European tax in Bologna, Italy. This large conference with many of the key academic tax players from around Europe was specifically designed<sup>98</sup> to further tax integration and deal with the problems of implementing it.<sup>99</sup>

In the Bologna conference and my extensive discussions with a range of experts across Europe, many considered the ECJ had over-reached. They criticized the tendency to apply the EU norms slavishly without sufficient reference to competing tax policy priorities, that the ECJ lacked the experience and tax expertise to balance sophisticated tax policy issues, took on fundamental tax issues without sufficient attention to the fundamental rules being rewritten and was moving too fast. Another view was that there was some method in this ‘madness’. The fundamental challenges could best be explained as a means of forcing negotiations toward a consensus on a new tax convention between EU states. If existing individual state corporate tax systems were rendered untenable, the only practical option became an agreement on principles for a new, harmonized, EU business tax system.

UK delegates emphasized the dangers of the radical changes currently being pursued in the EU. David Oliver of Cambridge University Law Faculty emphasized lack of EU awareness of the sovereignty of member states and, in particular, the very different approach of the UK, which eschewed general statements of principle such as those in the Spanish General Tax law. EU law was made part of UK domestic law as late as 1998. It was clear that the ECJ had adopted civil law models and these dominate the legal modalities in the increasingly integrated EU. The UK courts are unused to the wide ranging direct role of Constitutional courts in tax matters and the changes require very large shifts in their mode of reasoning. It is a revolution in approaches, in sharp contrast to the more customary evolutionary approaches of UK courts in rule making. Oliver argued that this activist model elevated the role of the courts and Commission and that many of the major initiatives lacked solid grass roots democratic support. Note the paradox that the Australian main institutional structure and tax code are a much closer analogy to Europe but Australian courts are more UK in their tax approach than the UK.

Professor David Southern contrasted the different development of English constitutionalism with the European system. Under the English system Parliament (and in particular the lower house) is omnipotent and not subject to political constraints. The language of the rule is everything. The EU chose the German model, he argued, because the UK got an ‘instability disease’. Lack of a coherent

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<sup>98</sup> Emphasized in the opening of the Rector of the University of Bologna conference op cit

<sup>99</sup> Facolta di Giurisprudenza, *Tax Law Principles in Europe* (16 September 2003, University of Bologna); papers were in various European languages with oral translations into English but full written translations were not available and the versions here depend on the notes of the author. This means the responsibility for accuracy is mine and readers should guard against the possibility, before attributing statements to speakers that they might have lost something in the translation or transcription. The help of Professor Di Petrio and Marco Greggi in assisting attendance by the author and other Australian delegates is gratefully acknowledged.

identification of the principles underlying tax rules promotes the need for frequent rewrites of tax law to deal with emerging problems and incoherence. It tends to politicized every significant tax debate and to that, this author would add, to undermine Parliament's control. We can add that it gives excessive power to lobby groups who can target judicial discretions behind the cloak of complex technicalities and legalistic reasoning. Much of this analysis is extremely relevant to Australia.

The comparison between principles and rules was drawn out by a number of speakers at the Oxford<sup>100</sup> and Bologna<sup>101</sup> conferences and at a detailed analysis of ECJ tax decisions at the Institute of Advanced Legal Studies<sup>102</sup>. The UK debate sometimes drifted to a point where the attempt to introduce precision in definitions obscured the key issues, hence underscoring the very issues articulated in this paper. French Professor Cyrille David, Sorbonne Law Faculty of the Paris University, identified the tensions with some clarity. There is a divergence between administrative and wider policy norms (like fairness or proportionality or equality of treatment) and the normal rules imposed by the rules and hierarchy of authority. This, in turn, raises the familiar Catch 22 generated by the imperatives for delegation in a mass decision making process: the need for consistent rules and the increased opportunity that spelling out of such rules provides for hijacking of such norms by delegated decision makers.

In continental Europe this tension is handled, in the civil law tradition, by hiving off the protection of fundamental administrative principles to administrative courts and leaving normal rules to the normal courts. If you think about it, this idea is not foreign to Anglo-Australian traditions. There is a solid common law precedent for this practice. It is the separate stream of equity which lived for centuries in constant creative tension with the common law before the fusion of law and equity and before equity got rheumatic. The creation of the office of Ombudsman is a modern, rather proscribed, version of the same idea. And, of course, there is the over-riding principles enshrined in the Australian written Constitution. It also raises issues, David explores, of the consistency with which such wider norms are applied and the difficulty of accessing them in the normal run of cases where costs and timeliness are a major issue. The preoccupation in the EU, as articulated by David, is to achieve coherence and consistency by strategies to increase the convergence of EU taxes and the understanding of their purposes. This process will always involve contradictions, he argues, because various taxes pursue divergent policies and because there are inherent contradictions in the wider norms and specific job of micro tax management.

If this argument applies to the UK, it applies much more strongly in Australia. Because judges have adopted, on the surface at least, self-restraint on entering policy, there is completely inadequate on-going dialogue on emerging principles and the appropriateness of the current principles. Ideas, Southern asserted, are not useless pondering on philosophy and the meaning of life but important beacons in the construction of a coherent tax system [both in transnational organizations like the EU and with nations like Australia<sup>103</sup>].

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<sup>100</sup> UK Tax Research Network Oxford conference (17 Sep 2003)

<sup>101</sup> Facoltà di Giurisprudenza, *Tax Law Principles in Europe* (16 September 2003, University of Bologna) Professor Cyrille David, Université de Paris

<sup>102</sup> British Institute of International & Comparative Law conference *EU and Tax Law – Fiscal and Wider Implications* (9 Dec 2003)

<sup>103</sup> This is author's addendum, not Southern's.

The search for coherent and more or less consistent norms across jurisdictions, Southern argued, is the key to tax harmonization both within the EU and, of course, in the move to coherent relations between other key players in the international arena. It has been started by the OECD in moves over recent years to marginalize tax havens. It is continuing in the various domestic rules to remove barriers where trading partners have comparable tax systems. It has been pushed by German attempts to design a corporate tax system built on the principle of neutrality between domestic and foreign sources of corporate income. Australia will have to grapple with these issues increasingly as it integrates its economy with the US and Asia and, if international trade liberalization, gets beyond the current stalemate, to the rest of the world economy.

#### **Asserting core principles: Spanish fundamental law model<sup>104</sup>**

Part of the problem with broad directives to the tax judges in Australia in the past has been the ease with which they can be marginalized or ignored. There are civil law precedents in which important principles are given emphasis with quasi-constitutional tax legislation. This methodology could help address this problem.

Spain draws heavily on the German and Italian civil law models. The original 1919 German umbrella tax code, the *Abgabenordnung*,<sup>105</sup> was the basis of its 1967 fundamental tax law and Latin America imported it from Spain. Like the German model, it uses a general tax act to spell out fundamental rules and principles and specific legislation to elaborate it for each of the taxes. So the general tax act is quasi ‘constitutional’ legislation which spells out core principles and the very basic conceptual tax framework. Most significant for our purposes, it contains general anti-avoidance provisions and form-substance principles. It also contains general procedural rules for assessment and collection (analogous to the Australian Tax Administration Act but with much of the detail in regulations). Like a constitution, it is more stable than the legislation spelling out technical rules for specific taxes. The effect of this general tax legislation is to create uniform principles, as appropriate, for taxing events, the tax base and the tax unit. It spells out very basic protections like a general rule against double taxation or double dipping on deductions and exemptions. Professor Soler Roch<sup>106</sup> sees the articulation of high level general principles based on ‘a conceptual model’, as opposed to mere technical definitions, now ‘unanimously praised, as a decisive ‘guarantee of legal certainty’. This contrasts sharply with the unexamined *assumption* of many Australian practitioners and judges that it will lead to uncertainty.

In 2003, Spain was in the process of its first rewrite for 40 years. This contained a much more explicit attempt to establish a balance between powers of the tax administration and taxpayer rights.<sup>107</sup> This general tax law is ‘highly conceptual’,<sup>108</sup> using such broad concepts as ability to pay, equality, progressivity and constraints on

<sup>104</sup> This section draws heavily and directly from MT Soler Roch, ‘The Reform of the Tax Code Based on Experience of the Spanish General Tax Law’ Paper to Tax Research Network Oxford conference 2003 (17 September 2003, paper 4). Her analysis is pruned and largely phrased in more familiar Australian terminology but the ideas are an attempt to encapsulate her concepts.

<sup>105</sup> Rewritten in 1977 and continuously updated since. Acknowledge Prof Heinzen of Free University of Berlin

<sup>106</sup> Soler Roch op cit 5

<sup>107</sup> Published by House of Commons 6 June 2003

<sup>108</sup> Soler Roch op cit 4

confiscatory taxes. It has general definitions of taxation. It interpolates concepts like proportionality (see below) and ‘indirect costs’, presumably referring to transaction and compliance costs. Interestingly, the main debate in Spain was whether the general tax law needed to explicitly specify concepts articulated in the Spanish Constitution.

The earlier general tax legislation drew on the German model and contained a general principle of ‘substance over form’ which empowers the tax administration to define a taxable event ‘in accordance with its true nature, irrespective of the form or denomination given thereto by interested parties’.<sup>109</sup> This is, of course, a very wide power to re-characterize transactions according to their substantive commercial or non-tax outcomes. There was also a provision in the case of tax avoidance, analogous to, but weaker than, the general anti-avoidance provisions in Part IVA, enabling intervention by the Administration where there is a “proven intention to avoid tax.”<sup>110</sup> Such an approach is, of course, far less effective than the Australian test based largely on inferences from objective actions and, given the difficult burden of proof. This, along with a 1995 provision for striking down shams, was rarely applied.<sup>111</sup> The administration relied on the substance doctrine. The 2003 draft strengthens the substance and avoidance intent rule. It strengthens the concept that the Administration has the power to characterize a scheme “irrespective of the classification previously given thereto by the interested party”.<sup>112</sup> The subjective intention rule was replaced by objective criteria, more closely analogous to the Australian general anti-avoidance rules. The test is now whether the acts of the business, individually or together “obviously contrived or inappropriate to achieve the result obtained” and, with echoes of recent debates in Australia, there are *no* significant results other than tax savings. This last rule would not, of course, capture a scheme which achieves commercial outcomes by a contrived, tax avoidance path but the general rule about substance might well pre-empt such techniques.

The debate in the UK, as we saw earlier, has focused on distinctions between ‘principles’ and ordinary law, between tax law used in its ‘ordinary’ and ‘legal’ sense. Such distinctions are another manifestation of the ability of tax lawyers to reduce a holistic communication into its constituent parts and, hence, to lose that meaning. The essential job? To create a hierarchy of concepts. The legislature can assist by pulling key concepts out from the ‘noise’. Where it fails to do the job, delegated decision-makers must do it. They need to resist getting sucked into sterile definitional debates; the very problem at issue.

The significant point about the Spanish experience is the general ‘quasi constitutional’ approach in which broad, over-riding principles are spelt out and, to that extent, whether we deal with the problem of judges going on frolics of their own and hiding it in a cloud of technical detail. It is not, of course, a magic bullet. It involves active judgment by decision makers. Slavish adherence to general principles is almost as bad as low level slavish application of rules. But it should cleanse and clarify by creating an explicit hierarchy of policies and hence a framework for principled criticism. It will promote transparency and accountability. It will promote coherence and consistency. It will assist those who wish to prevent fundamental principles from being submerged

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<sup>109</sup> Article 25 of 1963 General Tax Law and Art 28(2) amended in 1995

<sup>110</sup> Art 24 of 1963 General Tax Law

<sup>111</sup> Soler Roch op cit 15

<sup>112</sup> Art 15 2003 draft

in a self-justifying spiral of mindless technical analysis feeding on itself. And, yes, these sorts of problems are all too prevalent in Australian tax law and they do need addressing.

As a footnote, Australian lawyers and accountants are not unfamiliar with these devices. But, for the most part, they leave them at the door when they give tax opinions. Australian lawyers are familiar with rules in the Constitution which over-ride specific legislation and delegated rule making. Australian accountants are aware of the UK 'true and fair' over-ride which, in dealing with problems very similar to those involved in tax avoidance, imposes this general principle over and above specific rules for the drawing of accounts.<sup>113</sup>

#### CASE STUDY: COMPARE CHOICE PRINCIPLE & EUROPEAN PROPORTIONALITY DOCTRINE

Legal systems have internal dynamics which give them their special character, and it is important to understand these in order to appreciate what makes a legal tradition distinctive. But legal systems are not immutable. They can change through national and international pressures. Cross fertilization ... is an important facet of legal evolution.

John Bell<sup>114</sup>

Under the European Convention on Human Rights, if any state wishes to abridge the rights of citizens in a way which interferes with rights guaranteed under the Convention, "it must endeavour to ensure that, in every case in which that law may fail to be applied, any interferences caused will be found to be proportionate when judged against all the circumstances ...."<sup>115</sup> We will use this case study to compare the operation of this proportionality principle in European public law<sup>116</sup> with the sharply contrasting operation of the Australian judge made choice principle operating on the general tax anti-avoidance provisions. The two principles have analogous operation. Both set up over-arching principles to discipline detailed rules and ensure they do not offend core policy principles. But the approach is very different. This ability to maintain a creative tension in Europe contrasts sharply with the polarization in the Australian choice principle cases. In Australia, the approach of tax judges to the balancing job is thin on articulated policy appreciation or an iterative, evolutionary approach to the development of doctrine.

In the Australian general tax anti-avoidance provisions, the broad directives set up 'rules of fair tax play' whose purpose is to over-ride more specific tax rules in cases of tax avoidance. In Spain, such provisions are entrenched in a fundamental tax law. In

<sup>113</sup> Acknowledgement to C James, *Beyond Separation of Powers: Re-engineering the process by which tax policy is translated into practical outcomes* (2002. Unpublished work for Current problems in Taxation at ATAX supervised by author). She also makes some very useful practical suggestions for use of this approach in VAT and practical suggestions which will hopefully be published.

<sup>114</sup> J Bell 'Mechanisms for Cross-fertilization of Administrative Law in Europe' in J Beatson and T Tridimas, *New Directions in European Law* (Hart Publishing, 1998), 147

<sup>116</sup> There is some controversy about whether the principle should apply to taxation. Professor Markus Heintzen of FUB quotes Hans-Jürgen Papier, president of the Federal Constitutional Court, in his book *Die Finanzrechtlichen Gesetzesvorbehalte und das Grundgesetzliche Demokratieprinzip*, 1973, s76 ff and Joachim Lang, *Vom Verbot der Erdrösselungssteuer zum Halbteilungsgrundsatz*, *Festschrift für Klaus Vogel*, (2000) s173 ff. He quotes the decision of German Federal Constitutional Court (June 22, 1995; 2 BvL 37/91) Vol. 93 *Decisions of the Federal Constitutional Court*, 121 where the court says that any taxation in excess of about 50 percent is a violation of the guarantee of property by art 14 of German Constitution.



the case of the European Convention on Human Rights, government interference with the individual liberties of the citizen must be measured against a benchmark that such interference is not, in all the circumstances, a disproportionate curtailment of such rights. One of the most intractable problems in a wide-ranging general anti-avoidance provision is the relationship between the wide directives in that provision and detailed, technical provisions of tax legislation and particularly of deliberate tax expenditures. A great deal of superficial reasoning, often driven by other agendas, has driven analysis of this tension in Australia. In the overblown version in the extended choice principle articulated in *Cridland*<sup>117</sup>, it was held by the High Court that the general anti-avoidance provisions have *no* room for operation *at all* where some specific rule in the Income Tax Assessment Act gives the taxpayer a choice of options.

Of course, the dynamic approach to rule making in the proportionality doctrine now operates, not just in Strasbourg and the ‘dark’ reaches of Italy, but in relation to bread and butter domestic issues in the *English* Common law courts, which are the modern embodiment of our Australian judicial heritage!

### European proportionality doctrine: key features

The doctrine of proportionality is a wide principle designed to forestall the use of “a steam hammer to crack a nut, if a nutcracker would do.”<sup>118</sup> It is a doctrine which proscribes the measures used by public bodies to attain the use of legitimate public purposes. It ensures that public government intervention is strictly necessary and proportionate to that purpose. The doctrine is primarily “negative in application” and is used to decide whether “an administrative decision is disproportionate, thus causing injustice.”<sup>119</sup> The doctrine<sup>120</sup> “apart from a balancing mechanism of conflicting interests and values, ... constitutes a key safeguard of the essence of fundamental rights”. The doctrine of proportionality is the centre piece of much European substantive and procedural tax law and is the subject of a number of monographs. It is merely one of a number of similar doctrines<sup>121</sup> to guarantee due process and the protection of fundamental civil liberties.

Our treatment is short and eclectic to draw out relevant features for the case study. In detailed analysis of the operation of the proportionality doctrine Sales and Hooper<sup>122</sup> frankly acknowledge a “significant tension between the requirement of legal certainty ... and the doctrine of proportionality ...” They seek “two competing social needs” and all legal systems are “the product of a compromise between these two social needs.” It is the maintenance of this creative tension at the practical level which determines the effectiveness of a legal regime and the emphasis will, as Nonet explains,<sup>123</sup> turn on patterns of error at a particular historical moment.

<sup>117</sup> *Cridland v FCT* 77ATC 4538, 4541 (fully discussed below) and see earlier articulations in *Keighery Pty Ltd v FCT* (1957) 100 CLR 66; *FCT v Casuarina Pty Ltd* 71 ATC 4068

<sup>118</sup> Lord Diplock in *R v Goldsmith* [1983] 1WLR 151, 155

<sup>119</sup> N Emiliou, *The Principle of Proportionality in European Law: A comparative study* (1996, Kluwer), 173

<sup>120</sup> N Emiliou, *The Principle of Proportionality in European Law: A comparative study* (1996, Kluwer), 173

<sup>121</sup> Another is the doctrine of legitimate expectations.

<sup>122</sup> op cit 439. See also N Emiliou, *The Principle of Proportionality in European Law: A comparative study* (1996, Kluwer), 142 and sources cited to the effect that legal certainty, important as it may be, is not an absolute value inc HLA Hart.

<sup>123</sup> P Nonet, *Administrative Justice* (Russell Sage Foundation, 1969), 3.

The development of the doctrine in the courts has focused on a number of factors. In an ECJ formulation<sup>124</sup> it requires the three constituent components of suitability, necessity and proportionality (using the term in its narrow sense). Suitability ‘suggests that an interfering action be at least regarded as suitable for attaining its aim’. Necessity ‘demands that authorities must choose the least restrictive among equally effective means. Proportionality ‘demands a proper balance between the injury to an individual and the desired community interest, prohibiting those measures whose disadvantages to the individual outweighs the purported community interest.’<sup>125</sup> The *Fromançais*<sup>126</sup> case requires that the means employed to achieve an aim corresponds to the importance of the aim and are necessary for its achievement. This is expanded in the *Fedesa*<sup>127</sup> case to require that the measures do not exceed the limits of what is appropriate and necessary in order to attain the objectives *and* that, where there is a choice between means to attain the objective, ‘recourse must be had to the least onerous’. These criteria indicate the richness of analysis and contrast sharply to the one dimensional analysis of Australian tax courts on the choice principle.<sup>128</sup> It revisits age-old issues about the boundaries between the competence of judicial and political institutions.<sup>129</sup>

The proportionality doctrine, developed in the German Supreme Administrative Court and applied in other European jurisdictions like France, has been adopted by the EU courts since 1955<sup>130</sup> but gained increasing prominence during the 1970s and 1980s as a major tool in both EU substantive law and procedure.<sup>131</sup> There are significant differences between the very specific and highly developed German rules and those in the EU.<sup>132</sup>

The EU doctrine was originally a political doctrine which was part of the EC treaty designed to proscribe excessive arrogation of power by EU institutions at the expense of member states. It was essentially a doctrine to ensure that EU interventions achieved economic integration and no more. But, under the ECJ, it has been expanded

<sup>124</sup> Case C-331/88 *R v Ministry of Agriculture ...* [1990] ECR I-4023 quoted in Thomas *op cit* at 78

<sup>125</sup> Formulations all extracted from Y Arai-Takahashi, *The Margin of Appreciation Doctrine and the Principle of Proportionality in the Jurisprudence of the European Commission of Human Rights* (Intersentia, 2002) 192

<sup>126</sup> Case 66/82 [1983] ECR 395, 404

<sup>127</sup> Case C-331/88 [1990] ECR I-4023, 4063 from Emiliou *op cit* 134

<sup>128</sup> Analysed in Y Grbich, *Tax Decision-making at the Crossroads: Strategic directions in M Walpole and R Fisher (eds) 5<sup>th</sup> International Conference on Tax Administration* (Timebase, Sydney, 2003).

<sup>129</sup> See discussion in N Emiliou, *The Principle of Proportionality in European Law: A comparative study* (Kluwer, 1996) 171ff and refer to the large debate in the UK about the widespread intervention of ECJ into domestic UK law in pursuit of these doctrines.

<sup>130</sup> in *Fedchar* Case 8/55 [1954-56] ECR 292,299; Generally see Lord Hoffman ‘The Influence of the European Principle of Proportionality Upon UK Law’ in E Ellis, *The Principle of Proportionality in the Laws of Europe* (1999, Hart), 107 and G Note ‘General Principles of German and European Administrative Law: A comparison and historical perspective’ (1994) 57 *MLR* 19, 192

<sup>131</sup> Source is N Emiliou, *The Principle of Proportionality in European Law: A comparative study* (1996, Kluwer) and discussions with Professor Di Petrio Facolta De Giurisprudenza at University of Bologna. See extensive bibliography in Emiliou.

<sup>132</sup> Covered in depth in N Emiliou, *The Principle of Proportionality in European Law: A comparative study* (1996, Kluwer) particularly at 2, 134 on which this treatment draws extensively and see comparison with common law in R Thomas, *Legitimate Expectations and Proportionality in Administrative Law* (2000, Hart Publishing), xv

to pursue much wider objectives<sup>133</sup> and has reached into domestic law.<sup>134</sup> There are few areas of EU law where it is not now relevant.<sup>135</sup> In particular, its integration into domestic law has been the subject of heated debate and scholarly comment.

### Why does common law have a problem learning from Europe?

... all purely intellectual obstacles to assimilation [of broad European principles into common law] are, in practice, surmountable; the real obstacles are to be found in the widely differing histories, political and social structures of European countries.’

Kahn-Fruend<sup>136</sup>

The English legal system, in particular, has had to grapple with these specific problems as it integrates the proportionality doctrine, born in a different German and EU legal tradition, into its domestic administrative law. The difficulties this has caused English domestic law, says Thomas,<sup>137</sup> raise much more fundamental issues about the appropriate role of law [and judges] in a decision making process which so profoundly impacts on Government policy.<sup>138</sup> His hypothesis is that “any reconciliation of the principles [of proportionality and legitimate expectations] in English law ... would require a reconsideration of the basic conception of administrative legality [read the basic working premises of the approach of Anglo Australian tax courts to legal doctrine].”<sup>139</sup> Thomas’s conclusions<sup>140</sup> put the development of doctrines like proportionality down to the civil law ability to divide EU law into separate categories of public and private law. He blames the difficulty of adopting the principles into English law on the tradition of the common law of quarantining public law principles into a special category. Note that tax, even if many Australian judges have not yet realized it, is more public than private law.

Thomas’s argument offers good insights but his perspective is too narrow. While his argument can readily be accepted as historical explanation, it obscures more important observations which can inject clarity into the Australian tax experience. That is, the failure of the common law to adapt to the growth of legislation and the increased

<sup>133</sup> N Emiliou, *The Principle of Proportionality in European Law: A comparative study* (Kluwer, 1996), 140

<sup>134</sup> R Thomas, *Legitimate Expectations and Proportionality in Administrative Law* (Hart Publications, 2000); Y Arai-Takahashi, *The Margin of Appreciation Doctrine and the Principle of Proportionality in the Jurisprudence of the European Commission of Human Rights* (Intersentia, 2002)

<sup>135</sup> R Thomas, *Legitimate Expectations and Proportionality in Administrative Law* (Hart Publishing, 2000), 78 citing Advocate General Jacobs. Jacques Malherbe of the Catholic University of Louvan institutionalization argued that the key civil law concepts like proportionality were now institutionalized generally into EU law, including tax law.

<sup>136</sup> O Kahn-Fruend cited in R Thomas, *Legitimate Expectations and Proportionality in Administrative Law* (2000, Hart Publications), 112-3

<sup>137</sup> R Thomas, *Legitimate Expectations and Proportionality in Administrative Law* (Hart Publishing, 2000) who at 85 documents English use of the concept, for example in seventeenth century doctrines of disproportionate fines imposed by public authorities, and a lively debate about its extension but argues it ‘lacks authoritative presence’. He contrasts the well entrenched administrative concept of reasonableness. Readers might note that the later doctrine is almost completely absent from analysis of tax on either the taxpayer or revenue side, despite the public law nature of taxation. See also S Boyron, ‘Proportionality in English Administrative Law: A faulty translation?’ (1992) 12 OJLS 237; J Jowell & A Lester, ‘Beyond Wednesbury: substantive principles of administrative law’ (1987) *Public law* 368; J Schwartz, *European Administrative Law* (1992, Sweet & Maxwell) ch 5.

<sup>138</sup> op cit xv

<sup>139</sup> op cit, preface

<sup>140</sup> op cit 111

speed and depth of change, particularly in a codified area like tax. It includes failure to develop broad principles to crystallize and ensure orderly development by judges to discipline this growth and to contribute to intellectual constructs to guide it.

Thomas documents specific problems of adopting wide principles such as the proportionality doctrine into domestic common law.<sup>141</sup> He sets out, at length, a history of confusion over whether such broad doctrines are substantive or procedural, of increasingly threadbare attempts to quarantine English law from the influence of European law on proportionality,<sup>142</sup> of confusion and prevarication over the meaning of doctrines which “have failed to appreciate the nature of proportionality as a way of ensuring a relational relationship between means and ends, rather than simply a review of the merits...” The judges have lacked “the institutional confidence to undertake the assessments involved in a proportionality enquiry.”<sup>143</sup> He notes the diversity which the ECJ brings from member jurisdictions and the cross fertilization of collegiate judgments.<sup>144</sup> He contrasts the flexibility of EU law of comparatively recent origin and the more rigid and narrowly rationalist approaches of well established common law. Thomas makes the telling point “that English law has lacked the cultural and institutional infrastructure which has characterized Continental legal systems and influenced the ECJ.” He links this to a reluctance to develop general doctrine.<sup>145</sup>

Thomas articulates and rebuts the common justification for drawing very tight boundaries round judicial decision making which operates in highly politicized areas.<sup>146</sup> The rebuttal<sup>147</sup> is that the complexity of modern tax decision making makes recourse to judicial decisions and the position of judges much more central in generating operational norms. The weighing of alternative options for attainment of the same objectives under the proportionality doctrine [or choice principle] requires judges to be ‘informed of the purposes of public action’<sup>148</sup> and also to be more explicit about their increasingly strained rationalization that judges do not intervene on the merits in administrative decisions.

Thus, judges in Australia rely on a conservative and narrowly rationalist approach. They eschew active intervention according to broadly articulated principles of due process and fairness (let alone broader policy considerations). This is both an inadequate and loaded premise on which to construct a general approach to judicial decision making. Of course, this argument applies with particular force to decision making in areas, like sophisticated tax schemes, where the very operational objective is typically to exploit the rigidities of tightly drawn rules. The job of judges in these areas, to adapt the argument of Thomas,<sup>149</sup> is to keep an active and creative balance between the need for legal protection and legal regularity with the competing need for general norms which will wisely guide and discipline the body of rules. If they fail to

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<sup>141</sup> op cit 111

<sup>142</sup> op cit 99

<sup>143</sup> op cit 111

<sup>144</sup> Although noting the advantages of dissents and differing views which “allows the law to develop through open debate.”

<sup>145</sup> op cit 111

<sup>146</sup> op cit 112

<sup>147</sup> This argument draws on R Thomas, *Legitimate Expectations and Proportionality in Administrative Law* (Hart Publishing, 2000), 112 but this is my argument not his.

<sup>148</sup> op cit 100

<sup>149</sup> op cit 112

articulate specific justifications to explain their broad approach, they create rule by men and institutions working towards ends which are often only broadly [I prefer the term ‘vaguely’] conceived and only partly defined or, indeed, understood by the actors’.<sup>150</sup> One might have thought that the articulation of such premises was at the very root of any honest adherence to the, much vaunted, ‘rule of law’, more honoured in the breach than the observance.

Of course, it is not suggested that the doctrine of proportionality should be indiscriminately applied to tax law. It is hard to use this as an operational concept for judicial intervention to control the rates of taxes but perhaps easier to see it operate if quarantined to various specific issues about the collection of taxes and concepts used to distribute the tax burden. This issue is currently one of controversy in Germany.<sup>151</sup> The point of the analysis is not to argue for direct application but to give a benchmark against which to analyze the interaction of general directives in legislation and specific provisions.

### **Australian judicial performance on choice principle**

This comparative analysis, the argument supporting it and the broader inferences resulting from it spell out with great clarity, the benchmark we should use in evaluating the choice principle, as applied in Australian tax courts. I want to use the European modalities as a benchmark for the judicially created choice principle as it applies to the general anti-avoidance provisions. The choice principle or some analogous concept is necessary to contain the tension at the borderline where there is a tax minimization transaction but the legislature has deliberately or implicitly created a tax concession. The obvious example is the explicit tax concessions for research and development investment or sunrise industries which exist in Australia and many other tax systems.

The choice principle reached its high water mark in Australia in the 1977 decision of Mason J in *Cridland v FCT*.<sup>152</sup> The wide formulation in *Cridland* that when specific provisions in the Act, or, presumably, the judicial interpretation of them, gave an answer to any tax problem (not merely a tax concession), the choice principle removed any scope for the operation of the old general anti-avoidance provision in s260. *Cridland* involved a scheme to allow unit holders to arbitrage primary production averaging provisions by participating in a unit trust. Mahoney J in the New South Wales Supreme Court held<sup>153</sup> that s260 applied. He held<sup>154</sup> that the choice principle could not apply whenever provisions of the Act created tax consequences in particular circumstances. These provisions could not exclude s260 “however artificial a procedure and for whatever tax avoidance purpose.”<sup>155</sup>

Mahoney J was reversed by the High Court. Mason J delivered a judgment in which Barwick CJ, Stephen, Jacobs and Aickin JJ concurred. He relied on *Mullens Investments Pty Ltd v FCT*<sup>156</sup> to hold that s260 did not apply because “the taxpayer is entitled to create a situation by entry into a transaction which will attract tax

<sup>150</sup> JDB Mitchell, *Constitutional Law* (1968, Green, 2<sup>nd</sup> ed) 7

<sup>151</sup> Acknowledge Prof Heinzen of Free University of Berlin

<sup>152</sup> 77 ATC 4538, 4541

<sup>153</sup> 76 ATC 4095

<sup>154</sup> at 4103

<sup>155</sup> *ibid*

<sup>156</sup> 76 ATC 4288, 4541

consequences for which the Act makes specific provision.”<sup>157</sup> His Honour added some obiter, gratuitous and, with the greatest respect, constitutionally arrogant advice to the Commissioner about the ‘long apparent’ ‘defects and deficiencies’ of s260<sup>158</sup> and, despite the Commissioner's victory in the lower court, expressed surprise at his reliance on it. This was the signal that s260, the old general anti-avoidance provision, was officially killed off by the judges.<sup>159</sup>

The decision in *Cridland* was largely ignored by the majority of the High Court in *FCT v Gulland*.<sup>160</sup> The choice principle was put in its proper perspective by Brennan J in *Gulland*<sup>161</sup>, where he said it was merely a version of the well known principle ‘*generalia non specialibus derogant*’ and should both limit specific provisions where it is appropriate to apply it and not be allowed to annihilate the general anti-avoidance provisions themselves. The dissent of Deane J contained a full and explicit discussion of the old authorities. Surprisingly, while he disagreed with their reasoning, he thought he was<sup>162</sup> bound by the cases propounding a wide choice principle and it was settled law that s260 could have no operation in these circumstances.

The frontal attack through the extravagant version of the choice principle was stemmed by Part IVA. But the problem is not dead. The new general anti-avoidance provisions have not properly resolved the issue and hence have delegated its final settlement to judges for some future time.<sup>163</sup> Deane's dissent in *Gulland*<sup>164</sup> was taken up some years later in *FCT v Rippon*<sup>165</sup>, without any mention that Deane was the sole dissenter. Cooper J developed a pedantic threshold argument in the Full Federal Court in *Spotless*, to narrow that provision. It built on a sweeping version of the choice principle, combined with a broad commercial dealing exception, to take a frontal assault on the effectiveness of the general anti-avoidance provisions in Part IVA. According to this doctrine, if a scheme has a commercial outcome, no matter how artificial or blatant the particular steps used to attain that outcome, the general anti-avoidance provisions could not operate. Though the Full High Court overruled the Full Federal Court, this construction was not explicitly rejected by the High Court and no principled response was articulated for the tough cases. On the basis of such a sweeping doctrine, the new general anti-avoidance provisions in Part IVA would have narrow application.

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<sup>157</sup> at 4542

<sup>158</sup> The thrust of which were reversed in later decisions in which the High Court attempted to resurrect s260 to combat the damage of public opinion and foreshadow the reforms in the pipeline in the new general anti-avoidance provisions in Part IVA

<sup>159</sup> The public outcry caused them to resurrect it and disown their own former doctrines but it was too late. A new general anti-avoidance provision was already on the drawing boards.

<sup>160</sup> (1985) 17 ATR 1; 85 ATC 4765

<sup>161</sup> 85 ATC 4765, 4777

<sup>162</sup> at 4787

<sup>163</sup> Section 177C(2) excludes from the operation of ‘tax benefit’, and hence from the operation of the anti-avoidance provisions, non-inclusion of benefits due to a ‘declaration, election or selection’ etc. But, significantly, the provisions do not spell out any effective limits to the exception. The provision in s177C(2)(a)(ii) which excludes schemes carried out ‘for the purpose of creating any circumstance’ necessary to enable the ‘declaration, election or selection’ etc to be given is far too wide and might catch someone going into an artificial film scheme solely to get the benefit of a tax expenditure with zero or very little funds flowing into the actual film.

<sup>164</sup> *FCT v Gulland* 85 ATC 4765

<sup>165</sup> 92 ATC 4689; involves an appeal from author's own decision in the Administrative Appeals Tribunal

According to the High Court in *FCT v Spotless Services Ltd*<sup>166</sup>, Part IVA is not some disembodied marginal part of the Act but ‘as much part of the statute under which liability to income tax is assessed as any other provision’ of the Act.<sup>167</sup> But more than this, like the European human rights protections, the provisions of Part IVA over-ride the rest of the *Income Tax Assessment Act 1936*.<sup>168</sup> Where a scheme infringes the annihilation provisions by circumventing the thrust of specific provisions in the Act, even where it accords with the existing interpretation of those provisions, it will be struck out.

The choice principle must be given a balanced construction and that construction must be based on the place of the general anti-avoidance provisions in the Act. It clearly can not be, nor should it ever have been, a complete defence to general anti-avoidance provisions.<sup>169</sup> That such a manifestly untenable position took root in the High Court, and still raises its hydra-headed presence, raises very clear and present concerns about the modalities in which the judges work in Australia.

The choice principle must be seen, as is the proportionality doctrine in Europe, as one priority which must live in creative tension with the core statutory predication test. It has a useful sphere of operation in weighing specific legislative policy objectives against the more general objective of protecting the charges to tax from being artificially circumvented, but indiscriminate use of it is in clear conflict with the clear intent of Part IVA which, incidentally, over-rides most other provisions of Australian tax law.<sup>170</sup> The central insight, of course, is that general anti-avoidance provisions, just like the Treaty protections for human rights in Europe, must always live in unresolved tension with specific provisions in the Act. General anti-avoidance provisions must be seen in a *dynamic* context with a particular priority to assert. They must, *inevitably*, impact on the construction of specific provisions. Because this involves questions about the way in which conflicts about construction of the Act ought to be resolved, like the perennial questions about the trade-off between economic efficiency and distributional justice, such issues rarely lend themselves to definitive resolution. Depending on the precise nature of the trade off of the provisions and the scheme, one or other priority will be asserted in a particular situation.

To this day, apart from the strong analysis by Brennan CJ, there is precious little in the way of an articulated and systematically applied generalization about the job of this doctrine in the anti-avoidance armory, no spelling out of the essential tensions and precious little attempt to systematically structure the principles to guide this central issue in the general anti-avoidance provisions. The development of the proportionality doctrine in Europe stands in sharp contrast and demonstrates what judges should be doing in Australia.

### Why did Australia go off the rails?

One of the reasons common law jurisdictions have not clearly identified the problems with judge focused delegated decision making is that, with not entirely unfamiliar,

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<sup>166</sup> 96 ATC 5201

<sup>167</sup> at 5206ff

<sup>168</sup> s177B(1)

<sup>169</sup> Y Grbich, ‘Section 260 Revisited: Posing critical questions about tax avoidance’ (1976) *UNSWLJ* 211, 217

<sup>170</sup> s177B(1) *Income Tax Assessment Act 1936* except international tax agreements.

ethnocentricity they have marginalized the European experience. Vranken<sup>171</sup> argues that mere technical comparison “is not sufficient in inducing a deeper understanding” of the “fundamentals of the European civil law.” He identifies differences in our history, mode of legal thinking, distinctive institutions, sources of law and ideology as the mix of factors producing distinct paradigms. But there is, he argues,<sup>172</sup> “one fundamental difference which goes to the very core” of the difference. It is the “perception of the concept of law itself”. This concept, developed in Europe from the Bologna model, created in the Renaissance universities of Italy. Vranken says:<sup>173</sup>

In a more contemporary context, law study continues to be an intellectual discipline first and foremost. The practical application of the law ...occupies second place. The importance that law teachers in the civil law attach to impressing upon their students the general rules and principles is by no means accidental. ... [L]aw continues to be approached as a philosophy subject at heart.

This contrasts sharply with Australia where the pendulum has swung dangerously far in the other direction. Legal philosophy is almost completely marginalized in taxation and is a term of abuse. Even generalization and discussion of general principles in ‘practical’ subjects like tax is considered an irrelevance by judges and, in turn, by students. Law was still a practical vocation based on apprenticeship which came very late to Oxford and Tax was still taught part time out of LSE when I read for my PhD.

But, as Vranken says,<sup>174</sup> the civil law approach does not mean civil law judges are not creative. He cites judicial doctrines developed in France which convert fault-based tort liability into a dual system of fault and non-fault and in Germany where there has been a surprising rewrite of the law of contract. But, and here is the essence, “at no time can individual cases be allowed to blur the broader picture.” And this is the precise problem in Australian judge made tax law, where the technical tail, most emphatically, does wag the policy dog. To drive the point home, Vranken argues:<sup>175</sup>

When court decisions shape the ... civil law it is the result of an interactive process involving not only the legislature but also an ever vigilant scholarly community that observes, commends or criticizes the courts so as to ensure that any shaping or re-shaping of the law remains a controlled activity.

In other words, this can be read as an indictment of the Australian and UK scholarly community who identify with the profession and are far too subservient in their attitude to the judicial thinking that dominates the commanding heights of the Australian tax system.

## CONCLUSIONS

- 1) Like it or despair about it, the brunt of tax rule making will move, as it has increasingly in recent years, to tax administrators. As Alberto Ibanez says “[At] the end of the twentieth century [globalization] ..., among other factors, [has created] very complex societies with enormous information flows which require an increasing amount of specialized knowledge and the use of technologies .... Despite the fact that, traditionally, the bodies entrusted to ensure the enforcement

<sup>171</sup> M Vranken, *Fundamentals of European Civil Law* (Federation Press, 1997) 214

<sup>172</sup> op cit 215

<sup>173</sup> op cit 215

<sup>174</sup> op cit 216

<sup>175</sup> op cit 216



of law have been judicial, this new social complexity requires more active intervention [by] administrations ....<sup>176</sup> In tax, judges were simply not capable of responding to the escalating demands of this job.

- 2) Notwithstanding their increasing marginalization in rule making, the judges in Australia still command the heights of the tax decision making process. They largely control the detailed rules of engagement. Their modalities of analysis can derail the entire tax decision making process. Tax judges must accept their contribution to the vicious downward spiral of legalistic constructions and more convoluted legislation. They must adapt their working modalities to the new, radically changing environment in which our tax system must operate. We must not suffer the hijacking of core policy decisions by low level debates about words in a vacuum or the exercise of judicial discretion hidden behind a jungle of complexity. Australian judicial performance in developing core principles and structuring them could benefit from study of civil law experience. Australia must learn from both the modalities and the many mistakes of Europe.
- 3) The essence of the civil law is that core policy imperatives shape the agenda. They discipline analysis of technical tax details and the creation of detailed rules by delegated decision makers, *including judges*. In Australian tax cases this discipline has broken down. Barren verbal analysis and technical minutiae was the policy dog. Judicial accountability is 'in-house' and over the years has not, notwithstanding the 'right' rhetoric from the High Court, rooted out these systemic problems.
- 4) Civil law experience with the use of, quasi constitutional, fundamental tax laws may translate into the Australian system. It may help make Australian tax judges somewhat more accountable for applying the manifest policy of general tax anti-avoidance provisions and statutory directives to have regard to substance, as well as red flagging other fundamental norms in the tax system.
- 5) But Australia can no longer wait for the ponderous common law to adapt. Parallel to judicial reforms and the increase of *real* accountability for tax judges, we must work towards strengthening other delegated tax decision making institutions. Such tax reform must draw on the track record of the EU, particularly the unique European Commission. This includes an agenda setting and implementation capacity which spans political and bureaucratic decision making.
- 6) This will involve far more than rebottling old wine in new bottles. We need a sharp rethink of our delegated decision making institutions and the new ideas to drive their work. If the tax system is to become a proactive and sharply honed tool for taking on the tough log of problems which are currently languishing, we need to refashion institutional modalities. This means intelligent social engineering. Institutions must have the capacity to articulate and to gradually evolve core legislative policy directives in a climate of intellectual rigour. They must develop the capacity to intelligently structure those concepts into guidelines for clear and consistent implementation. This demands we learn from recent Australian quick fixes.

Australian tax teachers need to be more active and more fundamental critics of the performance of judges. They are one of the few groups who have the objectivity and skills to make judges meaningfully accountable in complex tax cases, where normal

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<sup>176</sup> A Ibanez, *The Administrative Supervision and Enforcement of EC Law* (Hart, 1999), 1

processes of democratic accountability are effectively marginalized. They need to develop a great deal more independence and the courage to make the necessary hard criticisms. In Professor Di Petro's introduction at the Bologna Tax Conference,<sup>177</sup> academic writing was seen as holding a significant role in emphasizing principles which should be considered in the drafting and implementation of legislation. Di Petro said it was the *core* job of *academics* in Europe to emphasize principles where they were neglected by legislators and judges. Australian tax teachers need to take this on board.

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<sup>177</sup> Facoltà di Giurisprudenza, *Tax Law Principles in Europe* (16 September 2003, University of Bologna)