

eJournal of Tax Research

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eJournal of Tax Research

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An Examination of the Influence of Inheritance Tax upon Business Succession - Lessons for Germany

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Abstract

Family enterprises form the backbone running right through the economy of nations; therefore the business environment and business succession are subjects which are currently receiving widespread attention in most European countries. In Germany there are about 350,000 enterprises - most of them are family-owned - which will have to carry out business succession during the next five years. One major factor influencing business succession is taxation. Many business successions are completed within the family without financial compensation, so there is a strong connection between business succession and inheritance tax as a major fiscal threat. In Germany over the past years there has been intensive discussion about the liquidity burden created by inheritance tax liability endangering the continuation of family enterprises. The inheritance tax rules for business property under discussion in Germany are somewhat similar to the UK ones. Moreover, the UK legal system is more favourable to business succession than most European countries. Therefore the prospective reform in Germany will be informed through an exchange of scholarly experience and also improved by using established recommendations based on the existing UK inheritance tax system. With respect to the German parliament's consideration of an inheritance tax reform bill, the research analyses the impact of inheritance tax on business succession decisions. Thus this research sought both to improve the basis for decision-making by the legislators and also to avoid undesired tax incentives in terms of business succession. The research methodology involved an empirical examination of the impact of the inheritance tax on business succession including personal interviews and written questionnaires with UK tax professionals.

1. INHERITANCE TAX AND THE PLANNING OF BUSINESS SUCCESSION

1.1 Background of research question

In the second half of the 20th century economic growth and political stability allowed the accumulation of private and business wealth in Germany. Those assets are now and in the next years to be given to the following generation.¹ Accordingly, business succession will be an important task to be handled. Following recent statistics, about 350,000 companies with approximately 3,400,000 employees in Germany have to be transferred in the next five years.² From this point of view, business succession can be seen as a major task for the German economy.³

Many factors have an influence on business succession. Management, legal and psychological questions have to be considered, but taxation also plays an important

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¹ See Kohli, M./Künemund, H./Schäfer, A. et al. (2006), p. 58.

² See Institut für Mittelstandsforschung (ed.) (2005).

³ See Spiegelberger, S. (2007), p. 354.

role.⁴ The inherent complexity leads to specific challenges for the senior generation as for the successor.⁵ The general aim of a business succession – not only from the successor's personal point of view, but also from a German constitutional perspective,⁶ is to guarantee the survival of the company and its jobs as well as the economic existence of the successor in the long run.⁷ For closely held companies, especially if held by a family, the going concern of the company under family supervision can be an aim itself.⁸

Almost 95% of all companies existing in Germany are managed by families. Each year nearly 71,000 companies are to be transferred,⁹ and in the past approximately 44% were succeeded by a relative.¹⁰ Intra-family business succession is generally not on a (100%) for-money-basis, so gift and inheritance taxes have a major influence on structure and timing of business succession. Accordingly, tax optimisation is seen as an important task in the process of planning such kind of succession.¹¹

Inheritance tax has to be paid out of the successor's property and thus can lead to an extraordinary reduction of liquidity.¹² As business succession is not normally planned under liquidity aspects, the successor has to liquidate his private property and may even be forced to extract liquidity from the business.¹³ This can lead to a lack of liquidity at the company level and may even threaten its going concern.¹⁴ To resolve such problems, the German tax system provides a tax deferral in such cases,¹⁵ but as it is subject to strong restrictions, it is of low importance for the praxis of succession planning.¹⁶ Additionally, these regulations only shift the tax burden in time without abolishing it, so they lead to a mere time effect.¹⁷

The European Communities see causality between the failure of business succession and the connected tax burden¹⁸ and are regularly confirmed in their opinion by scientific literature.¹⁹ Even as there has not been any empirical proof for this assumption, it can be seen as a major reason for the ongoing discussion of inheritance tax reforms in Germany.²⁰

⁴ See Friedrich, K./Steidle, B./Gunzelmann, U. (2006), p. 19.

⁵ This can be seen easily by counting the amount of information brochures and practical guidelines of chambers of commerce and professional associations. See e.g. Industrie- und Handelskammer Baden-Württemberg (ed.) (2005); Deutscher Industrie- und Handelskammertag (ed.) (2004); Bundessteuerberaterkammer (ed.) (2007).

⁶ See Art. 14 Abs. 2 GG.

⁷ See Steuerberaterkammer Stuttgart (ed.) (2006), p. 6.

⁸ See Watrin, C. (1997), p. 18.

⁹ See Bundesministerium für Wirtschaft und Technologie (ed.) (2007), p. 12.

¹⁰ See Gesmann-Nuissl, D. (2006), p. 2; Bundesministerium für Wirtschaft und Technologie (ed.) (2007), p. 38.

¹¹ See Watrin, C. (1997), p. 18 ff.

¹² See Lehmann, D./Treptow, O. (2006a), p. 413.

¹³ See Karle, M. (2006), p. 12.

¹⁴ E.g. see Schaumburg, H. (2006), p. 22.

¹⁵ See § 28 ErbStG.

¹⁶ See Schulte, W. (2007), p. 320.

¹⁷ See Scheffler, W./Wigger, B. U. (2006), p. 2445.

¹⁸ See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994), p. 2.

¹⁹ E.g. see Schaumburg, H. (2006), p. 22; Scheffler, W./Wigger, B. U. (2006), p. 2445.

²⁰ See Ziegler, J. (1996), p. 454.

On 11th December 2007, the German government once again published a new version of an inheritance tax reform that still gives space for discussion in several details.²¹ An important influence on this draft was the judgement of the highest German court of justice, dated on 7th November 2006:²² which forces the German government to abolish gift and inheritance tax if no re-regulation is implemented up to the end of 2008. Since the beginning of 2009, a revised Inheritance Tax Act is available, but the discussion about possible effects on business succession continues.

1.2 Problem, aim and structure of discussion

Tax policy is one of the most discussed topics in German legislation.²³ Due to the dynamic surrounding, tax legislation always has to be adjusted according to changing circumstances.²⁴ This process can be done on a theoretical basis, but instead of retrospective evaluation and changes it seems to be of more practical use to get a prospective insight into the causalities to avoid “trial and error” legislation as much as possible. Tax policy should be guided by well defined political goals and thus needs detailed information about economic results of specified tax changes. Without such knowledge of tax effects, no clear ex ante-evaluation of tax reform prototypes can be done. Besides that, the government has to face the danger of unforeseen and unpleasant side effects of their reform. This seems evident in case of tax reforms that are structured under the aim of self-financing or increase of tax revenue.²⁵ Under these circumstances it seems questionable whether a goal-oriented tax policy can be achieved without fundamental scientific knowledge about the effects of tax reforms.

There is no clear evidence about how far taxation has an influence on taxpayers’ economic decisions. Even with an inheritance tax broadly discussed in the recent past, little research has been conducted.²⁶ Science faces a particular lack of empirical data about practical influence of inheritance tax on business decision.²⁷ But, a reliable data basis is seen as basic condition for an effective and goal-driven tax policy.²⁸

The effect on decisions by gift and inheritance taxes have been determined in the past mainly based on theoretical decision models that start with the assumption of a taxpayer with the one and only goal of minimising his tax burden.²⁹ This will be the case for business successions, too, but neglects psychological aspects influencing the economic decision. As has been shown, business successions in particular have a strong psychological impact and thus can be analysed only partly by models that are merely tax driven. If the aim is to determine behavioural effects of taxation, empirical research is needed.³⁰ As there is a lack of empirical data about business succession decisions based on monetary plus psychological reasons, such kind of data basis has to

²¹ Kabinettsache 16/08146 of 06.12.2007.

²² BVerfG, 1 BvL 10/02, et al. DStR 2007, p. 235 ff.

²³ See Schratzenstaller, M. (2007), p. 21.

²⁴ See Becker, J./Fuest, C. (2007), p. 47.

²⁵ Driven by restrictions of public households, the gift and inheritance tax reform must not have an influence on the tax return of approximately €4 billion.

²⁶ See Schupp, J./Szydlik, M. (2004), p. 3; Lehmann, D./Treptow, O. (2006b), p. 323.

²⁷ See Lehmann, D./Treptow, O. (2006a), p. 413.

²⁸ See Herz, W. (2006), p. 22.

²⁹ See e.g. Scheffler, W./Spengel, C. (2004b); Spengel, C./Broer, E. (2008), p. 86 ff.

³⁰ See Rose, G. (1982), p. 224.

be determined first.³¹ In a second step it will be possible to design goal-oriented and long-lasting gift and inheritance tax reform.

There is little knowledge about evaluation of primary empirical data in the field of tax research, especially in Germany. Thus, the research project underlying this paper had two different aims to fulfil:

- The first **aim with regards to the content** of the research is empirical research on decision effects of inheritance tax that will provide causality information between tax principles on one side and intra-family business succession on the other. Based on this, an evaluation of tax reform alternatives is possible. In a further step, political advice for tax legislation are deduced in an “if then”-format for tax legislation.
- The second **aim with regard to method** is an improvement of empirical tax research in Germany, which has been underrepresented in the past. Using different instruments developed by empirical social researchers will give broad information about pros and cons of these methods in tax research.

In this paper, chapter 2 describes the theoretical framework for the research project. The role of the British tax system as a blueprint for the German inheritance tax reform (chapter 3) and the design of the study (chapter 4) are then explained. Chapter 5 contains the results of a first survey and is split up into evidence of the general influence of inheritance tax on business succession decisions on one hand and in analysis of special regulations in the British Inheritance Act on the other. A summary and an appraisal (chapter 6) lead to the additional questions that are worthy of further research (chapter 7).

2. METHODOLOGY

2.1 Foreign tax systems as blueprint for national tax reforms

The basic idea of German inheritance tax reform is a model of incentivising the transfer of business assets that was in its main structures copied from the British tax system:³² Well-defined circumstances lead to business assets being freed from gift and inheritance tax burden partly or all in all. As stated by the highest German court of justice, the Federal Constitutional Court (Bundesverfassungsgericht), in 1995,³³ the German inheritance tax system has to provide special regulations for the transfer of business assets in a manner that ensures that the going-concern of the transferred firm is not endangered by the tax burden.³⁴ As the British tax system has provided such regulations for several decades now, it seems self-evident to introduce parts of them in Germany as well.

³¹ Statistics about gift and inheritance tax were abolished in Germany in the early 1980s. For the fiscal year 2002, the Federal Statistical Office (Statistisches Bundesamt) has made a new survey. Beginning with the fiscal year 2007, gift and inheritance statistics shall be done regularly. See § 2 Abs. 7 Nr. 2 StStatG.

³² See Birk, D./Pöllath, R. (2006), p. 209; Maiterth, R./Niemann, R./Blaufus, K. et al. (2006), p. 2702; Wachter, T. (2007), p. 582; Richter, A. (2008), p. 62.

³³ See BStBl II 1995, p. 671 ff.

³⁴ See Albrecht, P. (1997), p. 482.

Using the British inheritance tax system as a blueprint has been suggested several times in the past by the European Commission³⁵ as well as in literature³⁶ and was topic of general discussions.³⁷ The Commission even directly recommended the British model for tax system reorganisations in the EU member states,³⁸ and as recently as European Autumn 2007 the International Fiscal Association (IFA) discussed the advantages for Germany in learning from Great Britain in the field of taxation of business successions.³⁹ For this reason, the research project described on the following pages was based on British inheritance tax law.

2.2 Theoretical framework

The research project is based on a hypothetic-deductive understanding of science,⁴⁰ leading to a general research structure of (1) definition of hypotheses, (2) evaluation of variables and (3) test of the hypotheses based on empirical primary data. In this context, the term “hypothesis” is understood as an assumption of causalities with the aim to identify interrelations (instead of the measurement of stand-alone variables).

In social sciences, an empirical theory is seen as a system of hypotheses that (a) are using well-defined terms and (b) are free of discrepancies.⁴¹ The discussion of possible inheritance tax reforms has lead to several assumptions of interrelations, none of them yet being tested by scientific research yet.⁴² For this reason, they are used for deduction of general research hypotheses as well as for theoretical discussion of probable decision effects of inheritance tax systems. Personal experience in tax advisory for business successions is added.⁴³

2.3 Methodological framework

Following the above-mentioned understanding of sciences, emphasis has to be set on the scientific test of hypotheses.⁴⁴ The analysis methods and instruments are taken from the area of empirical behavioural research in socio-economics:

Empirical reality exists in natural situations or can be designed artificially. Accordingly, empirical research offers different methods for controlled and systematic data evaluation. Basis techniques for primary data evaluation are interrogation, observation, analysis of contents as well as so-called non-reactive evaluation methods,⁴⁵ the latter two not being appropriate for this research context. Observation in the sense of participation of the scientist obviously has to be excluded in the area of inheritance tax. What remains is the interrogation as first-best method. The research design has to follow this conclusion.

³⁵ See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994a), p. 1.

³⁶ See Ritter, W. (1994), p. 2290; Ziegler, J. (1996), p. 456.

³⁷ See Kühn, A. (1996), p. 11; Albrecht, P. (1997), p. 482.

³⁸ See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994b), p. 12.

³⁹ See Richter, A. (2008), p. 59 ff.

⁴⁰ See Kromrey, H. (2006), p. 85 f.

⁴¹ See Kromrey, H. (2006), p. 52.

⁴² E.g. see Bundesverband der Selbständigen/Deutscher Gewerbeverband (ed.) (2004), p. 3; Arbeitsgemeinschaft Selbständiger Unternehmer (ed.) (2002), p. 1.

⁴³ Hypotheses are stated in table 2 of chapter 5.

⁴⁴ See Kromrey, H. (2006), p. 91.

⁴⁵ See Atteslander, P. (2006), p. 49; Diekmann, A. (2006), p. 371 ff.; Kromrey, H. (2006), p. 317 ff.

In empiric socio-economic research, interrogation is seen as the most used and most developed method for data evaluation.⁴⁶ Behavioural research in the field of decision effects of taxation can be done solely in this manner, as motives for the taxpayers' decisions have to be evaluated verbally.⁴⁷ Despite methodological and practical limitations, interrogations are seen as the single proper method for field research with the aim of determining tax mentalities.⁴⁸

Empirical research is in most cases based on only one or few evaluation instruments and thus can lead to instrument-specific distortions.⁴⁹ By the parallel use of several methods, such problems can be avoided or at least be under better control. Additionally, research based on more than one method uses more than one strategy of operationalisation and thus leads to more reliable results. For this reason, empirical research might use written questionnaires as well as oral interviews for data evaluation.

Standardised written or oral interrogations allow a generalised measurement, mostly with the questioned person being the party whose reactions are to be measured. But, in an expert-interrogation, the questioned person has only informational status, informing the interrogator about the person concerned, its characteristics and economic decisions.⁵⁰ So expert-interrogation is an indirect method of evaluation and is as far accepted for empiric, socio-economic research.⁵¹ For this research project, it seems to be appropriate because of the following reasons:

(1) High complexity of research topic. Practical experience shows that business decision-makers usually rely on experts for analysis of tax aspects, caused by the high complexity of this legal area.⁵² Due to this, experts have a deeper insight into tax effects in detail.

(2) Objectivity of tax advisors. As entrepreneurs are personally affected by tax systems, their judgements will often be influenced by individual settings. To exclude subjectivism, experts can be used as a more neutral source of information.⁵³

(3) Status of a multiple. Tax experts usually concentrate on specific areas of advisory and thus have accumulated practical knowledge. As an entrepreneur can give information only about his own decisions, well-experienced experts can answer the research questionnaire based on multi-annual experience in a broad range of situations. Thus, they can be used as multiples in the process of data evaluation.⁵⁴

In the following chapters, experts will be defined as tax advisors that complete advisory work for business successions under the British inheritance tax system.

⁴⁶ See Diekmann, A. (2006), p. 371; Kromrey, H. (2006), p. 358.

⁴⁷ See Hüsing, S. (2007), p. 3.

⁴⁸ See Hosing, S. (2007), p. 24 f.; as an example for empiric research about "felt" tax burden using written questionnaires see Dietrich, M./Kiesewetter, D./Moosmann (2006).

⁴⁹ See Kromrey, H. (2006), p. 535.

⁵⁰ See Kromrey, H. (2006), p. 257 ff., p. 391 f.

⁵¹ E.g. see Felden, B. (2007), p. 475 ff.

⁵² An empirical survey shows for example that about 78% of the polled Swiss entrepreneurs included their tax advisors and chartered accountants in the process of succession; see PricewaterhouseCoopers (ed.) (2005), p. 28 f.

⁵³ See Kromrey, H. (2006), p. 107.

⁵⁴ An example can be seen at Felden, B. (2007), p. 475 ff.

The results of a first survey described in chapter 5 are based on information of 20 participants. The tax professionals that have been interviewed are divided into three categories of experience (CE). The categorisation has been done particularly with regard to the number of business successions that have been advised (see table 1). The criterion "cases per professional" corresponded largely with the temporal and professional work experience of the participants that has also been requested in the survey.

As illustrated in table 1 the evaluation that is given by all of the participants is based on at least 666 business successions.

TABLE 1: DATABASE OF THE SURVEY

CE	Cases per professional	Number of professionals	Database
1	< 10	3	3
2	10 - 30	4	40
3	> 30	13*	403 (623*)
* this includes 11 professionals with > 50 cases			446 (666*)

3. SURVEY OF THE BRITISH INHERITANCE TAX SYSTEM

For a survey on the British Inheritance Tax Act (IHTA) concerning transfers of business as assets, the focus has been set on the special regulations of Potentially Exempt Transfers (PET) and Business Property Relief (BPR). Seen from an economic perspective, these regulations seem comparable to major parts of the German inheritance tax reform suggestions. The other parts of the IHTA are not described in this text, but can be read in the law itself⁵⁵ or in the literature mentioned later.

British inheritance tax is levied based on the Inheritance Tax Act (1984) and its annual amendments, the so-called Finance Acts.⁵⁶ It is a type of duty on death or gift⁵⁷ and so far different from the German system of tax on succession. In the UK, tax is levied on the value of heritage, not on the increase in wealth at the level of the beneficiary as in Germany. IHT is levied in both cases of inheritance by death and of gift beyond living parties. Gifts beyond living parties are tax exempt if the donor lives for at least seven years after the donation, (making the transfers so-called Potentially Exempt Transfers (PET)). If the donor dies during this seven year period, inheritance tax is levied on a pro-rata-temporis basis.⁵⁸ IHT is therefore an inheritance as well as a gift tax, with the gift tax being potentially avoidable through time, partly or in the whole amount.

Next to the PET regulation the IHTA offers a broad variety of tax reductions and tax reliefs for the transfer of certain business assets by death or beyond living, called Business Property Relief (BPR).⁵⁹ These incentives can be seen as a material element of the British inheritance tax system,⁶⁰ as the transfer of a well defined group of business assets (the so-called Relevant Business Property) is taxed after a value

⁵⁵ See <http://www.hmrc.gov.uk/ihta/index.htm>.

⁵⁶ See Alberts, W. in Mennel, A./Förster, J., *Steuern Großbritannien*, Rn. 256.

⁵⁷ See Kau, M. in Wilms, H./Jochum, G., *Erbschaftsteuergesetz*, Anhang 2 Rn. 151.

⁵⁸ See IHTA 1984 s 3 A, 7 (4).

⁵⁹ See IHTA 1984 s 104.

⁶⁰ See Richter, A. (2008), p. 59.

reduction of 50% or even 100%. Thus, inheritance tax can be avoided partially or totally.

In order to make use of such incentives, the following conditions must be fulfilled:

- a) The fundamental condition for accessing the incentives is the existence of an active trading operation (IHTA 1984 s 105(3)). The aim of the regulation is the exclusion of investment companies from gaining access to the incentives, so the condition can be seen as an activity or productivity clause. In the case of mixed use for trade and production (being active) as well as for investments (being passive) the incentives are restricted to assets used wholly or mainly for active operations. In order to determine which part of a company can be transferred with a reduced or nil tax burden, the balance sheets have to be analysed to separate active from passive property.
- b) Incentives are possible only for business assets that are not used for activities defined as excluded business.⁶¹ Exclusion is mainly for activities such as trading shares, trading real estate or holding participations. An exception exists for holding companies with subsidiaries not conducting excluded business.⁶²
- c) Business assets subject to a binding sales contract cannot access the incentives, even if they fulfil all other conditions.⁶³
- d) In addition to assets that are used in excluded business activities, single assets (known as excepted assets) can also be excluded from tax incentives. Excepted assets are characterised by not being used mainly for business purposes in the past two years and not being planned for business use in the following two years.⁶⁴ Excluded assets can not be included in the amount designed for BPR incentives.⁶⁵
- e) In order to gain access to the incentives, business assets must have been kept in the transferor's property for at least two years prior to the transfer.⁶⁶

The incentives can be used only for the above-mentioned relevant business property and result in either a 100% or a 50% reduction of the taxable amount.⁶⁷ The 100% reduction, i.e. the full tax exemption, is possible for the transfer of the following assets:

- a) Business and interest in a business including sole proprietorships and partnerships.⁶⁸
- b) Above 50% of securities in a non-quoted corporation as well as non-quoted shares in corporations without a minimum participation requirement.⁶⁹

The 50% reduction, i.e. 50% tax exemption, is allowed on the transfer of:

⁶¹ See IHTA 1984 s 105 (3).

⁶² See IHTA 1984 s 105 (4)(b).

⁶³ See IHTA 1984 s 113.

⁶⁴ See IHTA 1984 s 112 (2).

⁶⁵ See IHTA 1984 s 112 (1).

⁶⁶ See IHTA 1984 s 106.

⁶⁷ See IHTA 1984 s 104 (1)(a) and (b).

⁶⁸ See IHTA 1984 s 105 (1)(a).

⁶⁹ See IHTA 1984 s 105 (1)(b), (bb).

- a) More than 50% of the securities of a quoted corporation;⁷⁰ and
- b) Real estate as well as plant and machinery if used mainly or exclusively by a qualified shareholder or by the partner of a partnership.⁷¹

Basically, the British tax incentives on PETs and the Business Property Relief for relevant business property are the regulations discussed broadly for the reform of inheritance tax in Germany. This can be seen as the starting point for the research project discussed on the following pages.

4. RESEARCH STRUCTURE

The results presented in the next chapter are taken from a larger research project. The following figure gives an overview on the structure of this project and its basic steps.⁷² After having defined the research question and analysed the research objective, hypotheses were derived from literature and personal practice in tax advisory as to how and to what extent taxation of gifts and inheritances can influence the decisions that are to be made regarding business successions.

Next, the research methodology was chosen, data evaluation instruments were designed, and after selection of probands, a pre-test was carried out. The main part of this manuscript is used to describe the evaluation of first available data and to deduce first evidence about the validity of the formerly derived hypotheses or interrelations. All other steps of research are described in so far as is needed for further understanding.

The first questionnaire and interview guideline was constructed based on state of the art-literature about socio-empiric research.⁷³ Questions of conception and quality assurance were discussed with the centre for interrogation, methods and analysis (Zentrum für Umfragen, Methoden und Analysen – ZUMA) in Mannheim, Germany, and further experts of the pedagogic institute at the University of Mainz. After the first version of the questionnaire was written in German, it was translated into English using the HM Revenue & Customs Inheritance Tax Glossary of Terms.⁷⁴ A second quality test was done by an English native speaker. The last test was made by two British tax experts, filling in the questionnaire independently. As no amendments or questions were sent back, the questionnaire's quality was determined to be sufficient. Based on this positive return, an interview guideline was extracted from the written questionnaire. The results available in this paper are based on data that have been collected by use of the guideline for personal interviews with British tax experts in November, 2007. These experts were chosen from nation-wide operating law or business advisory companies, performing tax advisory at a partner level in the private clients-area.⁷⁵

⁷⁰ See IHTA 1984 s 105 (1)(cc).

⁷¹ See IHTA 1984 s 105 (1)(d).

⁷² The figure was constructed referring to Kromrey, H. (2006), p. 76 ff.

⁷³ See especially Atteslander, P. (2006); Bortz, J./Döring, N. (2003); Diekmann, A. (2006); Jacob, R./Eirmbter, W. H. (2000); Kromrey, H. (2006); Mayer, H. O. (2006).

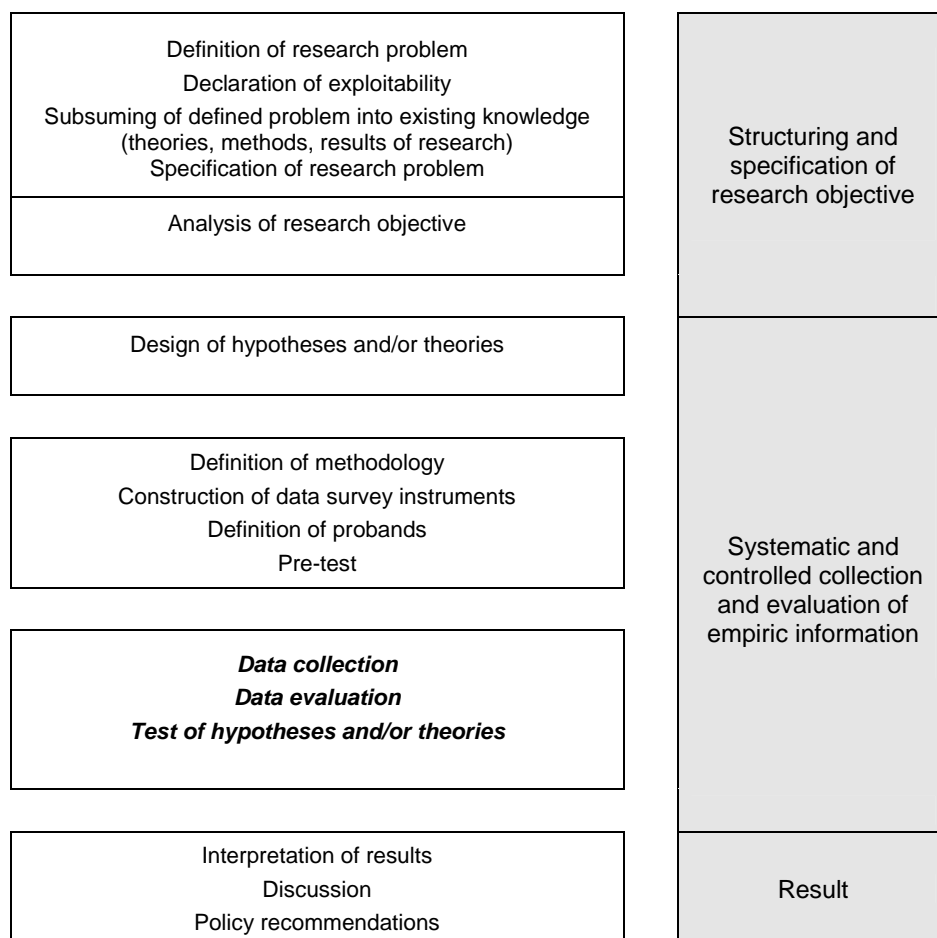
⁷⁴ See HM Revenue & Customs (2007).

⁷⁵ In UK, tax planning for business succession is done mainly in cooperation of tax advisors, tax accountants, business consultants and solicitors.

Additionally, the written questionnaire was sent out with support of the Society's of Trust and Estate Practitioners (STEP) Worldwide Office in London. The second survey covers about 200 members of the Family Business Special Interest Group at STEP and as far as possible gives a guarantee as to the practitioners' expertise in gift and inheritance tax advisory. The questionnaire was sent in Summer 2008 via email by STEP's Chief Executive, and return is still ongoing. Several reminders have been sent.

The willingness of tax professionals to participate in the survey was very low. A possible reason for this may be because tax advisors and solicitors currently have large workloads due to the announcement by the legislator of further essential changes of the British tax law. This would, in many cases, require a form of financial compensation to be given to advisers as an incentive for them to participate in a survey. Therefore the database actually consists of the personal interviews. This database will need to be enlarged by doing further research (see chapter 7), if the results of this first survey are helpful for the research question.

FIGURE 1: RESEARCH PROCESS



5. RESULTS OF THE SURVEY

5.1 Preliminary remarks

In the following we describe the results of the survey among British tax professionals concerning the general effects of the inheritance tax on business succession as well as effects of specific regulations of the British Inheritance Tax Act.

The figures show the results over all of the three categories of experience and additionally the evaluation of the participants with the most experience (CE 3). One participant represents 5% (over all CE) respectively 7,7% (CE 3). The percentage values in brackets that are mentioned under the figures show the evaluation that has been given by participants with most of experience (CE 3).

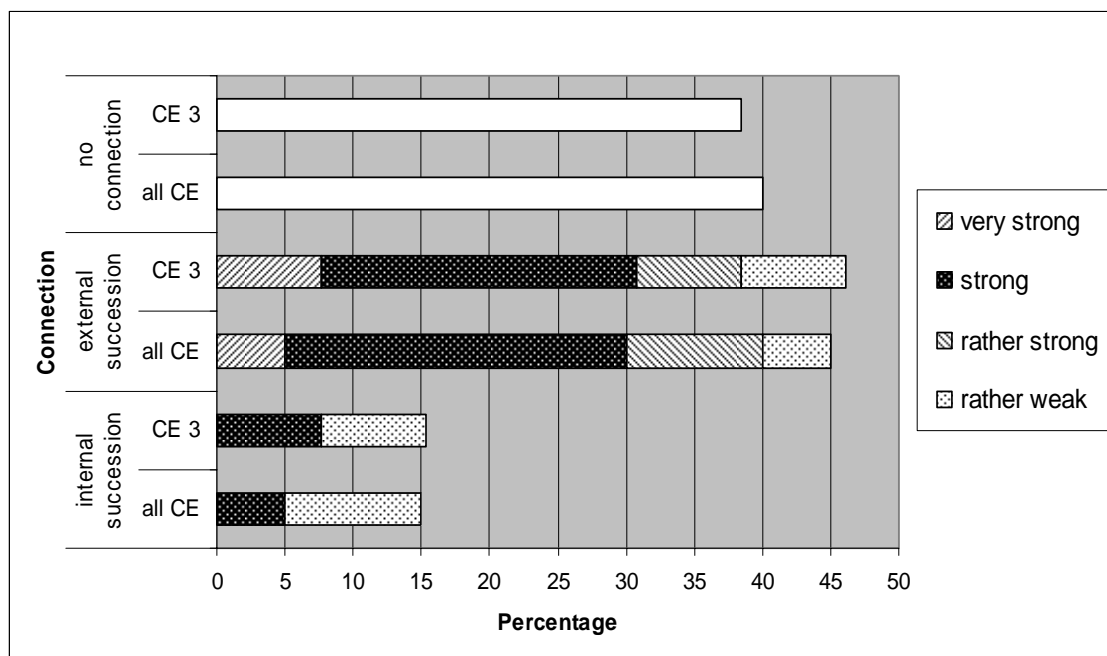
The categories of answers consist of "very strong", "strong", "rather strong", "rather weak", "weak" and "very weak". If one of these categories does not exist in the evaluations, it is not shown in the respective figure.

5.2 General effects of the inheritance tax on business succession

5.2.1 Liquidity burden and way of succession

Figure 2 shows if there is a connection between the liquidity burden due to taxation and whether the business succession occurs within the family (internal succession) or by external succession, typically by selling the enterprise. If there is a connection from experience, the figure illustrates also the strength of this connection.

FIGURE 2: LIQUIDITY BURDEN AND WAY OF SUCCESSION



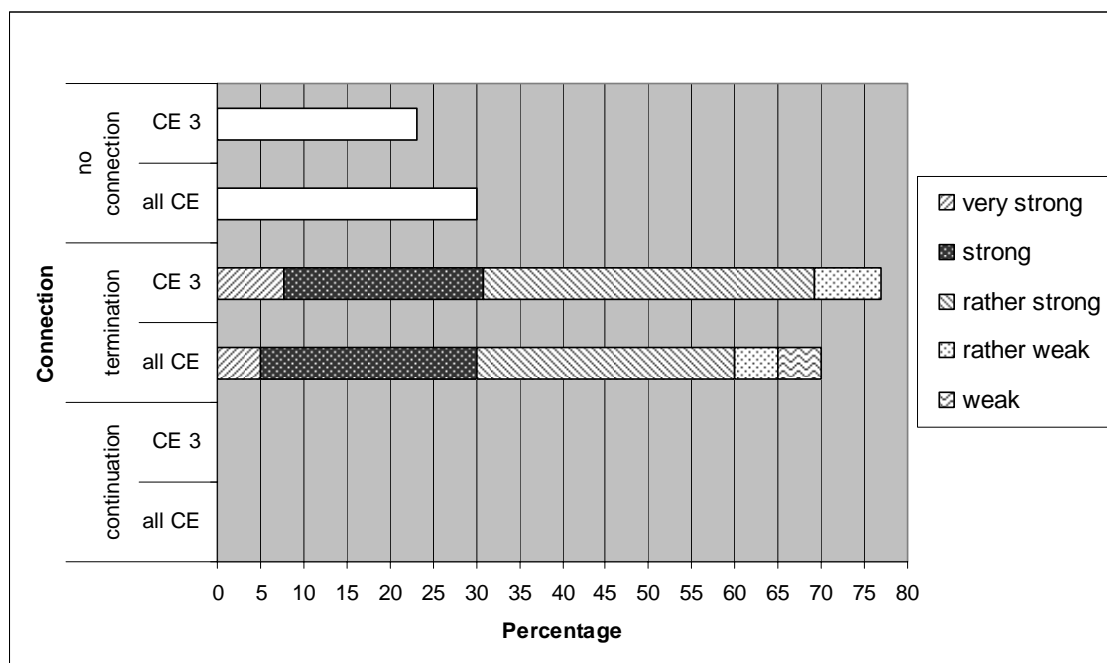
A connection between the liquidity burden due to inheritance tax and the way of succession is confirmed by 60% (61,6%) of the interviewed tax professionals. 45% (46,2%) of them evaluate the connection as "very strong", "strong" and "rather strong", and can be summarised as an overall strong connection.

15% (15,4%) of the professionals are of the opinion that business successions occur within the family despite the higher liquidity burden. The reason for this is the expectation of the successors that the liquidity burden can be compensated after the enterprise has been successfully continued within the family for some years. However 45% (46,2%) believe that the higher the liquidity burden, the more probable an external succession becomes. 40% (38,4%) state that there is no connection between the liquidity burden due to inheritance tax and the way of succession.

5.2.2 Liquidity burden and continuation of the enterprise

Figure 3 shows if the participants believe there is a connection between the liquidity burden due to taxation and greater probability of either the continuation of an enterprise by the successor or the termination of the enterprise at a later date. The strength of this possible connection is also shown.

FIGURE 3: LIQUIDITY BURDEN AND CONTINUATION OF THE ENTERPRISE



70% (76,9%) of the professionals believe that the liquidity burden due to inheritance tax influences the future of an enterprise. The strength of this connection is evaluated by 60% (69,2%) as "very strong", "strong" and "rather strong" and can therefore be summarised as an overall strong connection.

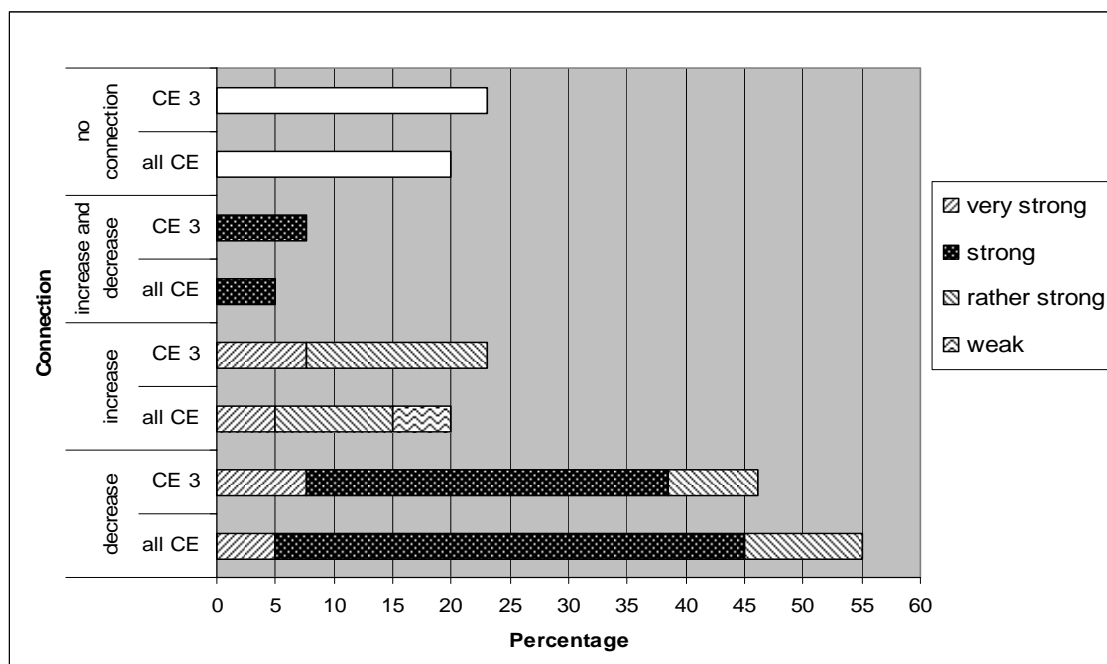
All participants who confirm a connection believe that the higher the liquidity burden, the more probable the termination of the enterprise at a later date will be. 30% (23,1%) are certain that there is no connection between the liquidity burden and the continuation or the termination of an enterprise.

5.2.3 Tax burden and volume of the transferred assets

One can assume that taxation reduces the motivation for asset accumulation in front of the business succession. The following figure 4 shows if the participants confirm a

connection between the level of the tax burden and the volume of the transferred assets and how strong this possible connection is.

FIGURE 4: TAX BURDEN AND VOLUME OF THE TRANSFERRED ASSETS



A connection between the level of the tax burden and the volume of the transferred assets is confirmed by 80% (76,9%) of the participants. 75% (76,9%) declare an overall strong connection by evaluating it as a "very strong", "strong" or "rather strong" connection.

While 55% (46,1%) explain that the volume of the transferred assets decreases when the level of the tax burden increases, 20% (23,1%) describe an increase of the transferred assets when the tax burden increases. The main argument for the decrease of the assets is that transferring business assets to the private property in front of the business succession will minimise the arising inheritance tax. 5% (7,7%) confirm that there is an increase as well as a decrease of the transferred assets if the tax burden is increasing. According to 20% (23,1%) of the participants there is no connection.

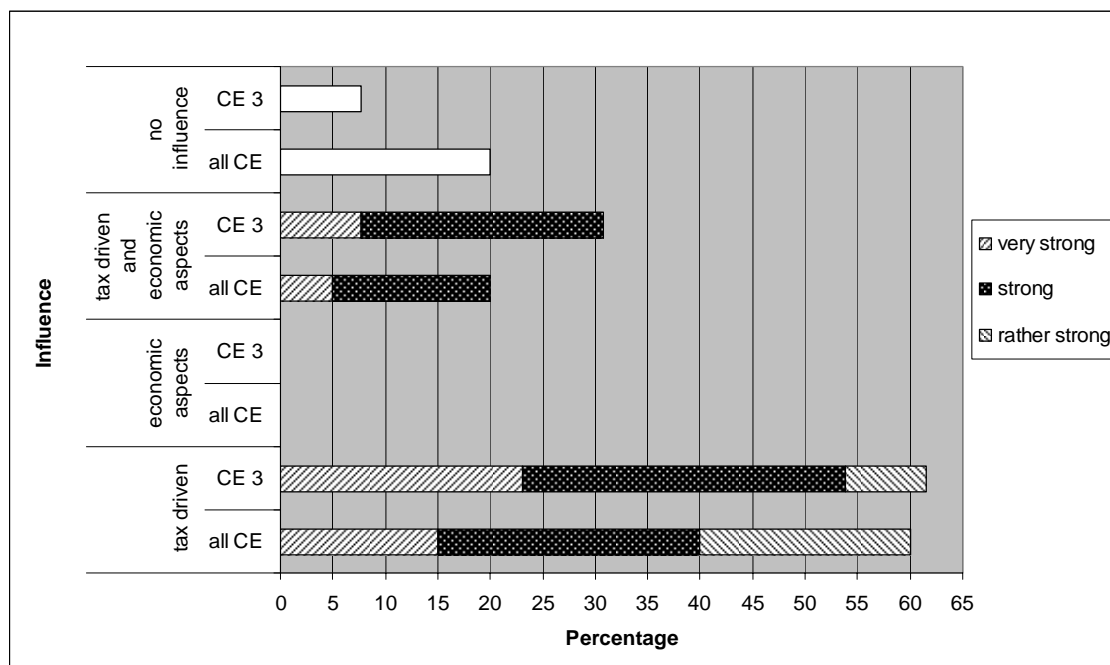
5.2.4 Tax burden and composition of the transferred assets

Figure 5 illustrates if the level of the tax burden influences the composition of the transferred assets. The question is whether the composition of assets has mainly the aim of optimising the economic position of an enterprise or of realising the lowest possible tax burden. Additionally the figure shows the strength of this possible influence.

80% (92,3%) of the participants have confirmed that there is an influence of the level of the tax burden to the composition of the transferred assets. They evaluate this influence as "very strong", "strong" and "rather strong", so there is an overall strong influence.

60% (61,5%) declare that the composition of the assets has the aim of realising the lowest possible tax burden. 20% (30,8%) confirm that the composition is tax driven but follows also economic aspects. No one of the interviewed tax professionals confirms solely economic aspects as relevant for the composition of the transferred assets. According to 20% (7,7%) of the participants there is no influence.

FIGURE 5: TAX BURDEN AND COMPOSITION OF THE TRANSFERRED ASSETS



5.2.5 Tax burden and willingness to move abroad

Fulfilling the requirements for avoidance of the British tax liability is difficult. However, the possibility of relocating abroad for tax reasons does exist. Figure 6 demonstrates if and how strong the level of the tax burden due to inheritance tax influences the willingness of taxpayers to move abroad to a country with lower taxes. In figure 7 it is shown how often the possibility of moving abroad is really carried out.

The majority of the participants, 80% (84,6%), verify a connection between the level of the tax burden and the willingness to move abroad. 45% (53,8%) evaluate this connection as "very strong", "strong" or "rather strong" and can be summarised as an overall strong connection. 20% (15,4%) negate a connection.

The survey shows that moving abroad is indeed often discussed among taxpayers, but occurs rarely. 80% (76,9%) of the interviewed tax professionals declare that moving abroad to a country with lower taxes is carried out seldom, very seldom or never. But 20% (23,1%) are of the opinion moving abroad for tax reasons occurs very often or sometimes.

FIGURE 6: TAX BURDEN AND WILLINGNESS TO MOVE ABROAD

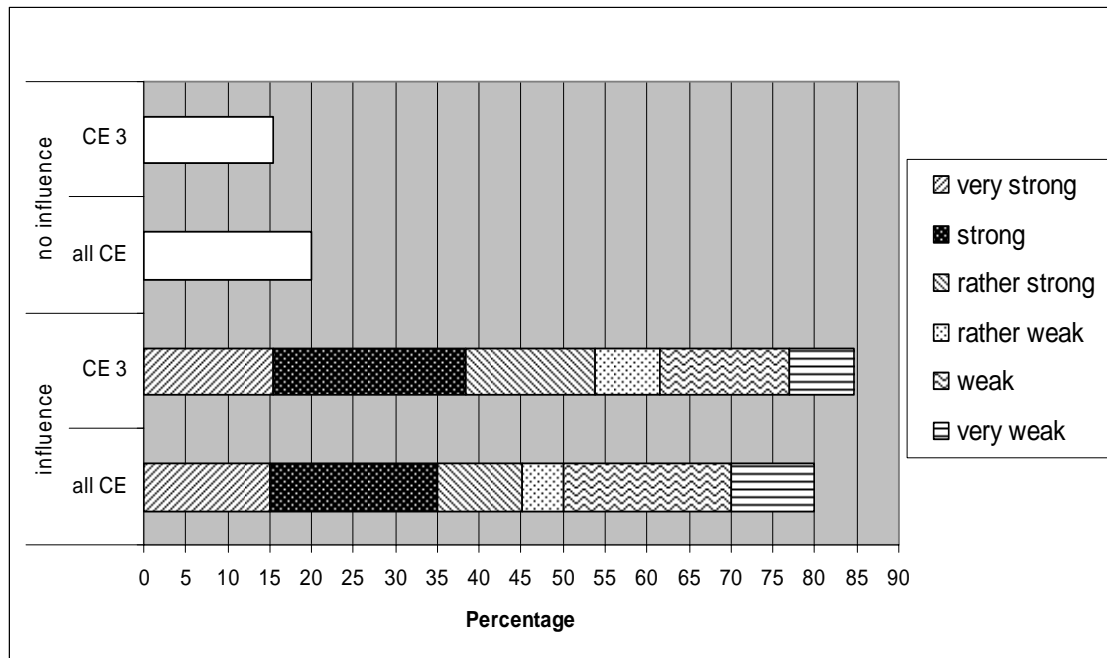
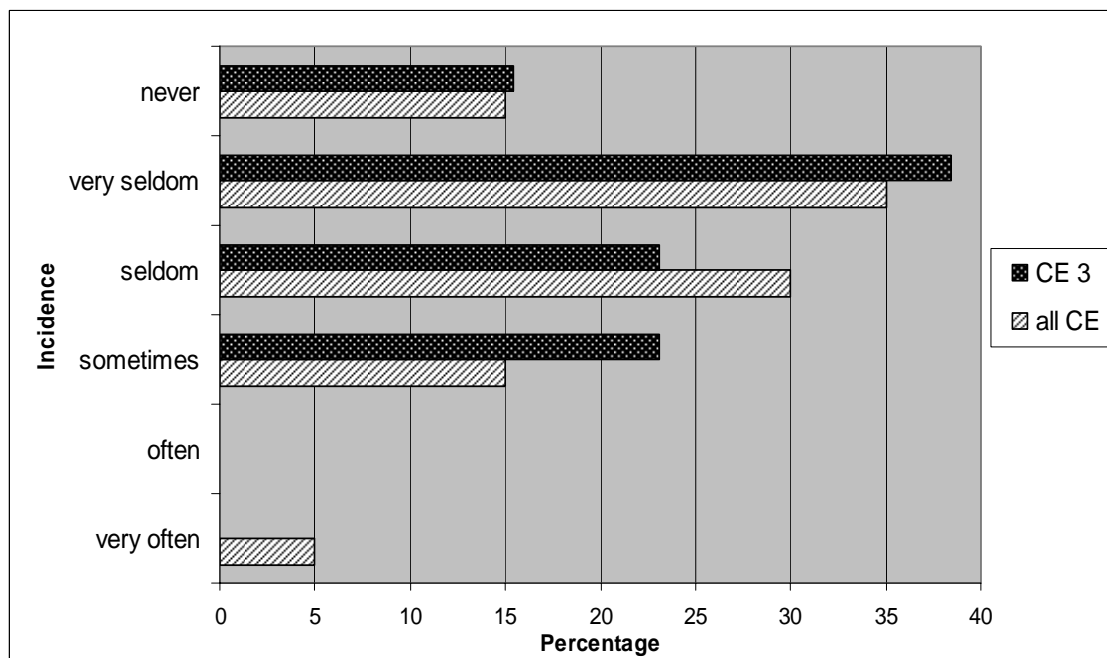


FIGURE 7: INCIDENCE OF MOVING ABROAD



5.2.6 Preferential treatment of business property to ensure business succession within the family

Figure 8 shows the personal opinion of the participants concerning the question if the preferential tax treatment on the transfer of business property is necessary to ensure the business succession within the family.

The preferential tax treatment on the transfer of business property to ensure the business succession within the family is confirmed by 90% (100%) of the interviewed tax professionals as a necessary measure. They evaluate the preferential tax treatment as "absolutely necessary", "necessary" or "rather necessary", and can be summarised as necessary overall. Only 10%, (solely participants who are categorised in CE 1 and 2), negate this necessity.

FIGURE 8: NECESSITY OF THE PREFERENTIAL TAX TREATMENT OF BUSINESS PROPERTY

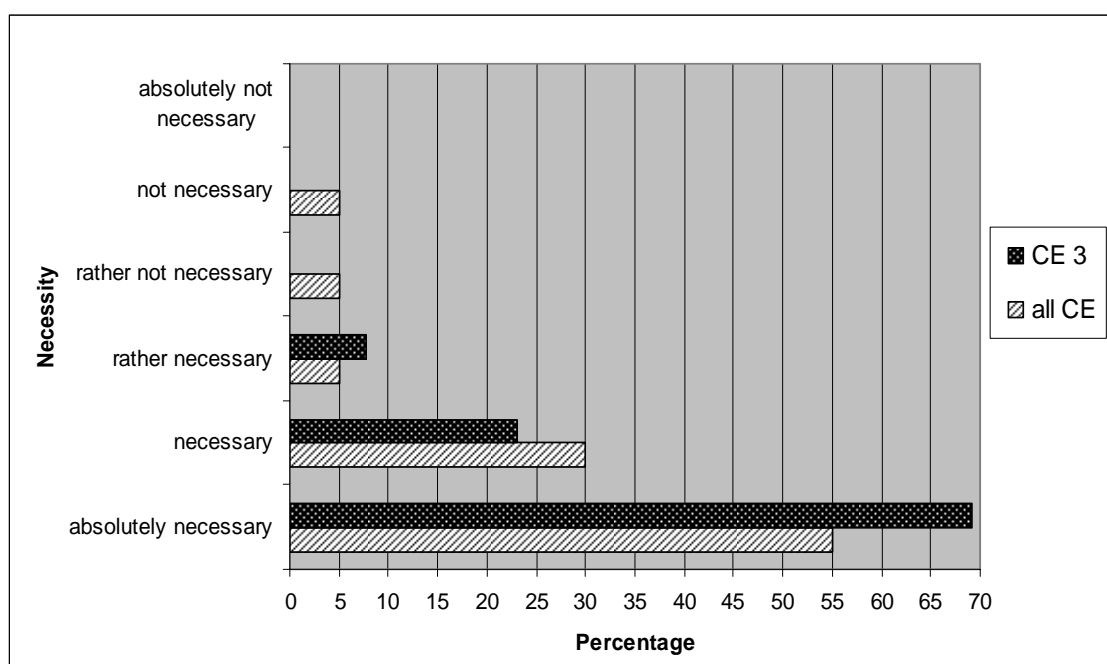
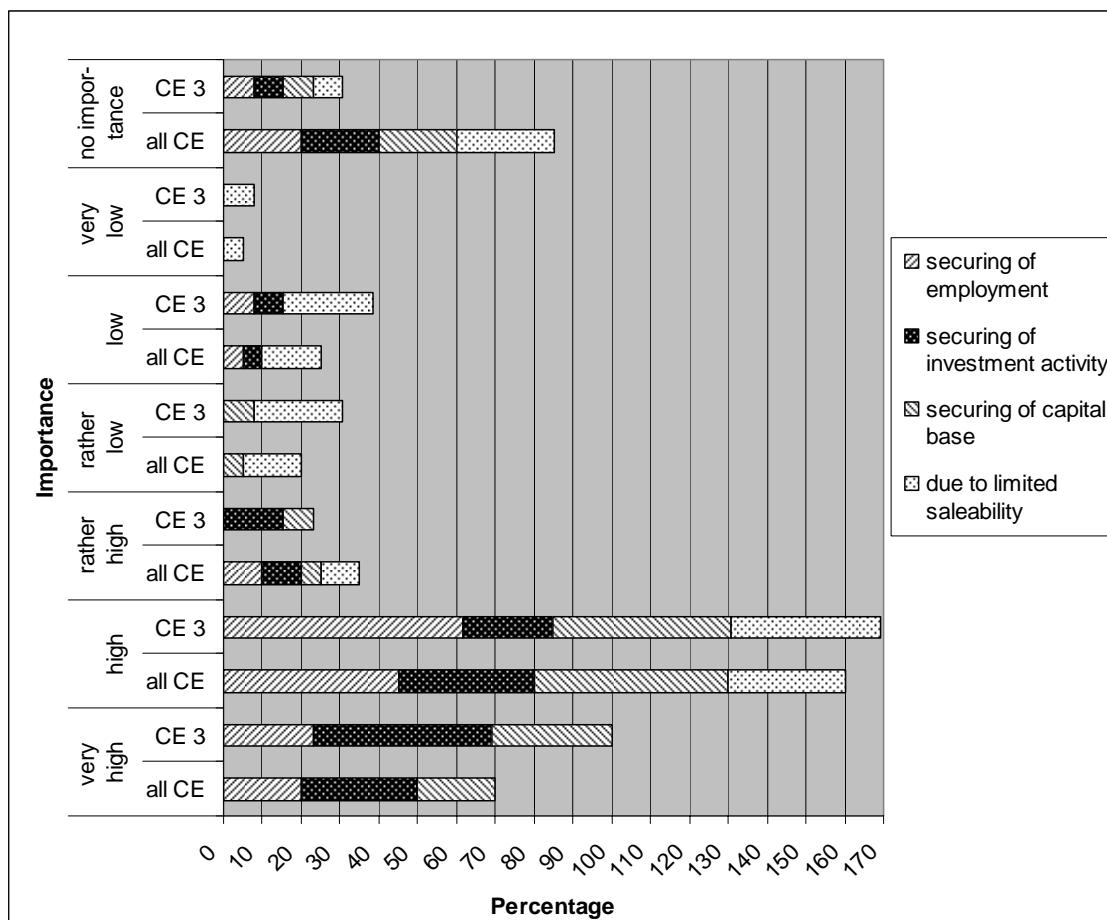


Figure 9 shows the reasons the participants mention as justification of a preferential tax treatment on the transfer of business property to ensure the business succession within the family. The level of importance of each reason is also shown in the figure.

Securing of employment, investment activity and capital base of a transferred enterprise as reasons for a preferential tax treatment are confirmed by 80% (92,3%) of the respondents. 75% (84,6%) evaluate each of these reasons as "very high", "high" and "rather high", showing they have an overall high importance.

The possible limited saleability of business property is seen as another reason for preferential tax treatment by 75% (92,3%) of the interviewed tax professionals. An overall high importance is confirmed by 40% (38,5%). 35% (53,8%) evaluate this reason as being of "rather low", "low" and "very low" importance. Based only on the evaluation of participants who are categorised in CE 3, this reason has an overall low importance.

FIGURE 9: REASONS AND IMPORTANCE OF A PREFERENTIAL TAX TREATMENT

5.3 Effects of specific regulations of the British Inheritance Tax Act

5.3.1 Potentially Exempt Transfers (PET)

Lifetime transfers are exempt from inheritance tax, if the donor survives at least seven years after the transfer, otherwise the transfer is taxed and the tax burden depends on the time lag between transfer and death. Figure 10 shows if there is a connection between this regulation of potentially exempt transfers and the timing when an enterprise is transferred to the successor.

All of the interviewed tax professionals confirm that there is a connection between PET and the timing of a transfer to the successor. The evaluations "very strong", "strong" and "rather strong" were given by 85% (84,6%) of the respondents, thus affirming an overall strong connection.

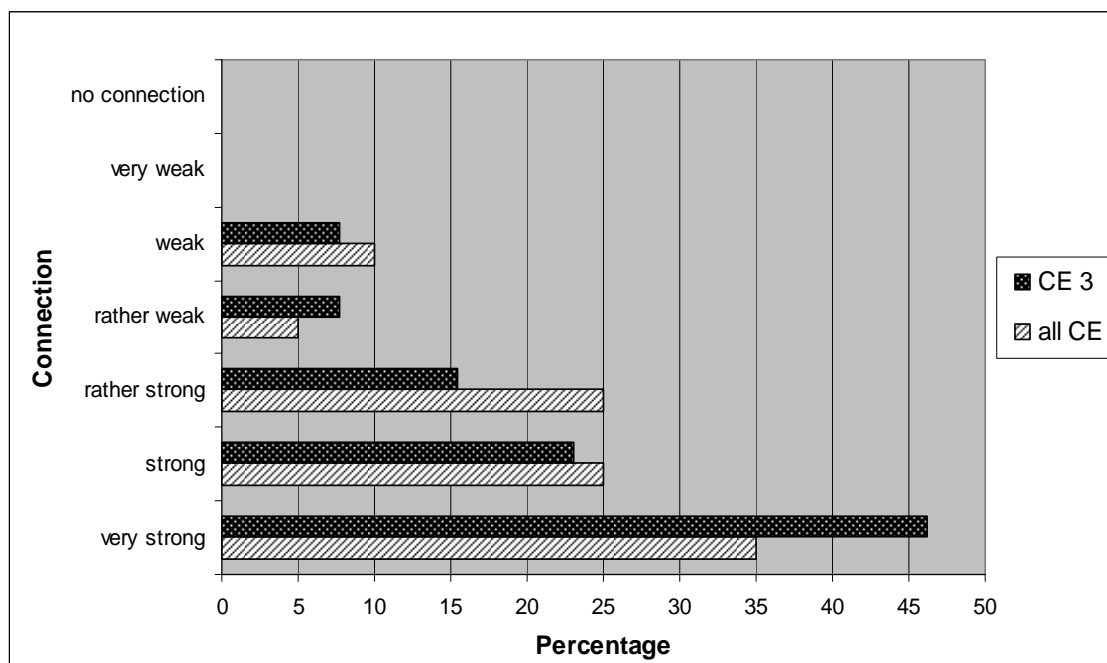
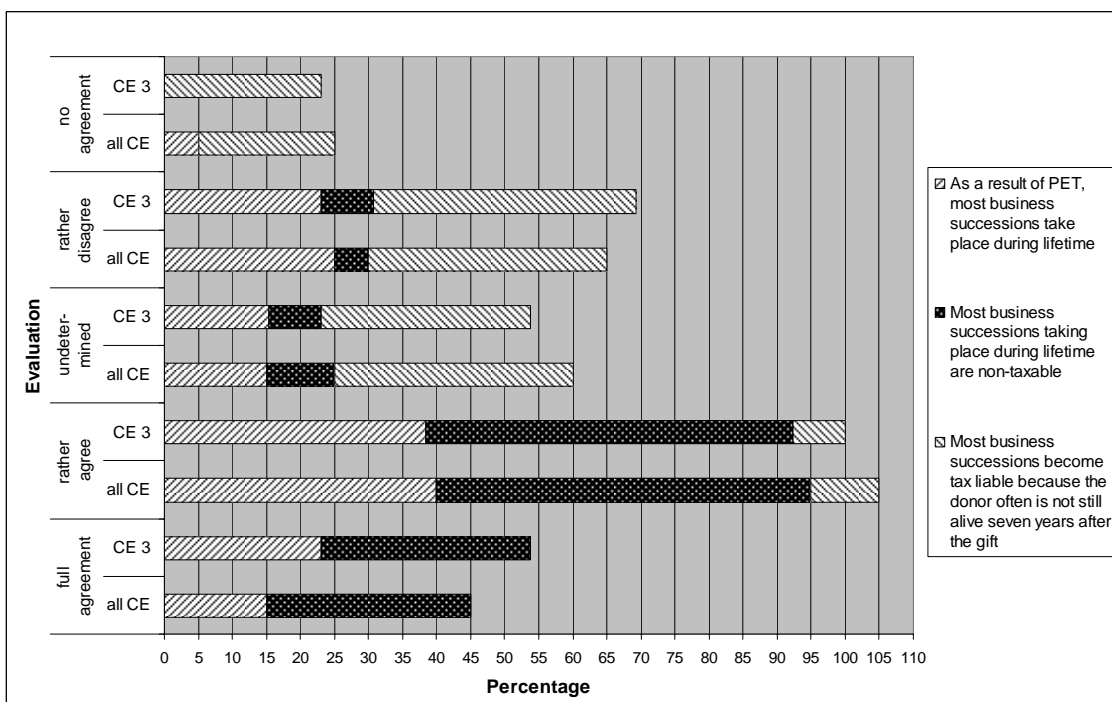
FIGURE 10: CONNECTION BETWEEN PET AND THE TIMING OF A TRANSFER

Figure 11 shows the evaluation of predetermined connections between PET and business succession. The level of agreement is used as standard of evaluation.

FIGURE 11: CONNECTIONS BETWEEN PET AND BUSINESS SUCCESSION

55% (61,5%) of the respondents fully or rather agree with the statement, that most business successions take place during lifetime as a result of PET. 15% (15,4%) explain that they are undetermined while 30% (23,1%) rather disagree or do not agree.

85% (84,6%) fully or rather agree with the statement, that most business successions taking place during lifetime are non-taxable because business property is transferred more than seven years before the death of the donor. 10% (7,7%) are undetermined and 5% (7,7%) rather disagree or do not agree.

The statement, that most business successions become tax liable because the donor often is not still alive seven years after the transfer, is rather agreed by 10% (7,7%). 55% (61,5%) however rather disagree while 35% (30,8%) are undetermined.

5.3.2 Business Property Relief (BPR)

The Business Property Relief differentiates between a full- or a half-tax exemption for specified property. The tax exemption is achieved through the reduction of the transferred value. Figure 12 shows if there is a connection between this regulation and business succession. Connection here means the importance of this regulation for business succession within the family.

All of the interviewed tax professionals confirm that a connection between a full- or a half-tax exemption and business succession does exist. 80% (76,9%) evaluate this connection as "very strong", "strong" or "rather strong", hence it can be summarised as an overall strong connection.

FIGURE 12: CONNECTION BETWEEN BPR AND BUSINESS SUCCESSION

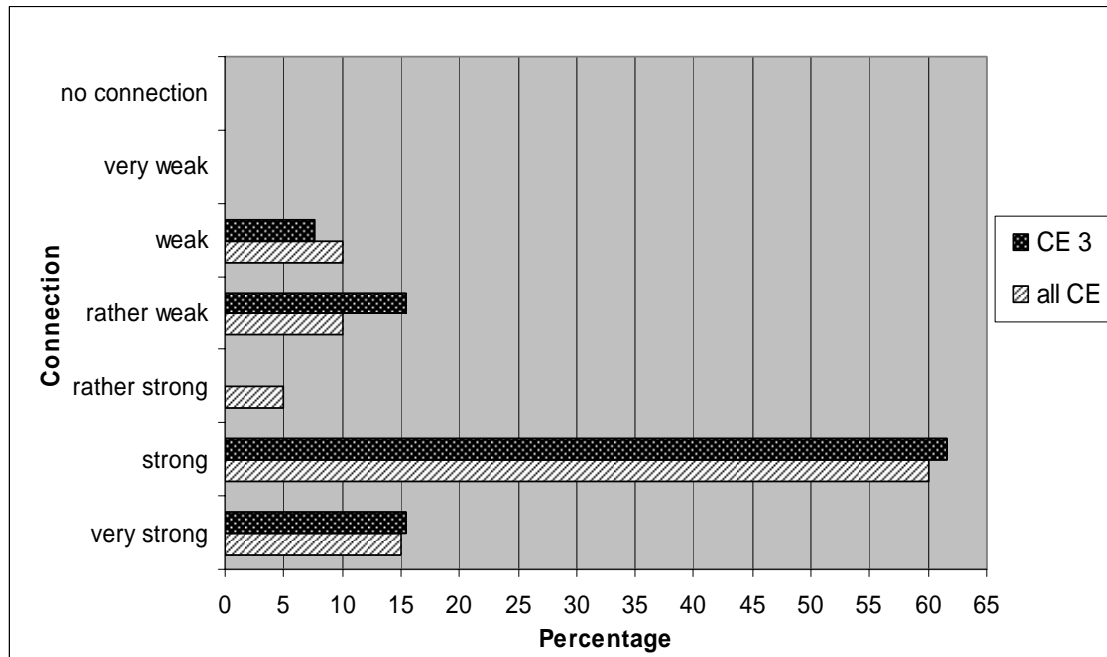
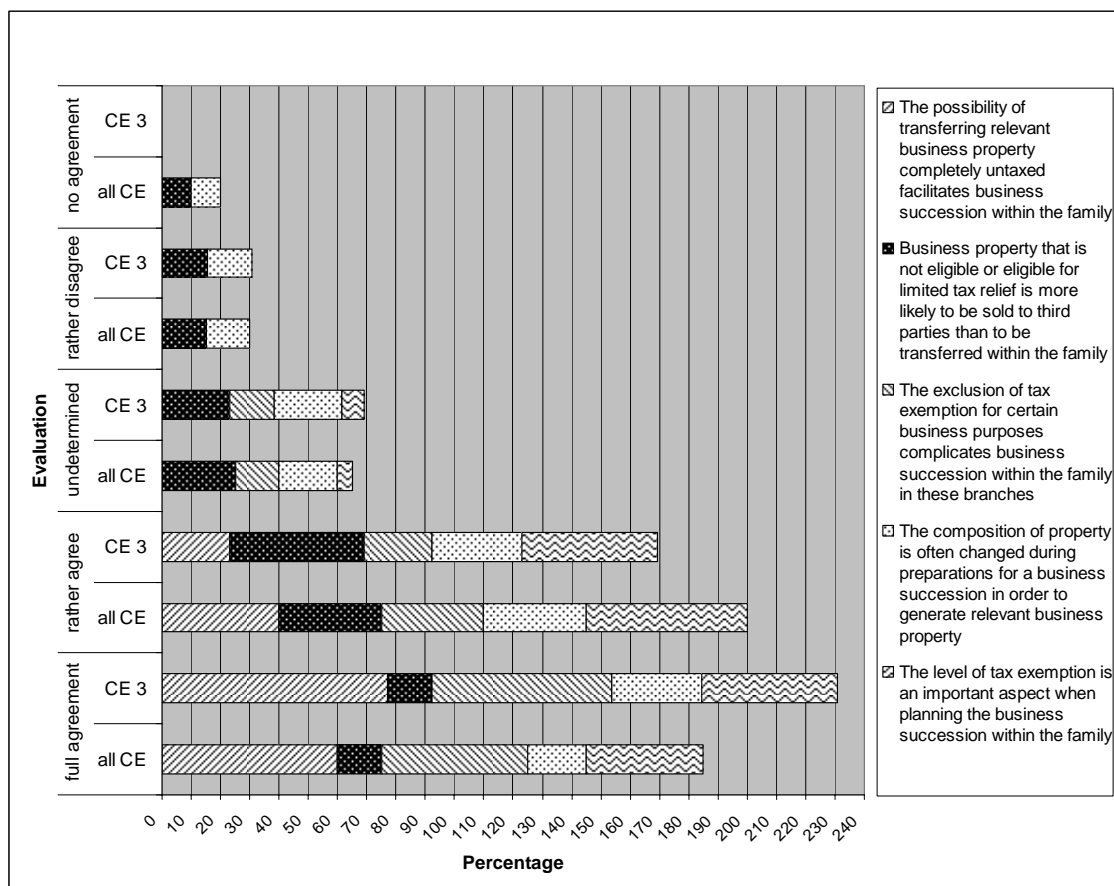


Figure 13 shows the evaluation of predetermined connections between BPR and business succession. The level of agreement is used as standard of evaluation.

FIGURE 13: CONNECTIONS BETWEEN BPR AND BUSINESS SUCCESSION

The statement, “that the possibility of transferring relevant business property completely untaxed facilitates the business succession within the family”, is fully or rather agreed by all of the participants.

50% (61,5%) of the respondents fully or rather agreed to the statement, “business property that is not eligible or eligible for limited tax relief is more likely to be sold to third parties than to be transferred within the family”. 25% (23,1%) are undetermined and 25% do not agree (15,4%).

85% (84,6%) of the respondents fully or rather agreed that “the exclusion of tax exemption for certain business purposes (dealing in securities, stocks or shares, land or buildings; making or holding investments) is fully or rather seen as complication for business succession within the family in these branches” . 15% (15,4%) were undetermined, but there was no disagreement with the statement.

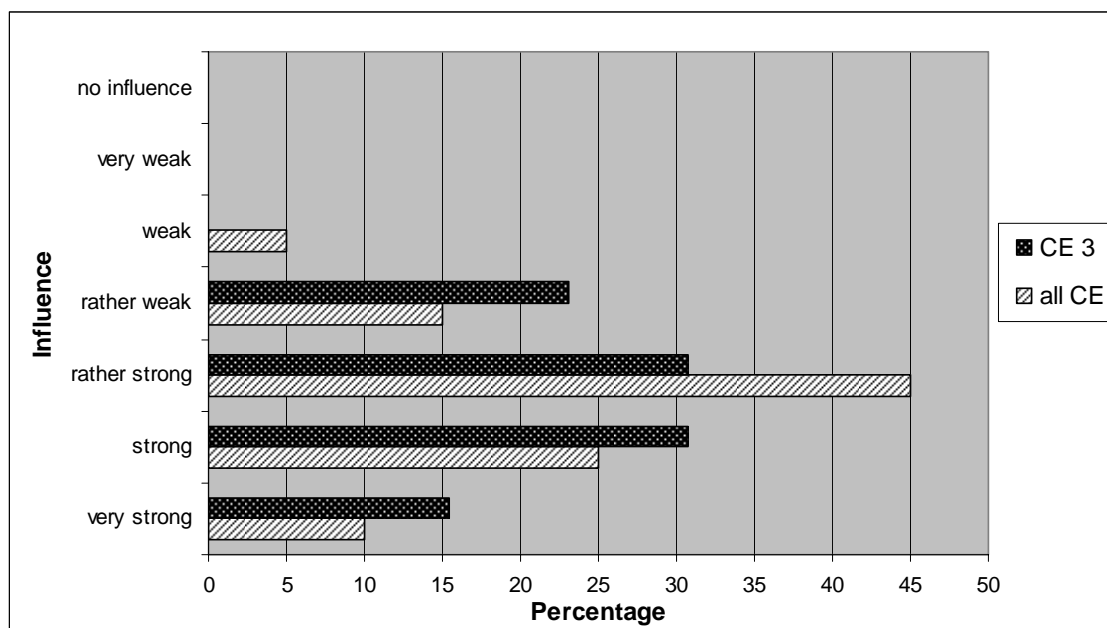
55% (61,5%) fully or rather agreed with the statement, “that the composition of business property is often changed during preparations for a business succession in order to generate non-taxable or partly taxable property”. 20% (23,1%) were undetermined, while 25% (15,4%) did not agree to this statement.

The level of tax exemption was evaluated as an important aspect by 95% (92,3%) of the interviewed tax professionals when planning the business succession within the family. The remaining 5% (7,7%) were undetermined, there was no disagreement.

5.3.3 Level of tax exemption of business property

The following figure shows the influence of the general level of tax exemption on business succession and the strength of this possible influence. “General level” means the division of business property into non-taxable or partially taxable (see BPR) and non-exempt (exempt property) business property. “Influence” means the importance of this differentiation for business succession within the family.

FIGURE 14: INFLUENCE OF LEVEL OF TAX EXEMPTION ON BUSINESS SUCCESSION



All respondents confirmed that the level of tax exemption influenced business succession. 80% (76,9%) evaluated this influence as "very strong", "strong" and "rather strong", and can be summarised as an overall strong influence.

Figure 15 shows the evaluation of the predetermined connections between the level of tax exemption (specific regulations) and business succession. The level of agreement is used as a standard of evaluation.

If the purpose of a transferred enterprise consists wholly or mainly in making or holding investments there is generally no tax exemption. But there is an exemption for holding companies, so that the BPR can be applicable. 55% (69,2%) of the respondents agreed fully or rather agreed to the statement, "this exception for holding companies facilitates the business succession of multi-level companies". 45% (30,8%) were undetermined, there was no disagreement.

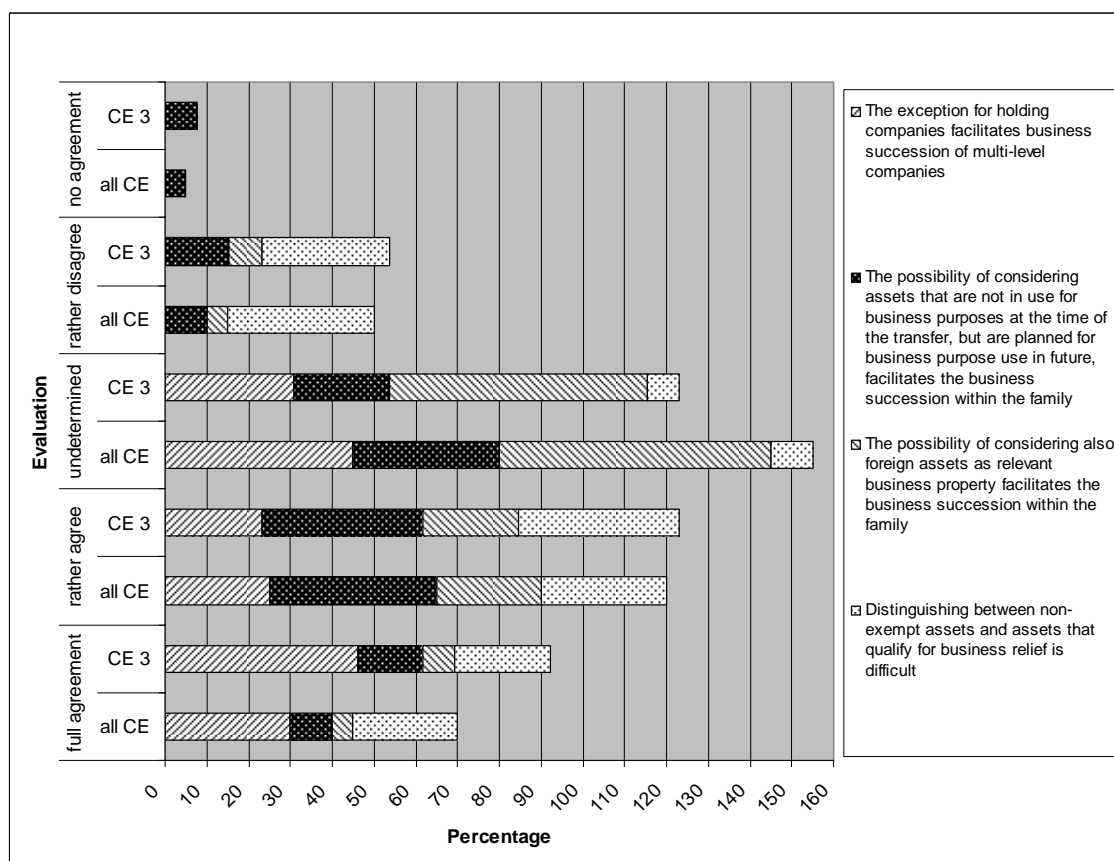
Property that is not used entrepreneurial is generally evaluated as excepted property with no tax exemption. But if such property is planned for business purpose use in future, the BPR can be applicable. According to 50% (53,8%) of the interviewed tax

professionals, this possibility facilitates business succession within the family. 35% (23,1%) were undetermined, while 15% (23,1%) did not agree.

The British preferential tax treatment of business property, (apart from in Germany), is not limited to domestic property. The statement, “that the possibility of considering also foreign assets as relevant business property facilitates business succession within the family”, was is fully or rather agreed by only 30% (30,8%) of the respondents. Most of the interviewed tax professionals, 65% (61,5%), of were undetermined and 5% (7,7%) did not agree.

The differentiation between business property that is available for a preferential tax treatment and business property that is taxed without an exception has to be done by using a so called wholly-or-mainly-test. This test has been developed because there is no fully legal definition that can be used to distinguish between non-exempt assets and assets that qualify for business relief. 55% (61,5%) of the participants have experience that this distinction is difficult, 10% (7,7%) are undetermined. According to 35% (30,8%) of the respondents, there is no difficulty distinguishing between non-exempt assets and assets that qualify for business relief.

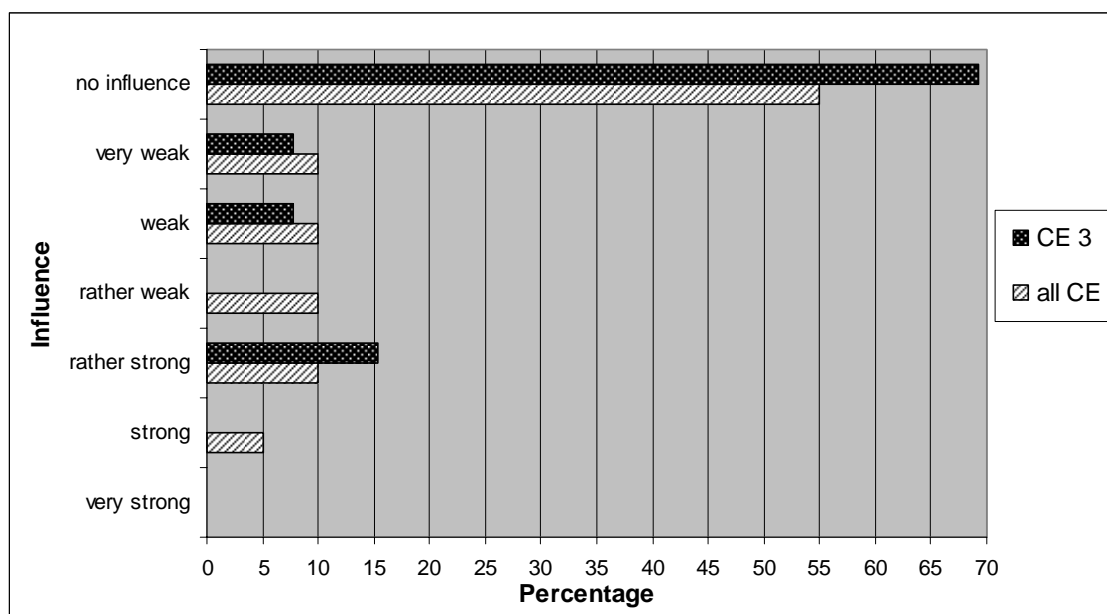
FIGURE 15: CONNECTIONS BETWEEN THE LEVEL OF TAX EXEMPTION AND BUSINESS SUCCESSION



5.3.4 Restriction of Potentially Exempt Transfers

When the transfer of business property is treated as PET, the tax exemption (BPR) lapses retroactively if the property is sold within seven years after the transfer and the donor died after the sale and within these seven years. Figure 16 shows the existence and the strength of a possible influence of this restriction to the willingness of a potential successor to assume the business succession.

FIGURE 16: RESTRICTION AND WILLINGNESS TO ASSUME A BUSINESS SUCCESSION



45% (30,8%) of the respondents confirm that the possible loss of the tax exemption to the willingness of a potential successor to assume the business succession. 15% (15,4%) evaluate this influence as "strong" and "rather strong". But most of the interviewed tax professionals, 55% (69,2%), do not believe that this influence exists.

Figure 17 shows if the loss of the tax exemption does influence the continuation of the enterprise and how strong this possible influence is.

According to 70% (61,5%) of the respondents there is an influence of the loss of tax exemption to the continuation of an enterprise. 30% (30,8%) evaluate this influence with "strong" and "rather strong", but 30% (38,5%) do not believe experience that this influence exists.

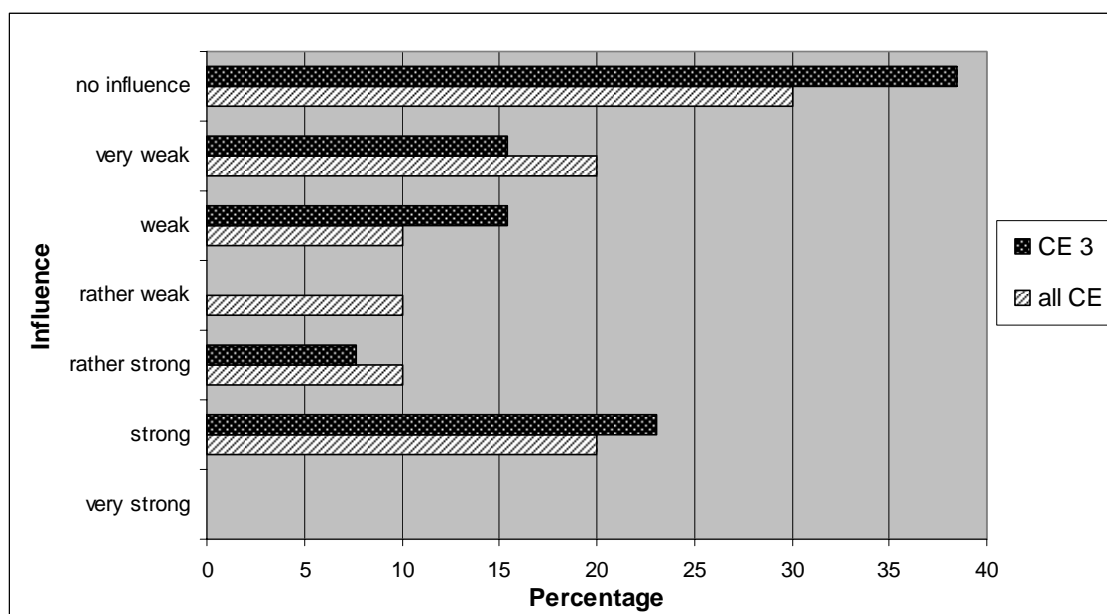
FIGURE 17: INFLUENCE OF THE LOSS OF TAX EXEMPTION TO THE CONTINUATION OF AN ENTERPRISE

Figure 18 shows the evaluation of predetermined connections between the possible implications mentioned above and business succession. The level of agreement is used as a standard of evaluation.

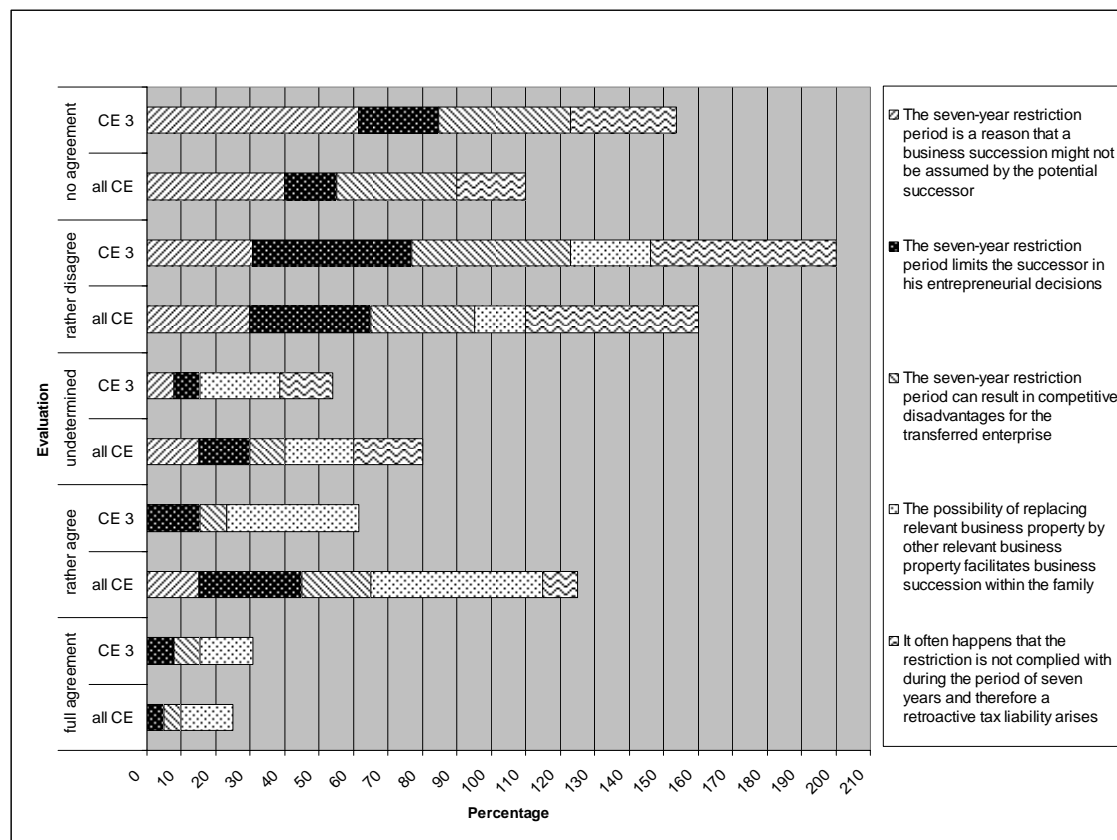
The statement, that the seven-year restriction period is a reason that a business succession is not assumed by the potential successor, was “rather agreed” by 15% of the respondents (but only participants who are categorised in CE 1 and 2). 15% (7,7%) were undetermined while 70% (92,3%) did not agree.

35% (23,1%) of the participants agreed that the seven-year restriction period limits the successor in his entrepreneurial decisions. 15% (7,7%) were undetermined and 50% (69,2%) did not agree.

The statement, “the seven-year restriction period can result in competitive disadvantages for the transferred enterprise”, was agreed by 25% (15,4%). 10% of the respondents, (only participants who were categorised in CE 1 and 2), were undetermined. 65% (84,6%) did not agree with the statement.

Relevant business property can be sold without a tax liability imposed if the sold property is replaced by other relevant property within one year after sale. 65% (53,8%) agreed that this possibility of reinvestment facilitates the business succession within the family. 20% (23,1%) were undetermined while 15% (23,1%) did not agree.

10% of the respondents (only participants who are categorised in CE 1 and 2) agreed that the restriction is often not complied with during the seven year period and a retroactive tax liability is imposed. 20% (15,4%) of the interviewed tax professionals were undetermined and 70% (84,6%) did not agree with this statement.

FIGURE 18: CONNECTIONS BETWEEN RESTRICTIONS OF PET AND BUSINESS SUCCESSION

6. SUMMARY AND DISCUSSION OF THE RESULTS

6.1 Fundamental Results

As general effects of the inheritance tax on business succession the survey has identified the following aspects:

- 1) There is no fundamental connection between the liquidity burden due to taxation and whether the business succession occurs within the family or by external succession. However, there are a significant number of cases where the liquidity burden has resulted in an external business succession.
- 2) There is a strong connection between the liquidity burden due to taxation and the continuation or termination of the enterprise after succession. The higher the liquidity burden, the higher the probability that there will be termination of the enterprise at a later date.
- 3) There is a strong connection between the level of the tax burden and the volume of the transferred assets. The volume decreases with the level of the tax burden.
- 4) The level of the tax burden does in fact influence the composition of the transferred assets. The composition has as a goal the lowest possible tax burden. Economic aspects are subordinated to this.

- 5) There is a strong connection between the willingness to move abroad to a country with lower taxes. However, the option to move abroad is rarely used.
- 6) Preferential tax treatment on the transfer of business property is absolutely necessary to ensure the business succession within the family, particularly to safeguard employment, investment activity, and capital base of the transferred enterprise.

As effects of specific regulations of the British Inheritance Tax Act on business succession it has been identified that:

- 1) The option of Potentially Exempt Transfers (IHTA 1984 s 3 A; 7 (4)) is an important incentive for the transfer of an enterprise during lifetime with the result that most business successions taking place during lifetime does not create any tax burden.
- 2) The Business Property Relief (IHTA 1984 s 104; 105) is very important to facilitate business succession within the family.
- 3) The risk that business property might be considered as non-tax exempt (IHTA 1984 s 112 (2)) hinders the business succession within the family.
- 4) The differentiation between relevant business property and property without a preferential tax treatment can be difficult.
- 5) The seven-year restriction period (IHTA 1984 s 113 A) influences neither the willingness to agree to a business succession nor the continuation of the enterprise.

These results are based on information of 20 participants respectively with the experience of at least 666 business successions. On this basis the results of the survey should be understood as first findings that have to be validated by further research. The existing database is currently improved by additional personal and written interviews with British tax professionals. However these first results can be used to investigate the effects of the British inheritance tax system on business succession that are expected during the hypothetical discussion (summarised in table 2) as one theoretical part of our research. The evaluation of the expected effects by using the first results mentioned above is shown in table 2. By using the first results most of the expected effects concerning inheritance tax and business succession can be confirmed.

It could be criticised that most of the expected effects are based on announcements that are perceptive. However to date there is no scientific knowledge concerning empirical effects of the inheritance tax on business succession. Further it has to be distinguished between simple awareness and scientific knowledge.⁷⁶

⁷⁶ See Kromrey, H. (2006), S. 17.

TABLE 2: EVALUATION OF THE EXPECTED EFFECTS

Expected effects	Confirmed	Partly confirmed	Not confirmed
The higher the liquidity burden due to taxation, the less probable is a business succession within the family.		X	
The higher the liquidity burden due to taxation, the less probable is the continuation of the enterprise within the family.	X		
The higher the level of the tax burden, the less the motivation for asset accumulation before the business succession.	X		
The taxation of business succession causes a composition of the transferred assets with the aim of the lowest possible tax burden.	X		
The higher the level of the tax burden, the more taxpayers move abroad to a country with lower taxes.			X
The potential tax exemption of lifetime transfers causes an early transfer of enterprise to the successors.	X		
The potential tax exemption of lifetime transfers ensures that most business transactions are non-taxable.	X		
The tax exemption for relevant business property facilitates the business succession within the family.	X		
The differentiation between relevant business property and property without a preferential tax treatment influences business succession within the family.	X		
Regulations for qualifying property without a preferential tax treatment as relevant business property facilitates business succession within the family.	X		
The restrictions of potentially exempt transfers have a negative influence to the willingness of the potential successor to assume the business succession.			X
The restrictions of potentially exempt transfers have a negative influence to the continuation of the enterprise within seven years after the transfer.		X	

The first results can be used to derive initial implications with reference to the conception or improvement of the legal framework. But further research has to be done before giving recommendations to the fiscal policy makers as to how to improve the existing tax systems.

One possible implication that can be mentioned is that the possibility of making lifetime transfers without inheritance tax could support the decision of an entrepreneur to transfer business property early. This effect should also be generated by the German legislation by using a similar instrument to generate an early responsibility of potential successors. The business retention restrictions that the preferential tax treatment generates do not have negative effects in regards to either the willingness of a potential successor to assume a business succession or to the economical situation of the enterprise. Therefore an obligation to retain the enterprise and keep it in progress would not be a disadvantage but could ensure the business succession within the family. However in the British tax system, (other than in German tax law), there are only a few cases where the restrictions are relevant (see chapter 5.3.4).

6.2 Methodological results

The results discussed in this paper are based on information of tax professionals who have participated in personal interviews.⁷⁷ To date the willingness of tax professionals to participate in the survey has been very low. One reason is that tax advisors and solicitors presently have large workloads because the legislator has announced further essential changes of the British tax law. This means that in many cases advisers would have required a form of financial compensation in order to participate in a survey. A further reason is the regional concentration of professionals who are working in the area of business succession consulting; most of them in cities like London, Manchester or Leeds. Other practitioners are often experienced only with private or agricultural property. This concentration of experience concerning business property requires a large amount of travelling to perform the personal interviews which means high travelling costs and a time gap between the interviews, which limits the number of possible interviews.

It can be summarised that there is a high financial effort to generate the relevant data, but the methodology that has been chosen in this research work seems to be adequate to generate information about the real effect of inheritance tax on business succession.

7 FURTHER RESEARCH

Empirical research concerning the question of how tax systems could influence the decision making of people is not common in the field of tax research. This paper should reveal that empirical methods are suitable for generating knowledge in the area of behavioural taxation. As a first step of our research the survey was limited to tax advisors as participants of personal interviews to examine if this first generated database is exploitable for deducting positive and negative effects of the British inheritance tax system to business succession decisions. Therefore our manuscript is characterized as an initial study that should evaluate this type of research in general by using the current German inheritance tax reform bill as practical research background.

The now existing database has to be enlarged to ensure evidence with high validity which enables a deeper evaluation of the positive and negative effects of the British inheritance tax system. In the future there will be further personal interviews in Great Britain to increase the number of participants. Additionally there will be a written survey among the British members of the Family Business Interest Group of STEP and further institutions.

As a second validation measure it is planned to perform personal interviews with entrepreneurs who are planning to transfer their business property to a successor. A further group of participants will be offered by entrepreneurs who have already taken over an enterprise. There are first connections to institutions like the Institute of Family Business (IFB) in London that is the British chapter of the International Family Business Network.

⁷⁷ Most of the interviews have been arranged by the Applied Research Group in Taxation, Coventry University Law School.

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Impact of Adoption of IFRS on the Thinly Capitalised Position of Australian Companies

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Abstract

This article investigates the impact of the adoption of the International Financial Reporting Standards (IFRS) in Australia on the thin capitalisation position of the top 105 ASX listed companies. Leading up to formal adoption of IFRS in Australia, several parties have expressed concern with the impact of adoption of the IFRSs on compliance of Australian entities with the thin capitalisation provisions. The results of the paired t-tests demonstrate that the thin capitalisation structure of Australian listed firms has changed as a direct consequence of IFRS adoption in Australia. Overall, the introduction of new IFRS rules in Australia does not present a major thin capitalisation compliance risk to listed firms.

1. INTRODUCTION

The Australian Financial Reporting Council (FRC) announced on 3 July 2002 that Australia would formerly adopt the International Financial Reporting Standards (IFRS) for reporting periods commencing on or after 1 January 2005. The FRC advanced the argument that the adoption of IFRS by Australian companies would facilitate cross-border comparisons by improving comparability and transparency in financial reporting thereby leading to more efficient contracting between various capital market participants, a lower cost of capital and an increased ability to raise finance or list overseas (FRC, 2005). Adoption of the International Financial Reporting Standards (IFRS) in Australia has had a profound impact on the recognition, measurement and disclosure of assets, liabilities, equity and profitability (Jubb, 2005; Jubb, 2006). The Australian Accounting Standards Board issued the Australian equivalents to the International Financial Reporting Standards to incorporate requirements that are specific to Australian entities. The conversion to IFRS has a fundamental impact on a number of important areas of financial reporting and taxation. Adoption of IFRS involved introduction of new accounting standards and changes to existing standards. Potentially, Australia's adoption of IFRS may adversely impact on an entity's thin capitalisation calculations. This is important as these firms may be denied income tax deductions relating to interest payments and associated borrowing fees on loans.

This study has important implications for accounting standard setting and income tax. Financial accounting concepts or accounting standards underpin or support a number of key provisions within the *Income Tax Assessment Act 1936* (ITAA 1936) and *Income Tax Assessment Act 1997* (ITAA 1997) including debt/equity classification,

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income tax consolidation and the thin capitalisation provisions. Consequently, accounting standard setters need to be mindful of the potential Australian income tax implications of IFRS adoption, particularly in the case of large multinational firms that operate between Australia and several other tax jurisdictions. The tax value of assets, liabilities and equity capital under the thin capitalisation rules are determined by reference to accounting standards and compliance of entities with these rules potentially may change as a direct consequence of IFRS adoption itself (Nethercott and Hanlon, 2004). This research will describe and quantify the impact of the introduction of IFRS on compliance with the Australian thin capitalisation provisions.

The Australian thin capitalisation provisions are designed to ensure that Australian and foreign owned multinational entities do not allocate an excessive amount of debt to their Australian operations or investments (Division 820 of the ITAA, 1997). This Division does this by limiting the debt deductions (interest payments and loan fees) an entity can claim against Australian assessable income when debt deductions are in excess of a 'maximum allowable debt' amount (ATO, 2006). These provisions apply to Australian entities and their associate entities investing overseas through an overseas permanent establishment or Australian controlled foreign entity, and foreign entities investing directly in Australia or through foreign controlled Australian entities (ATO, 2005)¹.

The next section outlines the significance of the study and significance of the study. Section 3 covers the research questions and issues while section 4 discusses the research approach. Section 5 provides the results of the empirical analysis while section 6 concludes the study.

2. SIGNIFICANCE OF THE STUDY

This study examines the impact of the Australian equivalents to the International Financial Reporting Standards on the thin capitalisation position of Australian listed companies. The objective of this project is twofold: to determine how and why the key IFRS could impact the thin capitalisation compliance of Australian companies and secondly to quantify these impacts and relate them back to accounting and taxation policy initiatives. Leading up to formal adoption of IFRS in Australia, several parties expressed concern over the impact of IFRS on compliance of Australian entities with the thin capitalisation provisions (The Group of 100, 2006; The Institute of Chartered Accountants in Australia, 2006), but there has been no in-depth research that quantifies the potential impact.

The adoption of IFRS in Australia on 1 January 2005 has the major consequences of impacting on a firm's dividend and franking policy, its thin capitalisation position, application of Australian withholding taxes and income tax consolidation (Leyden and Croft, 2004; Joseph, 2005). The Group of 100 (G100) and The Institute of Chartered Accountants in Australia clearly voice the view that the adoption of IFRS could have unintended negative and inappropriate tax consequences, particularly in respect to the thin capitalisation position of companies. Changes in the recognition and valuation of

¹ Potentially, the thin capitalisation provisions can apply to inward investing entities and outward investing entities. Inward investing entities are Australian entities that are foreign controlled Australian entities and foreign entities that directly invest in Australia or operate a business at or through a permanent establishment. Outward investing entities are Australian entities that control foreign entities or operate a business at or through overseas permanent establishments and associated entities.

assets, liabilities and equity under IFRS may result in some entities that were able to comply with the thin capitalisation rules under Australian Generally Accepted Accounting Principles (GAAP), to now fail the test, not because of any changes in the financing mix of the entity or any changes to the business operations, but due to compliance with IFRS (The Institute of Chartered Accountants in Australia, 2006).

Following adoption of IFRS, the Federal Treasurer provided a three year transitional period to 31 December 2007 where entities may elect, on an annual basis, to use either IFRS or GAAP as they existed pre-1 January 2005 to calculate their thin capitalisation position (The Treasurer, 2006). The G100 and The Institute of Chartered Accountants in Australia vociferously argue that a longer term solution is required to ensure that companies are not worse off under the thin capitalisation rules following IFRS adoption than they were prior to IFRS adoption.

The introduction of IFRS has the following major consequences:

1. These new rules may increase the quantum of assets and liabilities reported on the balance sheet (The Institute of Chartered Accountants in Australia, 2006; The G100, 2006; The Treasurer, 2006). For instance, unrealised losses of derivative financial instruments will be recorded as liabilities in the balance sheet and is relevant in determining a net asset amount which forms part of the thin capitalisation calculations.
2. Overall, there may be a reduction in the net asset position of the company and the net asset position may be subject to volatility not previously encountered under GAAP (The Institute of Chartered Accountants in Australia, 2006).
3. With the move to fair value accounting under IFRS, certain assets, liabilities and equity not currently recognised under GAAP may be recognised under IFRS, and the treatment of certain assets and liabilities currently recognised may change.

Jubb (2006) examined the GAAP-IFRS reconciliations within the half year and annual reports of 146 Australian listed companies to determine the extent of disclosure of expected IFRS impacts. Using an AIFRS disclosure score (ranging from 0 to 11), she found that some 66% of firms voluntarily disclosed information on their GAAP-IFRS reconciliations above the minimum requirements mandated under AASB 1. IFRS adoption impacted negatively on equity in all reconciliation statements while impact on profit was variable. In a similar study, Goodwin, Cooper and Johl (2007) noted that about one-third (356) Australian listed firms changed their GAAP-IFRS reconciliations for earnings, cashflows or equity in their annual financial statements including some large individual negative adjustments to equity following application of AASB 139 *Financial Instruments: Recognition and Measurement*. Adjustments to reconciliations related largely to a lack of knowledge of the standards or incorrect application of standards by the CFO and their auditors. The authors argue that these firms were largely unprepared for IFRS at transition. Lack of accounting preparedness is also likely to have tax flow-on sequences including application of the thin capitalisation provisions.

Ahmed and Goodwin (2006) reported an increase in total assets (mean \$1,614.76 million under GAAP compared to mean \$1,675.39 under IFRS) and total liabilities (mean \$1,305.84 million under GAAP compared to mean \$1,400.72 under IFRS) and

a decline in equity for a sample of 1386 Australian listed firms on transition to IFRS relating largely to the recognition of new assets and liabilities, reclassifications and changes in measurement of these balance sheet elements. They concluded that the two most common adjustments to equity are income tax and goodwill with mean total equity declining from \$308.72 million under GAAP to \$274.55 million under IFRS. The leverage ratio (total liabilities/total assets) increased under IFRS leading to Ahmed and Godwin (2006) suggesting that debt covenants and lending criteria may need to be re-examined in light of these changes.

For some Australian companies, a key concern is that the debt to capital ratio could increase under IFRS to the extent that they exceed the safe harbour debt limit of 75%, particularly if they had debt to capital ratios in the order of 60% to 75% prior to the introduction of IFRS. The safe harbour debt limit is 75% of the average asset value of Australian operations net of non-interest bearing liabilities and investments in associates. The consequence is that debt deductions² (e.g. interest payments, loan fees) can be disallowed when that entity's debt used to fund Australian assets exceeds the safe harbour debt amount³. Larger multinational companies commonly undertake recapitalisation programs whereby debt to capital ratios of 50% to 75% are maintained for the Australian corporate group (Australian Taxation Office, 2006). This range for asset to capital ratios is achieved through the introduction of debt into the Australian corporate group⁴ and adjusting the asset position through asset revaluations (Nethercott and Smith, 2007). The introduction of IFRS may cause further adjustments to balance sheet elements thereby influencing compliance with the thin capitalisation provisions of these companies.

There are some key differences between the older GAAP and the newly implemented IFRS rules. These variations have flow-on impacts in calculation of the thin capitalisation position of an Australian entity relating to the recognition, measurement and classification of financial assets and liabilities, intangibles, asset impairments and goodwill and income taxes (AASB, 2004). The reason for this is that values adopted for assets and liabilities as well as the entity's debt capital and equity capital must comply with accounting standards (ATO, 2006). The IFRS that are likely to have the greatest impact on the application of the thin capitalisation provisions are:

1. AASB 112 *Income Taxes*;
2. AASB 132 *Financial Instruments: Presentation and Disclosure*;
3. AASB 138 *Intangible assets*; and
4. AASB 139 *Financial Instruments: Recognition and Measurement*;

The impact of these accounting standards on the thin capitalisation position of a company is likely to be industry specific (The ICAA, 2006). The adoption of AASB 139 *Financial Instruments: Recognition and Measurement* has resulted in entities

² Debt deductions relate to a debt interest under the Division 974 debt equity rules.

³ In such an instance, the entity is referred to as being thinly capitalised.

⁴ It can be tax effective for entities with cross-border investments to allocate a disproportionate and excessive amount of debt to their Australian operations and thereby maximise income tax deductions available in Australia. This in turn would enable these entities to minimise their Australian income tax liability (Australian Taxation Office, 2005; 2006).

recognising available-for-sale investments and all derivative financial instruments as assets or liabilities at fair value in the balance sheet. Under GAAP, these instruments are not recognised in the financial statements. The effect of this is that the assets can change substantially, particularly if there are marked valuations at fair value up or down which will in turn impact on the thin capitalisation calculations of companies under IFRS. Under AASB 132, more financial instruments are classified as debt rather than equity. Under AASB 112 *Income Taxes*, companies are required to use the balance sheet method which compares carrying values with the tax bases of assets and liabilities to determine temporary differences which then formed the basis of deferred tax balances. Deferred tax assets and deferred tax liabilities are recognised for all temporary differences with certain exemptions such as goodwill. Deferred tax is also recognised in respect of asset revaluations and fair value adjustments made on a business combination. Under AASB 138, *Intangible Assets*, internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as assets. The application of AASB 138 results in companies not being able to recognise some of the intangibles that are currently reflected on company balance sheets such as brand names and costs related to research activities. Under AASB 138, the recognition of internally generated brand names and items of similar nature is prohibited. Some companies, on transition to IFRS, have to derecognise some intangible assets which were previously recorded in the company's book as an asset. For those companies which had a large amount of assets comprising these intangibles, the write-down of these assets impacted their asset base for thin capitalisation purposes.

3. KEY RESEARCH ISSUES

Australian Accounting standards are used to determine what are a company's assets and liabilities, and in valuing assets, liabilities, debt and equity capital for the purpose of applying the thin capitalisation provisions⁵. The thin capitalisation rules focus and intent are on entities whose assets are funded by a high level of debt and relatively little equity. The official concern is that allocation of a disproportionate level of the total of deductible funding expenses to its Australian operations could artificially lower taxable income in Australia whilst increasing such amounts in other lower tax jurisdictions. The rules seek to limit the amount of debt used to fund Australian operations or investments. This is achieved by disallowing the debt deductions (e.g. interest payment or loan fees) an entity can claim against Australian assessable income when the entity's debt used to fund Australian assets exceeds the safe harbour debt to equity ratio of 3:1.

The key research questions are:

1. What is the nature and scale of the expected impact of IFRS on the thin capitalisation position of non-financial, non-ADI (authorised deposit-taking

⁵ Section 820-680 of the ITAA 1997 requires compliance with 'accounting standards' both in determining what are a company's assets and liabilities, and in valuing assets, liabilities, debt and equity capital under the thin capitalisation rules. The ATO issued Taxation Ruling TR 2002/20 Income Tax: Thin Capitalisation which states that the definition of assets and liabilities for thin capitalisation purposes must be determined in accordance with Australian accounting standards.

institution⁶) Australian companies including the key accounting standards causing the impact?

2. How do these adjustments influence Australian accounting and taxation policy initiatives in relation to thin capitalisation?

4. RESEARCH METHOD

Data was collected from the annual financial reports of 150 top Australian listed companies by market capitalisation (Australian Financial Review, 2007⁷) in the year immediately pre-IFRS adoption and in the year in which companies had to prepare their first full year annual report under IFRS. The top 150 companies were chosen as these are more likely to be subject to the Australian thin capitalisation regime and also are potentially more likely to have their thin capitalisation position change as a direct consequence of IFRS adoption. Determination of whether an entity was subject to the thin capitalisation provisions was made based on segment assets and liabilities and source of borrowings. Finance, ADI and insurance companies were excluded from the sample set as the thin capitalisation calculation fundamentally differs for these entities. Consequently, data was only collected in respect of general, non-financial, non-ADI companies. Companies that did not provide their annual report online for both the immediate pre-IFRS and post-IFRS years were also excluded from the sample set. This resulted in a final sample size of 105 companies.

AASB 1047 *Disclosing the Impacts of Adopting the Australian Equivalents to the International Financial Reporting Standards*⁸ requires an entity to restate comparatives and provide reconciliation of GAAP to IFRS (AASB, 2004^f). These reconciled financial statement notes show the changes in assets, liabilities, equity and profit on transition from GAAP to IFRS. Further AASB 1 *First-Time Adoption of Australian Equivalents to International Financial Reporting Standards* allows an entity to make choices when first applying IFRS which may in turn impact on the thin capitalisation position of a company.

Reconciliation data⁹ relating to the most recent balance sheet date where the annual report was prepared under GAAP was used. For 31 December balance day companies,

⁶ ADIs are bodies corporate that have been granted the authority to carry on banking in Australia by the Australian Prudential Regulatory Authority.

⁷ Market capitalisation as at 15 June 2007.

⁸ The purpose of AASB 1047 was to keep stakeholders informed of the likely impacts of IFRS adoption as well as how companies were preparing for adoption (AASB, 2004^f). This standard, which applied to all reporting entities for reporting periods preceding the adoption of IFRS, required entities to disclose, pursuant to section 334 of *Corporations Act 2001*:

- information in respect to planning for the transition to IFRS and any key differences in accounting policies that are expected to arise on the adoption of IFRS for interim and annual reporting periods ending on or after 30 June 2004; and
- known or reliably estimable information about the impacts on the financial reports of annual reporting periods on or after 30 June 2005 had the financial report been prepared using IFRS.

Where quantitative information was not known, or was not reliably estimable, the entity was to make a statement to that effect. Where possible, the impact of IFRS on operating profit before tax, profit after tax, net profit, total assets, total liabilities and net assets for example was to be disclosed

⁹ Data on financial statement elements including interest bearing liabilities, the source and quantum of borrowings and segment assets, liabilities and equity were collected from annual reports to quantify the impact of adoption of key IFRS on the thin capitalisation position of these companies.

31 December 2004 reconciliation data was used. For 30 June balance day companies, 30 June 2005 reconciliation data was used.

The thin capitalisation provisions, through the use of method statements¹⁰, outline the process with which an entity can calculate the maximum amount of interest bearing debt that can give rise to interest deductions in a year of income, herein referred to as the 'maximum allowable debt'. The method applied to calculate the 'maximum allowable debt' varies depending on whether the entity is an inward investor or an outward investor, whether the entity is a general entity or a financial entity and whether or not the entity is an ADI. For instance, for an outward investing entity (non-ADI; non-financial), the maximum allowable debt is the greater of a 'safe harbour' test, an 'arm's length' test or a 'worldwide gearing amount'¹¹.

In this study, a company's thin capitalisation position is calculated utilising the safe harbour test¹². This test involves calculation of a safe harbour debt amount (SHDA). The safe harbour debt amount is calculated using the method statement outlined in section 820-95 of the ITAA 1997 (for outward investing general entities) or section 820-195 of the ITAA 1997 (for inward investing general entities) and is 75% of the average asset value of Australian operations net of non-interest bearing liabilities and investments in associates¹³. The method statement provided in section 820-95 of the ITAA 1997 is outlined in the Appendix.

The ratio of average debt to the SHDA (maximum allowable debt) was calculated using the financial statements of the consolidated entity immediately pre-IFRS and immediately post-IFRS adoption. The proxy measure of SHDA and average debt are reasonably close measures of the actual SHDA and average debt levels of sample companies.

Importantly, the direct link between the thin capitalisation provisions and accounting standards should result in a change in the safe harbour debt amount and consequently the ratio of average debt to the SHDA. In determining whether an entity has complied with the thin capitalisation provisions, the average debt amount is compared with the

¹⁰ Method statements refer to the sequence of instructions that are to be used to calculate an entity's thin capitalisation position.

¹¹ The fixed safe harbour gearing ratio is adopted as the first tier test and if exceeded, an arm's length test or test based on worldwide gearing limit is then applied. Entities, including associated entities, that claim debt deductions less than \$250,000 (section 820-35) or have 90% or more of the value of its assets represented by Australian assets (section 820-37) or have their operations confined entirely within Australia or entirely outside Australia are excluded from application of the thin capitalisation provisions.

¹² Determination of the maximum allowable debt using the arm's length test or worldwide gearing ratio will not be made as these methods are reliant on firm specific assumption and factors.

¹³ As an example, ABC Ltd is a listed Australian company with an average value of assets of \$100 million. The average values of its relevant associate entity debt, associate entity equity, controlled foreign debt, controlled foreign entity equity and non-debt liabilities are \$10million, \$8million, \$5million, \$2million and \$5million respectively. Deducting these amounts from the average asset value leaves \$70 million. Multiplying \$70 million by 3/4 results in \$52.5 million, the safe harbour debt amount. The average debt amount (predominantly interest bearing liabilities) is compared to the safe harbour debt amount. If the average debt amount is greater than \$52.5 million, debt deductions on that excess amount may be denied. The proxy measure of safe harbour debt amount and whether an entity can be regarded as thinly capitalised are based on the accounting definition of assets and liabilities (ATO, 2002; 2006). Furthermore, the thin capitalisation tax provisions rely on the valuation rules in the accounting standards to provide the value of assets and non-debt liabilities (ATO, 2002).

SHDA. An entity subject to the thin capitalisation provisions that has an average debt amount below the safe harbour debt amount of 75% of the average value of Australian assets is in compliance with those provisions. However, negative consequences occur if the average debt amount exceeds the SHDA as interest payments and loan fees may be denied as an allowable deduction against assessable income if that entity is subject to the thin capitalisation provisions.

A proxy measure of the safe harbour debt amount is calculated in accordance with section 820-95 of the ITAA 1997 under GAAP immediately prior to IFRS adoption and also at the commencement of IFRS adoption as follows:

$$\text{safe harbour debt amount (SHDA)} = (\text{Total assets} - \text{non-IBL}) \times 75\%$$

Where non-IBL refers to non-interest bearing liabilities

A proxy measure of average debt was calculated as:

$$\text{Average Debt} = \text{Total interest bearing liabilities (IBL)}$$

A proxy measure of maximum allowable debt was then calculated as:

$$\text{Maximum Allowable Debt (MAD) ratio} = \text{average debt} / \text{SHDA}$$

Companies with a MAD ratio in excess of 1.0 are potentially non-compliant with the thin capitalisation provisions. Conversely, companies with a MAD ratio less than 1.0 are potentially compliant with the thin capitalisation provisions. The focus of this study is to determine the change in this ratio as a direct consequence of IFRS adoption.

The change in assets, liabilities including interest bearing liabilities and equity on transition to IFRS adoption were obtained from the reconciliations of GAAP-IFRS financial statement elements as at 30 June 2005 (for June financial year end companies) or at 31 December (for December year end companies) provided in accordance with AASB 1047. Consequently, the change in average debt and SHDA was derived from these reconciliation statements. The change in average debt and SHDA on transition to IFRS is then used to determine whether IFRS adoption itself had a statistically significant impact of Australian listed companies' compliance with the thin capitalisation provisions.

There are a number of limitations and assumptions made in this study. First, although the overwhelming majority of companies subject to the thin capitalisation rules adopt the safe harbour test, an entity may use alternative tests to derive a MAD amount. Calculation of the impact of the IFRSs on the MAD using these alternative methods is not possible using annual financial report information only. A second limitation is that only an approximate measure of the SHDA for a company can be calculated utilising information derived from the annual financial report. Third, not all companies provided complete GAAP-IFRS reconciliation statements showing changes in assets, liabilities and interest bearing liabilities on transition to IFRS adoption. Despite these limitations, the proxy measure of the SHDA on transition to IFRS does provide an insight into the impact of the new standards themselves on thin capitalisation compliance.

5. RESULTS

Descriptive statistics provided as Table 1 show the mean assets, liabilities, equity, safe harbour debt amount (SHDA) and maximum allowable debt (MAD) for all sample firms under GAAP. The mean MAD is 37.98%. The range in MAD values from 0.00 to 131.00 indicates diversity in quantum of assets, debt and non-debt liabilities and therefore potential compliance with the thin capitalisation provisions. For companies with MAD values in excess of 100%, interest payments and loan fees in excess of that amount could be disallowed as tax deductions. Under GAAP, there are two companies with a MAD value greater than 100%, five companies with a MAD value greater than 80% and twelve companies with a MAD value greater than 60%.

TABLE 1: AUSTRALIAN COMPANIES' THIN CAPITALISATION POSITION UNDER GAAP

AGAAP (millions)	<i>Assets</i>	<i>Liabilities</i>	<i>Equity</i>	<i>non-IBL</i>	<i>IBL</i>	<i>SHDA</i>	<i>MAD</i>
Mean	3,718	1,969	2,301	885	1,104	1,517	37.98
Standard Error	592	364	338	173	238	258	3.51
Median	2,006	969	1,312	385	461	439	34.87
Standard Deviation	5,025	3,094	3,464	1,423	1,949	2,621	28.71
Kurtosis	25.21	22.64	20.58	11.94	23.45	30.83	0.55
Skewness	4.31	4.16	4.17	3.24	4.21	4.62	0.64
Minimum	50	1	-116	0.99	0	0	0.00
Maximum	36,310	21,429	24,163	8,095	13,334	21,161	131.00
Count	72	72	105	67	67	103	67

Descriptive statistics of the top Australian listed firms (by market capitalisation) sample firms immediately prior to IFRS adoption. All data was obtained from reconciliation tables of GAAP-IFRS financial statement elements on transition to IFRS adoption. Not all companies showed the reconciliation of assets and liabilities from GAAP to IFRS. All sample companies (105) provided the reconciliation of equity from GAAP to IFRS. Only 72 of the 105 companies provided reconciliation of assets and liabilities from GAAP to IFRS. Total interest-bearing liabilities (IBL) comprise both current borrowings and non-current borrowings. Non-IBL refers to non interest bearing liabilities. A proxy measure of Safe Harbour Debt Amount (SHDA) is measured as total assets less non-interest bearing liabilities multiplied by 75%. The proxy measure of SHDA is measured in accordance with the method statement provided in section 820-95 of the Income Tax Assessment Act (ITAA) 1997. The MAD refers to a proxy measure of IBL/SHDA.

Descriptive statistics provided as Table 2 show the mean assets, liabilities, equity and maximum allowable debt for all sample firms immediately following IFRS adoption. The mean MAD is 42.99%. Again there is a diversity of MAD values which range from 0.0 to 131.65. Post-IFRS adoption, there are three companies with a MAD value greater than 100%, eight companies with a MAD value greater than 80% and eighteen companies with a MAD value greater than 60%. There is one company out of the sample of 67 companies whose MAD has increased from 25.59 pre-IFRS to 131.65 post-IFRS. There were been two companies with MAD values less than 80% pre-IFRS

that have exceeded 80% post-IFRS and another three companies with MAD values less than 60% pre-IFRS that have exceeded 60% post-IFRS. These changes are the result of the changes in existing accounting standards and the introduction of new accounting standards on IFRS adoption in Australia.

TABLE 2: AUSTRALIAN COMPANIES' THIN CAPITALISATION POSITION ON TRANSITION TO IFRS ADOPTION

IFRS (millions)	Assets	Liabilities	Equity	non-IBL	IBL	SHDA	MAD
Mean	3,616	2,031	2,011	599	1,110	1,315	42.99
Standard Error	613	394	314	128	229	239	3.87
Median	1,914	1,068	1,088	201	461	395	41.87
Standard Deviation	5,022	3,229	3,217	1,299	1,876	2,427	31.67
Kurtosis	24.12	21.35	23.74	23.17	20.19	31.37	0.26
Skewness	4.28	4.12	4.46	4.43	3.90	4.69	0.58
Minimum	44	1,	-153,	0	0	0	0.00
Maximum	35,211	21,553	23,573	9,105	12,448	19,579	131.65
Count	67	67	105	103	67	103	67

Descriptive statistics of the top Australian listed firms (by market capitalisation) sample firms immediately following IFRS adoption. All data was obtained from reconciliation tables of GAAP-IFRS financial statement elements on transition to IFRS adoption. Not all companies showed the reconciliation of assets and liabilities from GAAP to IFRS. All sample companies (105) provided the reconciliation of equity from GAAP to IFRS. Only 72 of the 105 companies provided reconciliation of assets and liabilities from GAAP to IFRS. Total interest-bearing liabilities (IBL) comprise both current borrowings and non-current borrowings. Non-IBL refers to non interest bearing liabilities. A proxy measure of Safe Harbour Debt Amount (SHDA) is measured as total assets less non-interest bearing liabilities multiplied by 75%. The proxy measure of SHDA is measured in accordance with the method statement provided in section 820-95 of the Income Tax Assessment Act (ITAA) 1997. The MAD refers to a proxy measure of IBL/SHDA.

Descriptive statistics provided in Table 3 show the change in assets, change in liabilities and change in equity on transition to IFRS adoption. Also provided in Table 3 is the overall percentage change in MAD on transition to IFRS adoption. The key point in this study's evaluation of thin capitalisation compliance is that MAD increased from 37.98% (Table 1) to 42.99% (Table 2) as a direct consequence of adoption of the IFRSs. Mean equity declined by 9.07% (n = 105) on transition to IFRS adoption.

TABLE 3: AUSTRALIAN COMPANIES' CHANGES IN FINANCIAL STATEMENT ELEMENTS AND THIN CAPITALISATION POSITION ON TRANSITION TO IFRS

Change on Transition to IFRS	<i>Change in Assets</i>	<i>Change in Liabilities</i>	<i>Change in Equity</i>	<i>Change in MAD</i>
Mean	-6.16	6.70	-9.07	16.74
Standard Error	4.02	7.79	2.04	7.62
Median	0.00	0.49	-3.81	2.71
Standard Deviation	33.91	65.63	20.86	58.51
Kurtosis	6.75	11.64	6.87	37.98
Skewness	-0.32	2.65	-1.92	5.74
Minimum	-100.00	-100.00	-100.00	-32.01
Maximum	135.52	333.74	47.07	414.45
Count	71	71	105	59
Confidence Level(95.0%)	8.03	15.53	4.04	15.25

Descriptive statistics of the change in assets, liabilities, equity and thin capitalisation position of top Australian listed firms (by market capitalisation) sample firms on transition to IFRS adoption. All data used to calculate the change in financial statement elements was obtained from reconciliation tables of GAAP-IFRS financial statement elements on transition to IFRS adoption. Not all companies showed the reconciliation of assets and liabilities from GAAP to IFRS. All sample companies (105) provided the reconciliation of equity from GAAP to IFRS. Only 71 of the 105 companies provided reconciliation of assets and liabilities changes from GAAP to IFRS. Total interest-bearing liabilities (IBL) comprise both current borrowings and non-current borrowings. A proxy measure of Safe Harbour Debt Amount (SHDA) is measured as total assets less non-interest bearing liabilities multiplied by 75%. The proxy measure of SHDA is measured in accordance with the method statement provided in section 820-95 of the Income Tax Assessment Act (ITAA) 1997. The MAD refers to a proxy measure of IBL/SHDA.

Table 4 shows the quantum of mean change in equity as a direct consequence of adoption of specific IFRS. The IFRS that have had the greatest impact on equity are AASB 3 Business Combinations (mean \$61.12 million increase in equity), AASB 139 Financial Instruments (mean \$-61.72 million decrease in equity) and AASB 2 Share-Based Payment (mean \$-14.74 million decrease in equity).

TABLE 4: AUSTRALIAN COMPANIES' IMPACT OF KEY IFRSS ON EQUITY

Impact of IFRSs on Equity (millions)	AASB 2 <i>Share Based Payments</i>	AASB 3 <i>Business Combinations</i>	AASB 112 <i>Income Taxes</i>	AASB 116 <i>PPE</i>	AASB 123 <i>Borrowing Costs</i>	AASB 128 <i>Investments in Associates</i>	AASB 137 <i>Provisions</i>	AASB 138 <i>Intangibles</i>	AASB 139 <i>Financial Instruments</i>
Mean	-9.55	36.43	-48.31	-2.78	-4.89	3.01	-1.57	-3.89	-36.46
Standard Error	4.69	43.92	18.17	1,35	4.37	9.41	1,14	43.55	67.95
Median	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Standard Deviation	48.08	447.97	181.77	13.89	44.86	96.43	11.76	442.02	696.31
Kurtosis	68.06	91.32	28.39	24.78	102.89	68.00	72.96	54.31	62.09
Skewness	-7.74	9.12	-5.07	-4.72	-10.10	6.66	-8.04	4.82	-5.15
Minimum	-448.00	-1,002.08	-1,229.00	-90,40	-458.00	-308.40	-110.63	-1,919.10	-6,089.90
Maximum	21.05	4,417.00	90.60	26.70	10.00	877.55	15,74	3,723.00	3,524.72
Count	105	104	100	105	105	105	105	103	105

Descriptive statistics of the impact of specific IFRSs on equity on transition to IFRS of top Australian listed companies. The number of companies (count) varies depending on availability of data.

Table 5 provides the results of a paired t-test for the 105 sample companies. The introduction of IFRS itself has increased the MAD amount by a notable 13.19%. This increase is statistically significant for both one-tail and two-tail t-tests. This result is consistent with the findings of Ahmed and Goodwin (2006) who found a statistically significant increase in leverage (total liabilities/total assets) on transition to IFRS adoption.

TABLE 5: Paired t Test of the Maximum Allowable Debt Pre- and Post-IFRS Adoption

<i>Thin Capitalisation Position</i>	<i>MAD (GAAP)</i>	<i>MAD (IFRS)</i>
Mean	37.98	42.99
Variance	824.04	1003.19
Observations	67	67
Change %	13.19	
Hypothesised Mean Difference	0	
t Stat	-2.48	
P(T<=t) one-tail	0.01	
t Critical one-tail	1.67	
P(T<=t) two-tail	0.02	
t Critical two-tail	2.00	

Paired two sample t-test comparing mean maximum allowable debt (MAD) on transition to IFRS adoption The MAD refers to a proxy measure of IBL/SHDA. The mean MAD has increased by 13.18% on transition to IFRS adoption. This is statistically significant using both one-tail and two-tail t tests.

A MAD value exceeding 1.0 indicates that the quantum of interest bearing liabilities is excessively high compared to the SHDA amount. Consequently, interest payments and loan fees could be denied as an allowable deduction under the Australian thin capitalisation provisions. There is one company in the sample set that had a proxy measure of MAD ratio less than 1.0 pre-IFRS that then exceeded 1.0 post-IFRS, purely as a consequence of adoption of the new standards. In the absence of the three year transitional election provided by Treasury, debt deductions potentially could be denied for this company under the thin capitalisation provisions. Further, there are several other companies whose MAD ratio increased from less than 60% (80%) pre-IFRS to greater than 60% (80%) post-IFRS which may put those companies (be it significant or not) under pressure in meeting the thin capitalisation provisions. A consequence of this is that these companies may have to adjust the nature, quantum and source of new capital raisings (debt or equity) which inturn may be incompatible with the firm's business objectives.

6 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

Using a sample set of 105 top (by market capitalisation) non-financial, non-ADI, non-insurance Australian listed companies, this study analyses the income tax thin capitalisation consequence of the Australian movement to full adoption of IFRS rules.

This is important because the thin capitalisation rules apply to entities whose assets are funded by a high level of debt and relatively little equity. Companies that use debt to finance projects or investments do so to maximise the tax deductibility of interest payments in Australia.

The Treasury (2006) outline benefits associated with using accounting standards to value financial statement elements for thin capitalisation purposes. They state that IFRS are comprehensive, transparent and objective and that they reduce compliance costs as accounting standards are used for calculating thin capitalisation positions. Further as companies that are subject to the thin capitalisation rules are multinational companies operating in several jurisdictions, use of IFRS for thin capitalisation purposes facilitates comparability as these jurisdictions are also likely to use Australian IFRS equivalents.

There is a statistically significant increase in the ratio of interest bearing liabilities to a proxy measure of safe harbour debt amount on transition to IFRS adoption. This ratio increased by 13.19% from a mean of 37.98% under GAAP to 42.99% on commencement of IFRS adoption in Australia. This demonstrates that adoption of IFRS in Australia has had an important effect on the thin capitalisation position of Australian listed firms.

There are a number of policy implications arising from these results. One important policy implication revolves around the application of fair value accounting. A significant change with the introduction of IFRS is the fair value measurement and recognition of financial assets and financial liabilities. Determination of fair value may involve significant assumptions by management leading to inherent uncertainty in valuation of assets, liabilities and equity. Consequently, fair value measurement and recognition of financial statement elements may in turn impact on the thin capitalisation position of an entity and its compliance with those provisions (Joseph, 2005). Determination of fair value may have policy implications with respect to calculation of an entity's thin capitalisation position. However, as the thin capitalisation position of only one of 105 sample companies was significantly impacted by the introduction of IFRS, no significant policy implications involving fair value appear to be required. A second important policy implication centres on thin capitalisation compliance costs. Compliance costs may increase as companies require independent valuations or independent verifications of revalued assets under IFRS and fair value measurement of financial assets and liabilities for instance. Alignment of taxation provisions and accounting standards purportedly reduces compliance costs and ensures consistency in application thereby reducing uncertainty for stakeholders (Joseph, 2005). However, if the thin capitalisation position of companies varies greatly depending on fair value measurements of financial statement elements, then this may increase compliance costs.

Through calculation of a safe harbour debt amount and comparison of that amount with the interest bearing liabilities of the firm (i.e. debt interest), the impact of IFRS adoption in Australia on the thin capitalisation position of 105 Australian listed companies was quantified. There is one sample company that pre-IFRS adoption had no potential thin capitalisation compliance exposure but, as a direct consequence of IFRS adoption, now has thin capitalisation compliance exposure. Although the introduction of IFRS has had a significant impact on the thin capitalisation position of Australian listed firms, there is only one company with the sample set of 105 that potentially does not comply with those provisions as a direct result of IFRS adoption.

Overall, the introduction of the new IFRS rules in Australia does not present a major thin capitalisation compliance risk to listed firms.

Nethercott and Hanlon (2004) highlighted that the introduction of IFRS and convergence of tax and accounting standards in Australia would likely to lead to a reduction in thin capitalisation compliance costs. For those companies whose thin capitalisation position changed significantly as a consequence of IFRS adoption, the government may be required to legislate to remove the change relating to IFRS adoption. However, to modify the existing thin capitalisation provisions relating to a small group of companies may introduce unwarranted complexity into these provisions and associated increased administration costs. The Institute of Chartered Accountants (p. 7) has stipulated that their preferred option would be to allow these impacted companies to “recognise and/or establish their own valuation of certain assets or liabilities for thin capitalisation purposes, where those assets and liabilities would not be recognised or would be given a different value under AIFRS”. They further indicate that the IFRS impacts are not necessarily restricted to a limited number of special interest companies and should therefore be available to all companies and other entities on an optional elective basis. New tests relating to valuation and revaluations for thin capitalisation purposes are required based on the results. For instance, the ICAA highlight that internally generated intangibles could be provided with a particular asset value for thin capitalisation purposes even though they may not be recognised as assets in the balance sheet under IFRS. Integrity of valuations and revaluations would also be required. The results of this study indicate that the suggested policy initiatives of the ICAA could be implemented in respect of the small number of companies that do not or are in danger of not complying with the thin capitalisation provisions following the introduction of IFRS. Application of the ICAA policy initiatives would not unduly increase compliance costs or reduce consistency in application of the thin capitalisation rules. An alternative is to extend the existing grandfathering rules (i.e. GAAP) for thin capitalisation purposes as suggested by The G100 although this option was not supported by the ICAA. The findings of this study indicate that an extension of the previous accounting GAAP treatment of financial statement elements specially used to calculate the thin capitalisation position of firms could also be undertaken. These factors need to be considered by relevant stakeholders including the AASB, ATO, Treasury, auditors, lenders and company management.

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Tax Advantages for Bungling Trustees

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Abstract

Where property is transferred and the manner in which the transaction is carried out results in an unforeseen or unwanted tax liability, what can be done? For individuals, there are some remedies, but for the main part, where the only error was as to the tax liability, claims cannot be brought to undo the transaction or the tax liability. Trustees on the other hand seem to have an alternative avenue, using the principle in *Hastings-Bass*. This article considers the *Hastings-Bass* principle and its development and contrasts the position for trustees with the position for individuals. It will be seen that trustees can negate a tax liability in a very advantageous manner and so any justifications for this difference in treatment as between trustees and individuals will be considered along with the steps that should be taken in the absence of any good justification.

1. INTRODUCTION

On the occasion of any transaction, it is important to consider whether or not a tax consequence might ensue. Where someone (an individual) does not consider the tax consequences, or receives bad tax advice in relation to the tax consequences, or receives good advice on minimising the tax but fails to implement the advice correctly, there is no tax relief. In these circumstances the tax which is triggered by the transaction is nonetheless payable to the Revenue. The taxpayer may try to argue that had he known that the tax would be payable he either would not have entered into the transaction, or he would have structured it differently. However, this argument will not succeed – the tax liability has crystallised, it did so at the time of the transaction. The taxpayer cannot retrospectively “undo” the transaction so as to make the tax liability disappear. However, in the UK, in these circumstances, a trustee would be able to claim exactly what an individual could not claim – the trustee will be able to say he did not realise the tax consequences of the transaction and had he appreciated them, he would not have made the transfer and the transfer can be undone. This is the controversial rule in *Re Hastings-Bass*¹ that was established in England, and has been applied elsewhere.²

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¹ [1975] Ch 25.

² For example, it has been discussed in Ireland, (*Irish pensions Trust Ltd. v Central Remedial Clinic* (Unreported, High Court, 18th March, 2005) and *Boliden Tara Mines Limited v Cosgrove & Ors* [2007] IEHC 60). Also applied in Jersey (*Re the Green GLG Trust* (2002) 5 ITELR 590; *re representation Friedman and Asiastrust Ltd* [2006] JRC 187 (Royal Ct(Jer))) and in the Cayman Islands (*A v Rothschild Trust Cayman Ltd* [2006] WTLR 1129; *Barclays Private Bank & Trust (Cayman) Ltd v Chamberlain* [2007] WTLR 1697). However, the principle is not used in Scotland (see D. Francis “*Hastings Bass* and his Scottish friends” [2008] S.L.T. 161).

This article first considers the *Hastings-Bass* principle, which stems from case law, and the way in which it is evolving as a tool for trustees to escape from transactions where there are unwelcome tax consequences. Then it will explore the extent to which this goes further than the remedies available to individuals. Finally, it will consider for whose benefit the *Hastings-Bass* principle operates and whether there can be any justification for the difference in treatment between individuals and trusts.

Three observations are worth mentioning from the outset. First, the focus of this article is on unilateral, or gratuitous, transactions.³ Different rules can apply where there is a bilateral transaction, or transaction for value, at issue. This article will discuss only the former type of transfer. This is because *Hastings-Bass* cases relate to dispositions by trustees, and the best comparator is a unilateral transfer made by an individual.⁴ Secondly, these issues are not dealt with in the tax legislation. Thus far, tax legislation relating to mistakes made by the taxpayer relate to mistakes made in paying the tax – if an overpayment of tax is made by mistake, then it can be recovered using statutory mechanisms in place for the recovery of that overpayment.⁵ A common law claim in unjust enrichment could also (or alternatively) aid the taxpayer in recovering tax paid by mistake.⁶ The cases at issue in this article do not argue that the tax has been paid by mistake. Rather, they argue that the mistake is the transfer of funds which has been made to another party. That transfer triggered a tax liability, but if the transfer is undone, the basis of the tax liability disappears and so the tax should be recovered from the Revenue. These cases are therefore of a different species to those where the tax itself is paid as a result of a mistake. Finally, it is worth noting that the cases discussed in this article mainly concern the UK taxes Capital Gains Tax (“CGT”)⁷ and Inheritance Tax (“IHT”)⁸. This is not to say that the principle does not apply to other taxes, it is simply that in the UK, the cases that have been brought to court on this issue concern trustees failing to appreciate the CGT or IHT consequences of their transactions. Thus, this principle should be considered in a wider context as applicable to any taxes in relation to which trustees might make errors.

³ For a more fulsome discussion see B. Hacker “Mistakes in the Execution of Documents: Recent Cases on Rectification and Related Doctrines” (2008) 19 KLJ 293.

⁴ Note that there is a difference between a unilateral transfer and unilateral mistake and this article will not discuss rectification for unilateral mistake, only unilateral transfer.

⁵ E.g. ss.33 and 42 of the Taxes Management Act 1970 (UK) and s.80 of the Value Added Tax Act 1994 (UK).

⁶ There is some controversy over the interaction between the common law and legislative regimes where the legislation does not specifically exclude a common law claim. For more discussion see J. Beatson “Restitution of Taxes, Levies and Other Imposts” (1993) 109 LQR 405 at p.420; M. Bhandari and C. Mitchell “Lessons of the *Metallgesellschaft* litigation” [2008] RLR 1 at pp.15-17. See s.80(7) of the Value Added Tax Act 1994 (UK) for an example of legislation which specifically excludes a common law claim.

⁷ See Taxation of Chargeable Gains Act 1992 (UK).

⁸ See Inheritance Tax Act 1984 (UK).

2. THE *HASTINGS-BASS* PRINCIPLE

Whilst the decision in *Hastings-Bass* itself was made in 1975, the principle has, even recently, been described as “emerging” and “developing”.⁹ In fact, the principle in its current form was not even applied in *Hastings-Bass*, rather it is the principle as explained in *Mettoy Pension Trustees v Evans*¹⁰ that is used in later cases.¹¹ It is interesting to note that *Hastings-Bass* concerned the Revenue seeking to have a transaction set aside but it did not succeed. Yet in the more recent cases, the principle has been used successfully to avoid tax liabilities and so the Revenue contributed to creating the very principle which has come to haunt them.¹²

*Re Hastings-Bass*¹³ related to a tax avoidance scheme. On the death of the beneficiary of the trust, Captain Hastings Bass, his interest was to pass to his son, which would trigger estate duty. In order to minimise this tax charge, in 1958 the trustees of the settlement advanced a fund valued at £50,000 to another trust set up in 1957 by Captain Hastings-Bass’ sister, under which the son had a life interest. This would have the effect of removing the funds from his estate before his death and so they would not be subject to estate duty. The scheme would have been successful were it not for the Revenue’s appeal of *Re: Pilkington’s Will Trusts*¹⁴ in relation to the rule against perpetuities. The decision of the House of Lords¹⁵ in that case meant that the trust of the fund declared by reference to the 1957 trust was void for perpetuity. Therefore, the Revenue claimed that no life interest had vested in the son and the fund remained part of the original trust. As Captain Hastings-Bass had died in 1964, estate duty should be payable on the transfer of his life interest.

At first instance it was held that the transfer had not been effective on the basis that the actual transaction in 1958 was substantially or essentially different from the intentions of the transferring trustees. This decision was taken following the principle set out in *Re Abrahams Will Trust*.¹⁶ However, the Court of Appeal overturned the first instance decision. The court considered that this case could be distinguished from *Re Abrahams Will Trust*. In that case, the transaction actually carried out could be regarded as being substantially different to the intended transfer because it was possible to say that the actual transfer was not for the benefit of the intended recipient. Here, however, there was still a benefit to the son even though some parts of the trust were void for perpetuities. The court held that it would not interfere with the exercise of a trustee’s discretion, even if the transaction did not achieve the full effect that was attended, unless

“(2) it is clear that he [the trustee] would not have acted as he did

(a) had he not taken into account considerations which he should not have taken into account, or

⁹ *Breadner v Granville-Grossman’s Settlement* [2000] EWHC Ch 224 at [46] and [58]; *Sieff v Fox* [2005] EWHC 1312 (Ch) at [118]; *Gallaher Ltd v Gallaher Pensions Ltd* [2005] EWHC 42 (Ch) at [163].

¹⁰ [1990] 1 WLR 1587 at 1621.

¹¹ E.g. *Breander*, above, fn.9 at [59]; *AMP (UK) Ltd v Barker* [2000] EWHC Ch 42 at [85]; *Sieff*, above, fn.9 at [114]; *Burrell v Burrell* [2005] EWHC 245 (Ch) at [15] and [16].

¹² See M. Gunn “Turning the Clock Back” (2002) 148 Taxation 634.

¹³ Above, fn.1.

¹⁴ [1959] 1 Ch. 699.

¹⁵ [1964] AC 612.

¹⁶ [1969] 1 Ch. 463.

(b) had he not failed to take into account considerations which he ought to have taken into account.”¹⁷

This is the quotation which has proved fundamental to the development of the principle.¹⁸ The basis is that where the trustee has acted properly within his power, there is no reason for the court to interfere. The court set out clearly in its summary that unless the provisions of its condition were satisfied, a decision taken by a trustee could not be set aside. However, the quotation has often been described as being in a negative form,¹⁹ and it was in the case of *Mettoy* that it was put in the positive form that:

“where a trustee acts under a discretion given to him by the terms of the trust, the court will interfere with his action if it is clear that he would not have acted as he did had he not failed to take into account considerations which he ought to have taken into account.”²⁰

Whilst many commentators and the case law have seen this to be a mere positive form of what was said in *Hastings-Bass* it is submitted that this is in fact a development of the principle. In *Hastings-Bass* the court merely set out when it would not interfere. It certainly did not state that where the conditions were satisfied there was an obligation for the court to step in, nor that the court *should* step in.²¹ Thus, *Mettoy* was the first development of and move away from the original statement in *Hastings-Bass*. There is no reason for the court to interfere in every situation where a trustee takes into account irrelevant considerations and nor when relevant considerations are not taken into account. Often there is no harm to anyone and such cases will not even come to the attention of the courts. Just because a case does come to court, that is not to say that the court should always interfere, even where there is no party to object to the transaction being set aside and especially where the only supposed harm is a tax liability. In the tax cases it is common for both parties to a case to seek the remedy²², because they will both benefit from a reduced tax bill, as will be seen from the discussion of the cases below.

It is not in the interests of certainty that the courts can merely set aside transactions on the basis that the parties want to do so. Normally the cases come to court because to do so will benefit one party, but generally there is also a detriment to someone. In the cases of interest here, generally the Revenue will be affected.²³ In such circumstances, *Mettoy* suggests that the courts are compelled to interfere, and this is a move away from *Hastings-Bass*. A problem with the development of the principle is that the Court of Appeal has not had the chance to revisit this issue further to the developments in the

¹⁷ *Hastings-Bass*, above, fn.1 at 41.

¹⁸ There have been differing views between judges as to whether this is a principle or a rule. In this article, “principle” is used due to the preference of the view that it is not mandatory for the courts to apply this, rather they retain some discretion.

¹⁹ *Sieff*, above, fn.9 at [46]; *Burrell*, above, fn.11 at [16]; *Breadner*, above, fn.9 at [59]; *AMP*, above fn.11 at [84]; *Mettoy* above, fn.10 at 1621.

²⁰ *Mettoy*, above, fn.100 at 1621.

²¹ See also “HMRC and the Hastings Bass Principle” Revenue Tax Bulletin 83 (June 2006), also released as Revenue Interpretation 278, available at <http://www.hmrc.gov.uk/bulletins/tb83.htm#2>.

²² E.g. both the trustee and the beneficiary

²³ Other cases have used the principle in a different context, for example, in relation to pensions, which are outside the scope of this article. For more detail see for example *Kerr v British Leyland (Staff Trustees Ltd* [2001] WTLR 1071 and *Stannard v Fisons Pension Trust* [1991] PLR 224.

lower courts. One reason for this is that often there is no party contesting the setting aside of the transaction and therefore no party to appeal. The only party with an objection is the Revenue, yet, thus far, it has not appeared in the cases following *Hastings-Bass*.

3. THE REVENUE'S RELUCTANCE TO PARTICIPATE IN *HASTINGS-BASS* CASES

In many cases, an offer was made to the Revenue to be joined as a party, however it has always refused,²⁴ although in some cases it has additionally asked for certain authorities to be brought to the attention of the court.²⁵ Where the court makes an order, only the parties to that order are bound by it. Therefore, it seems possible that the Revenue hopes not be bound by the orders if it does not participate in any way and so does not have to refund (or waive a right to) any tax.²⁶ In rectification cases, in which the Revenue has also been reluctant to participate,²⁷ the Revenue has indicated that as long as it was asked to be joined as parties, it will accept the retrospective effect of the order for tax purposes.²⁸

Whilst it appears that the reluctance to be joined as a party stems from the Revenue's desire to escape from being bound by the court order, there have not been any cases in which the parties have requested that the court orders be enforced as against the Revenue or that a court order is issued against the Revenue. Therefore, there must be other reasons for the reluctance of the Revenue to be involved thus far. One possible further reason is perhaps that the Revenue does not have the resources to fight each of these claims. In recent cases, the reluctance of the Revenue to be involved in the court proceedings has been criticised²⁹ and therefore, the Revenue issued Revenue Interpretation 278³⁰ which indicates that the Revenue will be more likely to participate in such cases in the future. This is in part due to the criticism received in the case of *Sieff v Fox* and also because the Revenue considers that the principle has been formulated far too widely.

Additionally, the recent case of *Ogden v Trustees of the RHS Griffiths 2003 Settlement*³¹ is likely to persuade the Revenue to be much more actively involved in such cases. This was a mistake case and related to IHT. The deceased carried out transfers in order to minimise IHT, but the scheme would only work if he survived for 7 years. In fact, he only survived for 2 years because he had an aggressive form of cancer, which he did not know about when he made the transfer. If the transactions

²⁴ E.g. *Sieff*, above, fn.9 at [29]; *Burrell*, above, fn.11 at [13]; *Abacus Trust Company v Barr* [2003] EWHC 114 (Ch) at [12]; *Abacus Trust Co (Isle of Man) Ltd v NSPCC* [2001] STC 1344 at [2].

²⁵ E.g. *Burrell*, above, fn.11 at [13]. The same has been done in relation to mistake and rectification cases. See for example *Ogden v Trustees of the RHS Griffiths 2003 Settlement* [2008] EWHC 118 (Ch) at [6]; *Farmer v Sloan* [2004] EWHC 606 (Ch) at [8].

²⁶ *Gunn*, above, fn.122 at p.636. See also *NSPCC*, above, fn.24 at [2] where the Revenue refused to agree to be bound by the decision of the court.

²⁷ E.g. *Farmer*, above, fn.25 at [8]; *Racal Group Services Ltd v Ashmore* [1995] STC 1151 at 1154.

²⁸ See C. Gothard *Breaches of trust – "Recent Developments, Pitfalls and Ways out for the UK and Offshore Trustees"* (2002) 8 *Trusts and Trustees* 9 at p.14, where he mentions the statement by P. Trevett QC in a lecture that this is confirmed in the CTO Trust manual at para.1865.

²⁹ E.g. *Sieff*, above, fn.9 at [83], although Lloyd LJ recognised there might be policy reasons for this stance by the Revenue. For problems stemming from Revenue's reluctance to be joined as a party see C. Mitchell "Reining in the Rule in *Re Hastings-Bass*" (2006) 122 LQR 35 at p.36; *Breadner*, above, fn.5 at [61]; R Walker, "The Limits of the Principle in *Re Hastings-Bass*" (2002) 13 KCLJ 173 at p.183.

³⁰ Above, fn.21.

³¹ *Ogden*, above, fn.25.

had not been carried out, the estate would have passed to the deceased's wife tax free³² but in the event attracted IHT of over £1million.³³ Lewison J. allowed a transaction to be undone on the basis that the deceased had made a mistake as to his health. However, he also said it was difficult to say for certain that the deceased did indeed have cancer at the relevant date and had the facts been contested, it would have been difficult to make the finding of cancer existing at the time of the transaction.³⁴ Thus, if the Revenue had not refused to participate in the proceedings,³⁵ adversarial argument, even just regarding the significance of doctor's reports and the weight that could be attached to vague statements, might have made all the difference.

The fact that the Revenue insists on a court order for the transaction to be set aside before it adjusts any tax consequences is entirely appropriate based on the fact that the parties involved will normally agree to set aside the transaction, as it will be to their benefit. The Revenue should not be forced to accept a reduction in tax with no legal force – the tax liability arose lawfully and so in the absence of any reason to negate the liability, it has no obligation to waive it. The parties' claim of "because we want to," can not be sufficient. However, without the presentation of argument by the Revenue, it is difficult to get a real sense of what the contrary arguments to the application of the *Hastings-Bass* principle actually are. It should be noted, however, that judges have praised parties in the cases for presenting both sides of the argument even where they both seek to have the transaction set aside.³⁶ The Revenue's position of non-interference may stem from the reluctance to have binding authority against them, which parties would then be able to use as a precedent without going to court. If the Revenue does intervene in a case, it is likely to be one which is very much in its favour, rather than a case strongly based on precedent to have the transaction set aside.

4. HASTINGS-BASS IN AN EARLY TAX CASE

An example of the *Hastings-Bass* principle being successfully applied in the tax context is *Green v Cobham*,³⁷ one of the first significant tax cases in which the trustees were able to set aside the transaction. The case opened the doors for trustees to escape from unwanted tax consequences. A will trust was set up in the British Virgin Islands and its assets included ownership of a holding company, which held shares in companies established by the testator. The beneficiaries of the trust included the grandchildren of the testator. In 1990, the holding company had a large reserve of retained profits and the trustees wished to distribute these to the grandchildren. As three of them were minors, their shares were distributed through two accumulation and maintenance trusts ("A&M trusts").³⁸

³² S.18 of the IHTA 1984.

³³ *Ogden*, above, fn.25 at para.5. However, had the scheme worked correctly a great deal more tax would have been saved.

³⁴ *ibid*, at [18].

³⁵ *ibid*, at [6].

³⁶ *Gallaher*, above, fn.9 at [162]; *NSPCC*, above, fn. 24 at [2].

³⁷ [2002] STC 820 (judgment given January 2000).

³⁸ An accumulation and maintenance trust is one in which most of the income is accumulated in the trust until a later date. Income is only paid out to the extent that it is necessary for the maintenance of the beneficiary (e.g. for education, living expenses). This type of trust is common to provide a benefit at a later date, for example, to provide for infants or children, whose need during childhood is simply to have education and/or living expenses paid for. The accumulated income and capital portion of the trust is retained for their benefit in the future after the age of perhaps 18, 21 or 25. The tax consequences of

The will trust and the A&M trusts were treated as one single settlement for CGT purposes. In order to prevent tax from being paid in the UK, the trust had to be non-resident in the UK. In order to achieve this, a sufficient number of the trustees had to be non-resident. On setting up the will trust and the A&M trusts, this requirement was satisfied. Some of the trustees were non-resident by virtue of the rule at the time in s69(2) of the Taxation of Chargeable Gains Act 1992 (UK) (TCGA) which set out that if a trustee carried on the business of managing trusts, and was the trustee of a will trust, he was treated as non-resident wherever he actually resided.³⁹ The A&M trusts were established in November 1990. In December 1990 one of the trustees of the A&M trust retired from practice. Therefore, he no longer fulfilled the condition in s69(2) and was now a UK resident trustee. There were no longer sufficient non-resident trustees for the settlement to be treated as non-UK resident. Thus UK tax rules applied to the settlement and CGT would be payable on all disposals by both the holding company and the will trust. The shares held by the holding company had approximately £35million unrealised gains.

The trustees sought to have the declaration of the A&M trusts set aside, so that the retirement of the trustee from a law firm had no effect on the residency of the will trust and so UK CGT would not be payable. They sought to have the declaration set aside on the basis that they did not take into account the CGT consequences of the declaration and had they realised the CGT consequences, they would not have made it. It was clear that the trustees had not thought about the CGT consequences at all⁴⁰ and nor had they been advised to do so by lawyers advising them on the transaction. This was essentially because no one had considered that the A&M trusts would be treated as part of the same settlement as the will trust. Both parties here sought an order from the court to set aside the declaration, but the defendants put forward the opposing arguments, in the absence of an opposing party. However, as has been mentioned, this is not the same as the Revenue putting forward their own arguments.

Jonathan Parker J. accepted that such matters were those that the trustees should have taken into account and that the trustees would not have made the declaration if they had taken into account the CGT consequences.⁴¹ The problem is that the only reason the trust became resident in the UK was because one trustee ceased to practice at a law firm, but Jonathan Parker J. rejected this argument against setting aside the declaration. He stated that the tax consequences flowed from the trust deed itself, even though they did not flow immediately. The error was making the residence of the will trust dependent on the make up of trustees of the A&M trusts, which was out of the control of the will trust trustees.

However, this reasoning is problematic. Had the trustee not retired, there would have been no cause to have the declaration set aside – the declaration of trusts only became “defective” due to a later event, unrelated to the declaration itself. Whilst it may be that this falls within the strict letter of the *Hastings-Bass* principle, it is doubtful

these trusts was changed considerably by the Finance Act 2006 (UK) and in many cases, it is no longer as tax efficient to defer the benefit of the trust any later than the age of 18.

³⁹ This legislation was changed by s.88 and Sch. 12 of the Finance Act 2006 (UK) and the reference to residence related to managing trusts abroad has been removed. Therefore, the trustees in this case would no longer be able to escape from being UK resident for CGT purposes in the same way any longer.

⁴⁰ *Green*, above, fn.37 at 824.

⁴¹ *ibid*, at 828.

whether this is actually a deserving case. As will be seen below, outside the context of a trust, if you regret arranging your affairs in a certain way so as to attract an unwanted tax liability, it is unlikely the affairs can be changed or the transactions enacted set aside. Jonathan Parker J. suggested that if the declaration were effective, the CGT effects would be “catastrophic.”⁴² Whilst it is true that a substantial tax liability would have ensued, this description of a tax liability on a £35million gain is questionable.⁴³ What is clear from the application of the *Hastings-Bass* principle in this case is that where an error is made in relation to the tax consequences of a transaction by a trustee, it can be set aside.

5. REMEDIES FOR INDIVIDUALS: RESCISSION AND RECTIFICATION

In order to compare the treatment of trusts and individuals, the extent to which an individual might be able to set aside, or modify, a transaction where there are unwelcome tax consequences which flow from the transaction must be considered. There are two means of changing transactions available to individuals and trustees which are seen more commonly in the courts than the *Hastings-Bass* principle, and which are far less controversial:⁴⁴ rescission due to a mistake and rectification. Both of these are equitable remedies and it has been said that in fact rectification is just one aspect of a wider equitable jurisdiction to relieve parties from the consequences of mistake⁴⁵ and so rescission and rectification are different remedies for mistakes.⁴⁶ Rescission undoes the transaction and so the situation is treated as if the transaction never occurred. This is because rescission is the remedy for a situation where a mistake has been made such that consent to the transaction is negated. Where such a mistake is established it can be said that the transaction never actually happened. Rectification on the other hand is the remedy where a mistake has been made such that the intention of the transferor is not borne out. Therefore, this remedy allows the transferor to rectify the documentation so that it accurately reflects his intention.

A full consideration of these two remedies is outside the scope of this article.⁴⁷ However, two observations are worthy of note. First, in cases involving tax, these remedies are rarely available⁴⁸ and in particular, they are not usually available where the only mistake relates to tax consequences. For example, in relation to rescission for mistake the line drawn in *Gibbon v Mitchell*⁴⁹ is most often used, where Millet J. stated that the mistake must relate to the legal effects of the transaction and not merely the consequences or advantages to be gained by entering into it.⁵⁰ This distinction between the effects and the consequences of the transaction has been used to deny relief in cases where the mistake made relates purely to the tax (or commercial)

⁴² *ibid.*, at 824.

⁴³ See Walker, above, fn.29 at p.178.

⁴⁴ Cf. J. Hilliard “*Re Hastings-Bass*: too good to be true?” (2002) 16 TLI 202 at pp.203-204.

⁴⁵ *Gibbon v Mitchell* [1990] 1 WLR 1304 (Ch D) at 1307.

⁴⁶ *ibid.* See also Häcker, above, fn.3 at p.320.

⁴⁷ For more detail see J. Hilliard “*Gibbon v Mitchell* reconsidered: mistakes as to effects and mistakes as to consequences: part 1” [2004] PCB 357; J. Hilliard “*Gibbon v Mitchell* reconsidered: mistakes as to effects and mistakes as to consequences: part 2” [2005] PCB 31; Häcker, above, fn.46.

⁴⁸ E.g. remedies refused in *Racal*, above, fn.27; *Whiteside v Whiteside* [1950] Ch. 56; *Allnutt v Wilding* [2007] EWCA Civ. 412.

⁴⁹ Above, fn.45.

⁵⁰ *ibid.* at 1309.

consequences of the mistake. Whilst, this distinction is not without its critics,⁵¹ it is still the key test used in the case law.

Second, and more importantly for the current purposes, it has only been in cases where rescission for mistake and rectification are *not* available as remedies that the *Hastings-Bass* principle has been used. Either the other remedies have been argued and discounted or it has been assumed that the other remedies are not available and so the *Hastings-Bass* principle can be used.

Therefore it is clear that whilst individuals do have remedies available to them in order to undo a mistake, they cannot usually escape from the tax consequences of a transaction. The *Hastings-Bass* principle allows a transaction to be undone in cases where an individual would have no success. Thus, there is a difference in the extent to which trustees and individuals can undo transactions for tax purposes.

6. TYPES OF MISTAKE RELATING TO TAX

One further issue to consider is whether the type of error relating to taxation should make any difference. A range of tax errors can be at issue when a taxpayer wishes to undo a transaction. The taxpayer may simply be unaware of a tax charge at the time of entering into the transaction, the taxpayer may have received incorrect tax advice relating to the transaction or the taxpayer may have implemented the tax advice incorrectly. In the first circumstance, where the taxpayer is simply unaware of the tax charge, this should not be a sufficient reason to undo the transaction. Many tax consequences can attach to transactions and taxpayers have an obligation to inform themselves of the tax liabilities which flow from a transaction. Therefore the fact that the charge was “unknown” at the time of entering into the transaction cannot be a sufficient mistake to undo the transaction.⁵² Certainly if an individual claims he would not have entered into a transaction if he had known the tax consequences of it, there would be no basis for setting aside the transaction. However, in the case of trustees, this issue becomes more complicated, because the trustees have not informed themselves of a factor relevant to the transaction and therefore, they can invoke *Hastings-Bass*.

An example of this is *Burrell v Burrell*⁵³ which concerned an IHT liability that the trustees had failed to appreciate. The settlor wished to pass some of the substantial shareholding in a company, of which he was chairman, to his family. These shares were of the type that attracted Business Property Relief for IHT purposes,⁵⁴ which should have meant that the shares were IHT-exempt on transfer. An A&M trust of the shares was set up in favour of the settlor’s son.⁵⁵ However, when the son reached the age of majority, the settlor thought the dividends on the shares were too high for someone of such a young age to receive. Therefore, the trustees decided to end the

⁵¹ E.g. J. Hilliard “Limiting *Re Hastings-Bass*” [2004] *Conveyancer* 208 at p.217.

⁵² Note, in *Barclays Private Bank*, above, fn.2 the trustees did not take into account a change in the law relating to CGT and this was sufficient to set aside the transaction on the basis that a relevant consideration was not taken into account. If such a rule is allowed to stand, there is no motivation for trustees to inform themselves of the law and keep up to date with it. Further, knowledge of the law and changes in it are imputed to individuals and yet trustees seem to be sheltered from the same.

⁵³ Above, fn.11.

⁵⁴ See ss.105(1)(bb) and 122 of the IHTA 1984.

⁵⁵ s.71 of the IHTA 1984. The rules relating to the beneficial IHT treatment of these trusts have changed since the Finance Act 2006 (UK), which undertook a major overhaul of the IHT treatment of trusts.

interest in possession and create two new trusts. The shares mentioned previously were transferred into a discretionary trust. Although the shares were eligible for business property relief, which relieves a lifetime charge to IHT on entry into the trust, the shares had to be owned for two years before the transfer to attract the relief.⁵⁶ The interest in the shares for IHT purposes only vested in the son when he gained an interest in possession of the trust,⁵⁷ which was at the age of 18. The transfer took place when he was 19 and so he had not owned the shares for the requisite period. Thus the transfer into the trust attracted an IHT liability of up to £1.47million. Mann J. suggested that this would be “a very serious loss to the trust estate.”⁵⁸ Mann J. stated that trustees must consider the tax consequences of their decisions and that failure to do so can trigger the *Hastings-Bass* principle.⁵⁹ The trustees had tax consequences in their mind, but they did not give them proper attention.⁶⁰

However, another way of looking at this is to say that the trustees have not done something which it is their duty to do; they should take into account the tax consequences of a transaction, in the same manner that an individual must. If trustees do not, they have acted in a manner that is negligent and thus a negligence claim or breach of duty claim can be pursued. It is not right to undo the transaction in order to make the tax liability disappear. In fact, in *Burrell* it can be said that the trustee gave the tax issues as much thought as he was able. He then relied on the legal advisers to give him proper advice about the tax consequences. The solicitors were negligent in failing to give the trustees the full picture in relation to tax consequences.⁶¹ Mann J. granted the declaration of invalidity of this trust despite the fact that both the legal advisers and the trustees were clearly negligent. This means they both escaped any liability for their negligence and were able simply to escape from the transaction altogether.⁶² Furthermore, the trustees had put in place another deed of appointment on the basis that the original creation of the discretionary trust was invalid. Therefore, it was not actually sufficient to set aside the transaction, another transaction had to be carried out and so this should really have been a case for rectification.⁶³

This leads us to other types of mistake. Where tax advice has been received but the advice is incorrect or flawed in some way, giving rise to a tax liability, this is also an error which should be insufficient to set aside the transaction, but has been sufficient in *Hastings-Bass* cases.⁶⁴ For example, in *Sieff* the assets of a settlement included Woburn Abbey and a number of chattels of high value. Of significance is that there was a discretionary trust which contained the chattels. On the 10 year anniversary of the trust (2001), there was a very high 10-year IHT charge.⁶⁵ The trustees sought a

⁵⁶ s.106 of the IHTA 1984.

⁵⁷ s.49 of the IHTA 1984.

⁵⁸ Above, fn.11 at [10].

⁵⁹ *ibid* at [19].

⁶⁰ *ibid* at [20].

⁶¹ *ibid* at [11].

⁶² Note that Hilliard suggests this might in fact be positive, so that the long term relationship between the trustee and the beneficiary can be maintained. See Hilliard, above, fn.44 at p.212.

⁶³ Rectification was not mentioned in this case, but note *Smithson v Hamilton* [2007] EWHC 2900 (Ch) at [60]-[80], Park J. suggests that rectification should not be allowed through the back door by using a *Hastings-Bass* claim.

⁶⁴ *ibid* at [104].

⁶⁵ s.64 of the IHTA 1984. This is a charge that arises on each 10 year anniversary of some types of trust, including discretionary trusts.

way to minimise this charge in future. One option given by the advisers was to transfer the property from the original settlement to Lord Howland, the primary beneficiary, contingent on his being alive on a future date. At that time, Lord Howland would resettle the property in a more flexible trust. The trustees were advised that a CGT charge would arise on the transfer of the assets from one trust to the other,⁶⁶ but that hold-over relief⁶⁷ would be available and so there would be no tax payable at that time. Further, no IHT exit charge⁶⁸ on the transfer out of the discretionary trust would be payable as long as the transfer occurred within three months of the 10 year charge.⁶⁹ This advice was incorrect because this type of hold-over relief for CGT can only operate where there is an IHT charge. Here, there was no IHT charge, as the transfer was made within three months of the 10 year charge (if this had not been the case, an IHT exit charge would have been payable). Thus no hold over relief was available and the CGT charge of approximately £1million was triggered.⁷⁰ (If there had been an IHT exit charge, hold-over relief would have been available).

The other problem with the transfer to the second trust arose in relation to IHT. Lord Howland, as had been planned for some time, moved into an apartment at Woburn Abbey, where the chattels were kept. When the chattels were transferred an IHT charge was triggered as it was an assignment of a contingent interest. However, once Lord Howland was enjoying some benefit from his gift, this would be seen as a gift with reservation of benefit⁷¹ and so the chattels would be treated as part of Lord Howland's estate on his death unless he paid market value for the use of the assets. This was approximately £40,000 a year.⁷² Thus Lloyd L.J.⁷³ pointed out that there was either a high IHT charge on his death, or a high annual sum to be paid from taxed income.⁷⁴ Quite why it is offensive for a taxpayer to have to pay a charge that anyone else in similar circumstances would have to pay from taxed income is unclear. However Lloyd L.J. found that if the trustees had appreciated the tax consequences of the appointment, they would not have made it. Yet the trustees did not overlook the tax consequences – this was a case where the legal advisers were erroneous in their advice. Despite this, the Revenue lost the tax which became payable due to the transaction, rather than the erring legal adviser bearing the burden of incorrect advice.

If tax advice is taken and it is incorrect, then this is not a reason for having the transaction set aside altogether. Rather it is a reason for saying that tax advice given was incorrect and remedies against the tax adviser should be sought.⁷⁵ This is a case where a negligence action should be pursued, rather than undoing the transaction

⁶⁶ s.71(1) of the TCGA 1994.

⁶⁷ s.260 of the TCGA 1994.

⁶⁸ s.65 of the IHTA 1994. This is a charge which arises when assets leave certain types of trust, including discretionary trusts.

⁶⁹ s.65 IHTA

⁷⁰ *Sieff*, above, fn.9 at [25]

⁷¹ s.102 of the Finance Act 1986 (UK).

⁷² *Sieff*, above, fn.99 at [225].

⁷³ Lloyd J. heard the case in the High Court but by the time he gave judgment, he had become Lloyd L.J. However, the judgment is still treated as stemming from the High Court and not the Court of Appeal.

⁷⁴ *Sieff*, above, fn.99 at [25].

⁷⁵ See T.H. Wu "Rationalising *Re Hastings-Bass*: a duty to act on proper bases" [2007] TLI 62 and also Revenue Interpretation 271, above, fn.21 at [6].

itself.⁷⁶ The transaction itself has achieved in legal terms what it was supposed to - the only problem is that it did not have the tax consequences that were hoped for. Where tax advice is sought, there is always a danger that it might not be correct – this is true for any instance of professional advice. The law has mechanisms to deal with such a problem, namely the action of negligence. There is no reason to give added protection to certain groups of people from the effects of such advice. If the advice were in fact correct, then the benefit would have been achieved from the tax avoidance. If there is a corresponding loss, that is simply the risk/reward balance that has to be taken into account when seeking advice.

Where tax advice is taken and is correctly given, but the taxpayer does not effect the transaction in accordance with the advice, then this is also not an error that warrants the transaction being set aside. Yet, again, the *Hastings-Bass* principle has aided trustees in this situation. One example is *Abacus Trust Co (Isle of Man) Ltd v NSPCC*,⁷⁷ which actually gave rise to other cases brought by the same trust company.⁷⁸ This shows how decisions in this area can open the “floodgates.” In *NSPCC*, a CGT liability of approximately £1.2million was successfully avoided. The trustees entered into a “flip flop” scheme to avoid CGT when a loan note matured. For the tax avoidance scheme to succeed, two trusts had to be set up in the tax year ending 5th April 1998 and an appointment to charity had to be undertaken after 6th April 1998: the transactions had to be in different tax years. Counsel advised the trustee company of this fact, but the lawyer drafting the documents suggested the appointment be made on 3rd April and the director of the trustee company agreed without referring to his notes from his meeting with Counsel. Patten J. held the trustees had an obligation to consider if an appointment would result in a significant tax charge for the beneficiaries or the fund and failure to do so could bring the *Hastings-Bass* principle into play.⁷⁹

The problem is that the trustees received good tax advice which they did not follow, yet they were able to escape from the tax consequences and any liability. This seems at odds with the way one would expect the law to consider those who follow accurate advice in an inaccurate manner. The fault lies with the trustees alone - why should the burden of their error be passed to anyone else?⁸⁰ By not taking care in effecting the transaction, the transferor has taken the risk of falling outside the parameters of the advice. If an individual does this, then there is no recourse to anyone, because this is the fault of the individual himself. If a trustee makes the same mistake and there is a resulting loss to the beneficiary, the beneficiary could seek compensation from the trustee. Where, the trustee has acted negligently, action against the trustee is the correct means for redress.

7. THE BENEFICIARY OF THE *HASTINGS-BASS* PRINCIPLE

As the use of the *Hastings-Bass* principle is available to trustees but not individuals, it is essential to consider who this differential treatment actually benefits so that any justifications for the difference in treatment can be explored. In most cases it will seem that the beneficiary will benefit from being able to set aside the transaction in tax

⁷⁶ In discussion of *Sieff*, above, fn.9 Mitchell, above, fn.29 at p.36 mentions that there must have been a sigh of relief from the legal advisers when the claim was permitted.

⁷⁷ Above, fn.24.

⁷⁸ *Barr*, above, fn.24.

⁷⁹ *NSPCC*, above, fn.24 at [16].

⁸⁰ Discussed further below. See also Wu, above fn.75 at p.76.

cases. This is because setting aside the transaction will either alleviate a tax burden on the beneficiary himself or on the trust. If the beneficiary's own tax burden is relieved, the benefit to the beneficiary is easy to see. If the trust is relieved of a tax burden, the beneficiary still benefits because there will be more assets in the trust in which they have an interest.⁸¹ However, whilst on the face of it the beneficiary benefits in these cases, in fact it is the trustee who benefits. This is because in overlooking a relevant consideration, the trustee has generally acted either in breach of trust⁸² or negligently. Therefore, usually there is a remedy for the beneficiary against the trustee, which would give them compensation for the lost tax.⁸³ Therefore, whilst the law gives protection to the beneficiary through other action, the *Hastings-Bass* principle in fact protects the trustee from an action being brought against them. In cases where the trustee has simply not recognised that there is a tax liability, he has not fulfilled his obligation to consider all aspects of the transaction. Where the trustee obtains legal advice but does not follow it, again the trustee has made the error and so the remedy sought should be against the trustee. Where the trustee has obtained legal advice but the advice has been given negligently, then the action should lie against the professional adviser and no one else. As stated by Wu,⁸⁴ it is a burden on society to undo the transaction where there are other remedies available.⁸⁵

Hilliard has argued that the trustee is not in fact protected by the principle. One reason he gives is that trustees will be protected by a wealth of exemption clauses in the trust documents and so it will be very difficult for beneficiaries to pursue them.⁸⁶ However, as Wu points out⁸⁷ this is an issue better dealt with by considering the rules relating to exemption clauses. If exemption clauses are available in such a wide range of situations that beneficiaries have no protection as against trustees, perhaps the rules for exemption clauses need to be reconsidered – this is not a reason to provide another legal remedy depriving a different person.⁸⁸ On the other hand, if there is a sound basis for the exemption clause rules then the trustees receive protection for sound reasons and the beneficiary should have no claim. The settlor has granted the right to the trustee to be protected against such claims from the beneficiary. Equally, the settlor acknowledges that if the trustee acts in a manner which is outside the bounds of his duty, the beneficiary will receive no protection. Thus, if exemption clauses protect the trustee from liability, the beneficiary has no remedy and this is the extent of the right the settlor has given the beneficiary and which the law allows. No further remedy need be available to protect the beneficiary, yet the *Hastings-Bass* principle means that the

⁸¹ cf. *NSPCC*, above, fn.24 where the undoing the transaction would result in the removal of a gift to a charity but this was not contested by the charity and nor was it by the Attorney General on behalf of the charity, who was invited to make representations in the case.

⁸² In *Barr*, above, fn.24, it was said that the *Hastings-Bass* principle could only be used where there was a breach of trust in place. However later cases have said such a limitation is not necessary, e.g. *Sieff*, above, fn.9, although it is usually present. See also R. Nolan and M. Conaglen "Trustee (in)discretion" [2006] CLJ 15 at pp.16-17; M Thomas and B Dowrick "The Odd Couple? *Hastings Bass* and mistake" [2006] Conveyancer and Property Lawyer 91 at p.95.

⁸³ See I. Ferrier "When trustees err" [2002] Conveyancer and Property Lawyer 199 at p.200 who argues the *Hastings-Bass* principle needs revisiting by the House of Lords, for policy reasons.

⁸⁴ Above, fn.75 at p.76.

⁸⁵ See also I. Dawson "The effect of an unthinking trustees' action" [2002] Conveyancer and Property Lawyer 67 at pp.71-72; R. Nolan and M. Conaglen "*Hastings-Bass* and third parties" [2006] CLJ 499; *Donaldson v Smith* [2006] EWHC 1290 (Ch).

⁸⁶ See Hilliard, above, fn.51 at p. 212. See also *Breadner*, above, fn.9 at [57].

⁸⁷ Wu, above, fn.75 at pp.69-70 and fn.45.

⁸⁸ In the current discussion, that is the Revenue.

burden of the trustee's error moves to the Revenue because no avenue is available against the trustee.

Hilliard also argues that it is the beneficiary who is being protected because using the *Hastings-Bass* principle means that beneficiaries do not have to become entangled in a hostile negligence claim and they do not have to spend their own money to achieve the remedy. The trustee will often have to pay costs for a case involving the *Hastings-Bass* principle.⁸⁹ However, this argument is also weak because in other areas those pursuing a negligence action, for example against a legal adviser, will have to enter into a hostile claim and also pay for this action. There is no reason for which a beneficiary should be sheltered from these consequences.⁹⁰ In cases where the trustee has not acted in breach of trust and has not been negligent, and neither has an adviser to the trustee, there is no reason to protect the beneficiary at all and so there is no reason to allow the *Hastings-Bass* principle at all. Whilst the use of it here will not protect the trustee, it should not be available, as there is no policy motivation for allowing a claim in such circumstances.

It has also been argued that to the extent that no third party loses out, the beneficiary should be able to retain this extra level of protection.⁹¹ However, in tax cases there *is* a third party to consider – namely the Revenue.⁹² The point in these cases is that a tax liability has arisen. In order to say that the tax liability has, in fact, not arisen, requires a sound basis upon which the legitimate liability can be reversed. The Revenue should be considered as a third party which needs protection because its right to receive the money has arisen and wiping out that right to payment should be treated with the same reverence as in relation to the holder of any other right.⁹³ The fact that the parties wish it had not arisen simply cannot be sufficient, just as it would not be sufficient if an individual tried to change the tax consequences of a transaction on the basis that they wished a tax liability had not arisen. In so far as third parties should be considered,⁹⁴ the right of the Revenue should be equal against trustees as it is against individuals. This issue is related to a public policy argument.⁹⁵ If the transaction is set aside and the tax is not payable, society as a whole loses out in order to protect the trustee from a claim against him. The benefit of society as a whole should be put before the protection of a trustee, particularly trustees of the type in these cases who are remunerated for providing a service. There can be no justification for protecting them to the detriment of society as a whole.⁹⁶

⁸⁹ Hilliard, above, fn.51 at pp.207 and 212-213. cf. Dawson, above, fn.85 at p.76.

⁹⁰ See Wu, above, fn.75 at pp. 69-70.

⁹¹ Hilliard, above, fn.51 at p.213.

⁹² Walker, above, fn.29 at p.240 considers that this might be an option, but that the question is open to debate.

⁹³ It could be argued that the Revenue is merely a "volunteer" and therefore should not receive protection. However, the better view is that the Revenue's right is triggered by legislation and as such is at least as strong as that of a purchaser and so the right should be protected as a purchaser's right would be.

⁹⁴ Hilliard, above, fn.51 at p.213 and also Wu, above, fn.75.

⁹⁵ See Ferrier, above, fn.83.

⁹⁶ It is possible in some cases there might be different public policy issues at play which justify the operation of the principle, for example in the case of pensions, where the beneficiaries have purchased an interest and where the policy motivation is very different. There, the issue is not whether or not a tax charge is triggered, but rather whether other decisions taken by the trustees should stand. It has been recognised that pension cases are different, for example by the fact that it only be established that

8. DIFFERENCE IN TREATMENT BETWEEN AN INDIVIDUAL AND A TRUSTEE

It is clear that trustees are protected from tax errors in a way that individuals are not protected. Furthermore, a professional adviser giving advice to a trustee has more protection than one advising an individual because if they give negligent advice, in the former case the transaction can be overturned, but in the latter case a negligence claim may be possible.⁹⁷ The question is then whether there is any justification for this beneficial treatment of trustees. One possible reason why this issue has not been explored in detail in the past (alongside other issues stemming from the *Hastings-Bass* case) could be that it is mainly trust lawyers who have contributed to the discussion in this area, whose whole concern is the relationship between the trustee and beneficiary. From a tax point of view, on the other hand, equity as between taxpayers is a cornerstone of tax policy which should be maintained.⁹⁸ This is a very different aim and when considered, a serious unfairness can be seen.

In *Sieff v Fox* Lloyd L.J. recognised the difference in treatment between individuals and trustees⁹⁹ and said that such a difference was justified for two reasons: first because trustees are dealing with property which is not their own and secondly because trust taxation is more complex. In *Ogden* Lewison J. echoed the first reason by saying that a higher test should apply when an individual disposes of his own property.¹⁰⁰ However, in neither case were these “justifications” explained and, with respect, it is doubtful that these factors are really any justification for the differential treatment.¹⁰¹ In relation to the first, it is difficult to see why there is better protection as between those who are both legal owners. The trustee as a legal owner may hold the assets for the benefit of others, but this does not justify better treatment than for an individual holding property for his own benefit. It may be right that a beneficial owner should get protection against the actions of the legal owner, but that is a separate issue to whether a trustee as legal owner should have a privileged position relative to an absolute legal owner.

The complexity of trust taxation is not a sound reason for the difference either. Taxation can be complicated at any level and whilst the affairs of some individuals are straightforward, those of others are more complicated. As between individuals there is not more favourable treatment in terms of being able to undo the transaction based on the difficulty of the tax rules at issue and so this is not a good reason to justify difference in treatment as between trustees and individuals. Furthermore, whilst taxation of trusts can be complex, the parties have voluntarily put themselves within this complex regime. It is their choice to have the taxation regime of trusts apply to them from the outset and so the parties should not then be able to escape from the transaction when they volunteered to be subject to the complexity. Parties often use

trustees might have acted differently had they taken into account the relevant considerations. *Kerr*, above, fn.23 and *Stannard*, above, fn.23.

⁹⁷ Wu, above, fn.755 at p.68 argues that if the *Hastings-Bass* principle is sound, there is no reason to limit it to trustees, rather why not extend it to other professional advisers?

⁹⁸ This principle, that taxpayers in a similar position should pay a similar amount of tax was recognised in A. Smith *Wealth of Nations* Book V Ch II Part II “Of Taxes”

⁹⁹ *Sieff*, above, fn.9 at [85] and see also Thomas and Dowrick, above, fn.82 at 101.

¹⁰⁰ *Ogden*, above, fn.25 at [27].

¹⁰¹ Mitchell, above, fn.29 at p.41.

trusts in order to avoid tax.¹⁰² In this context the parties have chosen a more complicated regime of taxation in order to pay less. If that fails and they in fact have to pay as much as, or even more, than if they had not entered into the transaction, then that is again of their own volition – in the desire to minimise the tax, the risk of a more complicated taxation regime was taken.

Further, and related to the tax avoidance issue, whilst there is no obligation to set up affairs so as to incur the most amount of tax possible,¹⁰³ there is also no right to pay the minimum tax possible. Thus, the Revenue is an interested party in a transaction resulting in a tax liability, whether or not it was intentional. If an individual arranges his affairs, but fails to take advantage of a scheme which could reduce his tax, this last fact is insignificant. The tax liability crystallises as soon as he arranges his affairs in an legitimate manner and the tax legislation triggers the liability. This also deals with a point made in some cases that the Revenue is merely receiving a “windfall” in cases where a legitimate tax avoidance scheme is improperly implemented.¹⁰⁴ It may be true that the scheme would have avoided the tax if properly implemented, but the point is that once a transaction has been carried out and the scheme does not work, a tax liability crystallises. To say that this is a windfall to the Revenue would indicate that on any occasion where someone sets up their affairs so that there is a higher tax liability than there might have been, there is a windfall to the Revenue. This would mean that when setting up a transaction, there would be no incentive to be certain of the structure as any excess paid to the Revenue due to structure would merely be a windfall in the Revenue’s hands. The fact is, many taxes can be mitigated or avoided with good tax advice, but to allow taxpayers to go back and revisit transactions after seeking out better tax advice is reprehensible – it would give taxpayers no incentive to set out their affairs in a sensible manner from the outset and essentially gives tax advisers the benefit of hindsight and carte blanche to change transactions so as to minimise tax liability.¹⁰⁵ As long as the tax is a legitimate one in the first place, the liability to the Revenue cannot be classified as a windfall.¹⁰⁶

Clearly the purpose of setting aside transactions with unforeseen tax consequences is to avoid a tax charge, but it is also interesting to consider that the transaction itself is often part of a tax avoidance scheme. The approach of the courts in dealing with such cases can be contrasted to the approach to tax avoidance. One of the starting points in such cases is the fact that there is no obligation to pay the most amount of tax possible. However, the courts have acknowledged that if transactions have no commercial purpose other than to avoid tax, such transactions can be ignored for tax purposes and thus the transaction can be taxed as if artificial steps were not included.¹⁰⁷ Whilst there can be legitimate tax avoidance, and tax avoidance schemes have not always been

¹⁰² Although it should be noted that the use of trusts in tax planning has become less attractive in recent years further to the more punitive taxation of domestic trusts and those with offshore features.

¹⁰³ *IRC v Duke of Westminster* [1936] AC 1, *Ensign Tankers v Stokes* [1992] STC 617.

¹⁰⁴ *Re Slocock* [1979] 1 All E.R. 358 at 363.

¹⁰⁵ Cf. Hilliard, above, fn.47 at p.36.

¹⁰⁶ This is quite different from cases which arise in unjust enrichment where the tax paid to the Revenue can truly be seen as a windfall. Those are cases where the tax levied was not legitimate and therefore should never have been paid. If the Revenue is not required to refund the tax in those cases, the Revenue receives a windfall.

¹⁰⁷ *Furniss v Dawson* [1984] AC 474; *WT Ramsay Ltd v IRC* [1982] AC 300; *IRC v Burnham Oil* [1982] STC 30.

struck down,¹⁰⁸ the courts are wary of tax avoidance and recognise the need to separate transactions with a true commercial nature from those with the sole aim of avoiding tax.¹⁰⁹ Here we see a contrast with the approach in the *Hastings-Bass* cases, where the courts turn a blind eye to the fact that the transaction is related to tax avoidance and allowed trustees to escape from the tax consequences flowing from a tax avoidance scheme which has been improperly implemented. This is in particular contrast to the tax avoidance cases where the transaction entered into is extremely artificial.¹¹⁰ In fact, had the Revenue participated in such cases it would be surprising if it did not try to prevent the transaction from being set aside on the basis of tax avoidance. If courts can ignore artificial transactions where they have a tax avoidance purpose, then there is no reason to set aside a transaction which does not achieve its avoidance purpose. This is because, even if the transaction were put in place in the proper manner, the courts would be able to see through the transaction.

The courts need not strike down every tax avoidance scheme, but there is a vast difference between this and aiding taxpayers in their desire to escape tax by helping them to set aside the unwanted consequences of the transaction. Even though tax avoidance can be legitimate, this is not to say it should be actively encouraged by the courts and if the courts are to maintain control over tax avoidance, they cannot send conflicting messages. Thus, it is important that the courts continue to treat tax cases separately, as they do for individuals, and prevent parties from altering or undoing transactions simply due to unwanted tax consequences flowing from transactions.

There is also a pragmatic reason for preventing the unravelling of transactions which have tax consequences in that the potential tax consequences of unravelling a transaction are extremely difficult. A simple example would be that of a discretionary trust which makes an appointment of assets to a beneficiary. At the time of the appointment, there will be a CGT charge on the difference between the market value at the time of the appointment and the previous acquisition cost. Then the beneficiary will be directly taxed on any income which is received from the assets.¹¹¹ If the trustees, for some reason, realise that there are consequences of the transaction which are unpalatable, and wish to have the transaction set aside, the tax implications are difficult. The tax that was paid when the assets left the trust should not have been paid. If there was an exit charge for IHT purposes, that should not have been paid. Further, the tax paid on income arising from the assets was paid by the wrong taxpayer – if the appointment is set aside, the trustees owned the assets and so should have paid tax on the income arising from them. It is quite possible that the taxpayer in fact paid less tax

¹⁰⁸ E.g. *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51.

¹⁰⁹ Also worthy of note is the emerging principle of “abus de droit” in the European context, which uses this distinction. Case C-255/02 *Halifax plc v CC&E* [2006] ECR I-1609; *WHA v HMRC* [2007] EWCA Civ. 728; *Weald Leasing Ltd v HMRC* [2008] EWHC 30 (Ch); H.L. McCarthy “Abuse of rights: the effect of the doctrine on VAT planning” [2007] BTR 160; R. de la Feria “Prohibition of abuse of (Community) law: the creation of a new principle of EC law through tax” (2008) 45 CMLR 395; M. Ridsdale “Abuse of rights, fiscal neutrality and VAT” (2005) 14 ECTR 82.

¹¹⁰ Walker, above, fn.29 at p.177-178.

¹¹¹ Income tax will be calculated and payable according to income deriving from the type of asset (e.g. interest on cash in a bank account, dividends from shares, profits from a business etc...) and so either under the Income Tax (Earnings and Pensions) Act 2003 (UK), Income (Trading and Other Income) Act 2005 (UK) or Income Tax Act 2007 (UK).

than the trustee would have to pay,¹¹² although it is unlikely that the trustees would seek to have the transaction set aside in these circumstances. In *Hastings-Bass* itself, the court pointed out that the income tax consequences of setting the transaction aside would be difficult, as the previous income tax and CGT consequences would have been different if the transaction were not effective.¹¹³ The point is that there are many tax issues to consider even when setting aside just one transaction, particularly after some considerable time period has elapsed. Whilst this is not a strong reason to deny the relief on its own, this is of course a factor and added to the more forceful arguments, provides an extra incentive to deny a remedy where the issue pertains to tax consequences.

9. CONCLUSION

There has been much discussion about limiting the *Hastings-Bass* principle¹¹⁴ which is beyond the scope of this article. There are good reasons for the principle in some cases,¹¹⁵ however the tax arena is not one where the principle should be applied. A number of proposals of how the principle could operate in a more limited manner have been put forward,¹¹⁶ but the main thing that any change to the principle needs to achieve is to prevent trustees from avoiding tax charges in cases where an individual would not be able to obtain the same protection. It is possible that in the absence of judicial intervention on this issue, legislation could be put in place to prevent the application of the principle so as to avoid a tax charge. In fact, it is surprising that the Revenue has not taken some action on this thus far.¹¹⁷ However, the principle can no longer be allowed to run riot and reverse tax charges in an inequitable manner and continue to shelter trustees and their advisers to the detriment of the Revenue and therefore the public.

¹¹² Rates of CGT used to vary as between trustees and individuals, from 20% to 40%. However, since the Finance Act 2008 (UK), there is a general rate of CGT at 18% for all taxpayers.

¹¹³ *Hastings-Bass*, above, fn.1 at 38.

¹¹⁴ *Breadner*, above, fn.9; *NSPCC*, above, fn.24; Wu, above fn.75; Hilliard, above, fn.51, Mitchell, above, fn.29; Dawson, above, fn.85; E. Nugee Q.C., “*Re Hastings-Bass* Again--Void or Voidable? And Further Reflections” [2003] P.C.B. 173; B. Green “The law relating to trustees’ mistakes – where are we now?” (2003) 17 TLI 114.

¹¹⁵ For example in pension cases as discussed above.

¹¹⁶ See fn.114 above.

¹¹⁷ The Revenue often legislates pursuant to a case which decides tax is recoverable, or where there is a danger of the floodgates being opened as a consequence of a court decision. See for example legislation enacted in relation to time limits to bring claims in s.121 of the Finance Act 2008 (UK) and ss.320 and 321 of the Finance Act 2006 (UK).

Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes

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“Whoever hopes a faultless tax to see, hopes what ne’er was, is not, and ne’er shall be.”
Alexander Pope

Abstract

In the 2008 Australian Federal Budget, Treasurer Wayne Swan announced a comprehensive ‘root and branch’ review of the Australian tax system to help create the foundation for Australia’s future tax system. This Review is now underway. This article argues that a pivotal part of the review is clarifying and outlining *how* a tax will be evaluated because this functions as the context for the evaluation and can significantly influence the overall conclusion that is reached. The central proposition advanced in this article is that a multi-staged, integrated evaluative framework should be created to evaluate tax reform measures. The first part of this article examines the criteria endorsed in the Consultation Paper for the Review as potential design principles that can be used to evaluate a taxation measure and suggests a further key criterion that should be used – the rule of law. The second part of this article examines some of the potential interactions and trade-offs between the criteria to provide the framework for prioritising each principle in establishing the framework. The third part of the article suggests an integrated evaluation framework, by defining the three stages at which a tax can be evaluated: policy, drafting and administration and specifying which of the criteria should be considered at each stage and attributing a priority to each of the criteria.

INTRODUCTION

Tax reform is now firmly on Australia’s agenda. In the 2008 Australian Federal Budget, Treasurer Wayne Swan announced a ‘comprehensive review of Australia’s tax system.’¹ The stated aim of the review is to help create the foundation for Australia’s future tax system that will ‘deal with the demographic, social, economic, and environmental challenges of the 21st century.’² More specifically, the Treasurer stated:

We need a tax system that is fairer, that is simpler, that better rewards people for their hard work, that responds to our environmental and demographic challenges, that makes us

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¹ Commonwealth Government, *Terms of Reference for Australia’s Future Tax System Review* (2008) <http://www.treasury.gov.au/documents/1376/PDF/Terms%20of%20Reference%20-%20Australia's%20Future%20tax%20System.pdf> at 15 July 2008.

² Ibid.

internationally competitive, and that creates the incentives to invest in our productive capacity. One that supports national prosperity beyond the mining boom.³

The review designed to create Australia's future tax system (AFTS Review) is far-reaching – expressed by the Prime Minister Kevin Rudd to be a 'root-and-branch' review of the Australian tax system and is planned to cover all the following areas:

- Interactions between federal, state and local taxes;
- The interaction of the tax system with the proposed emission trading system and the welfare system;
- How to reduce inefficient taxes;
- The balance between work, investment and consumption taxes;
- Enhancing the taxation of savings, assets, property (including housing), investments, consumption (including excise but excluding GST), and other types of taxation collected by the states;
- The role and structure of company taxation;
- The role for environmental taxes; and
- The interrelationship between elements of the tax system.

The AFTS Review is now underway. An initial Discussion Paper: *The Architecture of Australia's Tax and Transfer Systems* was released on 19 August 2008.⁴ The AFTS Review Panel⁵ then requested public submissions guided by four consultation questions.⁶ The public submissions received⁷ contributed to the development of a Consultation Paper released in December 2008.⁸ The Consultation Paper outlines key issues, sets focus questions and establishes the foundation for further public and community consultation.⁹ The Review Panel is due to make specific recommendations to the Australian Government by the end of 2009.

Whilst most would agree that a holistic review of taxes that aims to achieve the principles of equity, efficiency, simplicity, sustainability and policy consistency is a worthy exercise, the history of tax reform in Australia has shown that it is difficult, if

³ Treasurer Wayne Swan, Budget Speech 2008-2009 (Speech delivered 13 May 2008) <http://www.budget.gov.au/2008-09/content/speech/html/speech-01.htm> at 15 May 2008.

⁴ Commonwealth Government, *Australia's Future Tax System: Architecture of Australia's tax and transfer system* (August 2008).

⁵ The Review Panel consists of Dr Ken Henry as Chair, Dr Jeff Harmer, Professor John Piggott, Ms Heather Ridout and Mr Greg Smith.

⁶ The consultation questions included:

- (1) What major challenges facing Australia need to be addressed through the tax transfer system?
- (2) What features should the system have in order to respond to these challenges?
- (3) What are the problems with the current system?
- (4) What reforms do we need to address these problems?

⁷ Approximately 500 formal submissions and 260 pieces of correspondence were received.

⁸ Commonwealth Government, *Australia's Future Tax System: Consultation Paper* (December 2008) (Consultation Paper).

⁹ Commonwealth Government, *Summary of Australia's Future Tax System: Consultation Paper* (December 2008), 1.

not impossible, to satisfy all of these criteria simultaneously. Thus, while previous reviews such as Asprey (1975), the Tax Summit (1985) and the Review of Business Taxation (1999) have all made significant contributions to tax reform in Australia, arguably none of these reviews has managed to satisfy all of the traditional criteria used to evaluate taxes and tax reform measures.

Arguably, therefore, one of the most significant challenges for the AFTS Review is to create a more appropriate, transparent and achievable evaluative framework, which recognises that not only are there trade offs between the stated criteria, which therefore need to be prioritised, but that different criteria are relevant in relation to evaluating a taxation measure's policy, drafting and administration.

A pivotal aspect of the AFTS Review will be to critically analyse some of Australia's existing taxes, such as reviewing the income tax law, including company taxes and proposals for an environmental tax. This article argues that a necessary antecedent step to this part of the review is to establish an appropriate and comprehensive evaluative framework.

Clearly outlining *how* a tax will be evaluated is crucial, because by functioning as the context for the evaluation, such a framework can significantly influence the conclusion reached. The central proposition that is put forward in this article is that a multi-staged, integrated evaluative framework should be created to evaluate this and other tax reform measures.

The structure of this article is as follows. The first part will examine the criteria that are endorsed in the Consultation Paper as potential design principles that can be used to evaluate a taxation measure. These criteria include equity, efficiency, simplicity,¹⁰ sustainability and policy consistency. It will be suggested that the further key criterion of adherence to the Rule of Law should also be included in critiquing a taxation measure. The meaning of the Rule of Law is discussed in part one below, along with suggested definitions that should be attributed to each of the criteria identified in the Consultation Paper.

The second part of the article acknowledges that, pragmatically, no tax can satisfy all of these criteria simultaneously and that trade offs between them are inevitable. Notably, this issue is recognised in the Consultation Paper and Question 8.3 of that Paper considers the extent to which policy objectives may be traded off to achieve a simpler tax/transfer system and further considers in what areas efficiency, equity or choice should be traded off for the attainment of simplicity.¹¹ Accordingly, in part two of this article some of the potential interactions and trade offs between the criteria is considered. The exploration of these interactions provides the foundations for determining where a priority is attributed to each of the criteria in establishing the framework.

¹⁰ For a further discussion of the traditional criteria see the Commonwealth Treasury *Review of Business Taxation: A Strong Foundation* (November 1998) <http://www.rbt.treasury.gov.au/> at 15 July 2008.; Skinner and Todd Campbell (ed), *Adam Smith An Inquiry into the Nature and Causes of the Wealth of Nations* (Clarendon Press Oxford, 1976); Joseph E Stiglitz, *Economics of the Public Sector* (New York: W.W.Norton & Company, 1988) 390.

¹¹ Consultation Paper, above n 8, 20.

The third part of the article puts forward an integrated evaluation framework, by defining the three stages at which a tax can be evaluated: policy, drafting and administration. The framework specifies which of the criteria should be considered at each stage and attributes a priority to each of the criteria. Notably this is only a suggested ranking and this may differ depending on the government's stated intention or policy goals in respect of each taxation measure. However it is imperative that whatever ranking is attributed to particular criteria it should be made explicit or transparent in any evaluation framework that is utilised.

The final part of the article draws conclusions and identifies areas for further possible research.

1. DEFINING THE CRITERIA FOR ASSESSING WHAT IS AN EFFECTIVE TAX

1.1 Defining the Criteria

The Consultation Paper outlines several design principles that submissions have identified which can be used to critique the "effectiveness" of a tax or tax reforms. These include equity efficiency, simplicity, sustainability and policy consistency.

For convenience, these principles will be adopted for the purposes of this article as the criteria used to evaluate a taxation measure for the purposes of the AFTS Review. However, it will be argued that the AFTS Review should also utilise a further pivotal design principle and this is adherence to the Rule of Law. The Consultation Paper appears to include one of the key elements of the Rule of Law - certainty within the criteria of simplicity. This article argues that, simplicity is not necessarily synonymous with certainty and that therefore, adherence to the Rule of Law (which includes certainty) should be included as a further fundamental design principle or criteria against which to evaluate a tax or tax reform measure.

These design principles represent characteristics that an effective tax or tax reform should display. However, a tax does not need to possess these characteristics in order for it to be constitutionally valid.¹² For example, in *Giris Pty. Ltd v Federal Commissioner of Taxation*¹³ the High Court commented on the utility of Adam Smith's canons of taxation when considering the constitutional validity of section 99A of the *Income Tax Assessment Act (Cth)* (ITAA 1936). The High Court stated:

Yet anyone remembering the record of Adam Smith's four "canons" of taxation must be beset by misgivings and regrets that Parliament forgot it... However, Adam Smith's canon is a political principle, not a Rule of Law. It states a characteristic which it is generally considered that a tax **should** have, not a characteristic which is of the essence of a tax. Parliament may seem to have acted in defiance of a recognized principle of taxation, but that does not of itself mean

¹² The criteria for an impost to be a constitutionally valid tax are contained in *Matthews v Chicory Marketing Board (Vic)* (1930) 60 CLR 263. This case is generally cited for the proposition that in order for an impost to be a tax it must be: 'A compulsory exaction of money by a public authority for Public Purposes, enforceable by law and not a payment for services.' For a more recent discussion of what will constitute a valid tax see *Luton v Lessells* (2002) 165 CLR 462. See also Clinton Alley and Duncan Bentley, 'A Remodelling of Adam Smith's Tax Design Principles' (2005) 20 *Australian Tax Forum* 579, 581.

¹³ (1969) 119 CLR 365.

that the law which it has made is not a law with respect to taxation... (emphasis added)¹⁴

In utilising these principles as potential measures against which to base an evaluation, one of the initial and fundamental difficulties faced by the AFTS Review is to clearly define what is meant by each of the criteria. A review of the literature in this area illustrates that the definitions attributed to these criteria can differ significantly and a discussion of these definitions is therefore instructive and will be undertaken later in the article.¹⁵

1.2 Equity

Uncontroversially, most would agree that a tax should be equitable. A tax that is perceived as fair or equitable should promote voluntary compliance.¹⁶ In this regard, Allan states:

It is clearly a desired characteristic of taxes that they be fair. Apart from the ethical desirability of equity, there is the practical need for taxes to be acceptable to the tax-paying public. If taxes are generally believed to be inequitable the consequences may range from widespread evasion to revolution.¹⁷

The Consultation Paper recognises that whilst equity is an important design principle for the review of a tax there is: 'no consensus about exactly what equity is or how to measure it.'¹⁸ The Consultation Paper discusses various perspectives on equity as advanced in the submissions including:

- That: 'all individuals should have the opportunity to participate in society and achieve the things that they value';¹⁹
- That those with greater economic means should pay more (vertical equity). It is noted however that there is little agreement about how economic means should be measured and what degree of progressivity in a tax system is appropriate;
- Minimal opportunities for tax avoidance and minimisation;
- That families or individuals with the same capacity should face the same taxation burden (horizontal equity);
- The benefit theory which specifies that people should pay in accordance with the benefit they receive from government spending; and
- Inter-temporal and inter-generational equity. Inter-temporal equity considers how the tax/transfer system affects people over their entire life not just on an annual basis. Whereas, Inter-generational equity is concerned with how the tax transfer decisions will affect future generations.

¹⁴ Ibid.

¹⁵ Alley and Bentley, above n 12.

¹⁶ Kristina Murphy, 'The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders' (2004) 28(2) *Law and Human Behaviour* 187-209.

¹⁷ Charles M Allan, *The Theory of Taxation* (Harmondsworth: Penguin Books Ltd, 1971) 36.

¹⁸ Consultation Paper, above n 8, 32.

¹⁹ Above n 8, 32-34.

It is suggested that for the purposes of the AFTS Review equity should be defined as encompassing a reference to horizontal, administrative, vertical and inter-nation equity. However, further work on refining the meaning to be attributed to equity should be undertaken by the Review in establishing the evaluation framework.

Horizontal equity is said to occur when people in the same situation are treated in the same manner by the tax. For example, people with the same income should be taxed the same amount. Allan states:

...horizontal equity, describes the equal treatment of equal people. This principle is unchallengeable as an ideal and is not impracticable of operation. People of equal incomes, for example, might be required to pay the same income taxes. All people who smoke twenty cigarettes per day would be required to pay the same in specific tobacco taxes.²⁰

Another attribute of horizontal equity is that the tax should apply equivalent treatment to transactions that achieve the same economic result. That is the tax should not apply differently to two transactions that although different in form (e.g. conducted through a company or trust) are economically equivalent.

Vertical equity refers to the proposition that people in different situations should be taxed differently. Thus, the concept of vertical equity requires a progressive tax system where those in a better position or with greater “means” should pay a greater amount of tax. However, as noted above there is little consensus regarding how economic means should be measured,

Administrative equity occurs where the administrative procedures that are adopted, in respect of a particular tax, ensure that all taxpayers are treated equally. This would include that all taxpayers had equal access to information pertaining to their tax affairs.

Inter-nation equity requires that a taxpayer should only be liable to tax in each jurisdiction or country in which they operate, in proportion to the extent of their economic involvement in that country or jurisdiction. This aspect of equity is not discussed in the Consultation Paper. However, arguably given that a key priority in the AFTS Review is designing a system that makes Australia internationally competitive, addressing increasing globalisation and the changing pattern of world economic activity, it is important that Australian domestic taxation policy remains internationally competitive by prioritising inter-nation equity as a key element of the design principle of equity.

Furthermore, there are other aspects of equity that all taxes should comply with. For example a tax law should not discriminate on the basis of race, sex or disability. However, these aspects of equity have not been discussed below as it is considered these are broader requirements of law (rather than criteria on which a taxation measure should be critiqued) and are embodied in existing Commonwealth Acts such as:

- *Disability Discrimination Act 1992*;
- *Human Rights and Equal Opportunity Commission Act 1986*;
- *Race Discrimination Act 1975*; and

²⁰ Allan, above n 17.

- *Sex Discrimination Act 1984.*

In conclusion on this point it is recognised that it can be problematic determining what is “fair” or equitable and that further detailed work is required in refining the definition of equity. The Asprey Report recognised these difficulties when it stated that that equity is: ‘an ideal exceedingly difficult to determine and harder still to measure.’²¹ The difficulty lies in determining the basis on which individuals should be compared. For example, when defining horizontal equity when will two taxpayers be in the same position? Should a comparison for the purposes of horizontal equity be undertaken on an individual or family unit basis? It is generally accepted that the “income” of the individual is a relevant measure to use for comparative purposes. However, there is some debate as to whether income should be the measure of an individual’s wealth and if it is, whether current or lifetime income should be used.²² Despite these difficulties, this article contends that equity should be one of the principles used to evaluate an efficient tax.

1.3 Efficiency (Neutrality)

A key aspect of efficiency is neutrality which is said to exist where taxes minimise distortions to economic activities and do not impede genuine commercial transactions. The US Department of Treasury states:

An ideal tax system would, however, interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not unduly favor leisure over work, or consumption over saving and investment. It would not needlessly cause business firms to modify their production techniques or their decisions on how to finance their activities. A neutral tax policy would not induce business to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses...²³

Similarly Allan defines neutrality to be in existence where: “the tax avoids distorting the workings of the market mechanism.”²⁴

The history of Australian taxation has shown that the Australian government frequently uses tax expenditures to influence and further particular economic or social goals. For example, to encourage gold mining in Australia, income from gold mining was tax exempt from 1924 to 1988. Therefore where it is an **intended effect** of the tax to influence economic activity, this would not be in contravention of the principle of efficiency. On this basis the article assumes that for the purposes of the AFTS Review, a tax is neutral where it avoids **unintentionally** distorting economic activity.

1.4 Simplicity

Ironically, “simplicity” (sometimes referred to as administrative efficiency)²⁵ is perhaps the most difficult of the criteria to define and, consequently, it has been attributed numerous and disparate meanings. The Asprey Report states that simplicity involves a ‘complex of ideas’.²⁶ Binh Tran-Nam states: ‘If there were ever to be

²¹ Commonwealth Taxation Review Committee *Full Report* (1975) (‘Asprey Report’).

²² *Ibid* 3.11-3.15.

²³ Department of Treasury, *Tax Reform for Fairness Simplicity and Economic Growth, Volume 1* (1984).

²⁴ Allan, above n 17, 37.

²⁵ Robin Woellner *et al*, *Australian Taxation Law* (19th ed, 2009) 24.

²⁶ Asprey Report, above n 21, 3.19.

agreement between tax academics, it must be that tax simplicity...is itself a complicated notion.²⁷

The difficulty in defining simplicity arises because simplicity is a subjective concept. For example, a taxation practitioner with several years of experience may find a particular tax very simple to apply, relative to a taxpayer with no specialised knowledge of the taxation law.

Simplicity is defined very broadly in the Asprey Report:

... A tax will be called simple, relative to others, if for each dollar raised by it the cost of official administration is small, and if the 'compliance costs', the costs in money and effort of all kinds to the taxpayer, are also small.²⁸

Based on the Asprey Report and for the purposes of this article, simplicity will be viewed in the context of compliance and administration (also known as administrative efficiency).

The first element is taken to be satisfied if a taxpayer (or their adviser) can understand and apply the tax with minimal compliance costs. The meaning of compliance costs is based on the definition assigned to it in the Report on the Review of Aspects of Income Tax Self Assessment²⁹ and includes direct financial costs, opportunity costs and non-financial compliance costs.

Direct financial costs include the costs to the taxpayer of engaging tax experts for managing their tax affairs. Opportunity costs include the time spent by the taxpayer complying with their tax obligations that may have been spent doing other activities (such as leisure or work). Non-financial compliance costs include any mental stress that may result from uncertainty placed on the taxpayer about whether they have discharged their tax obligations.

The second element provides that in order for a tax to be simple it must have minimal administration costs. Administration costs include the costs of tax policy planning, resolving taxation disputes (including taxation litigation), and the costs of administering the law including taxpayer education, rulings, circulars and the provision of other types of ATO information. One factor that can affect simplicity is the number of taxpayers affected by a taxation measure. For example the fewer taxpayers from which the tax is collected the simpler the tax. The Asprey Report states that: 'The sheikdom that can raise all the revenues it requires (and maybe much more) from a single tax on a single oil company has what is unquestionably the simplest tax of all.'³⁰

It is important to note that a brief tax law will not necessarily be simple. This is because brevity does not necessarily translate into simplicity. The Review of Business Taxation acknowledged this and stated:

²⁷ Binh Tran-Nam, 'Tax Reform and Tax Simplicity: A New and 'Simpler' Tax System' (2000) 23(2) *University of New South Wales Journal* 241.

²⁸ Asprey Report, above n 21, 3.20.

²⁹ Report on the Review of Aspects of Income Tax Self Assessment (2004 AGPS) <http://selfassessment.treasury.gov.au/content/report.asp> at 23 March 2009.

³⁰ Asprey Report, above n 21, 3.22.

Complexity and simplicity...are concepts lacking simple definitions. It may be anecdotally convenient, and not unduly misleading, to equate complexity to some index of the growth in volume of tax legislation ... Nevertheless, it is clear that short provisions of legislation may not be simple and long provisions may not be simple and long provisions may not be complex.³¹

1.5 Sustainability

The Review suggests that sustainability can be viewed from three perspectives: environmental, institutional and fiscal sustainability.

Environmental sustainability demands that a taxation reform measure should be compatible with environmental policies. The Report states that:

An important theme in submissions from environmental groups is that, given its central importance to economic decision making, the tax transfer system needs to be consistent with achieving sustainable economic growth...

Many submissions argue that tax transfer setting should be consistent with the objective of reducing carbon emissions.³²

Institutional sustainability requires that the legal and administrative frameworks of the tax reform are robust and community attitudes “maintain the legitimacy” of the system.

Fiscal sustainability requires that the tax system is sufficient to meet the revenue needs of Australia and that these needs are met without recourse to inefficient taxes. This further entails determining whether the policy underlying the taxation measure contribute to a fair and equitable society and are “affordable” over a long term basis. Fiscal sustainability advocates relying on a stable revenue stream by decreasing reliance upon more volatile taxes. Furthermore, it advocates flexible taxation measures that are able to apply appropriately to changing economic conditions, schemes or innovative structures.

1.6 Policy Consistency

The Consultation Paper suggests that a taxation measure should have policy consistency both internally (consistency between taxation measures within the taxation act under review) as well as being externally consistent with the Australian government’s broader policy objectives (for example, environmental climate change policies).

³¹ Review of Business Taxation (1998), above n 10.

³² Consultation Paper, above n 8, 27. It is generally accepted by the literature that regulation to encourage a change in the economic impact of business will cause a distortion to economic activity. For example, the Garnaut Report (Garnaut R 2008, *The Garnaut climate change review*, Cambridge University Press, Port Melbourne) looks at the ways that certain tax and transfer policies can address global warming by impacting the way business is conducted to encourage more desirable and sustainable activities. See also the Report by the NSW Business Chamber, *The challenge of green tape: growth of environmental law and its impact on small and medium enterprises across Australia* available at http://www.nswbusinesschamber.com.au/reference/influence_government/green_tape_report.pdf. This report considers the growing burden of environmental regulation on small and medium enterprises.

1.7 Rule of Law

Like simplicity, an exact or uniform definition of the Rule of Law is elusive. The exact characteristics of the Rule of Law are the subject of extensive debate which is beyond the scope of this article. Nevertheless the Rule of Law according to the most common attributes assigned to it by the literature will be discussed. This article advocates that the AFTS Review should adopt the Rule of Law as a further criteria to measure the effectiveness of any taxation measure.

The first attribute of the Rule of Law is the requirement that the law (in this context, the terms of the tax itself) must govern the rights of the individual. These rights should not be determined through the exercise of broad, discretionary powers vested in the administrative. In fact broad discretionary powers are the antithesis of the Rule of Law. In this regard, Professor Cooper notes that: ‘The excessive use of discretions, and even the delegation of legislative authority to bureaucrats, can contradict this notion since the bureaucrat may be empowered effectively to decide what the law is.’³³

Similarly, in relation to the relationship between the Rule of Law and broad discretionary powers, Heydon observed: ‘The Rule of Law operates as a bar to untrammelled discretionary power.’³⁴

In this regard, certainty underpins the Rule of Law. The Rule of Law requires taxpayers (or their advisers) to be able to ascertain from the legislation what their rights and obligations are. In order to do this the tax must be certain. Lord Diplock stated in *Merkur Island Corp v Laughton*³⁵ ‘Absence of clarity is destructive of the Rule of Law; it is unfair to those who wish to preserve the Rule of Law; it encourages those who wish to undermine it.’³⁶

Adam Smith noted the following about the maxim of certainty (in respect of a tax):

The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person...The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.³⁷

For the purposes of this article, a tax will be regarded as satisfying the Rule of Law when a taxpayer or their adviser is able to reasonably establish from the terms of the taxation measure itself when it will apply. Furthermore, a “certain” tax would generally not vest broad discretions in the administrator as the existence of such

³³ Graeme Cooper, ‘Conflicts, Challenges and Choices - The Rule of Law and Anti-Avoidance Rules’ in GS Cooper (ed), *Tax Avoidance and the Rule of Law* (The Netherlands: IBDF Publications 1997) 13.

³⁴ Dyson Heydon, ‘Judicial Activism and the Death of the Rule of Law’ (2003) XLVII(1-2) *Quadrant Magazine*.

³⁵ [1983] 2 AC 570.

³⁶ Nabil Orow, *General Anti-Avoidance Rules - A Comparative International Analysis* (Bristol: Jordans Publishing Limited, 2000) states that: ‘certainty of the law constitutes the essence of the Rule of Law’. Geoffrey De Q. Walker, ‘The Tax Wilderness: How to Restore the Rule of Law’ (2004) Winter *National Observer* 15-27 likewise, states: ‘Uncertainty in the law is a major factor in undermining the Rule of Law, and tax is riddled with it.’

³⁷ Skinner and Todd Campbell (ed), above n 10.

discretions would make it difficult for a taxpayer (or their adviser) to predict when the tax will apply.

The attainment of certainty, used for the purposes of this article, alters the traditional definition of certainty. The traditional definition (as outlined by Smith above) requires that the taxpayer is able to apply the tax law with certainty. In this article, it will be assumed that, certainty will be obtained where the taxpayer or *their adviser* is able to understand or apply the tax. The modification is made to the traditional definition because, given the point to which the tax law in Australia has evolved, it must be accepted that taxpayers may not be able to apply the taxation law themselves with certainty. Indeed, the complexity of the tax law and large number of discrete provisions within the ITAA 1936 and *Income Tax Assessment Act (Cth)* 1997 (ITAA 1997) has led many taxpayers (well over 70% of Australian individual taxpayers) to seek the assistance of a specialist or adviser to help them understand and apply the law.³⁸

The second widely accepted attribute of the Rule of Law is that government and the bureaucracy should comply with the laws that are passed.³⁹

Two other commonly accepted requirements of the Rule of Law are that people in similar circumstances should be treated alike.

Furthermore, the Rule of Law requires that the law is stable, certain and predictable. Thus the Court stated in *Black-Clawson International Ltd v Papierwerke Waldhof Aschaffenburg AG*:

The acceptance of the Rule of Law as a constitutional principle requires that a citizen before committing himself to any course of action should be able to know in advance what the legal consequences that will flow from it are. Where those consequences are regulated by a statute the source of that knowledge is what the statute says. In construing it the court must give effect to what the words of the statute would be reasonably understood to mean by those whose conduct it regulates.⁴⁰

The Australian Taxation Office (ATO) also acknowledges that the Rule of Law is an important value in Australia.⁴¹ Commissioner D'Ascenzo however outlines the difficulties of adhering to such a principle in Australia:

The Rule of Law provides an anchor for legislative regimes such as taxation and superannuation operating as they do in this choppy sea of change. Whilst this constancy safeguards rights and obligations, its ambulatory restrictions, the inherent vagaries of words, and the infinite variety of personal circumstances impose daunting difficulties on policy makers, legislators and administrators. Where the law blurs into indeterminacy

³⁸ Review of Aspects of Income Tax Self Assessment, above n 29. The Report suggests that 76% of people engage tax agents.

³⁹ Ronald Sackville, 'Avoiding tax avoidance: The primacy of Part IVA' (2004/2005) 39(6) *Taxation in Australia* 295.

⁴⁰ *Black-Clawson International Ltd v Papierwerke Waldhof Aschaffenburg AG* [1975] AC 591, 638.

⁴¹ Michael D'Ascenzo, Commissioner of Taxation 'Living Our Values' (a speech delivered at the 7th International Tax Administration Conference, Sydney Australia, 20 April 2006.)

there are difficulties also for taxpayers and their advisors and the potential for disputation increases.⁴²

2. RELATIONSHIPS BETWEEN THE CRITERIA

A tax or tax reform measure that exhibited all of the above attributes could only be achievable in 'Fiscal Utopia', as many of the criteria discussed above are conflicting or mutually exclusive. The corollary of this is that trade offs between the attainment of individual criterion are inevitable. Accordingly, part three of this article discusses the priorities to be assigned to the criteria defined above. However, to do this the relationships between the criteria must first be examined. This examination enables a ranking to be attributed to the criteria and assists in determining, where there is a conflict, which criteria should take precedence.

2.1 Equity and Efficiency

Traditionally, it is well recognised that there can be trade offs between achieving equity and efficiency. Vertical equity requires that those on higher incomes pay a higher amount of tax. This can impact efficiency as it may reduce incentives to enter into business transactions or invest, work, save or consume. As the Organisation for Economic Co-operation and Development (OECD) states in its Booklet on the Comparative Assessment of OECD Countries:

Governments are often faced with trade offs between equity and efficiency goals of tax policy. There is an abundance of examples of conflicts between equity and efficient inherent in the taxation of income generating activity... Specifically the choice of progressive tax rate structures reduces vertical inequality but increases inefficiency by reducing incentives to utilise labour and capital resources and prompt avoidance and evasion. Indeed this conflict between equity and efficiency lies at the heart of many differences between OECD countries in their choices of tax rate.⁴³

2.2 Equity and Simplicity

Equity and simplicity have a mixed relationship. In order to achieve equity, a taxation measure may need to be drafted in such a manner as to capture people's individual circumstances and attributes, which may result in voluminous and complicated legislation. In this respect, equity may conflict with simplicity. The Review of Business Taxation states:

Equity and complexity... certainly interact. Complexity in the tax legislation is created, for example, by the capture of individual taxpayer circumstances or by the provision of transitional provisions in meeting equity objectives.⁴⁴

However, legislation that is simple may not require a taxpayer to engage expert advice. Indeed it is recognised by the Consultation Paper that complexity tends to be regressive in its impact.

⁴² Michael D'Ascenzo, Commissioner of Taxation, 'The Rule of law: a corporate value' (a speech delivered to the Law Council of Australia, Rule of Law conference, Brisbane, 1 September 2007.)

⁴³ OECD, *Comparative Assessment of OECD Countries* (2001) http://books.google.com.au/books?id=zjXl6TmdvIAC&pg=PT23&lpg=PT23&dq=equity+and+neutrality+AND+taxation+AND+relationship&source=bl&ots=BIPQRIfl7U&sig=843u9rYGYGhMz2z7hWmiZ2Lh3wc&hl=en&ei=Bce9SfqKMNK1kAWYkPSKCA&sa=X&oi=book_result&resnum=5&ct=result#PPP1,M1 at 22 March 2009.

⁴⁴ Review of Business Taxation, above n 10.

The impact of complexity in the tax-transfer system tends to be regressive, falling most heavily on those with the least capacity to deal with it and the least means to get professional help. These people may make less advantageous decisions or be unaware of the transfers to which they are entitled.⁴⁵

That is that lower income taxpayers may be more significantly impacted by complexity within a revenue statute. The corollary of this is that if legislation is simple, the accessibility of the legislation is not governed by the financial means of the taxpayer and will assist in maintaining equity. Consequently, equity and simplicity have a mixed relationship.

2.3 Equity and Sustainability

Equity and sustainability would appear to have a largely complementary relationship. In order to achieve fiscal sustainability the review requires that the policy underlying the taxation measure is equitable. Furthermore, institutional sustainability requires that the tax measure is robust and that community attitudes towards the measure maintain the legitimacy of the system. Arguably to ensure that this legitimacy is maintained the system must be equitable.

2.4 Equity and Policy Consistency

Equity and policy consistency would appear to have a mixed relationship. The Consultation Paper states:

Consistency in policy settings within the tax-transfer system can help people to understand the system and helps to reduce complexity, cost and uncertainty for taxpayers. This can reduce the costs of the system and increase equity by improving levels of voluntary compliance. If taxpayers cannot understand the system, or if the system is clearly inconsistent in the way it treats different taxpayers, transactions or activities, then taxpayers are less likely to comply with their obligations.⁴⁶

Furthermore equity would be enhanced as individuals would be treated consistently within the same Act between statutes/Acts and state jurisdictions.

However in order to achieve equity in each individual statute, there may be a need to recognise different taxpayer attributes or activities which could create policy inconsistency between different external statutes. The Report on Aspects of Income Tax Self Assessment states:

In general, a smaller set of tax policies with broad application will involve fewer concepts, less law and be easier to comply with than a larger set of policies, each with narrower application. However, the latter approach allows distinctions between taxpayers and/or activities to be recognised through different tax treatments, which may be important for equity or other reasons.⁴⁷

2.5 Equity and Rule of Law

The Rule of Law requires certainty from the taxation measure. Certainty and equity appear to have a mixed relationship.

⁴⁵ Consultation Paper, above n 8, 33.

⁴⁶ Ibid 36.

⁴⁷ Report on the Review of Aspects of Income Tax Self Assessment, above n 29, Appendix 3.

A certain tax measure should not contain broad discretions. Broad discretions may compromise equity by vesting in the administrator the discretion to determine the treatment of individual taxpayers. This may result in individuals, in the same situation, being treated differently as the discretion may be exercised by different people (eg delegates of the Commissioner). The accessibility of a tax that is uncertain would also be differentiated on the basis of training or income. This is because, in respect of an uncertain tax, taxpayers would be inclined to seek expert advice in order to ascertain the likely operation of the tax. Consequently, only those taxpayers who have the financial means to engage experts or who possess the relevant knowledge themselves will be able to predict the operation of the tax.

In order to achieve certainty, however, a tax conveying complex policy goals may need to be drafted in a lengthy and prescriptive manner. This may lead to complexity, which may compromise equity, as only those taxpayers with the requisite financial means to engage experts, or who possess the relevant knowledge themselves, will be able to apply the tax correctly. The Review Business Taxation recognised this issue:

Equity and complexity... certainly interact. Complexity in the tax legislation is created, for example, by the capture of individual taxpayer circumstances or by the provision of transitional provisions in meeting equity objectives. Conversely, increased complexity diminishes equity where the relative accessibility of the business tax law is differentiated by taxpayer training, experience or income, or where taxpayer capacity to exploit the opportunities created by an increasingly complex code is similarly differentiated.⁴⁸

Whilst the Rule of Law may satisfy horizontal equity it will not necessarily satisfy vertical equity. The Rule of Law requires that all individuals are treated equally, whilst vertical equity requires that individuals in different positions should be treated differently.

Furthermore, there are examples of where a certain tax may be equitable in the administrative sense but not necessarily in the horizontal or vertical equity sense. A poll tax for example satisfies the criteria of certainty but does not rank well when considered in terms of the criteria of vertical equity, as it fails to take into account the financial means of each person taxed.

2.6 Efficiency and Simplicity

Efficiency and simplicity have a mixed relationship. A simple tax will minimise the time spent on tax planning, which can divert resources away from their most productive use. The Consultation Paper states:

complexity may also reduce economic efficiency by increasing the level of uncertainty about the expected payoffs to long-term investment decisions, such as: investment in education; retirement products; long-lived productive assets; or the choice of business structure.⁴⁹

Another complementary aspect of the relationship between efficiency and simplicity is that a simple tax will reduce the time spent on “unproductive activities” like tax planning, tax litigation and in some cases tax administration. *Report 410 on Tax Administration* by the Joint Committee of Public Accounts and Audit Report states

⁴⁸ Review of Business Taxation, above n 10, 6.23.

⁴⁹ See Consultation Paper, above n 8, 34.

(Report 410):' A simpler system will deliver savings to both taxpayers and government and allows entrepreneurs to focus on growing their business, rather than complying with arbitrary tax rules.'⁵⁰

However, there are also notable examples of where an efficient tax can be more costly to administer. For example the GST is a more neutral or efficient tax than a wholesale sales tax. For example according to the Asprey Committee in Australia:

A broad based tax serves horizontal equity by not discriminating between savings and consumption, but by itself it cannot be adopted to the varying situations of individuals. Nor is it, by itself, suitable for vertical equity. It is essentially a proportionate consumption tax and actually regressive as a tax on income since the proportion of consumption to income normally fall as income increases. It stands high by the test of simplicity, certainly far higher than personal income tax when both are compared as major revenue raisers.⁵¹

However given it is collected at multiple stages it is a significantly more complex and costly tax for the ATO to administer.

2.7 Efficiency and Sustainability

Efficiency and Sustainability have a mixed relationship.

For example, it may be argued that tax policies that are environmentally sustainable may impact economic decision making and therefore efficiency. This was recognised in the Consultation Paper where it is stated that: “ number of submissions arguing taxes relating to the Carbon Pollution Reduction Scheme should be designed to minimise the costs imposed on business.”⁵² Furthermore the Consultation Paper recognises that whilst taxes are a way of “improving environmental amenity” they can also “detract from environmental outcomes” through creating inappropriate incentives. Taxes impact economic activity and help to mitigate environmental damages by either imposing: “a cost on some products or activities that are environmentally damaging, or give a benefit to some products or activities that are environmentally beneficial”.⁵³

A report by Fullerton, Leicester and Smith for the UK Mirrlees Review recognises that tax policies designed to impact sustainable economic growth can distort and impact economic activity.

Barriers to implementing a domestic carbon tax could also come from concerns over international competitiveness and distribution. It would be undesirable for production to move abroad as a result of a unilateral carbon tax, reducing any net environmental gain, and widespread sectoral exemptions from any tax would significantly blunt its environmental impact.⁵⁴

However, fiscal sustainability demands that the tax system or tax measure should be certain and provide a stable revenue base. Indeed instability will reduce efficiency and

⁵⁰ Joint Committee of Public Accounts and Audit, *Report 410 Tax Administration (June 2008)* ('Report 410') <http://www.aph.gov.au/House/committee/jpaa/reports.htm> at 23 March 2009, Executive Summary xxviii.

⁵¹ Asprey Report, above n 21, 3.43.

⁵² Consultation Paper, above n 8, 27.

⁵³ Consultation Paper, above n 8, 245-246.

⁵⁴ D Fullerton, A Leicester, S Smith 2008, 'Environmental Taxes' in *Reforming the Tax System for the 21st Century*: The Mirrlees Review, *Institute for Fiscal Studies*, London, www.ifs.org.uk/mirrleesreview.

in this regard the two criteria have a complementary relationship. The Consultation Paper states:

Instability in tax-transfer settings...may also reduce economic efficiency by increasing the level of uncertainty about the expected payoffs to long-term investment decisions.⁵⁵

2.8 Efficiency and Policy Consistency

Efficiency and Policy Consistency have a largely complementary relationship.

If a taxation measure has an internally consistent policy with other provisions in the same taxation act it will provide the basis for a more stable revenue act and will overall ensure the act is easier to apply and less likely to negatively impact economic activity. Conversely, where policies are inconsistent it may result in multiple provisions having to be drafted to counter-act the effect of one another and as Braithwaite has observed: 'A smorgasbord of rules engenders a cat and mouse legal drafting culture of loophole closing and reopening by creative compliance.'⁵⁶

Furthermore, if a taxation measure has a policy that is externally consistent with other Australian Acts and broader government objectives– it will be simpler, easier to comply with and more effective to apply, as entities will only need to consider consistent policies, rather than a patchwork of different legislative policies. This will reduce the time spent by entities on complying with the tax laws giving them more time to focus on productive economic activities.

2.9 Efficiency and Rule of Law

The Rule of Law and efficiency have a mixed relationship.

A certain tax may be less likely to cause unintended distortions to economic activity. When a tax is uncertain it may distort economic activity because taxpayers (and their advisers) will be unable to predict the consequences of their business decisions and this may discourage the entry into genuine commercial activities.

However, a certain tax may nonetheless contravene efficiency. For example, a tax such as a wholesale sales tax may be drafted in a very precise and certain manner, but may cause unexpected distortions to economic activity by changing the relative prices of products.

Furthermore in order to be efficient and minimise distortions to economic activity, it is imperative that the bureaucracy complies with the laws that are passed. Transparency in the actions of the bureaucracy will promote a climate of legislative certainty and stability which arguably would be less likely to distort economic activity.

Similarly, the rule of law requires equality of treatment between individuals and entities in similar situations. Consistent treatment of individuals and entities would be less likely to distort economic activity.

2.10 Simplicity and Sustainability

Simplicity and sustainability have a mixed relationship.

⁵⁵ Consultation Paper above n 8 27.

⁵⁶ John Braithwaite, 'Making Tax Law More Certain: A Theory' (The Australian National University Australian Taxation Office, 2002).

To ensure environmental sustainability a revenue act may need to embrace non-revenue raising goals which may compromise the simplicity of the act.

However, in order to obtain institutional sustainability and a positive community attitude towards the taxation system arguably it is fundamental that the system is not overly burdensome on taxpayers. Furthermore in order for a tax system to be fiscally sustainable the costs of raising revenue must be minimised (administrative simplicity) to ensure that the tax system is able to meet the revenue of Australian governments.

2.11 Simplicity and Policy Consistency

Simplicity and policy consistency would appear to have a largely complementary relationship. One of the sources of complexity, as acknowledged by the Report is where there is a large number of different taxes, with little harmonisation of Acts across jurisdictions. By trying to align the policies underlying different taxation measures this would make it easier for a taxpayer to apply the multiple taxation measures thereby enhance simplicity, making it easier for a taxpayer to understand the policy underlying all taxation measures. The Report on Aspects of Income Tax Self Assessment states:

In general, a smaller set of tax policies with broad application will involve fewer concepts, less law and be easier to comply with than a larger set of policies, each with narrower application. However, the latter approach allows distinctions between taxpayers and/or activities to be recognised through different tax treatments, which may be important for equity or other reasons.⁵⁷

Thus by having a smaller number of policies to comply with (or policies that are consistent) it will enhance simplicity.

2.12 Simplicity and the Rule of Law

The Rule of Law and simplicity have a mixed relationship.

A tax seeking to give effect to complex policy goals may not be simple to apply (for example it may be highly prescriptive and detailed) however, its application may be certain. In fact, a tax that is conveying a difficult concept may need to be drafted in a complex and lengthy manner, in order to attain certainty. This will likely increase compliance costs, thereby compromising simplicity. Alley and Bentley noted the following regarding the relationship between certainty and simplicity:

It is appropriate to consider certainty and simplicity together because so often there is a conflict between them, both in terms of legislative drafting and taxpayer compliance. The more certain are the rules, the less simple they usually are to understand. The simpler the rules the less simple they usually are to either comply with or administer.⁵⁸

Equally, however, an uncertain tax would commonly require the taxpayer to consult with an expert to ascertain its likely operation, which would most likely again increase compliance costs and compromise simplicity. Thus certainty can operate to both increase and minimise compliance costs and therefore can have dual effects on simplicity. The Asprey Report recognised this when it discussed the two aspects of simplicity:

⁵⁷ Report on the Review of Aspects of Income Tax Self Assessment, above n 29, 87.

⁵⁸ Alley and Bentley, above n 12, 59.

These two ideals are of course connected, and add up to much the same as the ancient canon of certainty. Both costs will be the less if assessor and assessed can each establish with certainty what is due: uncertainty entails costs of consultation with experts and sometimes the yet greater costs of litigation. Both kinds of cost are increased, and certainty is endangered, when a tax, whether in the interests of equity or efficiency, requires the drawing of fine distinctions between what is and what is not liable, and when these distinctions involve such uncertain ideas as 'purpose' or 'value to the recipient'. Then the legal definitions get longer and longer and beyond the comprehension of those untrained in the law, and the relevant facts in particular cases become more and more disputable.⁵⁹

Furthermore, another complementary aspect of the relationship with simplicity involves the use of discretions. Broad discretions are the antithesis of the Rule of Law. The existence of these discretions in a tax would normally compel a taxpayer to seek expert advice on the likely operation of the tax, which would increase compliance costs and conflict with simplicity.

2.13 Sustainability and Policy Consistency

Sustainability and policy consistency are complementary criteria. Environmental sustainability demands that tax reform measures are compatible with Australia's broader environmental policies and this creates consistency between Commonwealth statutes.

Further, for a taxation measure to be institutionally sustainable and command community support arguably it would need to have a consistent policy base with other statutes, this would make the measure less susceptible to amendment and hence, more stable.

One aspect of fiscal sustainability looks at whether the taxation measure will be stable over the longer term. Arguably, only a policy that is consistent with other broader government goals and across taxes will be a stable law and less susceptible to frequent amendment.

2.14 Sustainability and Rule of Law

The Rule of Law and sustainability are complementary criteria. The Rule of Law requires that the law must be certain and stable. Whilst institutional sustainability requires that the law have the support of the community – in order to do this arguably the community would demand that their obligations be certain.

Fiscal sustainability, like the Rule of Law, also requires that the law is certain, predictable and stable.

2.15 Policy Consistency and Rule of Law

The Rule of Law and policy consistency are complementary criteria. The Rule of Law requires that the law must be certain and stable. Policy consistency enhances stability in the law by ensuring a consistent policy underlying each of the various statutes. Where all statutes reflect a consistent policy base the law would appear they would be less likely to require frequent amendment and would therefore be more stable.

⁵⁹ Asprey Report, above n 21, 3.20.

2.16 Summary –Relationship Matrix

The table below indicates the relationships between the various criteria and the number reference where they are discussed, in this chapter, above.

TABLE 1: RELATIONSHIP MATRIX

	Equity	Efficiency	Simplicity	Sustainability	Policy Consistency	Rule of Law
Equity		X (2.1)	X/√ (2.2)	X/√ (2.3)	√ (2.4)	X/√ (2.5)
Efficiency			X/√ (2.6)	X/√ (2.7)	√ (2.8)	X/√ (2.9)
Simplicity			(X/√ (2.10)	√ (2.11)	X/√ (2.12)
Sustainability					√ (2.13)	√ (2.14)
Policy Consistency						√ (2.15)

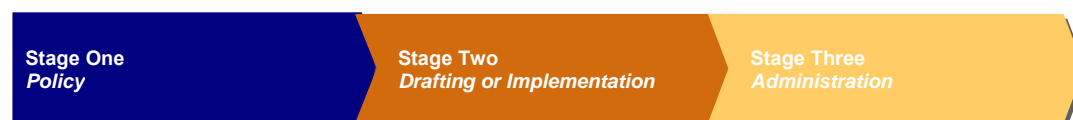
Key	
√	Complementary Relationship
X	Conflicting Relationship
X/√	Both Conflicting and Complementary Relationship (Mixed Relationship)

The above matrix shows that inter-relationships exist between all of the criteria. In trying to satisfy one criterion, therefore, the effect on the other criteria must be considered. In cases where a conflicting or mixed relationship exists choices must be made between the criteria. Therefore, in order to have a meaningful evaluation framework the criteria must be ranked and prioritised.

3. AN INTEGRATED EVALUATION FRAMEWORK – A THREE-STAGED INQUIRY

Having identified and defined the criteria for evaluating a tax or tax reform measure in the previous part of this article, this part of the article addresses the next step which is the development of an integrated three staged evaluative framework. This article argues that the development of this new framework needs to be undertaken in three stages. These three stages follow the development of a tax from its conception at the policy level to its translation into legislation and finally to its practical administration of the taxation measure by the ATO. This may be depicted diagrammatically as follows:

FIGURE 1: A THREE STAGED EVALUATION



The first stage should review the tax at the policy level – this will involve evaluating the policy underlying the tax. The second stage involves reviewing the drafting of the tax. This will entail an examination of the actual legislation or mechanics of the tax. The third stage encompasses a review the administration of the tax. This trichotomy is

based on the delineation made of the three “core processes” outlined in the Review of Business Taxation Report.

The distinction between these three stages is not merely semantics and is in fact pivotal because as will be seen the criteria used at each stage of the evaluation are different.

Furthermore, the conclusion reached when critiquing a tax may differ with respect to each stage. For example, whilst the policy behind the tax may be desirable and appropriate, the ability of the English language to convey or give effect to such a measure, at the drafting stage, may be limited. Furthermore a taxation measure must rank well at each stage because a defect in drafting policy may impact administration.

For example in Report 410, it was recognised that complexity in the policy and drafting of a taxation measure had a direct impact on the quality and effectiveness of administration:

The main challenge in Australian tax administration is the complexity of the tax system. Under self assessment, this has imposed significant compliance costs on taxpayers and pushed large numbers of taxpayers into using tax agents. In effect, complexity has increased the tax burden. A simpler system will deliver savings to both taxpayers and government and allow entrepreneurs to focus on growing their business, rather than complying with arbitrary tax rules.⁶⁰

Furthermore the Report on Aspects of Income Tax Self Assessment notes the impact that tax policy has upon drafting and administration

Tax policy can have a major impact on the structure of the tax law, its administration and compliance costs for taxpayers.⁶¹

In fact a significant factor in moving the task of drafting legislation from the ATO to the Department of Treasury was to ensure that those who formulated tax policy should be involved in its implementation into the drafting stage.⁶²

Another defining factor in constructing the evaluation framework is to consider the impact the self assessment system in Australia has on the desirability and consequent priority attributed to the criteria discussed above. Many of Australia’s taxes are subject to self assessment. For example self assessment was introduced into Australia

⁶⁰ Report 410, above n 50.

⁶¹ Report on Aspects of Income Tax Self Assessment, above n 29.

⁶² Notably, two recent 2008 reports by the Inspector General of Taxation identify a need for greater transparency in the interactions between the Tax Office and Treasury. These reports are: Review of the Tax Office’s administration of GST audits for large taxpayers (June 2008) http://www.igt.gov.au/content/reports/GST_audits/default.asp at 4 May 2008. (“GST Audit Report”) and Report on Improvements to tax administration arising from the Inspector-General’s case study reviews of the Tax Office’s management of major, complex issues (October 2008). Specifically Recommendation 2.20 to the GST Audit Report states that there is a need for clarification regarding the ATO’s and Treasury’s expectations of one another in relation to interpreting the legislation. Treasury states that the discussions regarding the ‘policy’ of enacted legislation are not relevant to interpreting the legislation. This further confirms the need for the policy intent of the legislation to be clearly enunciated through the terms of the legislation and supports the proposition that this legislation must be efficiently and consistently administered by the taxation office. This supports a three pronged approach to evaluating a taxation measure as advocated in this article.

from 1986/1987 in relation to income tax. Under this system the onus is upon the taxpayer to calculate their tax liability. The ATO will usually accept the tax return upon lodgement; however, they retain specific rights of amendment for errors of calculation and mistakes of fact or law.⁶³ The self assessment system is supported by a rigorous penalty regime imposed on taxpayers for errors and non-compliance. Indeed, this system places an onerous burden on taxpayers to digest and apply accurately the voluminous and complicated body of income tax legislation apparent in Australia. As Dirkis and Payne Mulcahy observed:

The introduction of self assessment fundamentally altered the balance of power and focus of responsibilities between taxpayers and the Australian Taxation Office. It has also impacted dramatically on the triangular relationship between the ATO, taxpayers and their tax advisers creating an often fractious relationship.⁶⁴

3.2 Stage One – Evaluating the Policy of the tax

Underlying every piece of tax legislation is a “policy” objective that Parliament is seeking to achieve. An effective taxation policy should be equitable. The taxation policy should also be efficient, compliant with the Rule of Law, sustainable and consistent with other policies. The importance of these criteria to critiquing a tax policy is discussed below. Notably the Consultation Paper recognises the need to target and reform the process of developing tax policy. The Consultation Paper states that:

A common theme in submissions is the need for the tax policy process to be more open and transparent, particularly around the trade offs between efficiency, equity and simplicity.⁶⁵

By establishing the criteria that are relevant in evaluating taxation policy and giving a ranking to the criteria as we have below, the need for openness and transparency in policy processes is being enhanced.

3.2.1 Rule of Law

The Rule of Law requires that a taxation measure is certain for a taxpayer to apply. Therefore, it should be considered at the policy level, whether the tax’s policy is certain.⁶⁶ To ascertain whether the policy of a tax is sufficiently certain it should be clear:

- who the tax is intended to apply to (“the targets”); and
- why the tax is being (or has been) enacted (“the intention”)?

At this stage policymakers should also consider whether this policy certainty can translate to certain drafting. In this regard, when designing a tax policymakers should always be aiming for certainty and in the words of Sir John Donaldson in *Merkur Island Corporation v Laughton*:

⁶³Ibid.

⁶⁴M Dirkis, and M Payne Mulcahy, ‘Self assessment 14 years on: Time for a change’ (2002) 36(8) *Taxation in Australia* 412-416.

⁶⁵ Consultation Paper, above n 8, 30.

⁶⁶ Alley and Bentley, above n 12.

Ministers when formulating policy, should at all times be asking themselves and asking parliamentary counsel ‘Is this concept too refined to be expressed in basic English? If so, is there some way in which we can modify the policy so it can be expressed?’⁶⁷

Uncertainty will inevitably flow through to the drafting stage and will make it extremely difficult, if not impossible, for the drafters to implement the tax in a certain way.⁶⁸ In this regard, the Review of Business Taxation states: ‘Nor is the issue of complexity solely one of legal language: no application of plain English may be able to render intelligible a poorly defined policy.’⁶⁹

Certainty should be paramount in critiquing a tax at the policy (and also at the drafting and administration levels as discussed below). A major factor influencing the primacy that should be assigned to certainty arises because many Australian taxes rely on a self assessment system. The self assessment system is built on the presumption that a taxpayer or their adviser can calculate and ascertain their taxable liability. If a tax is uncertain then a taxpayer or their adviser will be unable to determine when the tax will apply and would not be able to self assess.⁷⁰

However, the importance of certainty transcends self assessment. Certainty can potentially enhance the attainment of many of the other criteria such as efficiency, equity, sustainability and policy consistency, as discussed above.⁷¹

A further reason to require certainty in the policy of tax legislation is that there is some evidence to suggest that uncertainty in the taxation law can result in an increase in tax evasion because taxpayers lose respect for the taxation law and are therefore, more likely to evade it.⁷² Orow suggests, in this regard, that uncertain law is “retroactive law”. He states: ‘Further uncertain law is retroactive law because the effect of the law is known only after the event. It also penalises those anxious to obey it and eventually creates contempt for the law.’⁷³

⁶⁷ [1983] 2 AC 570.

⁶⁸ House of Representatives Standing Committee on Legal and Constitutional Affairs Clearer Commonwealth Law (September 1993).

⁶⁹ Review of Business Taxation, above n 10.

⁷⁰ Graeme Cooper, ‘Incentives and Strategic Choices Facing Taxpayers Under the Tax Self-Assessment System’ (1995) 12 *Australian Tax Forum* 99.

⁷¹ Orow, above n 36, states:

It is submitted that the criterion of certainty in relation to the terms and operation of GAAR is the most significant because it underpins all the other standards including the institution of law and the legitimacy of the power of the state to exact taxation from its subjects. Uncertainty in taxation law can significantly undermine the equity and efficiency of the taxation systems and have serious consequences on the Rule of Law and the right of taxpayers to organise their financial affairs within the law.

...Further, policy consideration that militate against uncertainty include the proposition that uncertainty in the relevant sense is contrary to generally recognised and accepted principles of sound taxation such as equity, efficiency and the Rule of Law. The OECD Committee on Fiscal Affairs identified certainty as a “right” and said that taxpayers have a right to a high degree of certainty as to the taxation consequences of their actions.

⁷² Neil Brooks, ‘Key Issues in Income Tax: Challenges of Tax Administration and Compliance’ (Paper presented at the Asian Development Bank 2001 Tax Conference, 8 September 2001).

⁷³ Orow, above n 36.

3.2.2 Equity

The importance of the policy underlying a tax being equitable cannot be overstated. Equity is pivotal because it encourages the perception of fairness by taxpayers, which supports voluntary compliance with the taxation law.⁷⁴ The Review of Business Taxation states: 'Multifaceted though it is, no acceptable system of taxation can proceed without due weight being given to equity considerations — the history of democracy has many object lessons in that regard.'⁷⁵ Furthermore, in order to achieve the AFTS Review's aim of enhancing international competitiveness any taxation policy should maintain inter-nation equity, by ensuring Australia is only claiming its share of profits from multinational entities.

3.2.3 Efficiency

In order to maximise the revenue raised by the government, a tax should not impede economic growth.⁷⁶ A tax which adversely effects economic growth by unintentionally distorting economic activity will diminish the revenue base as a whole. Therefore, in critiquing a tax or tax reform measure, one must determine: will the tax protect or raise revenue or will it have unintended economic effects that will impede economic growth and, therefore, diminish the revenue base?

Where a tax is not neutral the unintended economic distortions may compromise the benefit of the extra revenue raised.

3.2.4 Sustainability

The fiscal sustainability of the tax should be considered. If the tax is likely to cost more to administer than will be collected by implementing it, the tax may not be viable. An obvious difficulty in ascertaining the likely revenue benefits from administering a tax is that the amount of revenue that the tax protects from avoidance activities may not be included in the revenue collection forecast. Thus, in this respect, the tax may be acting as a barrier to tax avoidance and, protecting the integrity of the revenue base. This consideration must also be recognised in measuring the revenue benefits, although it would appear to be extremely difficult to quantify.

The environmental impact the tax measure may have should also be considered.

Furthermore, through extensive community consultation the communities attitude towards the taxation measure should be improved and institutional sustainability achieved, particularly if the results of the consultation are incorporated into the taxation measures operation. Recommendation 5 of Report 410 emphasises the need for Government to improve its community consultation on taxation measures. In particular, recommendation 5 suggests increasing consultation at the initial stages of policy development, before the policy intent of the legislation is announced.

⁷⁴ Brooks, above n 71.

⁷⁵ Review of Business Taxation, above n 10, 6.1.

⁷⁶ The Review of Business Taxation (above n 10) in Chapter 6 states that optimizing economic growth means:

'Imposition of the smallest possible impediment to economic growth, including jobs growth, thereby reducing the resource allocation and risk-taking distortions necessarily associated with revenue raising from business taxation.'

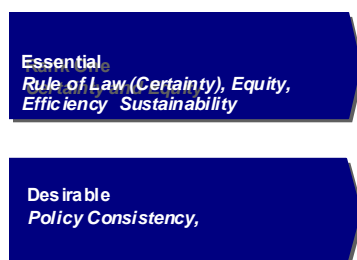
3.2.5 Policy Consistency

A critical criterion at this stage is to ascertain if the taxation measure is consistent with the policy underlying other taxation measures within the same Act and whether it is consistent with broader policy goals. This will enhance the stability of the taxation measure and make it easier to draft at the drafting stage as consistent terminology and structures can be utilised.

3.2.6 Summary of the Criteria Relevant for Evaluating Taxation Policy

It is important, at the policy stage, that a taxation measure adheres to the requirements of the Rule of Law and is equitable, efficient, has policy consistency and is sustainable. Whilst there may not necessarily be a trade off between these criteria for certain taxation measures, if trade offs do occur it is suggested that priority should be given to the design principles of adherence to the Rule of Law, equity, efficiency and sustainability. As a subsidiary goal it is desirable that the taxation policy should be policy consistent. Policy consistency is made a subsidiary goal as sometimes trying to utilise the tax system to pursue non-revenue raising goals and achieve external policy consistency, can jeopardise the efficiency and certainty of the Act and given the primacy of these goals (as discussed above) arguably this criteria should be given a subsidiary ranking.

FIGURE 2: STAGE ONE - POLICY



3.3 Stage Two – Evaluating Drafting

The second stage of the evaluation framework, critiques the legislative words or the “drafting” of a taxation measure. When critiquing drafting, the Rule of Law, equity and simplicity should be considered.⁷⁷

3.3.1 Rule of Law

There is mixed opinion on the importance of the Rule of Law in the context of the self assessment system. Professor Cooper observed:

...the Rule of Law might be a value that should be given absolute primacy in cases where the curtailment of personal freedoms or the expropriation of property without some attempts at lawful justification is threatened. But might be appropriate to modify or

⁷⁷ Note the composition of these can also differ. See for example the differing formulations of what constitutes a good tax by Adam Smith and Joseph Stiglitz.

circumscribe its application in a tax context, especially one characterised by, say, a high degree of artificiality and a motive which taints the taxpayers position.⁷⁸

This article argues that the Rule of Law should be attributed high importance in assessing the drafting of a tax. Certainty of application should be contained in the words of the tax. Furthermore, as taxpayers operate in the self assessment system have a right for their obligations to be contained in the text of the Act that also assesses (and can penalise) them.

Thus, in critiquing a tax at the drafting level it is important to consider if the tax is certain. There is some debate surrounding how certainty can be achieved in the drafting of a tax. Some scholars argue that “broad-based principled” drafting can result in shorter taxes that are still capable of certain application. Broad based-principled taxes utilise drafting that seeks to convey the intended result of the legislation, rather than set out the mechanics to achieve it. Certain application, however, will only be obtained by the tax being supplemented with extraneous materials such as rulings, guidance papers and binding ATO advice which clarifies the application of the tax. The Review of Business Taxation, for example, states:

- 6.133 It is administratively desirable that taxpayers have certainty with regard to their income tax liability and how the law operates. As noted above, certainty can be achieved through other means apart from ever more complex legislation (which often can produce the opposite result). As is now done, the tax administration can provide mechanisms like rulings to clarify the operation of the law in particular cases. Reliability also requires consistency in decision making and is assisted by a more cohesive administration that has increased coordination across its functions and over time.
- 6.134 There are, however, some tensions in trying to achieve certainty or reliability in tax administration. Certainty and reliability are enhanced by a stable system that is not subject to constant change, leading to a recurring need to re-educate taxpayers. Yet it is also important that an administration be flexible and responsive where necessary. Additionally, while it is desirable that taxpayers receive consistent treatment, decision makers must still have sufficient discretion to be able to respond to taxpayers’ individual circumstances within the general policy principles of the tax system.⁷⁹

The converse of this argument is that certainty can only be achieved by the drafting of sometimes lengthy and highly prescriptive taxes, particularly where the policy, that the tax seeks to convey, is itself, complicated. This argument will not be addressed in this article. However it is acknowledged that achieving certainty is an extremely important goal at the drafting level. Taxpayers should have the law available to them to undertake an assessment of their tax affairs and this can only occur where the legislation is certain. Previously, the judiciary was one of the strongest proponents of the need for taxation legislation to be certain and overtly clear in its operation. For example in *Westraders v FCT*⁸⁰ Chief Justice Barwick stated: “It is for the Parliament to specify, and to do so, in my opinion, as far as language will permit, with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax.”

⁷⁸ Cooper, above n 33.

⁷⁹ Review of Business Taxation, above n 10, 6.133 - 6.134.

⁸⁰ (1980) 144 CLR 55.

In more recent times, however, the judiciary has been more amenable to give effect to legislation by interpreting it in a purposive manner.⁸¹ This approach has been formalised by the enactment of section 15AA of the *Acts Interpretation Act (1901)* (Cth).⁸² Section 15AB of the *Acts Interpretation Act (1901)* (Cth) also advocates the use of extrinsic material to assist in the interpretation of a provision of an Act.⁸³

Despite this change in statutory interpretation and the recognition, by the *Acts Interpretation Act (1901)* (Cth), that regard can be had to extraneous materials; it is argued that this does not diminish the importance of aiming for certainty in drafting of the tax to begin with. Therefore, in this regard and for the reasons discussed under stage one, adherence to the principle of the Rule of Law that legislation be certain is held to be paramount in evaluating drafting of a tax. This involves ascertaining whether the taxpayer can determine when and to what extent the legislation applies to any transaction they enter into.

3.3.2 Equity

Just as it is important that the overall policy of the tax is equitable, it is equally important that the drafting of the tax maintains this equity. In this regard it must be ensured that the drafting of the taxation measure captures all the attributes of a taxpayer that are necessary to ensure a fair basis of comparison and that equity is achieved by the practical operation of the Act. Equity aids voluntary compliance and encourages the perception of fairness by taxpayers. This is pivotal for any system of taxation but particularly a taxation system that relies upon self assessment.

3.3.3 Simplicity

At an Australasian Tax Teachers Conference when asked about complexity in the tax laws, Michael D'Ascenzo the Commissioner of Taxation stated: '...in a sense, who cares?'⁸⁴ He then went on to explain that 73 percent of people engage tax agents and the tax profession and ninety-five percent of companies utilise the tax profession. He stated that if you live a complex society it must be expected that the laws may also be complex. The Consultation Paper for the AFTS review recognises that the tax/transfer system is extremely complex and acknowledges that to some degree this reflects a system that has equity and efficiency objectives. However, it states that complexity adds cost and risk to business and personal activities and that complexity has an impact on choices to work, save and consume.

⁸¹ *Cooper Brooks (Woolongong) Pty Ltd v FCT* (1980) 147 CLR 297.

⁸² Section 15AA(1) states:

In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.

⁸³ Section 15AB states:

(a) confirm that the meaning of the provision is the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act; or
(b) determine the meaning of the provision when:
(i) the provision is ambiguous or obscure; or
(ii) the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act leads to a result that is manifestly absurd or is unreasonable.

⁸⁴ Michael D'Ascenzo, Commissioner of Taxation, 'It is the community's tax system' (Speech delivered at the 18th Annual Conference, Australasian Tax Teachers Association, Melbourne, 2006).

In short, simplicity is not always desirable or possible. In some cases simplicity may only be possible where the policy underlying the tax is not complex. Realistically, in many respects, much of the Australian tax legislation is seeking to serve and convey desirable complex policy goals and, therefore cannot be conveyed simply.

Binh Tran-Nam argues that the goal of simplicity should not be overstated, as a complicated tax law can be a necessary consequence of a developed economy:

In a more mature economy where market structures, business organizations and commercial transactions have grown continuously and rapidly in complexity, tax laws have to evolve accordingly. The tax system of an economy is analogous to the dress of a person. As a person grows taller, a well-fitted dress should become accordingly longer and wider. A complex economy must have more complicated tax laws.

In sum, it must be recognised that the tax system cannot remain simple in the absolute or static sense while the economy continues to evolve. Tax simplification at the expense of other objectives of the tax system may not be a desirable thing. Instead of scoring political points, the government should be open and frank about the inherent difficulties in trying to simplify the tax system. It is not productive for the government to exaggerate the true simplification prospects of its tax reforms in order to pursue other hidden agenda.⁸⁵

Furthermore, as the decision matrix above illustrates, simplicity may arguably compromise more important goals like equity and adherence to the Rule of Law.

Another reason for not overstating the importance of trying to achieve simplicity is that it may be “inefficient” to pursue the goal of simplification. Professor Cooper states that it may be “highly inefficient” to pursue the goal that ordinary citizens should understand all of the laws with which they are to comply:

...It is also likely that the level of understanding of the audience – the ordinary citizen - depends upon educational levels and achievements, so that at some point investing greater resources in better drafting may show lower returns than investing greater resources in educating readers.⁸⁶

An extension of this is that most taxpayers “interact selectively”⁸⁷ with the tax system. Most individual taxpayers would not, for example, have to apply the consolidation regime in the ITAA 1997. Accordingly, the degree of simplicity that is appropriate for tax that apply to corporations or business would differ to that appropriate for a tax more frequently applied by individual taxpayers.

Therefore, applying the criteria of simplicity to a tax that is seeking to convey a complex policy goal is, in many respects, redundant. A greater degree of simplicity is optimal and should be aimed for where possible; however, it should not be aimed for at the expense of more important goals such as equity and certainty. Furthermore, the degree of simplicity differs depending on the taxpayers targeted by the tax. Where businesses or corporations are the targets of a particular tax a higher degree of complexity may be acceptable.

⁸⁵ Binh Tran-Nam, above n 27.

⁸⁶ Professor Graeme Cooper, ‘Themes and Issues in Tax Simplification’ (1993) 10 *Australian Tax Forum* 417.

⁸⁷ Review of Business Taxation, above n 10.

For these reasons, simplicity is seen as a desirable principle and not one that should be aimed for at the expense of other essential design principles.

3.3.4 Summary of the Criteria Relevant for evaluating Drafting at Stage Two

The most important criteria in stage two is that a tax be implemented with certainty (thereby satisfying the Rule of Law) and maintains equity. Whilst an ideal tax would also satisfy the criterion of simplicity to the extent that this means the taxation measure conflicts with the attainment of certainty or equity arguably this should be attributed lower (desirable) importance when critiquing a tax under stage two.

FIGURE 3: STAGE TWO - DRAFTING



3.4 Step Three – Evaluating the Administration of the Tax

Stage three involves evaluating the administration of the tax. The three criteria that are relevant under the administration stage are adherence to the Rule of Law, administrative equity, efficiency and simplicity.

3.4.1 Adherence to the Rule of Law

The main consideration here is whether the tax is being administered in a way that provides the taxpayer with certainty. Pivotal to achieving certainty in tax administration is transparency. For a taxpayer to understand how the system of taxation administration works – the information and process must be made transparent and open, furthermore the bureaucracy must comply with the law that has been passed. In considering this it is relevant to consider the following questions:

- Is it clear from the terms of the tax how it is to be administered?
- Do the rulings (private, public etc) on the tax provide consistent decisions on the application of the tax?
- Has the administrator made its view clear (via tax rulings, booklets and other guidelines) as to when it considers the tax will apply? Does its view accord with the stated intention of how the taxation measure is to apply (obtained from the Explanatory Memorandum);
- Has the tax been administered in a timely manner or have there been significant delays in the administrator's view being clarified?
- Has the tax been widely litigated? Does the case law provide consistent decisions on the application of the tax in question? In such decisions has the Court had to

refer to extrinsic materials to determine in what circumstances the tax is designed to apply?

- Does the tax contain a discretion? If it does contain a discretion has the administrator indicated when it would exercise this discretion? Is it clear what considerations will be relevant and irrelevant in the exercise of the discretion?
- Are the avenues of review open to the taxpayer transparent and easily accessible? Does the tax allow for independent review of its application?
- Has the Commissioner followed any Court decisions regarding the particular provision? Recommendation 11 in *Report 410: Tax Administration* suggests that if the ATO has concerns about a decision of the Court it should publicly announce these concerns in the decision impact statement and commit to resolving the issue within 12 months.

3.4.2 Administrative Equity

In looking at whether the tax has been administered equitably the overall question is has horizontal equity been maintained in the administration of the tax?

In this regard some anecdotal evidence regarding administration of the tax may be relevant. It will again be relevant to consider whether like cases have been treated alike, have economically equivalent transactions been afforded the same taxation treatment. Again it is relevant to determine whether the tax contains broad discretions, which have the potential to be exercised inequitably? If the tax does contain broad discretions are there sufficient safeguards to ensure that the tax will be administered equitably and fairly? Such safeguards may include the existence of opportunities for independent review, guidelines as to how the tax will be administered or the opportunity to obtain a private ruling in a timely manner.

3.4.3 Simplicity

At this stage it is relevant to consider whether the administrator has or is likely to incur significant administrative costs in enforcing and collecting the tax. Is it likely that the costs of administration will diminish overtime?

Where the tax has been enacted again it is relevant to consider the following questions:

- Has the tax been extensively litigated? Do the Courts decisions reveal a consistent basis for applying the tax?
- Has the administrator needed to incur significant costs providing responses to requests for private rulings?
- Has the ATO issued significant rulings, taxpayer alerts, booklets or advice on the tax?
- Has there been a review of the administration tax by an independent Board of Review such as the Ombudsman, Inspector General or Board of Taxation?

These questions address the amount of administrative resources that have been dedicated to clarifying or enforcing the particular legislative provision. For example where there has been the need to litigate a number of times in relation to a particular

legislative provision, it is arguable that the provision is uncertain or has been administered in a way that has not enhanced transparency or taxpayer certainty. Furthermore, where there have been a large number of private ruling requests or the need to issue a number of public rulings in relation to a particular provision this would appear to indicate that a particular provision is ambiguous or unclear and is resulting in administrative complexity.

It is also imperative that the tax has been administered in a manner to minimise compliance costs and so that economic activity is impacted as little as possible. This will involve a consideration of many of the factors listed under 3.4.1 in deciding whether the ATO acted in a transparent and timely manner or whether there has been a considerable delay in providing advice to taxpayers. One particularly important aspect of efficient administration is the timeliness in which the ATO provides private rulings. Report 410 comments on the pivotal role that rulings play in the self-assessment system. Therefore an assessment on how quickly private rulings that concern the operation of a particular taxation measure have been issued will be relevant in determining administrative efficiency.

3.4.4 Criteria Relevant for critiquing the administration of a taxation measure at Stage Three

Under stage three, it is very important that a tax is able to be administered equitably, in compliance with the Rule of Law. The goal of administrative simplicity is of secondary importance. This is because, arguably, administrative costs are already minimised significantly under a self assessment system and, therefore, it is more important in such a system to pursue the goals of certainty and equity. However, where the tax is certain it is likely to also be capable of being administered cost effectively and therefore, where certainty is pursued it is likely that administrative costs will be minimised.

FIGURE 4: STAGE 3 - ADMINISTRATION



4. CONCLUSIONS

In order for the AFTS Review to be effective, this article has argued a comprehensive and more appropriate evaluative framework for the review of Australia's existing taxes than currently exists must be constructed. The Review Panel needs to be transparent in defining the criteria it will use in its evaluation for the AFTS Review, detail the priorities given to each of these objectives and the structure of the framework that it plans to use. This article advocates a three staged evaluation framework and suggests an essential/desirable ranking that should be attributed to these criteria.

The first stage evaluates the policy underlying the tax. At this stage, five criteria are relevant. The policy of the tax should comply with the Rule of Law, be equitable, efficient, and sustainable and it is also desirable that it is policy consistent.

The second stage evaluates the drafting of the tax. Three criteria are used to evaluate drafting and should be given the following ranking. It is crucial that the tax does not detract from the Rule of Law and is equitable. Optimally the tax will also be simple. However, in some circumstances simplicity will conflict with equity and the Rule of Law and to the extent of any conflict this criteria should be treated as a merely desirable, subsidiary criterion.

The final stage critiques the ability of the tax to be administered effectively. Four criteria are relevant at this stage and should be assigned the following ranking. At this stage (as at the policy level) it is most important that the tax can be administered in a certain, efficient and equitable manner. It is also desirable that the administrative costs of the tax are minimal or in other words the tax satisfies the criteria of simplicity. However, this should be a subsidiary goal to the extent that it conflicts with certainty and equity. This is particularly the case because many of Australia's taxes are administered on a self assessment basis and these costs are already minimised. Importantly where a tax does not rank well in relation to the administration stage it should be considered whether this highlights a flaw in the drafting of the tax that enables the defective administration.

The integrated evaluation framework advanced in this article highlights the utility for the Review Panel of using a multi-staged evaluation framework to conduct the AFTS Review because it:

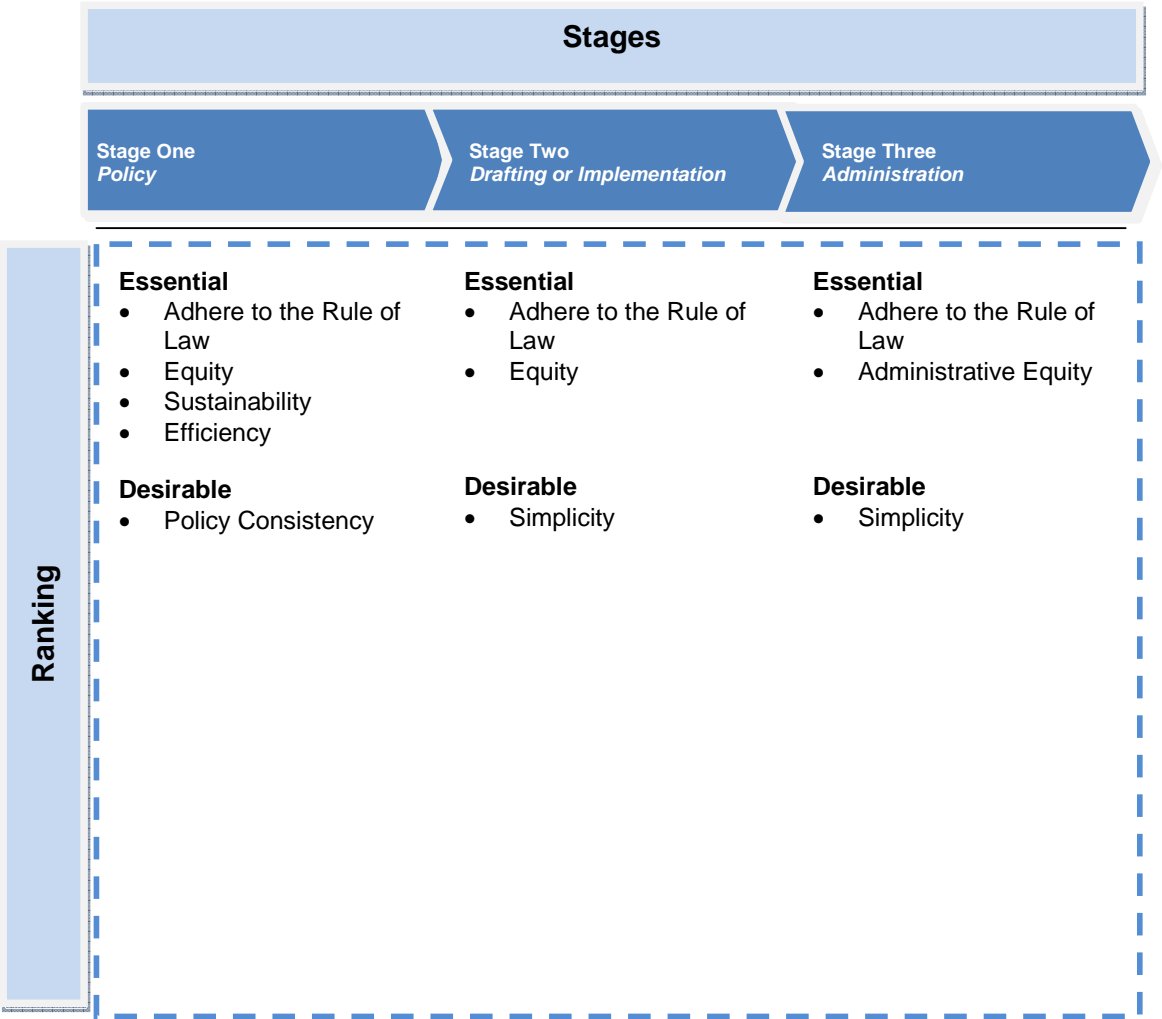
1. Recognises that a tax or tax reform measure has three elements (policy, drafting and administration) that need to be critiqued. To be "effective" the tax should function well at **all** three levels. It is not enough that the policy behind the tax is effective, that policy must also be capable of transformation into effectively drafted law and have the ability to be administered in a certain, equitable and simple or administratively efficient manner.
2. Illustrates that any defects in the tax will flow through from policy to drafting to administration. In order to be effective the tax must rank well at the policy stage. Where the policy is uncertain, for example, this will necessarily flow through to the drafting and the administration of the tax.
3. Acknowledges that each level has a different set of criteria, which are relevant.
4. Assists in identifying at what "level" problems with a tax should be dealt with. For example, identifying whether a problem with a tax is a result of the drafting or administration, or whether it arises from a more entrenched "foundational" flaw in the policy underlying the tax.
5. Acknowledges that no tax can be perfect and that trade offs between the criteria are inevitable. Where one design principle is given precedence this ranking should be explicit. Therefore, the most desirable criteria (as discussed in the article) should be given precedence, in evaluating the tax.
6. Recognises that "Rule of Law" is an important criteria and should be included in any evaluation framework adopted by the AFTS Review.

7. Recognises that there are several different views as to the meaning of each criterion and therefore, that the meaning attributed to each criterion must be explicitly set out in the AFTS Review evaluation framework.

It is accepted that further work could usefully be undertaken on the suggested integrated evaluation framework put forward in this article. For example, significant work needs to be conducted into how to measure each of the criteria and on mapping the relationships between the criteria. However, it is suggested that by adopting the methodology outlined in this article, the framework advocated in this Article could help the effectiveness of the AFTS Review because it:

- (a) Explicitly explores the interactions and relationships between each of the traditional criteria for evaluating a tax or tax reform measure and recognises that conflicts or trade offs exist between many of them;
- (b) Recognises the importance of evaluating a new tax or tax reform measure in three stages at a policy level, at an drafting level and at an administration level; and finally
- (c) Analyses the value and ranking that should be attributed to these criteria at each level identified in point (b) and advocates the use of a transparent framework in undertaking an evaluation of a taxation measure.

APPENDIX 1: STRUCTURE OF THE PROPOSED THREE STAGE EVALUATION FRAMEWORK



APPENDIX 2: REPORT CARD FORMAT FOR THE INTEGRATED EVALUATION FRAMEWORK

Stage One – Policy	
Criteria	Relevant Considerations
Rule of Law	Is it clear who the tax is intended to target? Is it clear what mischief the tax is designed to curb?
Equity	Does the policy of the legislation apply to all entities consistently?
Sustainability	Is the policy of the legislation environmentally, fiscally and institutionally sustainable?
Efficiency	Does the policy of the legislation impede economic growth or hinder legitimate economic activity?
Policy Consistency	Does the policy of the legislation complement other policies within the relevant tax legislation?
Stage Two – Drafting	
Rule of Law	Can the taxpayer or their adviser able ascertain whether the legislation applies to them? Is it clear to the taxpayer what transactions may trigger the operation of the legislation? Can the taxpayer ascertain the application of the legislation from the legislation itself (eg without recourse to the Explanatory Memorandum or ATO Rulings/Booklets/Guidance etc)?
Equity	Does the legislation promote horizontal, vertical or inter-nation equity?
Simplicity	Can the taxpayer understand the legislation easily or do they have to incur significance compliance costs to understand the legislation?
Stage Three – Administration	
Rule of Law	Is the tax administered in a way that promotes and maintains certainty regarding the tax? Is the tax administrated in a way that preserves transparency?
Equity	Is the tax administered in a way that preserves equity?
Simplicity	Has the administrator incurred significant costs in administering the tax?
Administrative Efficiency	Has the tax been administered in a timely, open and transparent manner?