

eJournal of Tax Research

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eJournal of Tax Research

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The International Income Taxation of Portfolio Debt in the Presence of Bi-Directional Capital Flows[†]

Ewen McCann* and Tim Edgar**

Abstract

A country's net flow of capital consists of simultaneously occurring imports and exports. Because a tax on the income from capital imports affects the quantity of capital exports and vice versa, tax policies toward inbound and outbound capital should be jointly formulated in order to avoid distorting these bi-directional flows and the local capital market more generally. For a small open economy, distortion-free local capital markets are shown to require, in the limited case of portfolio debt flows: (1) the taxation of income from capital imports by the importing country at the same rate as income of residents from locally invested capital; and (2) the exemption from net tax (that is, after any foreign tax credit) in the home country of the income of its residents from capital exports.

INTRODUCTION

A country is either a net importer or exporter of capital, although the decomposition of the capital flows will show that some residents export their savings at the same time as others are importing capital. In short, the disaggregated capital flows of a country are bi-directional at any instant or over any defined period. This paper considers the income tax regime for the capital imports and exports of a small open economy in a partial equilibrium framework. The focus is the bi-directional flow of portfolio debt capital, by which we mean a loan contract between parties whose relationship is arm's length in the sense that one party does not control the decisions of the other.¹

Simultaneous bi-directional flows of capital would occur in an open-economy setting without taxation when residents have different rates of time preference that are above and below the interest rate. Those residents whose rate of time preference exceeds the rate of interest would be borrowers, and those whose rate of time preference is below

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* Latterly, the Principal Economist in the Policy Advice Division of the New Zealand Inland Revenue Department.

**Of the Faculty of Law, The University of Western Ontario, and a senior research fellow in the Taxation Law and Policy Research Institute at Monash University, Melbourne.

¹ The distinction between direct and portfolio investment is commonly defined in terms of the ownership of the voting securities of an entity. The bright-line conventionally used in the literature and by tax policy-makers as a proxy for control is a 10 percent or more ownership stake.

the rate of interest would be lenders. In an open-economy setting with competitive capital markets, a resident is just as likely to transact with a non-resident as with another resident.² Bi-directional international flows of homogeneous portfolio capital can occur when the world interest rate lies between disparate rates of time preference. Given this context, resident lenders and resident borrowers arbitrage between the local interest rate and the world interest rate, which are adjusted for the appropriate taxes. The actions of resident lenders and resident borrowers are thus linked by their arbitrage off private prices in the local capital market: that is, the local interest rate after taxes.

Perhaps somewhat surprisingly, the development of national policies toward the taxation of income from inbound and outbound capital flows does not reflect either the bi-directional nature of those flows or the interdependence of lenders and borrowers, both resident and non-resident, which arises from their participation in the same market. Taxes on capital imports or capital exports are usually developed and viewed as independent regimes, notwithstanding the private-price linkages and their simultaneity. This singular focus on either net inbound or net outbound capital flows is also reflected in the academic literature considering optimal tax policy in an open-economy setting.³ We attempt to illustrate the critical importance to the development of an international tax regime for a small open economy⁴ of the mutual consistency between capital import and capital export taxes. Policy for the taxation of capital imports should be developed with a view to policy for the taxation of capital exports and vice versa.

More particularly, the paper uses a partial equilibrium analysis to find that: (i) the return to inbound portfolio debt should be taxed consistently with the return to debt contracts between resident lenders and borrowers; and (ii) the return to outbound debt should be free of residence-country net tax (that is, after any foreign tax credit). The application of our results is restricted by our partial equilibrium approach to the market for portfolio debt capital. In treating our problem, Slemrod et al (1997) use a partial equilibrium approach, which is also used by Findlay (1986) and Bruce (1992) to analyze one-way net equity flows. A general equilibrium approach has been widely applied to one-way net direct investment, for example, by Gordon (1989), Gordon and Varian (1989) and by Feldstein and Hartman (1979). Some of these papers maximize national income, others optimize for a representative agent. Disparate rates of time preference preclude us from using a representative agent model, while the constrained maximization of national income does not provide policy conclusions to the problem treated by Slemrod et al, which we reexamine.

² In adopting this competitive assumption, we abstract from the issue of the tax-policy significance of an observed home-country bias of resident portfolio investors. Gordon and Hines (2002) survey briefly some of the literature documenting an apparent home-country bias of portfolio investors and the possible causes of this bias. Razin et al (1999) argue that optimal tax policy for portfolio debt in the presence of a home-country bias requires that a capital-importing country subsidize capital imports. The subsidy is intended to correct market failure and restore the cost of capital for resident borrowers of a small country to the world rate. See also Gordon and Bovenberg (1996) for a similar argument in the context of portfolio equity.

³ The one exception in the literature, of which we are aware, is Slemrod et al (1997). See part three, *infra*.

⁴ We adopt, for the purpose of the paper, the standard concept of a “small open economy” as one in which the interest rate is determined exogenously in the international market.

Part two of the paper begins with a brief background review of the standard policy prescriptions for international capital flows articulated in the literature. Part three provides the intuition for our results and relates them to those of Horst (1980) and Slemrod et al. It also highlights some important implementation issues that our policy prescription raises. Part four presents an illustrative numerical example and the formal derivations of our policy prescription for inbound and outbound portfolio debt flows. Part five concludes the paper.

As noted above, we limit our focus in this paper to bi-directional flows of portfolio debt capital. We have done so primarily because of the deduction/inclusion income tax treatment of interest expense and income, which is broadly consistent across countries. Although we believe that our framework can be extended to foreign portfolio equity, as well as foreign direct investment, subtle differences in the tax treatment of such investment across countries makes the exposition somewhat more complex. In short, the simple and standard treatment of portfolio debt capital makes the exposition of our framework and organizing principle somewhat easier in the first instance. We intend to explore in a future paper the possible explanatory power of our framework for bi-directional flows of portfolio equity and direct investment.

THE STANDARD POLICY PRESCRIPTIONS ASSOCIATED WITH CAPITAL-EXPORT NEUTRALITY AND CAPITAL-IMPORT NEUTRALITY

Country practice has developed a compromise jurisdictional division of the income tax base.⁵ Very broadly, this accepted division allocates the principal jurisdictional right to tax portfolio income to the country in which an investor is resident. Countries in which the income is considered to arise are granted a limited ability to impose gross withholding taxes on the income streams, and the country of residence is required to credit such source-country taxes. This residence-based jurisdiction is conventionally supported by controlled foreign corporation (CFC) and foreign investment entity regimes that look through the separate-entity treatment of a non-resident corporation or other non-resident entity and attribute investment income of the corporation or entity currently to resident investors.

In contrast with the treatment of portfolio income, the principal right to tax income from direct investment is allocated to source countries, with the country of residence of the investor required to provide recognition of source-country taxation either by exempting the income from residence-country tax or crediting source-country tax. Even with credit countries, two common aspects of credit systems ensure that source-country tax on the income is predominant. First, foreign-source income earned through a foreign corporation is generally not taxed by a residence country until repatriation to a resident investor. Second, although the amount of the credit is limited to residence-country tax that is otherwise payable on the income, an element of averaging of high-tax and low-tax foreign-source income is permitted. Combined with deferral of residence-country tax, the ability to use excess foreign tax credits to offset any residual tax on low-taxed foreign-source income, means that the functional difference between exemption and credit countries is much less than the formal difference would suggest.

⁵ This division of the jurisdiction to tax international income has been referred to as the “international tax compromise.” The early development of this compromise is described in Graetz and O’Hear (1997).

This accepted jurisdictional division of the international income tax base contrasts sharply with the standard policy prescriptions found in much of the economics literature. To some extent, the contrast can be attributed to a fundamental preoccupation in this literature with the specification of an efficient or optimal international tax regime, which tends to ignore other normative considerations, such as inter-nation and inter-personal equity (though Peggy Musgrave's work is the exception here), as well as more mundane issues of enforcement and administration. The contrast between economic theory and country practice may also be attributed, in no small part, to the conflicting efficiency concepts of capital-export neutrality (CEN) and capital-import neutrality (CIN).

Both CEN and CIN focus on the maximization of worldwide welfare, where world income is the welfare criterion. CEN focuses on the allocation of investment across countries. As originally articulated by Musgrave (1963 and 1969),⁶ CEN is nothing more than an application of the Diamond-Mirrlees (1971) production efficiency theorem to cross-border investment flows.⁷ Where investors allocate capital to maximize their income, risk-adjusted, pre-tax rates of return to investment will be equalized across countries such that no reallocation of investment can result in an increase in world income. The standard international tax policy prescription for the realization of production efficiency is an exclusively residence-based jurisdiction to tax, which is equated with CEN. This standard prescription is well known and similar in both a co-operative and a non-cooperative setting.⁸

In the former setting, all countries co-operate and agree to tax the foreign-source income of their residents consistent with the taxation of their domestic-source income. Consistency of treatment generally means recognition of foreign-source income by residents on an accrual basis. Residents thus face the same after-tax return on investments, which should ensure that the pre-tax returns on investments in different locations are not disturbed as compared to a no-tax world. Those returns are equated, and no reallocation of the location of investment would result in an increase in world income. In effect, the decision to locate an investment is not distorted by the imposition of a residence-based tax.

In a non-cooperative setting, the same residence-based approach also arises as the standard policy prescription, but with a significantly different treatment of source-country taxes by residence countries. In order to maximize the social return from foreign-source income, a single capital-exporting country should attempt to equate the pre-tax returns from domestic investment with the returns on foreign investment after any source-country tax. This result is realized generally by taxing the pre-tax foreign-source income of residents on an accrual basis, with a deduction from such income for any source-country taxes. This particular residence-based system is commonly associated with the concept of "national neutrality" (NN) and the work of Peggy Musgrave (1963 and 1969). Although foreign-source income is subject to a higher tax burden than domestic-source income, the social returns to foreign and domestic

⁶ Hufbauer (1975) is another important early work developing the equivalence of CEN and the maximization of world income.

⁷ Slemrod (1995) draws on the production efficiency theorem as the basis for the development of an international tax regime that implements CEN as the income-tax equivalent of a free-trade tax regime.

⁸ Razin and Sadka (1990).

investments are equated. Accordingly, the tax system of the capital-exporting country is said to be neutral as between foreign and domestic investment.⁹

For a single, capital-importing country whose economy is small and open, the standard policy prescription in a non-cooperative setting is the non-taxation of income from capital imports, except to the extent that the residence jurisdiction provides a credit for source-country taxes. In the absence of a credit, any tax on capital imports would impose a wedge between pre- and after-tax returns. Because the tax can be avoided by investing elsewhere, pre-tax returns in the capital-importing country must rise to equate after-tax returns, with the incidence of the tax ultimately falling on immobile factors, such as labour. The inequality in pre-tax returns means that capital is misallocated in the sense that a re-allocation could increase income. A direct tax on labour is thus preferable, since it would avoid the distortion of the location of investment.¹⁰

In contrast with CEN, CIN focuses on the allocation of savings across countries. In other words, CIN is concerned with the maintenance of “inter-temporal exchange efficiency,”¹¹ whereby the savings decision (that is, the choice between current and deferred consumption) is not distorted in a cross-border context. This decision is, in fact, distorted by the use of an exclusively residence-based system in pursuit of CEN. Although such a system ensures that the location of investment across jurisdictions is not distorted, differences in country tax rates mean that the savings decision is distorted. In a simple two-country model with the savings decision responsive to after-tax rates of return, investors resident in the country with a higher tax rate will save too little as compared to investors resident in a country with the lower tax rate.¹² World welfare could be increased if returns from savings were transferred from residents of the low-tax country to residents of the high-tax country. The standard tax-policy prescription for the realization of inter-temporal exchange efficiency is an exclusively source-based jurisdiction to tax, which is commonly associated with CIN. Under this system, investors in a particular location are taxed at the same rate, so that after-tax returns to savings invested in that location are equated.

It is well recognized that in a world of different country tax rates applied to investment and savings, CEN and CIN cannot be realized simultaneously, unless demand for capital or the supply of capital is completely inelastic.¹³ When these extreme assumptions are relaxed, the alternatives for tax policy-makers are seen to be an international tax regime that is: (i) source-based and thereby distorts the allocation of investment across countries; or (ii) residence-based and thereby distorts the choice between current and deferred consumption and the level of worldwide savings. The decision variables in the choice between these alternatives are formally modeled by Horst, who builds on the earlier work of Musgrave, but defines an optimal international tax regime as one that maintains the social opportunity cost of capital rather than maximizes national income as the policy goal. He argues that such a regime should ensure the equality of the weighted average of pre-tax and after-tax returns to capital, with the weighting determined by the elasticity of the supply of

⁹ Feldstein and Hartman (1979) have an early paper expressing this result.

¹⁰ These results are obtained in Gersovitz (1987); Gordon (1986); and Gordon (1992).

¹¹ Altshuler (2000, at 1581).

¹² *Id.*, at 1580-81.

¹³ See, for example, Graetz (2001, at 272).

capital. An exclusively residence-based system is optimal only if the demand for capital is elastic and the supply of capital is inelastic. In that case, such a system maintains equality of pre-tax returns across investments in different countries without distorting the level of worldwide savings. An exclusively source-based system is optimal if the demand for capital is inelastic and the supply of capital is elastic. In that case, such a system increases the level of worldwide savings without disturbing the location of investment.

Much of the international tax debate following the work of Musgrave and Horst has focused on CEN and CIN as guiding principles in the taxation of foreign-source income from foreign direct investment.¹⁴ The debate has tended to coalesce around the dictates of CEN, which are seen to require the accrual taxation of foreign-source income with credit for any source-country taxes, and the dictates of CIN, which are seen to require exemption of such income in the residence country. In the context of foreign direct investment, the compromise position appears to be the deferral of the residence jurisdiction until repatriation of foreign-source income to the residence country. Provision of deferral with credit or exemption results in a tax rate on foreign-source income that is somewhere between zero and the rate on the domestic income in the residence country.¹⁵ It has been suggested that this compromise rate can be justified on the basis that the optimal tax rate on foreign-source income is somewhere within this band, depending on the relative elasticities of the demand for and supply of capital.¹⁶

In contrast with the heated debate over the optimal taxation of income from foreign direct investment, the treatment of income from foreign portfolio investment has received little attention. Indeed, it seems to be accepted that an exclusively residence-based system dictated by CEN is optimal.¹⁷ This position is even advocated by some analysts who see an exclusively source-based system as desirable for foreign direct investment, and draw on the concept of CIN as tantamount to a requirement of equality of after-tax returns to ensure the competitiveness of multinational firms headquartered across different countries. For example, Frisch (1990) and Hufbauer (1992) both argue that increased capital mobility means that portfolio investment flows determine the allocation of savings worldwide, and direct investment no longer serves this important allocative function. In effect, direct investment is no longer needed to intermediate the source and use of funds when portfolio investors resident in a particular country can invest directly, or indirectly through investment funds, in the securities of entities resident in another country. An exclusively residence-based jurisdiction to tax is advocated as the means to achieve CEN in the allocation of worldwide savings. Graetz and Grinberg (2003) even argue that a deduction for source-country taxes should be the residence-country norm for foreign-source income from portfolio investment, on the apparent basis that the residence-country tax treatment of such income does not affect the important decision as to the location of investment. Source-country withholding taxes on inbound portfolio capital are

¹⁴ United States (2000, at 23-42) surveys much of this literature in the context of foreign direct investment.

¹⁵ Altshuler (2000, at 1582).

¹⁶ Ibid.

¹⁷ Brean, Bird and Krauss (1991) provide a detailed development of this position in the context of an international tax regime that permits a limited source-based jurisdiction to tax portfolio income and requires the provision of a foreign tax credit mechanism by the residence jurisdiction.

considered desirable only to the extent that they serve as a backup to the enforcement of the residence-country jurisdiction.¹⁸

We believe, however, that this standard policy prescription for the taxation of portfolio income is incorrect for a small open economy. The error is attributable to a failure in the international tax literature to account for the two-way or bi-directional flow of capital. In particular, the literature is dichotomized in a way that is similar to that of international tax regimes. A paper will usually deal either with inbound capital or with outbound capital, but not with both of them occurring simultaneously. A gap in both practice and in theory is the consequence of this characteristic. Capital-market distortions to outbound capital that are created by a tax policy towards inbound capital are camouflaged by the dichotomy. Conversely, a recommended tax policy on capital imports will miss the distortions it introduces to capital exports, if the capital flows are viewed separately. The bifurcation of theory and policy may be traceable to the early papers that dichotomize the problem into taxes on inbound capital and taxes on outbound capital.

We believe that the disparity and the complexity of the separated approaches to taxing capital imports and capital exports, in theory and in practice, offers the prospect that an alternative organizing principle might succeed in simplifying international tax regimes. The notions that we offer here are:

- Bifurcated tax regimes for inbound and outbound capital bring about an unrecognized capital market distortion that arises because resident lenders and borrowers arbitrage off their local after-tax interest rate;
- Bi-directional capital flows, and the arbitrage between their returns, are to be recognized in the development of international tax policy; and
- The equality of the private and social rates of return to outbound capital with the private and social rates of return to inbound capital integrates the tax treatment of capital exports and imports.

We are careful, however, to emphasize that our approach and alternative organizing principle are limited in the first instance to portfolio debt capital, since we believe there are certain features of such capital flows that lend themselves more easily to an integrated approach. In particular, international portfolio debt markets are closely integrated, with interest expense and income subject generally to a deduction/inclusion tax treatment across countries. Moreover, the arm's length nature of the relationship between the borrower and the lender means that non-tax factors generally constrain the ability to substitute debt and equity securities in response to differences in tax treatment in source and residence countries, with an eye to the foreign tax credit position of the lender.

EFFICIENT TAXATION OF PORTFOLIO DEBT IN THE PRESENCE OF BI-DIRECTIONAL CAPITAL FLOWS

This part offers the intuition for our results and contrasts them with Slemrod et al and Horst. It also highlights briefly some important implementation issues for an

¹⁸ Zee (1998). See also Gordon (1992) and Slemrod (1988). This role is reflected, in part, in the initiative of the European Union (EU) to adopt a minimum interest withholding tax. See Huizinga and Nielsen (2000); and Huizinga (1994).

exclusively source-based regime for the taxation of the returns on portfolio debt capital. A formal derivation of our policy prescription is provided in the next part.

The organizing principle underlying the formal derivation is that the private cost of capital should equal its social cost.¹⁹ The social cost of capital is the amount per unit of inbound capital that the small country as a whole sends abroad. This cost of capital consists of two components for the small country: (i) the after world tax world rate of interest that a large country investor must receive from every investment;²⁰ and (ii) any tax that the large country levies on its outbound investment, after accounting for foreign tax credits. Such tax is a necessary supplement to the first component of the social cost of capital for a small country, otherwise the non-resident investors would not receive the after world tax world rate of interest from the small country. The sum of the two components is the amount that the small country remits overseas and is the social cost of inbound capital. Interest rates must alter sufficiently in the small country to at least meet the sum of components (i) and (ii) of the social cost of capital, although there is another effect on the interest rate in a small country.

An additional component of the interest rate in a small country is the gross up of the rate to account for the tax that the small country imposes on capital imports. The gross up is not, however, a part of the social cost of capital, because it is not remitted overseas. The interest rate in the small country is thus the sum of three components, but only the first two described above constitute the social cost of capital. Provided that the tax rate on inbound capital is set to equal the tax rate on the local capital of residents, the interest rate in the small country will exceed the social cost of inbound capital by the rate of tax on local capital of residents. Deduction of interest at this rate of tax brings the private interest rate of residents into equality with the social rate of interest, being the sum of the first two components described above. Thus the efficient rate of inbound tax in our sense is equal to the rate of tax on residents.

The same organizing principle underlies our result that the net local rate of tax on capital exports from a small country should be zero. Such a net rate of tax is necessary to equalize the social costs and returns to capital. This result may be surprising, although the reason for it is clear, once we consider the meaning of the social rate of return to outbound capital. That return is the world interest rate less any tax paid to the foreign government. If the private rate of return to outbound investment differed from the social rate of return to it, there would be capital market inefficiency. Thus, if in addition to foreign tax paid, the small country levied tax on outbound capital, the private rate of return would be driven below the social rate of return to it, and this would introduce a capital market inefficiency.

We argue, therefore, that an exclusively source-based system for the taxation of income from portfolio debt is optimal for a small country in the sense that it equalizes the inter-temporal marginal rates of substitution in production and consumption in that country. In effect, this policy prescription promotes undistorted local capital markets in the sense of the equality between the private and the social rates of interest on

¹⁹ Consistent with standard usage, we define the “private price” of an item as the price, including all tax obligations, which an agent pays or receives for it. The “social price” of an item is the dollar value of all of the resources of the community that are necessary to produce the marginal unit of the item. A market will be said here to be undistorted if the social price of the item equals the private price for every agent.

²⁰ The small country as a whole must pay at least this amount to non-resident investors.

capital. One of our fundamental points, which the literature has largely ignored, is that a tax on capital exports affects capital imports, and vice versa. The recognition of this effect indicates that tax policies towards inbound and outbound capital should be developed in a way that allows for it. A failure to recognize this effect means that the standard international tax-policy prescriptions described in the previous part of the paper introduce a distortion to local capital markets that is overlooked.

Slemrod et al is the only paper of which we are aware that treats inbound and outbound capital flows simultaneously. They derive a “seesaw” principle for the establishment of optimal tax rates. Under this principle, an increase in the tax rate on capital imports implies a reduction in the tax rate on capital exports and vice versa. Consistent with much of the economics literature on international taxation, Slemrod et al maximize national income with respect to the stocks of inbound and outbound capital, holding wealth constant.

In terms of approach, Slemrod et al solve in the standard way the first-order conditions²¹ that maximize the national income of the small country to obtain the stock levels for: (i) inbound capital; (ii) outbound capital; and (iii) domestically-located capital. Those first-order conditions are then compared with the international after-tax interest arbitrage conditions for inbound and outbound capital.²² The two sets of conditions are seen to be inconsistent for arbitrary rates of tax on capital imports and capital exports. The tax rates on imported capital and exported capital are then changed to bring about the consistency of the two sets of conditions. The first-order conditions and the arbitrage conditions are found by this process to hold simultaneously when: (i) the capital-import tax rate is zero; and (ii) the capital-export tax rate equals the tax rate on the domestically-located capital of residents of the small country.²³ These tax rates are claimed to provide the optimal relation between capital-import and capital-export tax rates.

The principal difficulty with the approach of Slemrod et al is that it assumes that the levels of the stocks of inbound and outbound capital are independent of the key capital income tax rates. Their approach does not allow for the effects of the required adjustments to the capital import and export tax rates on the levels of inbound and outbound capital stocks or on total wealth.²⁴ Altering the rates of capital-import and capital-export taxes in the way that Slemrod et al describe would cause the stocks of inbound and outbound capital to vary from the quantities that provided the maximum value for national income. Those stocks would then no longer be at the levels determined by the first-order conditions and required to maximize national income.

²¹ See Slemrod et al, equations (5a) and (5b) and the earlier unnumbered definition of K_s .

²² *Id.*, equations (5a)-(6b).

²³ *Id.*, discussions following equations (5a)-(6b). The result cited is the principal one from among several results in a taxonomy of tax situations in the paper involving a succession of constant tax rates and is the reverse of the policy prescription developed in our paper.

²⁴ None of the inbound, outbound or total capital stocks of either country in any equation in Slemrod et al is written as a function of any tax rate or of any interest rate.

The rates of capital-import and capital-export taxes would thus be sub-optimal in the sense of not maximizing national income.²⁵

There is some degree of similarity between our results and those of Horst. In particular, he found that a large capital importer should tax income from capital imports at the same rate as income of residents from domestically-located capital. Further, a separate, large capital-exporting country should not tax income from capital exports. These results apply for inelastic supplies of domestic capital. As well, they apply for the respective countries with uni-directional net capital flows. In contrast, our similar results on tax rates are for a small country that both imports and exports capital, and they apply regardless of the elasticities.

We recognize that adoption of our policy prescription presents some significant implementation issues. In particular, the existing international tax compromise has embedded within it certain procedural aspects that are intended to protect the status quo. Perhaps most importantly, effective enforcement of an exclusively source-based jurisdiction to tax portfolio debt requires the use of interest withholding taxes for capital imports.²⁶ Consistency of treatment with resident lenders requires the extension of these withholding taxes to local capital markets, including otherwise tax-exempt investors, such as pension funds.²⁷ The required use of a uniform withholding tax applicable to capital imports and domestically-located portfolio debt would also necessitate the renegotiation of bilateral tax treaties to establish such a tax in excess of currently permissible amounts on portfolio interest. The alternative to renegotiation is the use of tax-treaty overrides in domestic legislation implementing a uniform withholding tax. However, this alternative is contentious and arguably constrained, particularly in certain countries that have incorporated a “monist” doctrine, whereby international law is considered superior to domestic law and cannot be overridden.

An exclusively source-based jurisdiction to tax also places pressure on the rules in a small country that determine the source of interest income. In general, there is a high element of arbitrariness in sourcing rules for income and expense. Sourcing of interest income is not all that different in this respect, with the residence of a borrower conventionally taken as the reference point for the sourcing of interest income. The integrity of this rule would need to be protected from tax-avoidance arrangements that attempt to exploit residence rules for corporations, trusts and partnerships as both lenders and borrowers.

²⁵ The standard approach to constrained optimization is to set up a Lagrange multiplier expression and to optimize it with respect to the choice variables, in this case the inbound and outbound tax rates. This procedure, not followed in the seesaw model, yields complex partial derivatives with respect to inbound and outbound tax rates of the domestic and foreign located capital stocks. These effects are important and are omitted from the seesaw approach; it therefore fails to optimize with respect to the policy variables. Applying the Lagrangian technique to the seesaw model provides several complicated equations that are devoid of policy conclusions.

²⁶ An important second-order design issue is a legislative definition of “interest” subject to withholding tax. In general, the definition needs to extend to both original issue and secondary market discounts, as well as interest surrogates generally. Such definitions are part of much of the legislative regimes governing the income tax treatment of interest income in many countries. See generally, Edgar (2000).

²⁷ To the extent symmetrical rates are adopted for resident borrowers and lenders (both resident and non-resident), accrual recognition of interest income and expense is not required to constrain tax-avoidance opportunities based on asymmetrical rates. See Bradford (1995). Cash-basis recognition for interest withholding purposes could be used for deduction purposes.

A related problem is the need to source interest expense, where such expense is to be accounted for in measuring interest income subject to tax. In effect, interest expense must somehow be matched with interest income generated with borrowed funds and thereby recognized at the same tax rates. Otherwise, differences in after-tax borrowing and lending rates will result, which can distort capital flows. This implementation issue has two distinct, but conceptually related dimensions. The first dimension concerns the reporting of interest income on a net basis by non-residents on-lending funds to a small country. In fact, “net” reporting of interest income is enforceable and thereby feasible for both residents of a small country and non-residents, such as international banks, with a business presence in the country. Interest expense sourcing rules become necessary for this category of non-resident lenders as a function of a decision to extend net reporting as an option to a gross interest withholding tax. Some portion of the interest expense of these non-resident lenders must be allocated to the small country and recognized at the local tax rate such that only the interest spread or net interest income is subject to tax in the small country. For other non-residents, a gross withholding tax may be maintained as a proxy for net reporting, with the country of residence providing interest expense allocation rules for net reporting purposes, including the foreign tax credit mechanism.

The other dimension of the need to source interest expense concerns residents of a small country who, under an exclusively source-based jurisdiction to tax portfolio debt with a net reporting element, would have an incentive to source interest expense in the small country, since such expense would be recognized at the rate applying to income from domestically-located capital.²⁸ The lack of any sourcing rules provides an arbitrage opportunity whereby residents borrow funds to lend abroad, with the interest expense recognized at the local tax rate and the interest income exempt from such taxation. Moreover, non-residents could face the same sourcing incentives depending on the tax rates in their residence countries.

As an attempt to address the sourcing of interest expense, formulary allocation approaches can be justified, not on the basis that they realize some correct allocation in any normative sense, but rather as an allocation methodology that most effectively constrains tax-driven allocations of interest expense. That said, proposals for the formulary allocation of expenses have proven particularly contentious.

ILLUSTRATIVE EXAMPLE AND FORMAL DERIVATION

This part of the paper furnishes a numerical example illustrating the intuition underlying our policy prescription of an exclusively source-based regime for the taxation of the return on portfolio debt capital. The example is followed by a formal derivation of this policy prescription.

Assume, for illustrative purposes, that the tax system of a small country has the following features, which conform to our policy prescription. That is, the tax rate on inbound capital in the small country equals the rate applied to the locally-sourced income of residents, and the tax rate on the income from capital exports of residents is zero. Explicitly, this tax system reverses the relation between capital import and export taxes dictated by the standard policy prescription and is, say,

²⁸ This incentive is muted if capital-exporting residents of the small country can report interest income on a net basis for source-country purposes, and the source-country tax rate exceeds that of the small country on domestically-located capital.

- outbound tax rate, zero
- inbound tax rate, 30 per cent, and
- tax rate on locally sourced income of residents, 30 per cent.

Capital importers may deduct interest expense at the rate of 30 per cent, and interest on loan transactions between resident borrowers and lenders are taxed and deducted, respectively, at 30 per cent. For simplicity, we assume that all taxes in the rest of the world are zero, and the world interest rate for the small country is 5 per cent.

A non-resident investing in the small country would receive 5 per cent by investing elsewhere, since there are no taxes in the rest of the world. In a world of mobile capital, arbitrage opportunities dictate that a non-resident investor receive 5 per cent after any tax in the small country. That is, the non-resident requires a pre-tax interest rate that leaves 5 per cent after the small-country tax. The pre-tax interest rate in the small country must rise therefore by the amount of tax that the inbound investor is required to pay.²⁹ After payment of tax to the small country on the higher interest rate, the inbound investor would be left with 5 per cent, which is the opportunity cost of capital. If r is the higher interest rate in the small country,

$$(1-0.3)r = 0.05$$

so

$$\begin{aligned} r &= 0.05/(1-0.3) \\ &= 0.071429 \end{aligned}$$

A resident capital importer would therefore face an after tax, or private, rate of interest of

$$(1-0.3)(0.071429)=0.05$$

A return of 5 per cent thus remains after local tax is deducted, and this return is remitted to non-resident investors by the small country. The social rate of interest is thereby 5 per cent, and the private rate of interest for resident capital importers equals the social cost of inbound capital. Capital transactions between residents would also take place at the pre-tax rate of interest of 7.1429 per cent, which converts to a private rate of interest of 5 per cent after tax. Removal of the tax on capital exports also means that resident capital exporters receive 5 per cent: that is, the full world rate of interest, which is the social rate of return to capital. Resident capital importers and resident capital exporters now have the same private price of capital of 5 per cent.

The upshot is that the private rate of return to capital, or private cost of capital, is 5 per cent for all residents. The social rate of return or the social cost of capital is also 5 per cent. Private and social costs of capital are equal in every direction, and the local capital market is undistorted (that is, “efficient” in our sense) under this tax regime. That is to say, the policy of not taxing the income of resident capital exporters and taxing capital imports at the same rate as the locally sourced income of residents,

²⁹ We refer to this increase in the pre-tax interest rate as “the gross-up principle.” Huizinga (1996) provides some empirical evidence of the gross-up of source-country withholding taxes into pre-tax interest rates. His data set, taken from the World Bank’s Debtor Reporting System, consists of 510 individual loans made by international banks to borrowers resident in developing countries from 1971-1981.

results in distortion free or efficient local portfolio capital markets. The amount of capital remaining in the small country, the amount of capital imported into the country, and the amount of capital exported by residents, all settle at their undistorted capital market no-tax levels.

This result contrasts with those under the standard policy prescription, where private and social costs of capital are not equal in every direction, and the local capital market is distorted (that is, it is “inefficient” in our sense). That is to say, the policy of not taxing capital imports and taxing the income of resident capital exporters, increases the amount of capital imported into the country, while decreasing the amount of capital provided by residents, both locally and abroad.

To reiterate, our proposed policy for a small country is the exemption of income from portfolio debt capital exports and the taxation of portfolio debt capital imports at the same rate as the taxation of the locally-sourced income of residents. The argument that our prescribed tax policy results in local capital markets that are efficient in our sense can be set out in terms of the following components:

- Inbound non-resident investors gross up the tax rate on the local income of residents into the interest rate in the local capital markets of a small country;
- The gross up ensures that inbound non-resident investors are paid the world rate of interest by a small country;
- The world rate of interest is the social cost of capital to a small country;
- Residents transacting with each other in the local capital market do so at the interest rate that is grossed up by their own tax rate, and this interest is either taxable or tax deductible so that loan transactions between residents result in an after-tax interest rate that is equal to the world rate of interest;
- Capital exporters resident in the small country are not taxed by it, so they too receive the world rate of interest;
- Every resident of the small country - capital exporters, capital importers and residents transacting with each other - has the same private price of capital; and
- The private price is the world rate of interest, which is the social price of capital.

We now provide a formal derivation of these results. In particular, we formally model how local capital market efficiency requires that inbound debt capital is to be taxed consistent with the treatment applied to the locally-invested capital of residents, while outbound portfolio debt is to be free of any tax in partial equilibrium. The treatment preserves the existing system of foreign tax credits.³⁰

A non-resident investing in a small country is in an excess limitation position, for foreign tax credit purposes, when $0 < \tau_c^w \leq \tau_l \leq \tau^w$, where τ_c^w is the foreign tax credit

³⁰ Our approach is broadly consistent with that of Huizinga (1996), who models the relationship between the gross-up principle and the foreign tax credit mechanism. He suggests that the extent of the gross up depends on the availability of offsetting foreign tax credits for lenders, although he finds that foreign tax credits are largely unexploited by the borrowing countries in his data set, which may be attributable to a fear of retaliation and to differences in tax bases in the borrowing and lending countries that push lenders into an excess credit position. Our approach differs, nonetheless, from that of Huizinga in that we deal with bi-directional capital flows. We also treat a certain world and model the foreign tax credit mechanism explicitly.

granted by the rest of the world, τ_1 is the small country's tax rate on imported capital and τ^w is the tax rate in the rest of the world. When r is the small country's interest rate, the total tax in the two jurisdictions paid per dollar of portfolio investment by such a non-resident is the local tax, $\tau_1 r$, plus the tax in the rest of the world shown in the square brackets:

$$\tau_1 r + [\tau^w (r - \tau_1 r + \tau^w_c r) - \tau^w_c r] \tag{1}$$

The term in square brackets for tax in the rest of the world shows how the foreign tax credit system is applied by the large country in the excess limitation case. Expression (1) says that the small country imposes a tax on its inbound foreign investors of, $\tau_1 r$. Then, the foreign country taxes its capital exporters at the rate τ^w as modified in the square brackets. The square brackets give the amount of tax raised by the foreign government under its foreign tax credit system. Initially, the foreign government taxes, at rate τ^w , the full amount of interest earned in the small country, r . As the foreign government recognizes the source-country tax of the small country, there is a deduction of that tax, of $\tau_1 r$, in the round brackets. Continuing, the foreign tax credit, $\tau^w_c r$, is incorporated, first, as a part of the taxable income in the round brackets and, second, as a deduction in the last term in the square brackets from the amount of tax otherwise raised by the foreign country.

An excess credit position, for foreign tax credit purposes, arises for the non-resident investor when, $\tau_1 > \tau^w > 0$, in which case $\tau^w_c = \tau^w$. The total tax liability in the two countries then becomes,

$$\tau_1 r + \tau^w r - \tau^w_c r = \tau_1 r \tag{2}$$

The discussion can be simplified by assuming, for the excess limitation case, that³¹

$$\tau_1 = \tau^w_c \leq \tau^w \tag{3}$$

Subtracting the tax in (1) from r using (3) gives the after all taxes return,

$$r - \{\tau_1 r + [\tau^w (r - \tau_1 r + \tau^w_c r) - \tau^w_c r]\} = (1 - \tau^w) r \tag{4}$$

for inbound debt capital in the excess limitation situation.³²

A non-resident investing in the rest of the world has an after tax return of $(1 - \tau^w) r^w$. Arbitrage requires that this equals (4), which is the small country after all tax return to non-residents investing in the small country, that is, $(1 - \tau^w) r = (1 - \tau^w) r^w$. Hence, in the excess limitation case under assumption (3), local interest rates are³³

$$r = r^w \tag{5}$$

For excess credits, the arbitrage condition is, $(1 - \tau^w) r^w = (1 - \tau_1) r$ by (2), and the local interest rate becomes,

³¹ This simplification was suggested to us by an anonymous referee. The more general case is carried in the following notes.

³² More generally, that is, with excess limitation but absent (3), the return after total tax in the two jurisdictions is, $r - \{\tau_1 r + [\tau^w (r - \tau_1 r + \tau^w_c r) - \tau^w_c r]\} = (1 - \tau^w)(1 - \tau_1 + \tau^w_c) r \dots$ (I)

³³ Relaxing assumption (3) with excess limitation gives the arbitrage condition $(1 - \tau^w)(1 - \tau_1 + \tau^w_c) r = (1 - \tau^w) r^w$ from (I) in note 32, supra, so that more generally under excess limitation, $r = r^w / (1 - \tau_1 + \tau^w_c) \dots$ (II)

$$r=(1-\tau^w)r^w/(1-\tau_I) \tag{6}$$

The social cost of inbound capital, r_s , for the small country is the amount per dollar of capital that residents remit to the rest of the world, $(1-\tau_I)r$. From (5), in the excess limitation case, this is,³⁴

$$r_s=(1-\tau_I)r=(1-\tau_I)r^w \tag{7}$$

or from (6), for excess credits, it is

$$r_s=(1-\tau_I)r=(1-\tau^w)r^w \tag{8}$$

Using (5), the private cost of inbound capital is,

$$r_p=(1-\tau)r=(1-\tau)r^w \tag{9}$$

with an excess limitation.³⁵ When there are excess credits, the private cost of capital is, using (6)

$$r_p=(1-\tau)r=(1-\tau)(1-\tau^w)r^w/(1-\tau_I) \tag{10}$$

The condition for undistorted local capital markets (efficiency in our sense) is that the private cost and the social cost of capital are the same, $r_s=r_p$. For an excess limitation, using (7) and (9), this equality provides,³⁶

$$(1-\tau_I)r^w=(1-\tau)r^w \text{ so that } \tau_I=\tau \tag{11}$$

When there are excess credits, using (8) and (10) shows that $r_s=r_p$ which implies that,

$$(1-\tau^w)r^w=(1-\tau)(1-\tau^w)r^w/(1-\tau_I) \text{ so that } \tau_I=\tau \tag{12}$$

Capital-market efficiency thus requires the taxation of the return on inbound portfolio debt at the same rate applicable to resident lenders in the domestic market.

With outbound portfolio debt from a small country, capital exports are not symmetric with inbound investment, because a capital exporter from a small country cannot gross up foreign taxes in the way that an exporter of capital from a large country to a small country can. The private return to the export of capital from the small country after tax in two jurisdictions is,

$$\begin{aligned} r_p &= r^w - \{ \tau^w r^w + [\tau(r^w - \tau^w r^w + \tau_c r^w) - \tau_c r^w] \} \\ &= (1-\tau)(1-\tau^w + \tau_c)r^w \\ &= (1-\tau)r \end{aligned} \tag{13}$$

by arbitrage with the local capital market, where τ^w_I is the tax rate that the rest of the world imposes on its capital imports, τ_c is the rate of foreign tax credits in the small

³⁴ More generally, the social cost of capital with an excess limitation is, from equation (II), $r_s=(1-\tau_I)r=(1-\tau_I)r^w/(1-\tau_I+\tau^w_c)\dots$ (III)

³⁵ More generally, for an excess limitation, the private cost of capital from (II) is, $r_p=(1-\tau)r=(1-\tau)r^w/(1-\tau_I+\tau^w_c)\dots$ (IV)

³⁶ Absent the simplifying assumption (3) with excess limitation $r_s=r_p$ implies, from (III) and (IV), $(1-\tau_I)r^w/(1-\tau_I+\tau^w_c)=(1-\tau)r^w/(1-\tau_I+\tau^w_c)$ or $\tau_I=\tau\dots$ (V)

exporting country, and the term in the square brackets reflects the operation of the small country's foreign tax credit system for the excess limitation case on the capital export side.³⁷

The social rate of return for capital exports is,

$$r_s = (1 - \tau^w) r^w \quad (14)$$

Equating (13) and (14) so that $r_s = r_p$ provides an undistorted capital market,

$$(1 - \tau^w) r^w = (1 - \tau)(1 - \tau^w + \tau_c) r^w \quad (15)$$

Solving (15) for $\tau_c = \tau^*_c$ yields the rate of foreign tax credit necessary for capital market efficiency,

$$\tau^*_c = \tau(1 - \tau^w) / (1 - \tau) \quad (16)$$

in the excess limitation case. Notice from equation (16) that,

$$\tau^*_c > \tau \quad \text{if} \quad \tau > \tau^w \quad (17)$$

For the excess credit situation, $\tau^w > \tau > 0$, in which case $\tau_c = \tau \neq \tau^*_c$, so our search for the non-distorting rate of foreign tax credit terminates.

Returning to the excess limit case, the tax revenue of the small country from taxation of the income from a dollar of outbound capital is given by the terms contained in the square brackets in equation (13). Using the "efficient" rate of foreign tax credit, τ^*_c , in those square brackets provides tax revenue per dollar of capital exports of

$$\begin{aligned} & [\tau(r^w - \tau^w r^w + \tau^*_c r^w) - \tau^*_c r^w] \\ &= [\tau(1 - \tau^w) + \tau^*_c(\tau - 1)] r^w \\ &= [\tau(1 - \tau^w) + \tau(1 - \tau^w)(\tau - 1) / (1 - \tau)] r^w \quad \text{from (16)} \\ &= 0 \quad (18) \end{aligned}$$

That is, the capital-market efficient rate of foreign tax credit on capital exporters is such as to offset the tax on foreign earnings that they would otherwise pay to their own government. The efficient (in our sense) net tax that resident capital exporters pay to the government of the small country is zero.

The formal derivation thus highlights the need for the mutual consistency between (or what we call the jointness of) the tax policies toward capital imports and exports. As far as we know, this paper is the only one in the literature to make this connection in a proper way. Jointness is met under our policy prescription through: (i) the arbitrage relations between the local after-tax interest rate; (ii) the after-tax interest rates faced by both capital importers and by capital exporters; and (iii) the social opportunity cost of capital. Our policy prescription makes them mutually consistent inasmuch as they result in a distortion-free local capital market. We abstract, however, from the problems of international tax rate inconsistency.

³⁷ See the earlier discussion of foreign tax credits, *supra*.

More particularly perhaps, we demonstrate the mutual consistency or jointness of the two tax policies by using arbitrage arguments when the proposed policy, $\tau_I = \tau$ and $\tau_c = \tau^*_c$, is in place. Under this policy, the local interest rate, r , is grossed up by $\tau_I = \tau$ plus the effects of foreign tax credits in the rest of the world. Capital importers and capital exporters arbitrage off their local after-tax interest rate, $(1-\tau)r = r_p$, which is their common private rate of interest and under the policy, $(1-\tau)r = (1-\tau_I)r = r_p$. However, the local rate of foreign tax credit $\tau_c = \tau^*_c$ is so chosen that, when taxed by their own government at the gross rate τ , capital exporters pay no net tax to it. They therefore receive a private rate of return, r_p , equal to what the world pays them, which is $(1-\tau^w_I)r^w = r_p$. This is the exporters' private rate of return, being the world interest rate less the tax that they pay to the foreign government. $(1-\tau^w_I)r^w$ is also what the small country as a whole receives for capital exports, so it is also the social return to capital exports, r_s , and $(1-\tau^w_I)r^w = r_s$. Exporters' arbitrage against the local market means, under our policy prescription, that $r_s = (1-\tau^w_I)r^w = (1-\tau)r$. But since $\tau_I = \tau$, we have $(1-\tau)r = (1-\tau_I)r = r_p$, which is the importers' private cost of capital under our policy prescription. Thus the policies of $\tau_I = \tau$ and $\tau_c = \tau^*_c$ imply $r_s = r_p$, and they are mutually consistent by arbitrage.

CONCLUSION

The paper has developed a regime for a small country for the taxation of income from portfolio debt in the presence of bi-directional capital flows. Our fundamental point, which has largely been neglected in the literature, is that tax policy for non-resident lenders into the small country and tax policy for resident lenders out of the country should be formulated together in order to ensure that policy in one area does not introduce distortions for the other. In other words, portfolio debt imports and exports should not have unrelated international tax regimes. Our reason for this position is that resident lenders and borrowers arbitrage off the same after-tax local interest rate, whether or not they transact with non-residents. The local capital market will be distortion free when this private price equals the social cost and return to international capital.

We have linked the tax regimes on the capital imports and exports of a small country and found the rates of tax on them that leave its capital market in an undistorted, static partial equilibrium. The general methodology involved the following four steps:

- Find the social rate of interest and return to capital imports and capital exports;
- Find the private rate of interest and return to capital imports and capital exports;
- Allow for the gross up into interest rates of local taxes on capital imports into the small country;
- Apply arbitrage conditions between lending and borrowing locally or abroad; and
- Equate the private and social costs of and returns to capital under this arbitrage and gross up.

In order to maintain equality of the social and private rates of return, we have argued that a small country should adopt an exclusively source-based regime in which: (i) capital imports are taxed at the same rate as the domestically-located capital of residents; and (ii) capital exports are exempted from taxation.

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Coming out of the Dark? The Uncertainties that Remain in Respect of Part IVA: How Does Recent Tax Office Guidance Help?

Nicole Wilson-Rogers*

Abstract

This article considers several issues that make the application of Part IVA uncertain and whether recent tax office guidance, in the form of PS LA 2005/24 and the Guide, provide any further clarity on these issues. It is suggested that PS LA 2005/24 and the Guide fail to provide further clarity and this is largely due to the fundamental problem that it is unclear what particular activities Part IVA seeks to target at a policy level. Consequently, Part IVA has been drafted in a manner that is amorphous and uncertain in order to combat these indeterminate activities.

INTRODUCTION

Despite the existence of a substantial body of Part IVA case law, it can still be an extremely difficult task for a practitioner to determine if Part IVA will apply to a transaction. Many commentators have remarked on the significant uncertainty surrounding the application of Part IVA,¹ rendering taxpayers partially blindfolded when entering the self-assessment battleground. In what appears to be an attempt to address some of these uncertainties, the Commissioner has released a guide for taxpayers outlining the “basic principles” as to how and when Part IVA will apply to an arrangement (“the Guide”). Accompanying the release of the Guide is the release of Practice Statement PS LA 2005/24,² which is designed to assist tax officers who are considering the potential application of Part IVA of the *Income Tax Assessment Act 1936 (Cth)* (“ITAA 1936”), or another General Anti Avoidance Rule (“GAAR”), such as Division 165 of *A New Tax System (Goods and Services Tax) Act 1999 (Cth)* and s 67 of the *Fringe Benefits Assessment Act 1986 (Cth)*.

* Nicole Wilson-Rogers is a PhD Candidate at the University of Western Australia.

¹ See, for example Justice Ronald Sackville, ‘Avoiding tax avoidance: The primacy of Part IVA’ (2004/2005) 39(6) *Taxation in Australia* 295. Sackville states at 295: “It is notoriously difficult to distinguish, as a matter of principle, between tax avoidance and legitimate tax minimisation.” See generally, N Orow, ‘Part IVA - Seriously Flawed in Principle’ (1998) 2(5) *Journal of Australian Taxation* 57;GT Pagone, ‘Anti-avoidance Provisions and Tax Reform.’ (2001) 30(2) *Australian Tax Review* 80.

² PS LA 2005/24 is entitled “Application of General Anti-Avoidance Rules” and it replaces PS LA 2000/10. Notably, however, by considering the operation of the other GAARs (Division 165 and s 67) PS LA 2005/24 breaks new ground. PS LA 2000/10 did not address the application of these other GAARs.

The focus of this article is not to give a comprehensive summary of the information covered by PS LA 2005/24 and the Guide regarding Part IVA. Rather, this article will identify and discuss several of the issues that make the application of Part IVA uncertain. It will consider whether PS LA 2005/24 and the Guide effectively assist practitioners to further clarify these issues in respect of Part IVA.

This article will focus on:

- the uncertainty that arises in attempting to identify the mischief that Part IVA seeks to target;
- several of the issues that arise when attempting to establish the preconditions in Part IVA: scheme, tax benefit and a dominant purpose to obtain a tax benefit;
- the uncertainty that surrounds establishing when the Commissioner will exercise his discretion to apply Part IVA;
- issues that arise in applying the compensating adjustment provisions;
- the relationship between Part IVA and other provisions in the ITAA 1936 and the *Income Tax Assessment Act 1997(Cth)* (“ITAA 1997”); and
- analysing an example in the Guide where the tax office have stated that they will not apply Part IVA.

It is suggested in this article that PS LA 2005/24 and the Guide fail to provide any further clarity on the application of Part IVA. It is asserted that this failure to provide certainty is largely due to the fundamental problem that it is unclear what particular activities Part IVA seeks to target at a policy level.³ Consequently, Part IVA has been drafted in a manner that is amorphous and uncertain in order to combat these indeterminate activities.

BACKGROUND TO PART IVA: DEFINING THE MISCHIEF PART IVA AIMS TO TARGET

The Explanatory Memorandum to Part IVA (“EM”) states that Part IVA is designed to target “tax avoidance activities” that are “blatant, artificial or contrived”.⁴

In this regard the question arises whether the EM is prescribing that Part IVA is designed to apply to activities that have two distinct characteristics. The first characteristic is that the activity constitutes tax avoidance. The second characteristic is that the tax avoidance activity is “blatant, artificial and contrived.”

From a literal reading of the words in the EM the next question one is invited to ask is: can there be different “degrees” of tax avoidance? Is the EM contemplating that some types of tax avoidance activities are “normal” and not intended to be caught by Part IVA? Likewise, is the EM contemplating that other types of tax avoidance are “blatant, artificial and contrived” and therefore, targeted by Part IVA? Based on the fact that the EM does not expand further on such a dichotomy, perhaps the preferable view is that Part IVA is designed to target all types of tax avoidance.

Tax avoidance occurs when a taxpayer, although complying with the black letter of the law, minimises their tax liability in a manner that is inconsistent with the intent of the legislation. Thus, tax avoidance is only possible when there is incongruence

³ See generally N Orow, *General Anti-Avoidance Rules - A Comparative International Analysis* (2000).

⁴ Explanatory Memorandum to Income Tax Laws Amendment Bill (No 2) 1981.

between the words of the tax act and the policy in which it has its basis. Parsons summarises it effectively, stating: “Tax avoidance is the greater, the more the law fails to express its policies”.⁵

By targeting tax avoidance, Part IVA and GAARs in general occupy a unique position by aiming to tax amounts that “would otherwise not be caught” by the operative provisions of the relevant taxing act.⁶ Furthermore, when a GAAR is enacted, the particular types of tax avoidance activities that they will target may be unknown. Cooper states that the enactment of a GAAR is, in this regard, a peculiar acknowledgment by parliament that they will penalise activities that cannot be foreseen and, therefore, specifically legislated against.⁷ When this fact alone is considered, it appears that PS LA 2005/24 and the Guide face an impossible task. How can these documents provide clarity or further significant guidance on what will be a tax avoidance activity when such an activity may not yet be in existence? It is true that some guidance can be provided in relation to whether existing activities constitute tax avoidance. Equally, however, it may be impossible to predict with certainty whether an innovative tax structuring product will or will not constitute tax avoidance and therefore, contravene the provisions of Part IVA.

“Warning Signs” that Part IVA may apply

PS LA 2005/24 and the Guide do, however, attempt to provide some “warning signs” that will indicate an arrangement may be tax driven and susceptible to the application of Part IVA.⁸ PS LA 2005/24 instructs that, if any of the following factors exist, a tax officer must consider the application of Part IVA to the arrangement. These factors include:

- The arrangement differs from the normal arrangements used to achieve the commercial objectives of the transaction;
- The arrangement is more complex than is necessary to achieve the relevant objective (family or commercial). There are, for example, steps in the arrangement

⁵ Parsons R W, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985),84, paragraph 16.55.

⁶ GT Pagone, ‘Part IVA the general anti avoidance provision in Australian taxation law.’ Dec (2003) 27 (3) *Melbourne University Law Review*, 770 states at page 771:

“General anti-avoidance provisions occupy a very special role in tax laws because their role is to underpin the effectiveness of the primary operative provisions when those primary provisions fail to achieve their purpose.”

⁷ G Cooper ‘International Experience with General Anti-Avoidance Rules’ 54 *SMU L. Rev.* 83 states at page 86:

“It is a strange admission by legislators to introduce a law which says, in effect: Parliament is enacting a rule to reverse something which it does not otherwise prohibit and cannot foresee, and so must either prevent by deterring *ex ante* or else cure by *ex post* reversal.”

⁸ PS LA 2005/24 states at paragraph 113:

“The presence of any of the following features whether alone or in combination in an arrangement means that Part IVA may apply to the arrangement. These features represent warning signs that the arrangement may be ‘tax driven’ and lead to a conclusion that the arrangement was entered into for the dominant purpose of enabling a taxpayer to obtain a tax benefit. The list of features is not meant to be exhaustive or exclusive and is provided only by way of guidance to officers who must consider and apply the provisions of Part IVA. The purpose in paragraph 177D(b) can only be objectively ascertained by reference to the eight factors. When any of the following features are present officers must consider the possible application of Part IVA in undertaking audits or issuing rulings to taxpayers.”

that serve no purpose other than to obtain a tax benefit, such as a company being interposed for no other purpose than to access a tax benefit;⁹

- The tax result is “at odds” with the overall commercial result of the transaction. A tax loss, for example, is claimed for a profitable commercial transaction;
- There is little or no risk in the transaction, in circumstances where significant risks would normally be expected;
- The terms of the arrangement are non-commercial; and/or
- There is a gap between the substance and the form of the arrangement.¹⁰

Many of these indicia actually do little to extend a practitioner’s understanding of what types of activities will constitute “tax avoidance” and, consequently, what Part IVA is aiming to target.

For example, a test relying on identifying when an arrangement differs from “normal arrangements” is problematic. The question that inevitably arises is: what is a “normal arrangement”? As Professor Parsons states: “In any case what is artificial at one time may become natural when it is generally practised.”¹¹ Does a test that focuses on normality mean that a taxpayer should not consider, for example, financial products with innovative tax structures because such structures are new and therefore, not normally used? Many practitioners may have thought that Phillips Trusts were “normal arrangements” as they were so widely utilised, but the tax office announced last year, that they considered that Part IVA may apply to some Phillips Arrangements.¹² Furthermore, the question arises: how does determining whether an activity is widely practised correspond with the legislative provisions of Part IVA that focus on whether an arrangement is entered into for the dominant purpose of obtaining a tax benefit?

Moreover, another of the warning signs identified by PS LA 2005/24 is that: “the arrangement is more complex than is necessary to achieve the relevant objective (family or commercial)”. Attempting to identify when an arrangement is more complex than is necessary to achieve a particular commercial objective is an inexact test. In Australia’s current business environment business people must consider an extremely complex web of tax and corporations laws. In such an environment, it is a difficult (if not impossible) task to draw a coherent line between what is “necessarily” and what is “unnecessarily” complex.

Unfortunately, neither the Guide, nor PS LA 2005/24, provides any further effective guidance on determining whether a particular activity will constitute tax avoidance. This is because, as discussed, attempting to define tax avoidance is a futile task. Part IVA (and GAARs in general) aim to tax activities, which cannot necessarily be foreseen at the time of enactment. In this sense, the activities that a GAAR targets are fundamentally uncertain. This may indicate that, ultimately, Part IVA (or any GAAR) is unworkable in the context of a self-assessment system which, to be effective, requires certainty in taxation laws. The self-assessment system of taxation places the

⁹ *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* 2001 ATC 4343.

¹⁰ Paragraph 113 of PS LA 2005/24.

¹¹ Parsons above n 5.

¹² See Draft Tax Ruling 2005/D5 Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements and the draft tax office booklet “Service Arrangements”.

onus on taxpayers to assess their own taxation liability and, consequently, the cornerstone of the self-assessment system is the ability of the taxpayer or their adviser to understand and apply the taxation laws. Indeed, this inability to define with precision the targets of Part IVA left the drafters of Part IVA in a difficult predicament: how can the provisions of Part IVA be expressed in a certain manner when the activities they target are uncertain? As Sir John Donaldson stated in *Merkur Island Corporation v Laughton*¹³:

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 that it can be so expressed?'

Arguably, the policy behind Part IVA to combat tax avoidance is far too broad to constitute a sensible policy basis from which the legislative drafters could work.

ISSUES ASSOCIATED WITH ESTABLISHING THE PRECONDITIONS OF PART IVA

The operation of Part IVA is two staged. The first stage is to establish the preconditions in Part IVA. That is, there must be a scheme,¹⁴ a tax benefit¹⁵ and the dominant purpose to obtain a tax benefit¹⁶. The existence of the preconditions are posited as objective facts and do not depend on an exercise of the Commissioner's discretion.¹⁷ The second stage is that the Commissioner must exercise his discretion to apply Part IVA.¹⁸

PS LA 2005/24 and the Guide examine the jurisprudence relating to the preconditions of Part IVA in detail. A complete summary of the information covered will not be repeated below. The purpose of the following sections is to consider the way that PS LA 2005/24 and the Guide deal with some of the more controversial issues that arise in respect of establishing each of the preconditions.

Notably, at the outset, it must be acknowledged that, although the application of Part IVA can be divided into these different elements, the sections must be construed as a whole. PS LA 2005/24 states that:

Focussing on the various elements of Part IVA should not obscure the way in which the Part as a whole is intended to operate. What constitutes a scheme is ultimately meaningful only in relation to the tax benefit that has been obtained since the tax benefit must be obtained in connection with the scheme. Likewise, the dominant purpose of a person in entering into or carrying out of the scheme, and the existence of the tax benefit, must both be considered against a comparison with an alternative.¹⁹

¹³ [1983] 2 A.C. 570, 595.

¹⁴ Scheme is defined in s 177A of the ITAA 1936. Notably, the scheme must have been entered into after 27 May 1981.

¹⁵ Tax benefit is defined in s 177C of the ITAA 1936.

¹⁶ The factors to be considered in ascertaining the dominant purpose are contained in s 177D of the ITAA 1936.

¹⁷ See *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 382.

¹⁸ Notably the exercise of the discretion must take place after the preconditions have been satisfied. PS LA 2005/24 states: "47. Before the Commissioner can exercise the discretion contained in s 177C(1) the requirements of Part IVA must be satisfied."

¹⁹ See paragraph 53 of PS LA 2005/24.

Precondition One: A Scheme

A “scheme” is defined very broadly in s 177A to include: “any agreement, arrangement, understanding, promise or undertaking.” It also includes agreements that are not enforceable, unilateral schemes and even inaction can constitute a scheme.²⁰

The High Court decision of *Commissioner of Taxation v Hart*²¹ has confirmed that the definition of a scheme in s 177A is extremely broad. Accordingly, in most cases it will rarely be a matter for dispute whether a scheme exists.

It is also accepted that the Commissioner is entitled to advance a narrow scheme within the wider scheme, provided that, when the alternate formulation is introduced, it does not cause “undue embarrassment or surprise to the other party to the dispute.”²² PS LA 2005/24 interprets this requirement very liberally to mean that a reformulation of the scheme will only be impermissible after the close of evidence if it effects the evidence that the other party, to the dispute, might have presented.²³ This is a very biased interpretation of when the Commissioner changing the formulation of the scheme will result in unfairness to the taxpayer to the dispute. It would appear reasonably arguable that a taxpayer could assert that the point at which the Commissioner should be precluded from changing the formulation of the scheme arises at an earlier time in the litigation process. The taxpayer could argue that they need sufficient time to digest and appreciate the differences in the formulation of the scheme and to consider the impact such a change has on their case and any new evidence they may wish to introduce. This may, however, prove to be a moot point, as it is likely the Commissioner will, in most cases, advance a wide and a narrow scheme at the beginning of the case. Therefore, the Commissioner will not need to change the formulation of the scheme during trial.

One of the issues arising from the judgement in *Hart*²⁴, however, is the importance that should be attributed to the scheme. More specifically, whether determining if there is a scheme is simply a matter of “procedural fairness” or whether it is fundamental to the operation of Part IVA. Two different views were taken by the High Court in *Hart*²⁵ on this issue.

Gleeson CJ and McHugh J expressed the view that identifying a scheme is central to the operation of Part IVA. They state: “The significance of the definition of the scheme extends beyond a question of procedural fairness to the taxpayer. It is central to the application of ss 177C, 177D and 177F.”²⁶

Gummow and Hayne JJ, on the other hand, saw the identification of a scheme as a matter of “procedural fairness” only.²⁷

The view of Gleeson CJ and McHugh J appears to be the preferable one. Indeed, the tax benefit must be obtained in connection with the “scheme” that has been

²⁰ See *Corporate Initiatives Pty Ltd v Commissioner of Taxation* 2005 ATC 4392.

²¹ (2004) 217 CLR 216.

²² *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 382.

²³ Paragraph 58 of PS LA 2005/24.

²⁴ (2004) 217 CLR 216.

²⁵ *Ibid.*

²⁶ *Ibid.*, 223.

²⁷ *Ibid.*, 237-241.

identified.²⁸ Furthermore, there is a clear relationship between the eight factors in s 177D and the scheme: for example, factor one focuses on the manner in which the “scheme” (as identified) was entered into or carried out. When the impact the formulation of the scheme has on the other preconditions is considered, it is difficult to understand how the formulation of the scheme could be seen as anything other than “central” to the operation of Part IVA.

The tax office, however, appears to support the view of Gummow and Hayne JJ. PS LA 2005/24 states that: “The need for the Commissioner to identify the scheme is simply an aspect of the requirement for a party to legal proceedings to particularise the case the other party or parties will have to meet.” PS LA 2005/24, however, does not offer any explanation as to why the tax office has not adopted the equally viable and arguably, preferable view of Gleeson CJ and McHugh J.²⁹

There are some further outstanding issues that remain relating to the formulation of the “scheme” identified by the literature, but not addressed by PS LA 2005/24 and the Guide. These issues include:

- Whether, after *Hart*³⁰, it is contemplated that there may still be cases where a set of circumstances only constitute “part” of a scheme (as contemplated in *Peabody*³¹), rather than a whole scheme.³²
- When a taxpayer will be engaging in several schemes (rather than one scheme) as part of an arrangement.³³

Precondition Two: Tax Benefit

Establishing that there has been a tax benefit can potentially present a substantial hurdle for the Commissioner. In fact, in some Part IVA cases, the taxpayer has been successful because the Commissioner has failed to establish a tax benefit.³⁴ There are four main types of tax benefits outlined in s 177C(1):

- an amount not included in assessable income;
- a deduction;
- a capital loss; and

²⁸ Gleeson CJ and McHugh J provide in *Hart* Ibid, 225: “in any case a wider or narrower approach may be taken to be the identification of the scheme but it cannot be an approach that divorces the scheme from the tax benefit.”

²⁹ See generally Chris Branson, ‘Hart’s Case What May Constitute A Scheme’ (2004/2005) 39(6) *Taxation in Australia* 315-319; G Cooper, ‘Part IVA Report Card’ (Paper presented at the Taxation Institute of Australia State Convention (Western Australian Division) National Convention, Perth, March 2005).

³⁰ (2004) 217 CLR 216.

³¹ *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359.

³² Cooper above n 29, 4. It appears from the judgement Gleeson CJ, McHugh and Callinan JJ’s judgements in *Hart* Ibid that whilst they did not specifically affirm *Peabody*, they all still contemplated a situation where a set of circumstances could constitute part of a scheme rather than a whole scheme. The opposite view was adopted by Gummow and Hayne JJ who firmly rejected an interpretation of *Peabody* which necessitated a scheme “standing on its own feet.” See generally D Carbone and J Tretola, ‘FCT v Hart: An analysis of the impact of the High Court decision on the application of Pt IVA’ (2005) 34(4) *Australian Tax Review* 196.

³³ Cooper above n 29, 4.

³⁴ See for example *FCT v Peabody* (1994) 181 CLR 359 and *Vincent v Federal Commissioner of Taxation* 2002 ATC 4742.

- a foreign tax credit.

There are two alternate tests to ascertain if the tax benefit has been obtained in connection with the scheme:

- the tax benefit **would not have been obtained** if the scheme had not been entered into or carried out; or
- the tax benefit **might reasonably be expected not to have been obtained** if the scheme had not been entered into or carried out (“reasonable expectation test”).

If it can be established that the tax benefit **would not** have been obtained if the scheme had not been entered into or carried out, there is no need to consider the reasonable expectation test. If this cannot be predicted with certainty, however, regard must be given to the reasonable expectation test.

The reasonable expectation test

A reasonable expectation involves more than a possibility, it embodies making a prediction as to what would have taken place if the scheme had not been entered into or carried out (“the counterfactual”).³⁵ Identifying the counterfactual is imperative not only with regard to establishing that there is a tax benefit but also because it forms the “backdrop” for determining the purpose of the taxpayer under s 177D.³⁶

Formulating the counterfactual

Identifying the counterfactual can be an extremely difficult task as it necessarily involves hypothetically recreating what would have happened. Where a clear arrangement existed before the scheme was entered into it may be easy to formulate the counterfactual.³⁷ However, substantial problems can arise in the formulation of the counterfactual when no prior transaction can be identified and therefore used to assist in predicting what might reasonably have happened.

Puckridge and Werbik provide:

The reasonable expectation test can be applied easily where there is strong evidence as to what the taxpayer would have done in the absence of the scheme. For example, where there is a clear antecedent arrangement or transaction which is being altered. In such cases it is reasonable to expect that in the absence of the scheme the antecedent arrangement or transaction would have continued. The results that would have been achieved under the antecedent arrangement or transaction would form the basis of the reasonable expectation.

However it may be difficult to apply where the evidence:

- is silent as to what the taxpayer might reasonably have done in the absence of the scheme;
- indicates the taxpayer would have done nothing in the absence of the scheme;

³⁵ See *FCT v Peabody* Ibid, 385.

³⁶ Paragraph 70 of PS LA 2005/24.

³⁷ Robert Puckridge and Andrew Werbick, *An Improved General Anti-Avoidance Rule* (2000) <http://www.ato.gov.au/printcontent.asp?doc=/content/Professionals/GAAR_talk_4.html>

- does not establish whether the taxpayer who received the monetary benefit in a particular income year would have obtained that benefit in the same income year;
- shows other schemes where available which would have given substantially the same taxation result.³⁸

General guidance for formulating the counterfactual

Despite these difficulties, PS LA 2005/24 and the Guide attempt to provide some general assistance in formulating the counterfactual that would need to be considered, including:

- The financial and other consequences of the scheme and whether the same outcomes (other than the tax advantage) could be achieved in a more straightforward, ordinary or convenient way;
- The commercial and social norms for the arrangement including standard industry behaviour or family obligations;
- The behaviour of the parties before or after the scheme compared with their behaviour during the scheme; and
- The actual cash flow of the scheme.

More than one counterfactual

An issue may arise where there is more than one potential counterfactual. PS LA 2005/24 gives some guidance on this matter by stating that the Commissioner may rely on more than one counterfactual in making a determination under Part IVA.³⁹ From a practitioner's point of view, therefore, it would appear to be prudent to consider all possible alternatives in formulating the counterfactual.

The counterfactual and discretion

The difficulties with identifying the counterfactual are intensified where discretionary powers are involved in the scheme. For example, in respect of a scheme where a discretionary trust is involved, it may be necessary to determine whether a particular beneficiary or the trustee would have received a distribution if the scheme had not been entered into or carried out. This will necessarily involve predicting how a trustee would exercise their discretion and could present great difficulties in predicting what might reasonably be expected to have happened.⁴⁰ In *Case VI60*⁴¹ the AAT provided in respect of Part IVA and trusts: "This provision does not in my opinion apply at all comfortably in a trust situation, especially where there are numerous beneficiaries who might take."⁴² Perhaps, considering the history of trust distributions to beneficiaries may be relevant. However, where there is no history of distributions or the trust is relatively new there may be no or limited distributions to refer to in attempting to

³⁸ Ibid.

³⁹ Paragraph 73 of PS LA 2005/24.

⁴⁰ Paragraph 77 of PS LA 2005/24 states:

"It may be difficult for a Tax officer to obtain evidence to support the counterfactual, i.e., the reconstructed version of events. In applying the reasonable expectation test in situations where there is a lack of information, reasonable inferences may be drawn, and reasonable assumptions may be made. For example, care needs to be taken in applying the reasonable expectation test to a scheme involving a trust. Officers may need to consider whether it was reasonable to expect that a particular beneficiary of a trust would, but for the scheme, have received a trust distribution."

⁴¹ 88 ATC 1058.

⁴² Ibid, 1070.

formulate the counterfactual. Furthermore, the question arises: what is the conceptual basis for using previous distributions to predict how future distributions would be made? One of the reasons the trustee is given a discretion is that it should be able to be exercised without the constraint of previous distributions. Thus, formulating a counterfactual on the basis that past distributions are predictive of future distributions appears to be formulating a counterfactual that is based on a fallacious assumption.

Whilst the tax office acknowledges these difficulties exist in respect of trusts, PS LA 2005/24 does not provide specific guidance to practitioners who are trying to formulate the counterfactual where a discretion exists.

The counterfactual that nothing would have been done

PS LA 2005/24 and the Guide acknowledge that, in some circumstances, it may be that nothing would have been done had the scheme not been carried out. The Guide states:

In some cases, it may be that nothing would have been done by the taxpayer if the scheme had not been carried out. This is particularly likely to be true if the scheme mainly results in a taxpayer artificially obtaining a tax deduction.

⁴³

Practitioners should also consider the scenario where the tax benefit is an amount not included in the assessable income of a taxpayer (s 177C(1)(a)) and the taxpayer argues that the counterfactual is that nothing would have been done. If such an argument could be sustained, the fact that nothing would have been done (for example, no scheme entered into and no assessable income derived) may work in favour of the taxpayer. Such an argument allows the taxpayer to assert that no assessable income would have been derived in any event and therefore, there is in fact **no** tax benefit.

The fact that this type of argument could work in a taxpayer's favour was obviously contemplated by parliament. In the Ralph Report⁴⁴ it was proposed that the reasonable expectation test be strengthened to address this kind of argument. The Ralph Report states at 6.4:

That operation of the existing reasonable hypothesis test (in s 177C) be improved by ensuring the counterfactual to a tax avoidance scheme reflects the commercial substance of the arrangement.

Currently, in order to demonstrate the existence of a tax avoidance scheme, the Commissioner of Taxation is required to construct a reasonable alternative transaction or counterfactual which does not give rise to the tax benefit. In some tax avoidance cases promoters of the scheme have argued that the reasonable alternative to the scheme may be that the taxpayer would not have done anything. The recommendation will confirm that this is not the case. For example, if the sale of property had an attached tax benefit, the alternative transaction would be constructed on the basis that the sale of property, without the tax benefit, would have taken place.

⁴³ PS LA 2005/24 also addresses this issue and states at Paragraph 75 that:

“If the scheme had no effect or outcome other than the obtaining of the relevant tax benefit(s), it will be reasonable to assume that nothing would have happened if the scheme had not been entered into or carried out.”

⁴⁴ Australian Government, 'Review of Business Taxation A Tax System Redesigned (Ralph Report)' (1999).

The “amount” of a tax benefit

A question also arises as to whether a tax benefit exists where an amount is not included in a taxpayer’s assessable income under one provision of the ITAA 1936 or ITAA 1997, however, it is included in the taxpayer’s assessable income by another provision. Woellner, Barkoczy, Murphy and Evans give the example of a scheme designed to transform a payment to an employee to an amount that is assessable as an eligible termination payment in order for the employee to obtain the special tax treatment accorded to such payments.⁴⁵ PS LA 2005/24 attempts to address this situation and states:

the fact that an amount was included in the assessable income of the taxpayer under the scheme by virtue of a different provision or circumstance does not affect the amount of a tax benefit, nor the provision by virtue of which it is to be included. Paragraph 177C(1)(a) focuses on what has been left out of assessable income by the scheme – not on what has been included.⁴⁶

Thus, the position adopted by the tax office on this issue is that the fact that an amount is included in the taxpayer’s assessable income by virtue of another provision does not affect its classification as a tax benefit. However, the tax office does recognise that this would become relevant in considering the dominant purpose of the taxpayer and the application of the compensating adjustment provisions in Part IVA.⁴⁷

Notably, this view of a tax benefit is controversial. Woellner, Barkoczy, Murphy and Evans state that a tax benefit does not arise where the amount is included in the taxpayer’s assessable income under another section. They state:

It is submitted that sec 177C(1)(a) does not apply to these characterisation schemes as they do not involve any overall reduction in a taxpayer’s assessable income. This argument is based on the proposition that the reference to “an amount not being included in assessable income” in sec. 177C(1)(a) is a reference to the global concept of assessable income (ie the total of all amounts included in the assessable income of the taxpayer). In other words, it does not matter how amounts enter assessable income provided there is no overall reduction in the total amount of assessable income.⁴⁸

The identification of the incorrect tax benefit

Furthermore, PS LA 2005/24 and the Guide do not address the situation where the Commissioner identifies the incorrect amount or type of tax benefit.⁴⁹ De Wijn and Alpins⁵⁰ argue that in some circumstances the fact that the wrong tax benefit is identified may affect the validity of a Part IVA determination as it will impact the validity of the exercise of the Commissioner’s discretion to apply Part IVA. They argue that where the quantum of the tax benefit has been *understated* this is likely to not effect the validity of a Commissioner’s discretion in relation to Part IVA.

⁴⁵ Woellner et al, *Australian taxation law 2006* (2006), 1511 Para 25-625.

⁴⁶ Paragraph 63 of PS LA 2005/24. See also the tax office’s similar view that is reflected in IT 2456: Income Tax Avoidance Schemes – Tax Benefit.

⁴⁷ IT 2456: Income Tax: Tax Avoidance Schemes – Tax Benefit.

⁴⁸ Woellner above n 45, 1511 Para 25-625.

⁴⁹ In relation to the incorrect identification of a tax benefit see generally J De Wijn and F J Alpins, ‘Part IVA: Twenty-two years on ... In a state of maturity? - Part II’ (2004) 38(7) *Taxation in Australia* 372.

⁵⁰ *Ibid.*

However, they provide that where the amount of the tax benefit is *overstated* this may effect the exercise of the Commissioner discretion. They give the example of the Commissioner making a determination to cancel a tax benefit of \$100,000 when the real amount of the tax benefit is \$100. They state that this may impact the conclusion reached under the dominant purpose test and therefore, the validity of the Commissioner's determination under s 177F. De Winj and Alpins provide that where the amount of the tax benefit is *overstated* whether this will affect the Commissioner's determination will depend on the difference in amount between the actual and the incorrectly identified tax benefit.⁵¹

De Winj and Alpins further state that where the qualitatively wrong tax benefit is identified by the Commissioner this will result in a miscarriage of the Commissioner's discretion:

in our view the Commissioner's discretion will automatically miscarry if it is exercised taking account of a qualitatively different tax benefit than the true tax benefit identified for the purpose of s 177C...s 177F(1) requires not only that there be a tax benefit within the terms of s 177C, but also that the Commissioner exercise his discretion by reference to that tax benefit as it is defined in a qualitative sense in paras (a) and (b) of s 177C(1). Accordingly, if the Commissioner exercises his discretion having regard to an incorrect tax benefit having a different nature or source, he will in our view have failed to address himself to the question s 177F(1) formulates.⁵²

Exceptions to Precondition Two – A Limited Choice Principle?

In considering whether there is a tax benefit, another important consideration for a practitioner is to determine whether the exception contained in s 177C(2) may apply.⁵³ Section 177C(2) provides that the term "tax benefit" should be read as not including a reference to tax benefits that are attributable to the making of:

- an agreement;
- a choice;
- a declaration;
- an election;
- a selection; or
- a notice or option (the above are together referred to as a "choice")

expressly provided by the ITAA 1936 or the ITAA 1997. This exclusion will not apply however, if the scheme was entered into or carried out (by any person) "for the purpose of creating any circumstance or state of affairs", which must exist to enable the choice to be made. An initial reading of the section suggests it may be a significant

⁵¹ Ibid. De Winj and Alpins Ibid, 374 state:

"Rather the issue will be whether taking into account the correct amount of the tax benefit would have materially affected the Commissioner's determination. This would raise issues such as the extent to which the quantum of the tax benefit has been overstated. The result of such analysis, depending on the facts of the case, may show that the Commissioner's discretion has miscarried."

⁵² Ibid.

⁵³ Other exceptions are contained in s 177C(2A) of the ITAA 1936 which deals with the non-inclusion of assessable income or the incurring of a capital loss where the tax benefit is attributable to making a CGT rollover election or agreement under Subdivision 170B and the scheme consisted solely of the making of the election.

exception for taxpayers. Hartigan J referred to the section in *Case W58*⁵⁴ as the “escape hatch to Pt IVA.”

There has, however, been little judicial consideration of this exception. In *Case W58*⁵⁵ the Tribunal held that the mere recognition of trusts by the ITAA 1936 did not mean that the use of a trust to divert income was a choice “expressly provided for” by the Act. The recent AAT decision in *Case 1/2006*⁵⁶ also considers s 177C(2) briefly. In *Case 1/2006* the taxpayers argued that the tax benefit they obtained (an uplift in the cost base of their shares) was attributable to an election made under Division 122-A of the ITAA 1997 and therefore, was not an exception to the definition of a tax benefit under section 177C(2). The AAT, however, rejected this argument stating that the tax benefit resulted from the steps or arrangements entered into after the election was made. Thus, the decision in *Case 1/2006* appeared to focus on the words “attributed to” and the AAT held that the tax benefit could not be attributed to the election. The AAT were interpreting the words “attributed to” as requiring (not surprisingly) a nexus between the election made and the tax benefit. The exact strength of the nexus necessary between the election and the tax benefit may however be a matter for some debate in the future.

Section 177C(2) was also considered by the AAT in *Ryan v Commissioner of Taxation*⁵⁷. In this case it was held that s 82AAA(2), 82AAC(1), (2) and (2A) relating to the deductibility of superannuation payments did not constitute a declaration, election, selection, notice or option.

Notably a “request” or “nomination” is not referred to in s 177C(2).⁵⁸ An example of a request can be found in s 80A of the ITAA 1936. Presumably, given it is not specifically referred to, a “request” could constitute a tax benefit. However, it is unlikely that Part IVA would ever be applied in such a situation. Where a request is granted by the Commissioner, even if this does constitute a tax benefit, this would probably be a circumstance where the Commissioner would not exercise his discretion to apply Part IVA, as considered below.

Purpose in s 177C(2)

Another issue is what type of “purpose” is being referred to in s 177C(2). Challoner and Richardson state that the purpose in s 177C(2) would be the subjective purpose of the party. This is because there is no legislative direction how to otherwise determine the purpose of a party. Challoner and Richardson state:

However, in contrast to the provisions of sec. 177D(b), there are no statutory directions as to what matters regard should be had in determining the purpose for which the scheme was entered into or carried out. It is thought, therefore that the “dominant purpose” in sec. 177C(2)(a)(ii) and (b)(ii) should be given the same meaning as in relation to sec. 26(a), i.e. that it is the subjective purpose of the person which must be determined. This may be contrasted with the objective conclusion which has to be reached in relation to sec. 177D...where it is suggested that regard should not be had to the

⁵⁴ 89 ATC 524, 536.

⁵⁵ Ibid.

⁵⁶ *Re Taxpayers and Federal Commissioner of Taxation* [2005] AATA 1251 (16 December 2005).

⁵⁷ 2004 ATC 2181.

⁵⁸ NE Challoner and RJ Richardson, *Tax Avoidance Implications of 1981 General Provisions (Part IVA)* (1981), 48.

taxpayer's own statements, because the conclusion which has to be reached is a conclusion having regard to certain specified matters that do not include any statements by the taxpayer.

As pointed out in *Pascoe v FCT* by Fullager J (1956) 11 ATD 108 at p 111, where a person's purpose has to be determined, the statements of that person in a sense provide the best evidence but, for obvious reasons, they must be tested more closely and received with the greatest caution. Nevertheless, in the absence of specific provisions as to the matters to which regard has to be had in determining the purpose for which a person enters into or carries out a scheme, it is thought that it is the subjective purpose of that person which has to be determined...⁵⁹

Arguably, where there is no statutory guidance to the contrary the subjective purpose of the taxpayer would be relevant under s 177C(2).

Unfortunately, however, PS LA 2005/24 only identifies and does not consider s 177C(2). Further guidance regarding the tax office view on this section would be very helpful as s 177C(2) could be a very important exception for practitioners to consider.

Precondition Three: Dominant Purpose Test – The Tunnel

The Guide and PS LA 2005/24 both provide that the pivotal element in determining if Part IVA will apply, is whether a reasonable person would conclude that a person who entered into or carried out the whole or part of the scheme did so for the dominant purpose of obtaining a tax benefit for the taxpayer. Notably, in ascertaining purpose, regard can be had to the taxpayer or a person who entered into or carried out the (or part of the) scheme. Regard can also be had to the objective purpose of an adviser and their purpose can be attributed to the taxpayer.⁶⁰

“Dominant” refers to the “ruling, prevailing or most influential purpose”.⁶¹ However, in reaching the conclusion as to purpose, regard must only be given to the eight factors listed in s 177D. In this sense, the legislation effectively constructs a “tunnel” of factors the Commissioner may consider in determining if the dominant purpose of the taxpayer in entering into the scheme **was** to obtain a tax benefit. Rather than act as an obstacle to the Commissioner applying Part IVA, the tunnel of factors constructed by s 177D, appears to facilitate a finding that the dominant purpose of the taxpayer **was** to obtain a tax benefit, by excluding factors that may support a taxpayer's argument that their dominant purpose was not to obtain a tax benefit. For example, in determining the taxpayer's dominant purpose factors such as the subjective purpose of the taxpayer entering into the transaction cannot be considered.⁶²

⁵⁹ Ibid, 45.

⁶⁰ PS LA 2005/24 provides at paragraph 86:

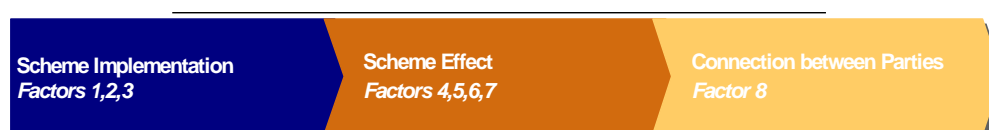
“It may be relevant in determining what objectively was the purpose of any person entering into or carrying out the scheme or any part of the scheme, to have regard to the purposes of the advisers or other agents of any of those persons. This of course, will be appropriate only where a person acts on professional advice and what was done on professional advice is relevant to considering the eight matters required to be considered in applying the purpose test in paragraph 177D(b).”

⁶¹ *Federal Commissioner of Taxation v Spotless Ltd* (1996) 186 CLR 404 and see paragraph 82 of PS LA 2005/24.

⁶² GT Pagone, ‘Part IVA the general anti avoidance provision in Australian taxation law.’ Dec (2003) 27 (3) *Melbourne University Law Review*, 770 states at page 771:

Both the Guide and PS LA 2005/24 divide the 8 factors into three overlapping groups. The first group of factors focuses on the scheme implementation and how the results of the scheme were obtained (manner, form and substance, and timing). The second group looks at the effects of the scheme (the tax results, financial changes and other consequences of the scheme.) The third group focuses on the nature of any connection between the parties and whether this illuminates what may have happened if there had been no connection between them. Notably, the conclusion reached under each of the eight factors will be closely linked to the counterfactual in establishing if there is a tax benefit. For example, under factor one, whether something is “artificial or contrived” may depend largely on comparing it to what is held to be the “normal” alternative way of conducting business.

FIGURE 1: PART IVA TUNNEL OF FACTORS TO CONSIDER FOR DOMINANT PURPOSE



Group One: Scheme Implementation

Factor 1 (manner of implementation), factor 2 (form and substance) and factor 3 (timing issues) are relevant under Group One. PS LA 2005/24 emphasises the importance of these first three factors as they involve an examination of the way in which the scheme achieves its effects. Indeed, this would appear to reflect an analysis of the case law on Part IVA which shows the conclusion reached in relation to the first three factors or the way in which the scheme is implemented appears to be decisive in relation to the overall conclusion reached as to the purpose of the taxpayer.⁶³ Hill J states that, in fact, it appears in *Hart*⁶⁴ it was the **manner** in which the scheme was carried out that led to a conclusion that the dominant purpose of the taxpayer was to obtain a tax benefit and consequently, that Part IVA applied. Hill J stated:

In my view *Hart* should be read as a case where the particular form of the finance agreement, the wealth optimizer aspects, required the conclusion adverse to the taxpayer to be reached. This is but another way of expressing the second part of the *Newton test*, namely the result to be reached if it is predicated that the taxpayer carried out the transaction “in that way” so as to avoid tax. It is not easy to read Part IVA this way. The question posed is: what conclusion would be reached as to the purpose of some person in entering into the scheme, not the alternative, namely the purpose in entering into the scheme in that way.⁶⁵

Factor 1: Manner of Implementation

In looking at factor one it is relevant to consider if the scheme was formed or implemented in a way that was: “contrived to obtain the tax benefit”. If steps are inserted into the transaction that would not be apparent in a comparable more

Part IVA seeks both to tax the amount that 'would otherwise' not be caught, and to do so upon the basis of a judgement made on a partial selection of the actual facts, rather than upon some precise and exacting application of the letter of the law to all of the facts as they are found.

⁶³ See generally *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216.

⁶⁴ *Ibid.*

⁶⁵ G Hill, ‘The incremental expansion of Part IVA’ (2005) 40(1) *Taxation in Australia* 23.

straightforward way of implementing the transaction this may point towards a purpose of obtaining a tax benefit.⁶⁶

Factor 2: Form and Substance

Factor two requires that the “substance of what is being done” be considered and compared to the form that the transaction takes. Where there is a discrepancy between the commercial or practical effect of the scheme and its legal form, this would point towards a conclusion that Part IVA would apply, particularly if the scheme could be achieved in a more straightforward or commercial manner. PS LA 2005/24 states that⁶⁷:

In practice these first two factors are likely to be related. For example, a divergence between form and substance could involve a roundabout way of implementing the scheme by steps that have no effect on the substance of what is achieved but lead directly to the obtaining of the tax benefit.

Factor 3: Timing Issues

The third factor considers the time the scheme was entered into and the period during which the scheme was carried out. A “flurry of activity” shortly before the end of the financial year may point towards a dominant purpose of obtaining a tax benefit, as may the fact that the timing of the scheme is not related to the commercial opportunity.⁶⁸ The fact that a scheme is carried out before the end of the year will not, however, necessarily point against a dominant purpose of obtaining a tax benefit. PS LA 2005/24 gives the example of a taxpayer who benefits before the end of the year by having their PAYG instalments varied.⁶⁹

Group 2: Scheme Effect

Under this group what should be considered are the tax results, financial changes and other important consequences of the scheme for the taxpayer and related parties. Factor four looks at the tax benefit and any other tax consequences resulting from the scheme, factor five, six and seven focus on the other effects of the scheme for the taxpayer and all other connected parties.

Factor four focuses on the tax benefit. It appears that there would never be a scheme (for which it had already been established that there was a tax benefit) where this factor would not point towards the dominant purpose of obtaining a tax benefit. In order to begin an inquiry as to purpose under the eight factors it must first be established that there is a tax benefit. The Guide states that: “the mere fact that a tax benefit exists does not mean Part IVA will apply.”⁷⁰ However, it does appear to indicate that factor four will always point towards the dominant purpose of obtaining a tax benefit and in this sense it will always contribute to an overall finding that the dominant purpose of the scheme was to obtain a tax benefit. This is because if a taxpayer obtained a tax benefit clearly the tax result of the scheme would be favourable to the taxpayer and thus, factor four would point towards a dominant purpose of obtaining a tax benefit.

⁶⁶ See *Federal Commissioner of Taxation v Consolidated Press Holdings* 2001 ATC 4343; *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216; *Sleight* 2004 ATC 4477.

⁶⁷ See Paragraph 96 of PS LA 2005/24.

⁶⁸ *Federal Commissioner of Taxation v Sleight* 2004 ATC 4477.

⁶⁹ See paragraph 101 of PS LA 2005/24.

⁷⁰ See page 2 of the Guide.

PS LA 2005/24 and the Guide suggest that the absence of a practical change in a taxpayer's overall financial, legal or economic position will "add weight" towards a conclusion being reached that the dominant purpose was to obtain a tax benefit. It is difficult to understand why PS LA 2005/24 suggests that this conclusion would be reached. Arguably, if the taxpayer entered into a scheme to obtain a tax benefit their overall financial position **would be** financially changed for the better (they would have to outlay less of their financial resources to pay tax). Furthermore, in cases where Part IVA applies to a scheme it is likely that the legal position of the taxpayer has indeed changed. For example in the mass-marketed scheme cases such as *Puzey*⁷¹, *Sleight*⁷² and *Calder*⁷³ it was held that the agreements were legally effective and the participants were carrying on a business. Thus, the legal rights of the taxpayers in these cases and most of the Part IVA cases to date had indeed changed.

PS LA 2005/24 further cautions that the change in a taxpayer's overall position must be considered along with the change of other connected parties positions:⁷⁴

the change in the position of the taxpayer may mean little if there is an inverse change in the position of another person as a result of the scheme, and that other person is an associate or alter ego of the taxpayer such as a spouse or a wholly-owned company. It may also be relevant to observe that an allowable deduction is, or is not, matched by a corresponding amount of assessable income among the other parties who are affected by the scheme. These factors will often require consideration in conjunction with the second factor.

This guidance is surprising. One of the fundamental tenets of income taxation law is that there is no "matching principle". That is, the fact that a deduction is allowable to one taxpayer does not mean that an amount must be assessable to another.⁷⁵ Yet, this factor is suggested by PS LA 2005/24 to point towards a finding that the taxpayer's dominant purpose was to obtain a tax benefit.⁷⁶

Group 3: The nature of the connection between the taxpayer and any other parties to the scheme

The third group consists of factor eight. Factor eight involves considering any connection between the parties to the scheme. Where a relationship exists between the parties to the scheme or/and they are not dealing at arms length this may indicate that the dominant purpose was to obtain a tax benefit. Whether the parties are at arms length will also be relevant to factors in the other two groups such as: the manner the scheme was entered into or carried out, form and substance of the scheme and the tax, financial and other consequences of the scheme. The fact that there is a relationship between the parties will not always work against a taxpayer. In fact, this could assist a taxpayer in some cases. PS LA 2005/24 states that:⁷⁷

Many dealings which would be decidedly odd between strangers may be entirely explicable between family members. For example, a businessman

⁷¹ 2003 ATC 4782.

⁷² 2004 ATC 4477.

⁷³ 2005 ATC 5050.

⁷⁴ See paragraph 106 of PS LA 2005/24.

⁷⁵ Parsons above n 5, Chapter 5 (paragraph 5.34).

⁷⁶ Paragraph 109 of PS LA 2005/24.

⁷⁷ See paragraph 111 of PS LA 2005/24.

who gives assets to strangers for less than they are worth may be subject to suspicion but a gift to his family could stand in a different light. Of course, it would be a different matter again if the family members do not benefit in substance from the arrangement.

Issues regarding the balancing act

Even with the additional guidance provided by PS LA 2005/24 and the Guide, it may still be extremely difficult for a practitioner to predict the conclusion that would be reached under the dominant purpose test. This is because, perhaps the most difficult element of forming a conclusion under s 177D is balancing or weighting the factors in order to form an overall conclusion as to what is the dominant purpose. For example, how does one determine whether Part IVA will apply when there appears to be an equal number of factors pointing towards and against a dominant purpose to obtain a tax benefit? Where a conclusion reached with respect to one of the factors is neutral does that support or detract from an overall finding that the dominant purpose is to obtain a tax benefit? ⁷⁸Accordingly, it can be difficult to predict what overall conclusion will be reached under the dominant purpose test.

There also appears to be significant analytical tension between the decision in *Cooke*⁷⁹ and those in cases such as, for example, *Calder*⁸⁰ and *Iddles*⁸¹. It seems in *Cooke*⁸² that one of the most decisive factors in saving the taxpayers from a finding that Part IVA applied was that they entered into the scheme to plan for their retirement. However, in *Calder*⁸³ and *Iddles*⁸⁴ a finding that the taxpayer's subjective purpose for entering into the scheme was to plan for their retirement was held not to be a matter that could be considered in s 177D. Despite *Cooke*⁸⁵ appearing to be an outlier decision, this highlights the fact that reasonable people can differ on the conclusion to be reached as to dominant purpose under Part IVA by placing greater weight on some factors than on others.

PS LA 2005/24 and the Guide provide scant guidance as to the weighting that should be given to each of the factors. PS LA 2005/24 stating that: "not all of the matters will be equally relevant in every case." The Guide states that one must: "consider and weigh them together in a practical and common sense way to get at the substance of what is really going on."⁸⁶ Unfortunately, such direction in practical terms provides little guidance for a practitioner.

When should the question as to purpose be tested?

The question of purpose is usually ascertained by examining the factors at the time the scheme is entered into, but according to the Full Federal Court in *Vincent*⁸⁷ purpose can also be "tested" while the scheme is being carried out.

The Full Federal Court in *Vincent*⁸⁸ state:

⁷⁸ Cooper above n 27.

⁷⁹ (2004) 55 ATR 183.

⁸⁰ 2005 ATC 5050.

⁸¹ 2005 ATC 2254.

⁸² (2004) 55 ATR 183.

⁸³ 2005 ATC 5050.

⁸⁴ 2005 ATC 2254.

⁸⁵ (2004) 55 ATR 183.

⁸⁶ See page 1 of the Guide.

⁸⁷ 2002 ATC 4742.

...the question of dominant purpose will usually be determined by reference to the time when the scheme is entered into. We accept that there can be cases where purpose is tested when the scheme is still being carried out. But in all cases the question of dominant purpose arises before there has been an assessment and by reference to a date no later than the expiration of the year of income in which the scheme is either entered into or being carried out.

PS LA 2005/24 gives no guidance on this issue but arguably it could be an important issue. For example if the scheme turns out to be profitable, will this (or should this) influence the conclusion reached under s 177D?

Procedural Issue – is the conclusion reached as to the dominant purpose of the taxpayer a conclusion of fact, a conclusion of law or a mixed conclusion of fact and law?

Recently commentators have suggested that an issue may arise as to whether the conclusion reached under s 177D is a conclusion of fact, a conclusion of law or a “conclusion reached by operation of a quasi-discretion”.⁸⁹ This is an issue on which clarification is needed, as what the conclusion under s 177D is classified as, is significant in determining the appeal rights of a taxpayer who is issued with a Part IVA determination.⁹⁰ Chang outlines the consequences as follows:

Clearly if the conclusion as to dominant purpose is something other than a question of law, the range of matters in which a taxpayer will be entitled to review of the conclusion beyond an initial proceeding under Part IVC TAA will be substantially reduced.⁹¹

The arguments as to whether a conclusion as to the application of Part IVA is a question of fact, law or a quasi-discretion will not be addressed in detail, however, a broad overview is provided below.

Conclusion of Fact

Chang suggests that some support for the proposition that the conclusion reached under s 177D is a conclusion of fact, appears in decisions such as the Full Federal Court decision in *Mochkin*⁹² and *Peabody*⁹³. In *Mochkin*⁹⁴ (with respect to one of the schemes identified in that case) the Full Federal Court considered whether the question of dominant purpose should be reconsidered and pointed to anterior errors in the Federal Courts reasoning in order to re-examine the issue.⁹⁵

Conclusion of a Quasi Discretion

Chang further suggests another alternative is that the conclusion may be a conclusion reached by operation of a “quasi discretion”. This is neither a conclusion of law or

⁸⁸ Ibid, 4760.

⁸⁹ See generally GT Pagone, ‘The Legal Nature of a Conclusion: Finding of fact vs Decision of law: some comments on *Mochkin*’ (2003) 37(9) *Taxation in Australia* 478; Jeffrey Chang, ‘Part IVA and the conclusion as to dominant purpose: preconditions for appeal and the impact of *Mochkin*’ (2004) 7(3) *Tax Specialist* 151; J H Momsen, ‘Part IVA - a matter for discretion’ (2004) 7(3) *Tax Specialist* 119.

⁹⁰ Chang Ibid; Momsen Ibid.

⁹¹ Chang above n 89, 154.

⁹² 2003 ATC 4272.

⁹³ (1994) 181 CLR 359

⁹⁴ 2003 ATC 4272.

⁹⁵ Chang above n 89, 154. Chang states:

“If the conclusion were the product of a quasi-discretion the preconditions for appeal would appear to be the same as if it were a finding of fact.”

fact. The consequences of being a conclusion of this type would mean that the appeal rights of a taxpayer (with regard to a Part IVA determination) would be limited.⁹⁶

Conclusion of law

Chang provides that cases such as *Eastern Nitrogen*⁹⁷ and *Hart*⁹⁸ would indicate that the conclusion reached under s 177D is a question of law, as the Court in these cases did not identify an “anterior error of principle” before re-examining the issue before it.⁹⁹

PS LA 2005/24 does not express any view on this issue. This could, however, prove to be an important issue for clarification in the future given its pervasive effect on appeal rights.

AN EXERCISE OF THE COMMISSIONER’S DISCRETION

What is equally (if not more) difficult than predicting the outcome of the dominant purpose test is determining when the Commissioner will exercise his discretion to apply Part IVA to an arrangement. Recent case law has significantly assisted practitioners in forming a view as to whether objectively the dominant purpose of a taxpayer would be to obtain a tax benefit. Cooper summarises this effectively when he states:

It is much less easy to understand why it [Part IVA] applies - or rather, why it is applied by the Commissioner – in some circumstances and not in others. Does (or should) Part IVA apply to an *Everett* – type assignment of a right to receive future income? Does (or should) it apply in the circumstances of *Galland* where the assignment of the right to income is made on 29 June but with effect for the whole of the year’s income, and the taxpayer is a potential beneficiary of the assignment? The Commissioner has indicated that he will not seek to apply Pt IVA to either of these transactions, but why not? Why he should *not* do so is less than obvious when it is recalled that neither in *Everett* nor *Galland* did the High Court consider s. 260. Or consider the interest offset accounts offered by various financial institutions. The Commissioner considers these not to be avoidance when they meet certain conditions and yet he has attacked split and linked loan arrangements and line of credit facilities which operate by generating deductions, rather than through income omission.¹⁰⁰

This statement is even more pertinent when examined in light of the example provided regarding husband and wife partnerships in the Guide, discussed below. Indeed, it does appear that the Commissioner accepts some forms of avoidance by not exercising his discretion to apply Part IVA in these scenarios.

However, neither the case law, nor the tax office guidance, has explored in depth the issue of when the Commissioner’s discretion to apply Part IVA will be exercised. This lack of guidance is very disappointing as when the Commissioner will exercise his discretion to apply Part IVA is one of the most important issues from a practitioner’s point of view. Even if the preconditions are satisfied, if the

⁹⁶ Ibid.

⁹⁷ 2001 ATC 4164.

⁹⁸ (2004) 217 CLR 216.

⁹⁹ Chang above n 89.

¹⁰⁰ Cooper above n 29.

Commissioner does not exercise his discretion to apply Part IVA, the taxpayer's arrangement will still be "safe". This is because, Part IVA is not a self-executing provision; it depends on the exercise of the Commissioner's discretion under s 177F. Once the Commissioner has determined to exercise his discretion to cancel a tax benefit the section enables him to: "take such action as he considers necessary to give effect to any such determination."

Does the word "may" in s 177F in Part IVA provide the Commissioner with a true discretion?

When analysing the Commissioner's discretion under s 177F, the first question is: does Part IVA provide the Commissioner with a true discretion?

One view is that Part IVA does not really provide the Commissioner with a discretion and the word "may" would be interpreted by the Courts to read, "must". The corollary of this view is that the Commissioner must apply Part IVA if the preconditions are satisfied.¹⁰¹ Support for this view can be found in the High Court decision in *Finance Facilities Pty Ltd v FCT*.¹⁰²

Finance Facilities involved the application of s 46(3) of the ITAA 1936. Section 46(3) sets out certain circumstances where the Commissioner "may allow" a shareholder a rebate for dividends. Subsection 46(3) states that the Commissioner "may allow" the shareholder a rebate in the following circumstances:

- (3) Subject to the succeeding provisions of this section, the Commissioner may allow a shareholder, being a company that is a private company in relation to the year of income and is a resident, a further rebate in its assessment of the amount obtained by applying the average rate of tax payable by the shareholder to one-half of the part of any private company dividends that is included in its taxable income if the Commissioner is satisfied that:
- (a) the shareholder has not paid, and will not pay, a dividend during the period commencing at the beginning of the year of income of the shareholder and ending at the expiration of ten months after that year of income to another private company;
 - (b) where the shareholder has paid, or may pay, a dividend during the period:
 - (i) commencing at the beginning of the year of income of the shareholders; and
 - (ii) ending at the expiration of ten months after that year of income, to a company, being a private company in relation to the year of income of the company in which the dividend was, or may be, paid, the company has not paid, and will not pay, dividend during the period -
 - (iii) commencing at the beginning of the year of income of the company in which the dividend has been, or may be, paid by the shareholder; and
 - (iv) ending at the expiration of ten months after that year of income, to another private company; or
 - (c) having regard to all the circumstances, it would be reasonable to allow the further rebate.

¹⁰¹ See generally M L Brabazon, 'Tax avoidance: the "new, improved" Part IVA' (1997) 1(1) *Tax Specialist* 28. Brabazon refers to the view that "may" means "must" in Part IVA and rejects it.

¹⁰² (1971) 127 CLR 106.

In interpreting this provision the High Court held that the Commissioner was required to allow a rebate, where the conditions were satisfied, despite the use of the words "may allow". Windeyer J stated:

The question, which comes back to the words "may allow", is not to be solved by concentrating on the word "may" apart from its context. Still less is the question answered by saying that "may" here means "shall". While Parliament uses the English language the word "may" in a statute means may. Used of a person having an official position, it is a word of permission, an authority to do something which otherwise he could not lawfully do. If the scope of the permission be not circumscribed by context or circumstances it enables the doing, or abstaining from doing, at discretion, of the thing so authorized... Here the scope of the permission or power given is circumscribed. Conditions precedent for its exercise are specified as alternatives. The question then is, must the permitted power be exercised if one of those conditions be fulfilled? ... This does not depend on the abstract meaning of the word "may" but of whether the particular context of words and circumstance make it not only an empowering word but indicate circumstances in which the power is to be exercised - so that in those events the "may" becomes a "must"... If the Commissioner, having considered the matter, is satisfied of facts out of which the power to allow a rebate arises, he cannot nevertheless refuse to allow it. That is obvious in the case of condition (c): and it seems to me to be so also in the case of the alternatives (a) and (b).

Section 46(3), is structurally different and has a different intended operation, from Part IVA. Unlike s 46(3), s 177F is separate from the sections in Part IVA that deal with the preconditions. Accordingly, s 177F does not have any conditions circumscribing its operation. In this respect, s 177F does appear to allow the Commissioner a choice between whether to disallow the whole or part of the tax benefit. Further, unlike s 46(3), s 177F does not provide that the Commissioner may exercise his discretion where the preconditions are satisfied.

Rather s 177F provides, once the preconditions have been established, **then** the Commissioner may exercise his discretion to cancel the whole or part of the tax benefit obtained from the scheme. Thus, although the preconditions in Part IVA must be satisfied in order to enliven s 177F, the preconditions do not circumscribe how the discretion should be exercised. In this respect, s 177F appears to give the Commissioner a real and virtually unfettered discretion to refuse to apply Part IVA.¹⁰³

Another point of differentiation is that s 46(3) is a provision designed to assist taxpayers, whereas s 177F is a very powerful provision that will assist the Commissioner. The consequences of Part IVA applying can have very serious implications for a taxpayer. It may be that Courts will be more likely to construe s 46(3) in a stricter manner because it assists a taxpayer. Even though recent decisions have indicated that courts will take more of a purposive approach to interpreting tax legislation, traditionally courts have interpreted tax legislation in a strict literal manner. This literal interpretation has its basis in the presumption that tax imposes a substantial obligation on taxpayers and an obligation should only be imposed on a taxpayer if the legislation that seeks to impose it is drafted in a clear and unambiguous

¹⁰³ A number of commentators also suggest that it is a real discretion. See generally Brabazon above n 101 and Terry Murphy, 'Part IVA: From Here To...' (2000) 3(3) *Journal of Australian Taxation* 198.

manner.¹⁰⁴ Thus, it may be that the Courts would still be more likely to interpret “may” as “must” where doing so would impose an obligation on the Commissioner to assist a taxpayer.

Challoner and Richardson¹⁰⁵ suggest a legislative indication that s 177F(1) bestows a discretionary power on the Commissioner is the clause at the end of the section “and, where the Commissioner makes such a determination, he shall take such action as he considers necessary to give effect to that determination”. Clearly, the words “**and where** the Commissioner makes such a determination” indicate that the Commissioner does indeed have a choice as to whether to apply Part IVA.

IT 2627 Income Tax: Application of Part IVA to dividend stripping arrangements indicates that the tax office also views s 177F as conferring a discretion on the Commissioner. IT 2627 states:

Subsection 177F(1) uses the word “may”. That gives the Commissioner a discretion whether or not to make a determination ...A determination will usually be made where the Commissioner believes the provisions of Part IVA are satisfied. However, the discretion will not be exercised if cases arise where the view is formed that there is no real avoidance of tax. This may be particularly relevant to the application of section 177E, where there need not be a tax benefit or a tax avoidance purpose before the section applies.¹⁰⁶

Again, this indicates that the Commissioner treats s 177F(1) as if it provides him with a true discretion.

Whilst not specifically discussing the discretion, PS LA 2005/24 appears to recognise that a discretion exists that can be exercised once the preconditions are satisfied. PS LA 2005/24 states:

Subsection 177F(1) gives the Commissioner a discretion to make a determination cancelling a tax benefit that has been obtained, or would but for section 177F be obtained, in connection with a scheme to which Part IVA applies. The discretion can only be exercised when a tax benefit has been obtained, or would but for the section be obtained, by a taxpayer in connection with a scheme to which Part IVA applies.

Another view is, that whilst s 177F does bestow upon the Commissioner a real discretion this discretion is limited to considering **the amount** of the tax benefit that should be cancelled. Batrouney states:

The Explanatory Memorandum which was circulated...seems to assume that the discretion in s 177F is confined to the amount of the tax benefit to be cancelled rather than the fact of cancellation.¹⁰⁷

Indeed, this view is reflected by the EM which states that:

Section 177F is the ‘reconstruction’ provision of Part IVA and will come into play once section 177D, together with section 177C (for the general run

¹⁰⁴ See for example *Duke of Westminster v IR Commrs* (1936) 19 T.C. 490.

¹⁰⁵ Challoner above n 58, 112.

¹⁰⁶ Paragraph 31 of IT 2627.

¹⁰⁷ Jennifer Batrouney SC, ‘Challenging the Commissioner's exercise of discretion’ (Paper presented at the Part IVA Masterclass, Crown Towers, Southbank, Melbourne, 19 July 2001).

of cases)...has done its work of both exposing for annihilation a sought-for 'non taxable' position and quantifying the amount of the 'tax benefit' that stands to be cancelled. The essential function of section 177F is to enable the Commissioner of Taxation, against the background of the other sections mentioned, to determine precisely what tax adjustments would be made in the assessments of the taxpayer concerned and of other taxpayers affected by the scheme.

Sub-section 1 effectively calls on the Commissioner to make a formal determination as to how much of the amount of the identified tax benefit is to be cancelled and directs him, where he has made such a determination, to take such assessing and other action as he considers necessary to give effect to it. There are two kinds of determination possible – under paragraph (a), that the whole or a part of any amount that is not otherwise included in assessable income be so included and, under paragraph (b), that the whole or a part of a deduction or of a part of a deduction that is otherwise allowable be not allowable.

The EM appears to contemplate that the Commissioner **may not** exercise his discretion to apply Part IVA, even when the preconditions are satisfied, by determining that no tax adjustment should be made. Specifically, the Commissioner could determine the amount of the adjustment made to the taxpayer's income is zero. In any case, as Batrouney suggests, even if the EM was intending that the discretion be limited to the amount of the tax benefit that should be cancelled for the reasons discussed above, the legislative provisions in Part IVA do not appear to reflect this limitation on the Commissioner's discretion.

When will the Commissioner refuse to exercise his discretion to apply Part IVA?

If it is accepted that s 177F supplies the Commissioner with a real discretion as to whether to apply Part IVA, the next questions that arise are:

- What factors will the Commissioner consider in determining whether to exercise his discretion to apply Part IVA?
- When will the Commissioner exercise his discretion **not** to apply Part IVA?

These two questions are linked. It is important to determine what are relevant and irrelevant considerations to the exercise of the Commissioner's discretion, as these will help predict when the Commissioner will exercise his discretion not to apply Part IVA. For the discretion to have any purpose (and for the structure of Part IVA to make sense) the factors the Commissioner will consider under s 177F must differ from those that will be considered in establishing the preconditions. For example, it is unlikely that factors such as the deductibility of the expenses under other provisions of the ITAA 1997 or ITAA 1936 would be relevant, as this has already been considered in determining if there is a tax benefit.

Commentators have suggested the Commissioner may not exercise his discretion to apply Part IVA in some of the following circumstances:

- The tax benefit resulted from an ordinary family or business transaction.¹⁰⁸ The difficulties with relying on a test of "normality" were discussed above. Such a criteria is highly problematic because what is "normal and ordinary" could mean

¹⁰⁸ Brabazon above n 89, 34.

different things to different people depending on their knowledge of the particular area concerned. The test of normality also appears to have no relationship with the legislative set up of Part IVA.

- The conduct was something, which as a matter of policy should be allowed. Such conduct may not fall within s 177C(2) but it would still be (as a matter of policy) desirable that it be allowable (for example something that the taxpayer was intended to have as a deduction under the ITAA 1936 such as deductions for film expenditure or superannuation or the concessions from the consolidation regime).¹⁰⁹ Certainly this appears to be a most compelling reason for not exercising the discretion, because the taxpayer is obtaining a deduction that was intended by the Act. But this is not a choice under the Act (so that the exception in s 177C(2) would not apply).
- Where the taxpayer has acted in accordance with tax office advice or the agreement of the Commissioner. This factor appears to suggest that the Commissioner may not exercise his discretion to apply Part IVA in order to maintain horizontal equity between taxpayers. For example, consider the scenario where a taxpayer had received a favourable private ruling on a particular scheme. Another taxpayer then entered into this scheme but did not obtain a private ruling. The Commissioner subsequently determines Part IVA could apply to the scheme. The Commissioner may decide that he would not exercise his discretion to apply Part IVA to the other taxpayer (despite technically being able to) in order to maintain horizontal equity between the taxpayers.
- Where no fiscal loss occurs to the tax office. Murphy provides in this regard:

where there is no loss to the revenue. In the context of income tax this could arise for a number of reasons such as, in the case of an assignment of income, the assignee being liable to pay the same amount of tax as the assignor would otherwise have been liable to pay. Another circumstance is where a taxpayer structures an arrangement to make it tax neutral by ensuring that it does not itself give rise to assessable income which would not have otherwise arisen. It may also arise in the context of other taxes such as fringe benefits tax, if, for example, the Commissioner were to disallow a deduction in circumstances where the transaction gave rise to a liability to fringe benefits tax (which, not being income or a deduction, cannot be mitigated under the compensating adjustment provisions of s 177F(3)).¹¹⁰

It is unlikely that this would be a reason why the Commissioner would not exercise his discretion as arguably, the Commissioner would want the correct taxpayer to be assessed, so the fact that another taxpayer was assessed for that and the scheme presented no “fiscal risk” would appear not to be a relevant consideration.

- Where the Part IVA determination would not increase the tax actually payable.¹¹¹ On this issue Murphy states:

where the making of the determination (and any consequential assessment) would not give rise to an increase in the tax actually payable. This may be because the taxpayer is a bankrupt. It is also possible to envisage some

¹⁰⁹ Brabazon above n 89, 34. Also see Murphy above n 103, 204.

¹¹⁰ Murphy above n 103, 205.

¹¹¹ Murphy above n 103, 205.

circumstances in which the revenue might suggest because of the requirement in s 177F(3) that the Commissioner make compensating adjustment. This would be the case if the taxpayer was bankrupt and the person in respect of whom the compensating adjustment was to be made would, as a consequence of the scheme, derive assessable income or not be entitled to a deduction.

Arguably, however, where the taxpayer was bankrupt the Commissioner would still make a Part IVA determination to ensure in the event (albeit unlikely) that any funds were available for distribution, the tax office would obtain its rightful share.

Another interesting factor the Commissioner may consider in choosing not to exercise his discretion to apply Part IVA is public policy reasons. For example, consider the scenario where a corporate taxpayer makes a donation to a registered charity on 29 June 2005. The taxpayer has no knowledge of the charity or what the proceeds of its donations will go towards. The donation is made following advice by its accountant that the taxpayer will have a substantial profit this year. The accountant advised that a way in which the company could reduce its assessable income is to make a donation to a particular charity. Despite it being highly arguable that objectively the dominant purpose of the transaction is to obtain a tax benefit it is unlikely for public policy reasons the Commissioner would ever apply Part IVA to a transaction involving a charity. This is because encouraging taxpayers to make donations to charities is desirable from a public policy point of view.

Another factor the Commissioner may take into account when deciding whether to exercise his discretion under s 177F is the maintenance of “economic parity” between transactions. For example, in the recent case of *Cumins v Commissioner of Taxation*¹¹² Mr Cumins claimed a capital loss under Part 3-1 of the ITAA 1997 for a transaction that resembled an ordinary, widely accepted, profit washing transaction. Mr Cumins owned shares which were mortgaged to the bank. Under the terms of the agreement with the Bank he was unable to assign or transfer his rights in the shares without its consent. Mr Cumins had significant unrealised losses on the shares and attempted to sell them to another wholly owned trust in order to realise the loss to offset against a gain he had on another parcel of shares. This transaction was similar to a “wash sale”, in most respects, as Mr Cumins was seeking to lock in a temporary capital loss. However, because Mr Cumins’ shares were mortgaged he had to attempt to create artificially circumstances in which he could realise the loss. This case is on appeal from the Full Federal Court and it is interesting to consider whether it is held that one of the factors the Commissioner may be able to take into account in determining whether or not to exercise his discretion is that the economic result of Mr Cumins’ transaction would not be any different to that achieved by wash sales which are sanctioned by the tax office.

Unfortunately, it is very difficult to determine (with any certainty) what factors the Commissioner would take into account, as there is no statutory or administrative guidance on this issue. Galligan states:

¹¹² [2006] FCA 43 (6 February 2006).

Just what factors must be taken into account where there is no express requirement, and what exactly taking into account means, is one of the recurring problems in the legal regulation of discretion.¹¹³

Thus, it can be seen that many of the issues involving the Commissioner's discretion under s 177F remain virtually unexplored. Like the purpose test, the exercise of the Commissioner's discretion is also pivotal to the application of Part IVA. Some further guidance from the tax office in respect of this discretion would be highly desirable.

THE COMPENSATING ADJUSTMENT PROVISIONS

Sections 177F(3) – 177F(7) of the ITAA 1936 contain the compensating adjustment provisions. Section 177F(3) allows the Commissioner to determine that an amount should not be included in a taxpayer's income where:

- An amount has been included, or would (if s 177F(3) did not apply), be included by virtue of the operation of Part IVA in the taxpayer's income; and
- In the Commissioner's opinion it is "fair and reasonable" that the amount should not be included in the taxpayer's income in that year.

Thus, the provisions effectively allow the Commissioner to reconstruct the position of the taxpayer. The Commissioner is able to take such action as is necessary to give effect to a reconstruction. These actions may include:

- excising an amount from a taxpayer's assessable income;¹¹⁴
- allowing a deduction to a taxpayer;¹¹⁵ or
- allowing a capital loss or foreign tax credit to a taxpayer.¹¹⁶

The taxpayer has the right to request that a compensating adjustment be made. However, the Commissioner may also make a compensating adjustment of his own volition.¹¹⁷

The compensating adjustment provisions should not be overlooked by practitioners as they could provide a useful mitigation tool for taxpayers. However, there has been little judicial consideration of when it will be "fair and reasonable" to make a compensating adjustment.

A real discretion?

A preliminary issue that again arises under s 177F(3) is whether the Commissioner has a real discretion to determine whether it is "fair and reasonable" to make a compensating adjustment. The alternative being (as discussed in respect of s 177F(1)) that "may" in this context ought to be interpreted to mean must, as it did in *Finance Facilities*.¹¹⁸

¹¹³ D Galligan, *Discretionary powers: a legal study of official discretion* (1986), 31.

¹¹⁴ Section 177F(3)(a) of ITAA 1936.

¹¹⁵ Section 177F(3)(b) of ITAA 1936.

¹¹⁶ Section 177F(3)(c) and (d) of ITAA 1936.

¹¹⁷ Section 177F(5). Wilson-Rogers, 'Compensating adjustments: The limits on the Commissioner's discretion' (2004) 7(5) *The Tax Specialist* 273-282.

¹¹⁸ (1971) 127 CLR 106.

The arguments for stating that the Commissioner *must* make a compensating adjustment where it is “fair and reasonable” to do so are far more compelling for s 177F(3) than they are under s 177F(1).

There are more similarities between s 177F(3) and s 46(3) in *Finance Facilities*¹¹⁹ than there are between s 177F(1) and s 46(3). The similarities between s 177F(3) and s 46(3) include:

- Both provisions are designed to assist a taxpayer and therefore, may be more likely to be strictly construed against the Commissioner;
- Both sections circumscribe the exercise of discretion with certain conditions.

Thus, it could be said that where it was found that it was “fair and reasonable” to do so the Commissioner would be compelled to make a compensating adjustment. If this is the case, it highlights the difficulties in applying Part IVA, that in one section of Part IVA (s 177F(1)) “may” is interpreted to grant a discretion, and in another section (s 177F(3)) “may” is held to mean “must”.

In any event, even if “may” is interpreted to mean “must” in the context of s 177F(3) the Commissioner may still retain some discretion in that he determines what is “fair and reasonable”. However, once he determines it is “fair and reasonable” he cannot then, nevertheless, determine not to exercise his discretion to grant a compensating adjustment. Galligan defines discretion very broadly to include: “the scope for personal assessments in the course of a decision”¹²⁰ If this definition of a discretion is accepted, then arguably, given the vague and undefined nature of the phrase “fair and reasonable” the Commissioner does have a discretion. This is especially so because the exact meaning of “fair and reasonable” has been largely unexplored by case law and consequently, is largely undefined.

PS LA 2005/24 does, however, provide some guidance on when the Commissioner will consider it to be “fair and reasonable” to make a compensating adjustment. PS LA 2005/24 states that: “A compensating adjustment must generally be made where the application of Part IVA causes double taxation of the same income.”¹²¹

The example provided in PS LA 2005/24 is where the scheme involves the diversion of personal services income to a family trust. The income has been distributed to beneficiaries and the income was taxed in the hands of the beneficiaries. The Commissioner then makes a determination with respect to the scheme including the income in the assessable income of the taxpayer. In this situation the Commissioner makes compensating adjustments in favour of the taxpayer’s family members so that the income of the beneficiaries from the trust is determined not to have been included in the beneficiaries assessable income.

However, there are obviously many other circumstances in which compensating adjustments may need to be made. For example, in personal services income splitting cases a compensating adjustment may need to be made. Where income paid to a company, for example, is held to be the taxpayer’s personal services income some deductions may still be allowable for the taxpayer against that income. The basis upon

¹¹⁹ Ibid.

¹²⁰ Galligan above n 113.

¹²¹ See paragraph 137 of PS LA 2005/24.

which it is “fair and reasonable” to allow those deductions under the compensating adjustment provisions can be an area of difficulty.

“Fair and reasonable”

In *Re Egan and Federal Commissioner of Taxation*¹²² consulting income earned by a company (wholly owned by a husband and wife) was held to be the husband’s personal services income by virtue of the provisions of Part IVA. The Commissioner did, however, allow some items of expenditure as deductions to the taxpayer under the compensating adjustment provisions. The Commissioner did not allow the taxpayer some additional expenditure items as deductions. The taxpayer objected to the additional items of expenditure that were not allowed (by virtue of the compensating adjustment provisions) as deductions. In that case, the AAT set some limits on what a decision-maker must take into account in determining what will be “fair and reasonable”:

While s 177F(3)(a) and (b) uses the words “fair and reasonable”, the acceptance of Mr James’s submission would require the respondent and the Tribunal to act in the capacity of an advisor to Mr Egan, AOS and TM and make assumptions of an arrangement between the three which might have happened if the advice was properly given, accepted by the parties and acted upon. It requires an assumption that the parties would or may have entered into transactions differently to those which actually happened. While Mr Egan was a director and, therefore, in relation to some provisions of the Act, an employer of AOS, this does not mean that AOS would have paid a particular level of salary, contributed the same amount to superannuation, provided a motor vehicle and provided rented premises closer to its office than was the residence of Mr Egan. It may well have done but it is difficult to accept that s177F(3) allows pure conjecture to be “fair and reasonable” .

It is not really clear what limits this sets on the meaning of “fair and reasonable” in practical terms. Despite the fact that the AAT have indicated it will not engage in “pure conjecture” as to what arrangements a taxpayer may have entered into and therefore, what deductions a taxpayer may be entitled to, what is “fair and reasonable” still remains an open question. Guidance on other types of examples (such as that in *Re Egan*) to what is “fair and reasonable” are not discussed in PS LA 2005/24.

Timing of a compensating adjustment

There are also some issues regarding the time when a compensating adjustment should be made, particularly where an objection is lodged against the Part IVA determination. For example, if the Commissioner makes a Part IVA determination and it is clear he will have to make a compensating adjustment (and he has this knowledge at the time of making the Part IVA determination) is he obliged to do so at that time or can he wait until the issues regarding the objection have been resolved? If he does not make a compensating adjustment at the time of making the Part IVA determination, where such knowledge is present, will the determination and the subsequent assessment be tentative or provisional, because the Commissioner knew it would have to be adjusted at some point in the future?

¹²² AAT Case [2002] AATA 563, *Re Egan and Federal Commissioner of Taxation* 50 ATR 1064.

Some of these issues were considered in *ANZ v Commissioner of Taxation*¹²³. Justice Stone held in this case that generally the Commissioner will not be obliged to make a compensating adjustment at the same time as making a Part IVA determination. This is particularly so where the application of Part IVA is being objected to or reviewed. This is because where an assessment is being objected to if a compensating adjustment was made at that point, such an adjustment would be provisional and may need to be adjusted depending on the outcome of the objection, the Commissioner will only be in a position to determine what is “fair and reasonable” when the application of Part IVA is established. PS LA 2005/24 reiterates this principle and states that in such a situation where it is clear that a compensating adjustment is expected to be made (at some point in the future) when the application of Part IVA is established, the taxpayer should be informed of the expected compensating adjustment.¹²⁴

Given that there is no time limit within which the Commissioner must make a compensating adjustment (or within which the taxpayer must request a compensating adjustment be made) it is unlikely that any timing obligations will be placed on the Commissioner with regard to making a compensating adjustment.

THE RELATIONSHIP BETWEEN PART IVA AND THE OTHER PROVISIONS OF THE ACT

The relationship Part IVA has with other provisions of the Act is peculiar. Only an “allowable” deduction will be capable of being susceptible to the operation of Part IVA. As Verick states: “If a tax avoidance arrangement is not a sham, runs the gauntlet of all the other provisions and manages to survive, it then comes up against Part IVA”.¹²⁵ Likewise, Raphael, further, states: “In a nutshell it is submitted that the operation of Part IVA and the balance of the Act are mutually exclusive...”¹²⁶ For example, where a deduction is not allowed under s 8-1 of the ITAA 1997 the deduction will never be challenged under Part IVA.¹²⁷ Thus, the more purposively s 8-1 of the ITAA 1997 and s 51(1) of the ITAA 1936 are interpreted the smaller the scope for the operation of Part IVA will be. In this respect Part IVA is a “provision of last resort”. Section 177B(3) and (4) reflect this.

Section 177B(3) states:

Where a provision of this Act other than this Part is expressed to have effect where a deduction would be allowable to a taxpayer but for or apart from a provision or provisions of this Act, the reference to that provision or to those

¹²³ [2003] FCA 1410.

¹²⁴ Paragraph 138 of PS LA 2005/24 states:

“Any action to make or give effect to compensating adjustments (for example amendment of assessments) should not as a general rule be undertaken while the application of Part IVA is subject to objection or review. Such an approach does not make the assessment giving effect to the relevant Part IVA determination(s) tentative or other than bona fide. The Commissioner will be in a position to determine whether it is ‘fair and reasonable’ that a compensating adjustment be made when the application of Part IVA is finally established...Where it is clear that a particular compensating adjustment is expected to be made when the application of Part IVA is established, the taxpayer should be informed of the expected compensating adjustment.”

¹²⁵ A Verick, ‘The Progression of Anti-Avoidance Legislation, Cases & Rulings’ (Paper presented at the Taxation Institute of Australia (Queensland Division) State Convention Papers, 20-22 April 1990).

¹²⁶ D Raphael, ‘The Progression of Anti-Avoidance Legislation, Cases & Rulings’ (Paper presented at the Taxation Institute of Australia (Queensland Division) State Convention Papers, Queensland, 20-22 April 1990).

¹²⁷ See for example *Vincent v Federal Commissioner of Taxation* 2002 ATC 4742.

provisions, as the case may be, shall be read as including a reference to subsection 177F(1).

Similarly, Section 177B(4) states:

Where a provision of this Act other than this Part is expressed to have effect where a deduction would otherwise be allowable to a taxpayer, that provision shall be deemed to be expressed to have effect where a deduction would, but for subsection 177F(1), be otherwise allowable to the taxpayer.

PS LA 2005/24 confirms that Part IVA is a provision of last resort and states:¹²⁸

Officers should be aware that Part IVA is a general anti-avoidance provision and that there are specific provisions which may or may not apply in a particular case. Officers should be aware of subsections 177B(3) and (4) which reflect the last resort character of Part IVA.

However, cases on Part IVA may reflect a different approach of the tax office, which seek to apply Part IVA despite the existence of a specific anti avoidance provision also designed to counter that type of tax avoidance. In this context, Hill J states that the relationship between specific anti-avoidance rules and Part IVA may become a litigated issue in the future. He remarks specifically on the relationship between the personal services income rules in Part 2-42 of the ITAA 1997 and Part IVA:

One might have thought that it would have been Parliament's intention that Part 2-42 would cover the field so that if it did not apply to tax the worker on the income then the worker was immune from further attack. The argument would be that where there is a general anti-avoidance provision (Part IVA) and a specific avoidance provision (2-42), the specific provision should prevail. It is certainly not clearly untenable. That is not the view of the Commissioner who takes the position that Part IVA may nevertheless apply to a case where an individual has incorporated and notwithstanding that, Part 2-42 of the 1997 Act has not operated to treat the income derived as personal income. The question of the interrelationship between Part IVA and Part 2-42 is one that is likely to be litigated soon.

Indeed, it does seem a peculiar result that where parliament has turned its mind to a particular activity and specific anti avoidance provisions are enacted to combat it, and a transaction of that type satisfies those provisions, Part IVA may apply in any event. It further indicates that Part IVA, although it is a provision of "last resort", will always be used as a backstop to the specific anti-avoidance provisions in the ITAA 1936 and ITAA 1997.

AN EXAMPLE IN THE GUIDE OF WHERE PART IVA WILL NOT APPLY: HUSBAND AND WIFE PARTNERSHIPS

The Guide provides an example of where the tax office considers Part IVA would not apply.¹²⁹ The example presented is a husband and wife partnership where only one party performs the bulk of the work and is the main generator of the income for the partnership. The arrangement, however, has the effect of dividing the income of the partnership equally between the parties. The Guide states that: "Part IVA would not

¹²⁸ Paragraph 50 of PS LA 2005/24.

¹²⁹ Page four of the Guide.

apply to a typical husband and wife partnership arrangement where there are no unusual features.”

Interestingly, the Guide states that when regard is had to the “tunnel” of factors in s 177D, it would not be objectively concluded that the dominant purpose of the partnership arrangement was to obtain a tax benefit, through the division of profits and losses.

Entering into a partnership is an ordinary means for a husband and wife to conduct a business together. There is nothing contrived about the manner of sharing profits and losses because that is what the Partnership Act prescribes as the normal consequence of forming a partnership.¹³⁰

The Guide emphasises that the arrangement has real financial consequences for the parties leaving both the husband and wife fully exposed to the debts of the partnership.

The Guide further provides that in such a scenario there is no divergence between the substance and form of the scheme and it is a way of the husband and wife conducting business in the long term. The Guide indicates, however, that there may be some modifications of this scenario where Part IVA will apply. It states:

In the absence of unusual features, therefore, Part IVA would not apply to such husband and wife partnerships. The sort of unusual features that could see Part IVA apply include where the:

- income generating activity was in reality a disguised employment arrangement; or
- use of the partnership is prohibited by regulatory or other laws.

In employee-like arrangements, provisions in the income tax law which specifically deal with the alienation of personal services income may apply in any event. This would mean that the partner performing the main bulk of the work is taxed on all of the partnership income. In such cases, Part IVA would have no application.

In many respects, this example is surprising, as arguably, several of the factors in such an arrangement **would** appear to point towards a dominant purpose of obtaining a tax benefit. Certainly in similar cases before the AAT such as *Case W58*¹³¹ and *Case X90*¹³² it was found that Part IVA would apply to an arrangement. However, the tax office has indicated that it no longer agrees that Part IVA should apply to these arrangements. The tax office states:

For example, the Administrative Appeals Tribunal (AAT) has in the past intimated that Part IVA operates to give effect to a ‘general rule that income from personal exertions is assessable in the hands of the person who earned it by those personal exertions’ (*Case X90 90 ATC 648 at 654*). This emphasis on the nature of the income has arguably been at the expense of an appropriate focus on the artificiality of the underlying arrangement.¹³³

¹³⁰ Ibid.

¹³¹ *Case W58 89 ATC 524*.

¹³² *Case X90 90 ATC 648*.

¹³³ See ATO Test Case Program Statement “Refocus of the income-splitting test case program” available at <http://www.ato.gov.au/corporate/content.asp?doc=/content/67313.htm>.

To explore the application of Part IVA to this scenario an analysis is undertaken below. For ease of analysis it is assumed that the wife is the party that does the bulk of the work and is the main generator of the income. The facts in the scenario provided in the Guide will also be compared to a similar factual scenario in *Case W58*¹³⁴ where it was held that Part IVA applied. In this case the company required the taxpayer to provide his services as a consultant through a company. Accordingly, he acquired a company and provided his services under a consultancy agreement. The taxpayer also created a discretionary family trust, the trustee of which was the company. In all other respects however, the taxpayer was like an employee of X Co. It was concluded in this case that the taxpayer's dominant purpose was to obtain a tax benefit and Part IVA applied. It was held that: "It was not sufficient that the arrangements could be described as normal family arrangements." The Tribunal held that:

4. In the absence of the trust arrangements it could reasonably be expected that the family company would have paid the taxpayer all the income it distributed as trust income to beneficiaries other than the taxpayer. Such income might reasonably have been expected to have been included in the taxpayer's assessable income, within the meaning of sec. 177C(1).
5. The taxpayer could not escape the operation of Pt IVA because of the "choice principle" offered by sec. 177C(2). The mere fact that the Assessment Act recognises such things as trusts and provides how they should be taxed does not mean that the choice of the trust mechanism for income splitting is a choice "expressly provided for" by the Act for the purposes of sec. 177C(2)(a)(i)...
6. In conclusion, the taxpayer entered into and carried out a scheme for the purpose of obtaining a tax benefit and which did in fact produce a tax benefit and the whole of that benefit should be cancelled under sec. 177F(1).

THE APPLICATION OF PART IVA TO THE SCENARIO IN THE GUIDE

Precondition One: Scheme

The broad scheme in the scenario provided in the Guide, would include:

- the establishment of the partnership between the husband and wife;
- the payment of income to the partnership for the services of predominantly of the wife; and
- the splitting of income between the parties unequally so that the wife receives less income than she would have had she billed for her work directly to clients.

It is possible that a narrower scheme for this scenario could also be formulated. The narrow scheme would consist of only the third element listed above: the splitting of the income between the parties unequally.

Precondition Two: Tax Benefit

The tax benefit would be the non-inclusion in the wife's assessable income of the full amount of the income received by the partnership pursuant to s 177C(1)(a).

¹³⁴ *Case W58* 89 ATC 524.

Precondition Three: Dominant Purpose

In relation to the third precondition the dominant purpose to obtain a tax benefit under section 177D, it is arguable that the way in which each of the factors would apply is as detailed below.

Factor 1 The manner in which the scheme was entered into or carried out (s177D(b)(i))

Income is received by the partnership, despite the services being provided mainly by the wife. The manner in which the income is split is that the husband (despite providing little in the way of services) receives an equal amount of income from the partnership. This factor points towards a dominant purpose of obtaining a tax benefit.

The fact that a partnership is a “normal” way of conducting business should not impact on the fact that the manner in which the partnership profits and losses are shared is artificial and contrived. Certainly in *Hart*¹³⁵ the fact that purchasing an investment property was a normal and commonly entered into transaction did not detract from the fact that the manner in which the transaction was structured was not normal and pointed towards a conclusion that the dominant purpose was to obtain a tax benefit.

Factor 2 The form and substance of the scheme s 177D(b)(ii)
Case W58 stated:

The form of a corporate vehicle which employed the taxpayer and controlled the trust belies the real substance of that arrangement which essentially allowed the taxpayer to act in such a way as to attract to himself a lower incidence to personal income tax.¹³⁶

Indeed, in this scenario, it appears that the partnership structure employed “belies the real substance of the arrangement” which essentially allowed the wife to reduce her income tax burden.

Factor 3 Time and Length of Scheme : s 177D(b)(iii)

There is no evidence pointing either way in relation to this factor and accordingly, it is neutral.

Factor 4 Result in relation to the Act that, apart from Part IVA, would be achieved by the scheme s 177D(b)(iv)

The result, but for the application of Part IVA, would be that significant tax advantages were obtained by the wife by splitting her income. This would point towards a dominant purpose of obtaining a tax benefit.

Factor 5, 6 and 7 Any change in the financial position of the taxpayer or people connected with the taxpayer and any other consequences for the taxpayer.

The change in financial position was to reduce the overall tax burden of the family, from what it would have been if the wife had derived (and paid tax) on all the income individually. Therefore, the scheme increased the overall wealth of the family. This would appear to point towards a dominant purpose of obtaining a tax benefit.

¹³⁵ *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216.

¹³⁶ *Case W58* 89 ATC 524, 535.

Legally the position of the husband and wife has changed and both would be joint and severally liable for the debts of the partnership. This would appear to point against a dominant purpose of obtaining a tax benefit.

Factor 8 The Relationship between the parties.

The partners are husband and wife and therefore, splitting the income will benefit the family as a whole. It is unclear whether this factor would point for or against a dominant purpose of obtaining a tax benefit. In *Case W58* the fact that the arrangement would have benefited the family's overall wealth was not sufficient to stop a finding that Part IVA would apply.

Overall, it appears that objectively viewed this arrangement would appear to point towards a dominant purpose of obtaining a tax benefit. It is difficult to see when comparing the scenario presented in the Guide to that in *Case W58* how the arrangements there were any more reprehensible and susceptible to the application of Part IVA. Indeed, it appears that an arbitrary distinction has been drawn between splitting income through a trust and splitting income through a partnership and it is not clear why.

When one considers all these factors it appears to be strained to state that a conclusion would be reached under s 177D that the dominant purpose was not to obtain a tax benefit. Perhaps this example could be explained more easily if the Commissioner stated that he would not exercise his discretion in these circumstances because he considers this to be an acceptable form of income splitting in a family business. Surely, such a justification would be preferable to the Commissioner trying to justify this conclusion artificially by stating that the dominant purpose, after going through the tunnel, would not be to obtain a tax benefit.

CONCLUSION

When the policy basis of Part IVA is considered, it is not surprising that it is difficult to predict with certainty when Part IVA will apply to a transaction. It is unclear as a matter of policy what will constitute "tax avoidance" and this is reflected in the broad and amorphous words of Part IVA. This wording allows Part IVA the flexibility to apply to a wide variety of transactions; however, with this flexibility comes uncertainty. Therefore, the guidance that the tax office can provide in the form of PS LA 2005/24 and the Guide is correspondingly limited.

PS LA 2005/24 and the Guide do, however, provide a good overview of the basic principles and case law in relation to establishing the existence of the preconditions: a scheme, tax benefit and a dominant purpose to obtain a tax benefit. PS LA 2005/24 and the Guide further illustrate that the three preconditions are inextricably linked and as such Part IVA must be construed as a whole rather than viewing any of the elements in isolation. In addition to providing a useful summary of the operation of Part IVA, it is also necessary that practitioners familiarise themselves with the information in PS LA 2005/24 and the Guide because of the penalty implications. The tax office states at the beginning of the Guide:

If you try to follow the information contained in our written general advice and publications and in doing so make an honest mistake you won't be

subject to a penalty. However as well as the underpaid tax, we may ask you to pay an interest charge¹³⁷

Several of the more intricate issues regarding the three preconditions, however, still remain unaddressed by the tax office in PS LA 2005/24 and the Guide.

The area in which PS LA 2005/24 and the Guide could have provided some invaluable assistance is in what circumstances the Commissioner would choose to exercise his discretion to apply Part IVA. This issue is not, however, addressed in PS LA 2005/24 and the Guide and it remains an area that has been largely unexplored by case law or commentary.

In summary, PS LA 2005/24 and the Guide have only marginally assisted in further illuminating how to establish the preconditions and the tunnel of factors in s 177D. However, at the end of the tunnel when practitioners must determine whether the Commissioner will exercise his discretion to apply Part IVA they still remain, very much, in the dark.

¹³⁷ The first page of the Guide.

The Case for Measuring Tax Gap

Jacqui McManus and Neil Warren*

Abstract

More recently an increasing number of revenue authorities have attempted to estimate the amount of tax that is legally owing to their government but not collected. This amount is commonly referred to as 'tax gap'. In the past tax gap studies were branded unreliable. Tax administrations and other bodies criticised any attempts at quantifying tax non-compliance on the basis that it was costly and inconclusive. However based on the significant number of tax gap studies undertaken recently there appears to have been a change of heart. This paper considers a range of tax gap studies for the purpose of identifying the core reasons they were undertaken, highlighting their benefits and limitations.

INTRODUCTION

Tax gap is the difference between the theoretical tax liability due in accordance with the tax legislation and the actual revenue collected. The tax gap may be classified as underreporting of income, underpayment of taxes, and non-filing of returns. However the sources of tax gap are varied and complex and will differ for each type of tax and in every jurisdiction. Sources of tax gap might include for example, uncollected taxes (ie bad debts), unintentional error, the underground economy and illegal activities. Dissatisfaction with governments and their spending, apathy and corruption are some of the reasons for non-compliance leading to tax gap. Complexity of the tax legislation may also be a contributing factor.

Understanding the sources of and reasons for non-compliance is important for the purposes of developing strategies to encourage and enforce compliance and deter non-compliance, the core business of a revenue authority. This intelligence can be gathered from many different activities undertaken by the revenue authority, particularly audits. External sources of information, such as national statistics and literature on taxpayer behaviour and risk management, will also contribute. An increasing popular method for analysing and using this information has been through the generation of tax gap estimations.

Quantifying the tax gap provides a picture of the total revenue due and from whom it should be collected (or in relation to what transactions). Mapping this information is very powerful for a revenue authority, although it was thought possible only in theory until more recently. Tax administrations and other bodies have traditionally criticised any attempts at quantifying tax non-compliance on the basis that it was costly and inconclusive. Since the 1990s however there have been a number of countries, both members of the Organisation for Cooperation and Development (OECD) and developing countries, which have been able to estimate tax gap. Many have publicised

* Jacqui McManus and Associate Professor Neil Warren are Associate Director, Development & International and Head of School respectively from the Australian School of Taxation (Atax), Faculty of Law, University of New South Wales.

the results widely and use them as performance indicators, both at the organisational and employee level.

This paper surveys some of the larger studies of tax gap that are publicly available to identify the reasons why they are now considered feasible and more reliable. In doing so, the benefits and limitations of tax gaps studies are highlighted. In conclusion, the literature indicates that tax gap estimates are possible and although there are still limitations associated with tax gap studies, they are far outweighed by the potential benefits.

WHICH JURISDICTIONS ARE ESTIMATING WHICH TAX GAP AND WHY?

A number of countries undertake tax gap estimates. This section outlines a range of tax gap estimates made publicly available. Where possible a brief history of when and why the estimates have been made is included. Details on the benefits and/or ways information obtained from calculating tax gap estimates have been used are included in the following section.

Prominent examples of countries estimating various types of tax gaps include France, Sweden, the United States of America (US), and the United Kingdom (UK). Several individual states of the US also estimate tax gaps, such as Minnesota, Idaho, New York and California.

France has prepared tax gap estimates for some time. As noted by Barthelemy:

....., VAT fraud is detected regularly in France by the INSEE, through the method of difference in VAT. To begin with, we calculate the amount of VAT actually received by the state. Then we determine the amount of VAT which theoretically should be received, taking into account the economic activity as it is understood by the different headings in the input-output tables.

The difference between the theoretical VAT and the actual VAT makes a VAT gap which is enough, with some correction, to obtain some estimation of evasion. The correction is based on legal exemptions and abatements and on the differences which arise from the legal rules for the paying in and the deduction of VAT.¹

Sweden has also estimated tax gap on a broad range of taxes and social security levies including VAT for the years 1997 and 2000. The total gap is estimated at between 4% and 5% of GDP.² Sweden's tax gap estimates are calculated to provide guidance on the magnitude of the gap rather than precise year-to-year trends in tax gap.

Tax gap estimates were also routinely prepared by the US Internal Revenue Service (IRS) throughout the 1980s and 1990s. Although the IRS continues to examine available data and use it in its compliance management, data collection supporting these estimates has been suspended. The primary reason for stopping data collection (through a specifically designed audit program) was politically motivated - taxpayer

¹ Barthelemy, P., "The macroeconomic estimates of the hidden economy: A critical analysis", (1998) 34 (2), *Review of Income and Wealth*, p 190, <www.roiw.org/1988/183.pdf> at 15 March 2006.

² See *Taxes in Sweden*, (2004), Section 6.12 <skatteverket.se/broschyrrer/104/10405.pdf> and more generally <http://skatteverket.se/infotext/om_webbplatsen/> at 15 March 2006.

dissatisfaction around the time of a change of government.³ The IRS has however recently re-launched its research program.⁴

Several US states also currently undertake tax gap estimates of different kinds including income tax and sales tax in Minnesota⁵ and income tax in California⁶. The Minnesota sales tax gap study was conducted by an organisation other than the relevant revenue authority, although the study was commissioned by the Minnesota Department of Revenue.

The UK is another example. The UK Her Majesty's Customs & Excise (HMCE) (now Her Majesty's Revenue & Customs (HMRC)) has been estimating VAT gap annually since 2001.⁷ The HMCE estimates of VAT gap are based on UK Office of National Statistics (ONS) national accounts and household data. Each year, VAT gap estimates are prepared and announced to government, with considerable associated publicity. Performance agreements with employees and with government in the UK also now include VAT gap as a key performance indicator of those responsible for collecting the VAT.⁸

In addition to various jurisdictions choosing to estimate tax gap for internal management purposes, the International Monetary Fund (IMF) and the World Bank also use tax gap estimates as a performance measure. The IMF requires a tax gap estimate in relation to jurisdictions that it supports, as a condition of providing

³ Witte, A., Woodbury, D., 'The effect of tax laws and tax administration on tax compliance: The case of the US individual income tax', (1985), 38, *National Tax Journal*, pp 1-15.

⁴ <www.irs.gov/newsroom/article/0,,id=137247,00.html>. at 15 March 2006.

⁵ *Sales and Use Tax Gap Project: Final Report*, (2002), American Economics Group, Inc, Minnesota,,
<http://www.taxes.state.mn.us/taxes/legal_policy/research_reports/content/tax_gap_study.shtml> at 15 March 2006.

⁶ *California's Tax Gap*, (2005), Californian Legislative Analyst's Office,
<http://www.lao.ca.gov/handouts/revtax/2005/Californias_Tax_Gap_030105.pdf> at 15 March 2006.

⁷ *Tackling Indirect Tax Fraud*, (2001), UK (HM Customs & Excise),
<<http://www.hm-treasury.gov.uk/mediastore/otherfiles/Fraud%20Complete.pdf>> ; and
Measuring Indirect Tax Fraud, (2001), UK (HM Customs & Excise),
<www.hmce.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD_011638> at 15 March 2006.

⁸ In the *HM Revenue and Customs: Public Service Agreement 2005-06 to 2007-08*: Technical Notes, it is stated that "PSA Target 1: By 2007-2008 - reduce the scale of VAT losses to no more than 11% of the theoretical VAT liability." See
<http://www.hmrc.gov.uk/psa/psatn2005_08.HTM> at 15 March 2006.

The public service agreement also explains the VAT gap as follows:

The theoretical VAT liability (VTTL) is an estimate of the tax that should be collected in the absence of any losses. It is constructed largely from the Office for National Statistics (ONS) national accounts sources, which are independent of the VAT administrative systems. The difference between the VTTL and net VAT receipts is an estimate of VAT losses known as the VAT gap.

VAT losses are attributable to a number of causes, from error, ignorance and financial difficulty through to abusive avoidance and deliberate fraud such as Missing Trader Intra Community Fraud (MTIC) VAT fraud.

assistance.⁹ The World Bank also assesses government performance using tax gap estimates amongst other measures.¹⁰

This section has identified just a few examples of tax gap studies undertaken in different countries around the world. A list of publicly available tax gap estimates and related documentation in these and other countries such as New Zealand, the Philippines and Brazil is provided in Appendix 1. The estimates identified cover a range of different taxes including:

- VAT gap estimates – for example in France, Sweden and the UK, as noted above.
- Sales tax gap estimates – as undertaken by Minnesota, US.
- Federal Income tax gap estimates – calculated in the US for example.¹¹
- State Income Tax Gap – calculated in Idaho, California and New York State.¹²
- Corporate tax gap estimates – currently being developed by the UK HMRC.¹³

The increasing number of jurisdictions investing in the development of tax gap models indicates there is significant value in doing so. The following section summarises the associated benefits of tax gap studies.

BENEFITS OF TAX GAP STUDIES

The literature on tax administration and tax compliance suggests there are three key benefits that flow from estimating tax gap. These are:

- the identification of the types and level of non-compliance that contribute to the tax gap;
- improved efficiency of resource allocation within a revenue authority to combat non-compliance; and
- as a measure of effectiveness of a revenue authority.

These three main benefits are discussed in more detail below. However it should also be noted that in the UK, the VAT gap estimates have had the added benefit of helping to identify areas where legislative amendment might be required in order to address problems when taxpayers interpret the law in a way that attracts a particular VAT

⁹ See the IMF involvement in the Caribbean Regional Technical Assistance Centre (CARTAC) program which involves tax gap estimates in Caribbean countries at <www.cartac.com.bb/CARTAC%20Activity%20Report%20Oct%2003%20-%20April%2004.doc> at 15 March 2006.

¹⁰ *Afghanistan Managing Public Finances for Development*, Report No. 34582-AF, 2005, World Bank, <http://siteresources.worldbank.org/AFGHANISTANEXTN/Resources/305984-1137783774207/afghanistan_pfm.pdf> at 15 March 2006.

¹¹ <<http://www.irs.gov/newsroom/article/0,,id=137246,00.html>> at 15 March 2006.

¹² See Appendix 1 and

<http://www.lao.ca.gov/handouts/revtax/2005/Californias_Tax_Gap_030105.pdf>,
<http://www.taxadmin.org/fta/meet/05rev_est/bolognino.pdf>,
<http://www.legislature.idaho.gov/ope/publications/reports/rt_generalgov.htm>

¹³ Although the UK HMRC corporate tax estimates are not yet publicly available, preliminary studies by an independent body are documented in 'Mind the Gap', (2006), *Tax Justice*, <http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_summary_-_13_Jan_2006.pdf> at 15th March 2006.

treatment (such as GST-free/zero rated) when this is not intended. Tax gap estimates can therefore potentially highlight inequities and economic inefficiencies which arise from non-compliance with taxes.

The UK VAT gap research has also highlighted data availability problems which have subsequently been addressed to improve the reliability of time series estimates, particularly the National Accounts methodology applied in relation to cross-border and trade.¹⁴ What has resulted is a better understanding of the size and operation of the underground economy, its impact on UK VAT raised and its implications for tax system integrity.

Identifying the sources and level of non-compliance

Identifying sources of non-compliance is a complex and difficult task but it is a key aspect of managing tax compliance. In order to identify sources of tax gap, a revenue authority needs to have a sound understanding of the tax(es) administered and associated types of compliance requirements, taxpayers and their compliance behaviours, and the environment in which they operate. This requires access to various sources of information which is typically gathered from audit and other compliance activities.

This process of identifying sources of non-compliance is often referred to as risk management. Tax gap estimates can assist in this process by providing considerable guidance on what the sources of risks are. The tax gap has three components: underreporting of income, underpayment of taxes, and non-filing of returns. The IRS allocates total tax gap across each of these types of non-compliance and then disaggregates the tax gap further by type of taxpayer (refer to Figure 1). Another example of how the sources of non-compliance can be identified and used as a result of tax gap estimates was highlighted by the OECD,

The tax gap can be divided into the assessment error (i.e. the difference between the theoretical tax and the tax actually billed to the taxpayer) and the collection loss (the difference between the tax bill and the tax actually paid). In Sweden collection losses are small, less than 1% of the total tax bill. Although difficult to estimate, the assessment error can safely be assumed to be much larger. Most estimates of the assessment error indicate that it falls within the range of 5–10% of the theoretical tax. Other estimates are much higher.¹⁵

Tax gap estimates also assist in the risk management process by providing considerable guidance on prioritising identified risks. Quantifying tax gap provides a means for comprehensively and more accurately assessing and ranking areas of risk to compliance. For example, using time series data associated with its VAT gap estimates, the UK has been able to identify the magnitude and high priority for

¹⁴ See for example <www.statistics.gov.uk/articles/economic_trends/ETAug03Ruffles.pdf> at 15 March 2006.

¹⁵ Olsson in Hôgye, Mihály, (ed), 'Local And Regional Tax Administration In Transition Countries', (2000), *Local Government and Public Reform Initiative*, Budapest., p 424, <<http://lgi.osi.hu/publications/default.asp?id=95>> at 15 March 2006.

addressing the case of ‘missing trader intra-community fraud’¹⁶ and other areas of increasing non-compliance.

Some revenue authorities however argue that they have a sufficient risk management system in place that allows them to identify and prioritise risks. These organisations believe that because they have access to a wide range of information and intelligence they can sufficiently group and rank non-compliant activities. However tax gap estimates used in conjunction with these data sets and indicators have been shown to enhance the value of risk assessment activities significantly. The detailed knowledge the tax administrator usually generates regarding risk areas are essentially sources of tax gap. Taking the additional step of estimating the tax gap enables:

- verification of the level of risk assessed in relation to risk areas identified;
- a comprehensive analysis of all areas of compliance and non-compliance;
- identification of areas of risk not previously ranked;
- monitoring of the quantification of risk areas over a period of time using a comparable estimate;
- assessment of the effectiveness of attempts to reduce the non-compliance in a risk area;
- assessment of the effectiveness of attempts to reduce the non-compliance in aggregate (as pressure on one form of non-compliance often merely manifests in another form rather than actually reducing non-compliance); and
- comparison of relative risks across all areas.

The ability to monitor and compare the risk associated with all areas and/or a type of non-compliance associated with a theoretical tax liability ensures that the eradication or reduction of one type of risk does not manifest itself in another form (which is most likely to go undetected for some period of time). Furthermore, the quantification of the tax gap in all types of transactions and/or required forms of compliance allows for the prioritisation or ranking of risk on a more reliable and comparable basis than some other arbitrary ranking processes that might only be used in relation to suspected risk areas.

This cross analysis of the possible sources of tax gap and the causes of it based on the revenue authority’s intelligence and data and tax gap estimates has proved very powerful in practice. For example, the IRS, as a result of measuring tax gap, was able to conclude that the largest components of the tax gap are non-compliance with the reporting requirements¹⁷ and individual taxpayers.¹⁸ In fact, the IRS has developed a

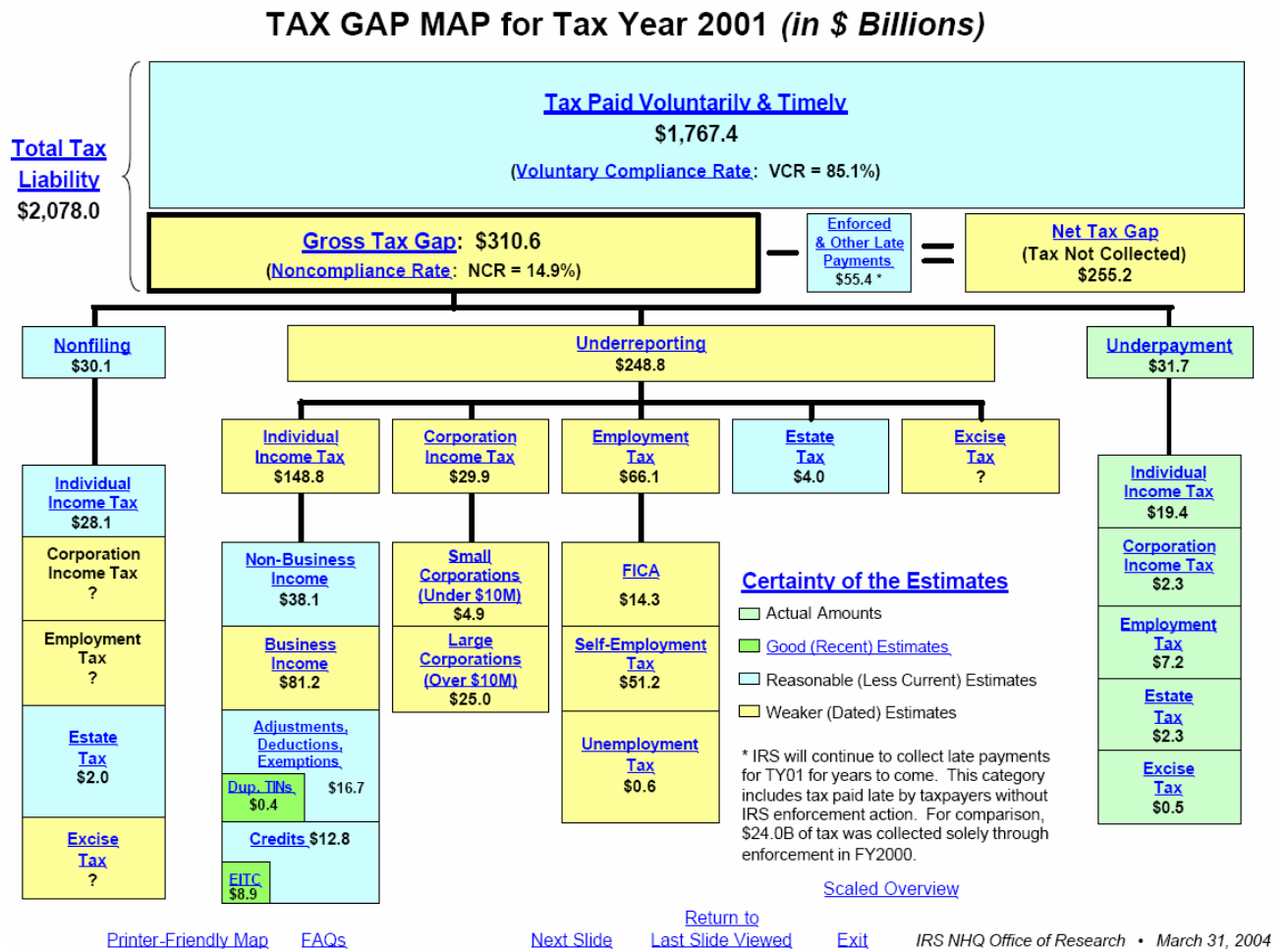
¹⁶ *Measuring and Tackling Indirect Tax Losses*, (2004), UK (HM Customs & Excise), pp.4 and 7, <www.hmce.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD_011582/> at 15 March 2006.

¹⁷ Brown, R. & Mazur, M., ‘The National Research Program: Measuring Taxpayer Compliance Comprehensively’, paper presented at the *2003 Kansas University Law Review Symposium*, Lawrence, 2003, p 2, <www.irs.gov/pub/irs-soi/01tgapmp.pdf> at 15 March 2006.

¹⁸ US Treasury Report on IRS Tax Gap Study, (2005), Section 9, p. 2, <http://www.irs.treas.gov/pub/irs-utl/tpi_2005_sec9_tax_gap_ir2005_38.pdf> at 15 March 2006.

summary of tax gaps and their sources as a result of its studies to assist in identifying and monitor them (refer to Figure 1).

FIGURE 1 - IRS TAX GAP MAP



Source: <www.irs.gov/pub/irs-soi/01tgamp.pdf>

Resource allocation efficiencies

An associated benefit of prioritising or ranking risk of non-compliance on a more reliable and comparable basis through tax gap estimates rather than other arbitrary ranking processes, is a more efficient resource allocation within the revenue authority. Because tax gap estimates allow the revenue authority to monitor changes in risk areas they are able to better identify what areas they should allocate resources to in order to achieve optimum results. This is a particularly important benefit given the limited resources available to revenue authorities.

For example, the IRS have shifted resource allocations as a result of completing their most recent tax gap estimates. Mr Everson, IRS Commissioner, said:

We are ramping up our audits on high-income taxpayers and corporations, focusing more attention on abusive shelters and launching more criminal investigations.¹⁹

The results of the UK VAT gap studies also provide an example of this potential use of tax gap information. The UK gap estimates were the stimulus for the development of a VAT Compliance Strategy (VCS) which was launched on 1 April 2003, with the claim of reversing the trend of an increasing difference between total 'theoretical' VAT liability and actual VAT receipts - the VAT gap.²⁰

Managing resources efficiently impacts on the level of effective performance in combating non-compliance. Tax gap estimates are also able to help revenue authorities assess their overall performance by monitoring changes in the estimated gap.

Revenue authority performance measure

In addition to being a valuable tool to tax administrators, tax gap studies can also be used by government to monitor performance of their tax administration agencies in maintaining integrity in their tax system. It is not uncommon for a government and revenue authority to enter into contracts for funding and other conditions based on achieving agreed levels of key performance indicators. One important indicator is effectiveness.

Effectiveness relates outcomes to objectives. The OECD acknowledges that, "reliable measures of effectiveness are highly desirable, but often difficult to find."²¹ Amongst the most commonly adopted indicator of effectiveness of revenue authorities are revenue targets. However revenue targets are not necessarily a good measure of the effectiveness of the revenue authority. Although revenue is easily measured and compared to a target, revenue collected depends on far more than effective management. The OECD highlights,

The problem with revenue as a target and measure of effectiveness is that in most countries the amount of revenue collected depends much more on economic growth and changes in tax legislation than on the general performance of the tax administration.²²

In relation to determining the *effectiveness* of the revenue authority, a tax gap estimate is a conceptually more relevant and valuable indicator, making it preferable. The OECD advocate tax gap studies particularly as a performance measure for the effectiveness of revenue authorities, despite past concerns expressed regarding the practical issues associated with estimating tax gap. Essentially effectiveness is about minimising the tax gap, i.e. the gap between theoretical tax (the tax that would have

¹⁹ US Treasury report on the IRS, Tax Practitioner Institute, (2005), Section 9, p. 1.

²⁰ *Measuring and Tackling Indirect Tax Losses*, (2004), UK (HM Customs & Excise), p4, <http://www.hmce.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD_011582/> at 15 March 2006.

²¹ 'General Administrative Principles – GAP005 Performance Measurement in Tax Administrations, Performance Measurement in Tax Administrations – Practice Note', (2001), *Centre for Tax Policy and Administration*, Tax guidance series, prepared by the OECD Committee of Fiscal Affairs Forum on Strategic Management.

²² *Ibid.* p 14.

been collected if no one tried to cheat and no mistakes were made) and the tax actually collected.²³

The IMF supports this view as it now routinely undertakes tax gap estimates in its review of the tax capacity of countries.²⁴ National auditors and accountability authorities are following suit and supporting the use of tax gap estimates and encouraging regular updates.²⁵ Where they have not been undertaken recommendations are being made to do them.²⁶

In summary the generally acknowledged benefits from undertaking tax gap estimates are that government will be better informed about:

- tax system integrity;
- risks to revenue buoyancy;
- performance of their tax collection agency and processes;
- evolving risks to revenue (and potential failures by their tax collection agencies);
- problems with the tax legislation;
- problems with the national statistics; and
- the impact of the non-observed economy on revenue.

These assurances are increasingly important to governments worldwide. For government, increasing demands for the provision of services (such as for health and welfare) means it is imperative that taxes due are paid. For the general public, any evidence of tax non-compliance has a direct impact on the equity and economic efficiency of taxes and this can lead to a loss of public confidence in the integrity of the tax and the revenue authority.

The significant benefits and overwhelming support for tax gap studies from a broad range of members of the tax community however should be considered in light of the various limitations claimed of such estimates.

LIMITATIONS OF TAX GAP STUDIES

While tax gap estimates are an important compliance management tool capable of complementing other performance indicators, such measures do have their limitations. These limitations include both conceptual issues, as well as those arising from data availability and integrity.²⁷

²³ Ibid. pp 5.6 and 29.

²⁴ See the IMF involvement in the Caribbean Regional Technical Assistance Centre (CARTAC) program which involves tax gap estimates in Caribbean countries at <www.cartac.com.bb/CARTAC%20Activity%20Report%20Oct%2003%20-%20April%2004.doc> at 15 March 2006.

²⁵ US Government Accountability Office, (2005), Tax Gap: Multiple Strategies, Better Compliance Data and long term goals are need to improve taxpayer compliance.

²⁶ See for example, *The ATO's Strategies to Address the Cash Economy*, (2006), Australia (Australian National Audit Office), Performance Audit, Audit Report No. 30, 2005-06.

²⁷ See for example the discussion in the OECD *General Administrative Principles – GAP005 Performance Measurement in Tax Administrations*, (2001), p 29.

When estimating tax gap, data is required from both the national statistician and the revenue authority. Broad issues which must be considered include the data's currency, reliability, validity and availability.

In relation to the data used in the tax gap estimates, a number of data problems have been raised regarding accuracy, reliability and cost. Specific concerns include the:

- timeliness of relevant data available, for example the latest Input-Output data in Australia relates to the 1998-99 financial year;
- lack of data on specific transactions such as capital stock/transfers;
- lack of a detailed industry break-up of data;
- inability to accurately map the national statistician's industry classification to those used by the revenue authority; and
- access to and/or of the revenue authority's data (based on privacy laws or tax laws relating to the use of information provided to the revenue authority, for example).

The data sources and their quality have a significant impact on the estimation not only in the validity of the result but in the design or ultimate methodology adopted. The data sources must match the required information that is dependent on both the approach adopted and the relevant tax legislation.

Although concerns regarding data are branded as limitations, recent experience shows that attempts to estimate tax gap can in fact assist in identifying data constraints and how they can be addressed, as has been the UK experience noted above. As a result the data limitations can be overcome and additional benefits arise. Overtime, with the improvement or changes in data collection and the refinement of the model for estimating the tax gap, valuable information can be obtained both regarding the sources and trends in the tax gap; and the performance of the tax administration.

Despite the fact that the data issues raised regarding tax gap issues can be addressed and in fact can produce additional benefits, some countries have still opted not to directly pursue tax gap estimates for data related and other reasons. For example,

...Australia does not attempt to estimate the total tax gap, but undertakes rigorous risk assessments to identify and address areas where this gap may be significant or have the potential to become significant.²⁸

The Australian Taxation Office (ATO) has indicated the reasons tax gap estimates could not be undertaken, include:

- the Australian Bureau of Statistics (ABS) confirms that the underground economy is 2% of GDP;
- PRISMOD [An Australian Treasury model] is of minimal use;
- tax gap estimates are unlikely to provide pertinent information for understanding the overall efficacy of the range of measures undertaken by the ATO;
- changes in trends identified as a result of tax gap estimates are not useful.²⁹

²⁸ OECD Practice Notes on *Performance Measurement in Tax Administrations*, (2001), p 30-31.

The ATO has also more recently stated that in its opinion,

the cost of inconveniencing compliant taxpayers through a program of rigorous, large scale, random audits is not commensurate with the benefits of the comparative, raw information obtained from these audits. The cost is further compounded by consuming resources that would otherwise be targeted at substantive compliance risks.³⁰

The lack of tax gap estimates has however been a point of concern in Australia. In 2004 the Australian National Audit Office (ANAO) recommended that the ATO explore the possibility of undertaking GST gap estimates.³¹ This recommendation was supported by the *Joint Committee of Public Accounts and Audit of the Commonwealth* (JCPAA). The Committee stated that it,

...feels that a rigorously derived estimate of the tax gap is required as an input to successful monitoring of prevention and control of Goods and Services Tax fraud.³²

Additionally, the JCPAA noted that it

4.51...believes that ATO should establish and maintain a dynamic mechanism to determine an estimate of the tax gap using appropriate Australian Bureau of Statistics economy-wide business indicators.³³

In a written response to the JCPAA the ATO indicated that appropriate indicators are being used and further developed, using ABS data.³⁴ For example, the ATO prepares indicators for:

- GST growth in relation to ABS household expenditure data;
- GST growth by surveys of enterprise;
- GST trends by industry; and
- indicators of ATO efficacy in relation to GST fraud.

However, some of the conceptual issues raised with regard to tax gap estimates may also apply to the indicators that the ATO currently and/or propose to calculate. Consequently, provided these issues are borne in mind in preparing and interpreting

²⁹ Australia (ATO), 2005, ATO response to Recommendation 5 of Joint Committee of Public Accounts and Audit, *Review of Auditor-General's Reports 2002-2003: Fourth Quarter*, 2004, <http://www.aph.gov.au/house/committee/jpaa/agfourth02_03/execmin.htm> at 15 March 2006.

³⁰ *The ATO's Strategies to Address the Cash Economy*, (2006), Audit Report No.30 2005–06 Performance Audit, Australia (ANAO), p 32, <www.anao.gov.au> at 1 March 2006.

³¹ *Goods and Services Tax Fraud Prevention and Control by the Australian Taxation Office*, Audit Report No.55 2002–03, Australia (ANAO), <www.anao.gov.au> at 1 March 2006.

³² *Review of the Auditor-General's Reports 2002-2003*, Report No. 398, (2004), Australia (JCPAA), p ix.

³³ Ibid.

³⁴ Australia (ATO), 2005, ATO response to Recommendation 5 of Joint Committee of Public Accounts and Audit, *Review of Auditor-General's Reports 2002-2003: Fourth Quarter*, 2004, <http://www.aph.gov.au/house/committee/jpaa/agfourth02_03/execmin.htm> at 15 March 2006.

the results, they should not pose barriers for estimating tax gap or the other performance indicators.

Clearly outlining the purpose and the limitations of performance indicators renders them valid and useful. As the ATO state, a trend increase in GST gap need not solely reflect increased GST fraud.³⁵ However, what the trends and changes in trends (in all relevant indicators, including tax gap) can do is complement other intelligence gathered by the revenue authority and allow it to make measured decisions about how resources should best be used.

The literature on tax gap supports this assertion as it contains no express intention for tax gap studies to be used in place of other work undertaken by revenue authorities in their pursuit of reducing non-compliance. The ideal situation is in fact quite the contrary. Tax gap estimates are typically used to not only assist in interpreting the revenue authority's existing data and intelligence but can be used to develop and refine the techniques used to gather that data. Furthermore tax gap estimates are designed to drive the development of an effective mix of a range of compliance strategies.

Finally, data limitations and concerns about the information value of tax gap estimates should be distinguished from the inertia that might arise against undertaking such estimates. It seems that the limitations of tax gap estimates identified in the past can be overcome and/or minimised and are not significant enough to dismiss the use of tax gap estimates. Any resistance to calculating tax gap estimates that might still exist is possibly due to the pressure that quantifying tax gap may impose on governments to collect additional revenue, revenue which it is difficult to collect (without generating adverse public reaction). Additionally there may be public concern that the additional revenue raised might be spent and therefore increase the size of government without comparable improvement in services. Nonetheless, these are not limitation or even concerns about the concept or process of estimating tax gap but the politics of taxation and the implications for government of public knowledge of the tax gap.

DEVELOPMENTS ENABLING BETTER TAX GAP ESTIMATES

The most important development that helps overcome the perceived conceptual issues regarding the possibility of estimating tax gap and the value of doing so is the documentation of the process and creation of models that have been used to estimate tax gap in various countries around the world.

More specifically, in relation to the primary limitation noted above, relevant data, there have been and must continue to be a revision of the data that national statisticians need to be collecting and how that data should be aggregated. Measures of GDP based on the United Nations System of National Accounts (SNA93)³⁶ are an essential ingredient in tax gap estimates. The concepts used in SNA93 are broad and inclusive of all productive activities regardless of their legality. Barthelemy reminds us that,

³⁵ Ibid.

³⁶ SNA, (1993), United Nations, <<http://unstats.un.org/unsd/sna1993/introduction.asp>>, at 15 March 2005.

...the fact that the GDP consists, in part, of incomes which undeniably come from the hidden economy means that in no case should we confuse hidden with unrecorded.³⁷

Clearly consideration of both the observed and non-observed economy is important. In relation to the latter, SNA93 includes consideration of underground production, illegal production, informal sector production, and production of households for own final use. The OECD and IMF have more recently worked together to provide further guidance on this reporting.³⁸

Specific examples of recent developments relating to relevant data also exist. Revisions of UK National Accounts methodology and trade and GDP estimates³⁹ were noted above. Additionally, recent changes to the secrecy provisions of Australia's *Income Tax Assessment Act 1936*⁴⁰ allow the ABS broader access to data collected by the ATO which could enable them to match their surveys with the respondents actual data report to the tax authorities.

On a more practical level, the positive view of tax gap estimates enforced by national auditors and accountability offices as well as revenue authorities have acted as the greatest enabler for the practice of tax gap estimates. The shift in attitude regarding tax gap studies appears to have arisen as a result of the recognition that undertaking time series estimates of tax gap - conditional on the estimates not having fundamental conceptual and data limitations - has merit in being able to illustrate trends which are important to government in relation to the performance of the revenue collection agency. That is, even if GST gap estimates are subject to various qualifications, as long as they do not fundamentally flaw the results, then resultant trend estimates can be highly informative.

CONCLUSION

A number of countries are now calculating tax gap estimates for their consumption based taxes and income taxes, encouraged by international institutions such as the OECD and the IMF which indicates that not only can tax gap be estimated but that the exercise is proving useful. Bird encapsulates the importance of tax gap estimates for a revenue authority in terms of maintaining and improving existing levels of compliance:

... in reality not all taxpayers are honest in any country. The second important task of any tax administration is to keep them that way. To do so, one must first have a good idea of the extent and nature of the potential tax base, for example, by estimating what is sometimes called the "revenue gap." This is not always easy to do, but it is essential if an administration is to have some idea of the size and nature of those not in the tax net. In some instances, the major problem may be that many potential taxpayers are

³⁷ Barthelemy, P., op. cit.

³⁸ *Measuring the Non-Observed Economy: A Handbook*, (2002), OECD; and *Tax Revenue, Uncollectible Tax, Tax Credits*, (2004), International Monetary Fund (Task Force on Harmonization of Public Sector Accounting), <<http://www.imf.org/external/np/sta/tfhpsa/2004/060104.pdf>> at 15 March 2006.

³⁹ See for example <www.statistics.gov.uk/articles/economic_trends/ETAug03Ruffles.pdf> at 15 March 2006.

⁴⁰ ITAA, 1936 (Cth), s 16(4)(ga), amended 9 Dec 2005.

simply not known to the authorities. In others, it may be that many taxpayers who are in the system are substantially underreporting tax base. In still others, both problems may be important. Unless a careful study of the unreported base, and its determinants, is undertaken, no administration can properly allocate its resources to improving fiscal outcomes – whether through “sweeps” to find unregistered taxpayers or the generally more productive, if technically much more demanding, route of auditing.⁴¹

As Bird enumerates the main benefits of tax gap, highlighting the necessity of estimating it in terms of compliance, it is important to note that tax gap estimates are not a replacement for other forms of compliance management (which includes but is not limited to risk management) but can act as an effective complement to them. Concerns regarding the reliability of tax gap estimates and their perceived limitations must also be taken into consideration in evaluating them.

However it is noted that despite a number of concerns regarding tax gap estimates, there is growing international recognition that there is value to be gained from estimating tax gap. This is due in part to the fact that the potential limitations, particularly in relation to data, can be overcome. Furthermore, there is acceptance that there are limitations to any compliance measure and performance indicator available. Consequently it is concluded that the clear trend towards the growing acceptance and widespread adoption of tax gap estimates in recent years, as indicated throughout this article (and in Appendix 1), signifies that the benefits of tax gap estimates far outweigh any limitations, costs or risks. Tax gap estimates are becoming increasingly important in reassuring governments and taxpayers that the tax in question has integrity from a revenue authority, economic efficiency and an equity perspective.

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⁴¹ Bird, R., “Administrative Dimensions of Tax Reform”, ITP Paper 0302, April 2003, International Tax Program Institute for International Business, Joseph L. Rotman School of Management, University of Toronto Toronto, Ontario Canada M5S 3E6
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APPENDIX 1 - EXAMPLES OF TAX GAP STUDIES

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IT Adoption Strategies and their Application to e-filing Self-Assessment Tax Returns: The Case of the UK

Ann Hansford, Andrew Lymer and Catherine Pilkington*

Abstract

This article considers Information Technology (IT) adoption strategies as applied to the particular circumstances of e-filing UK Self Assessment (SA) Tax returns¹. It reports the findings from a study that involved three interested groups in the UK; tax advisers, tax authorities and software providers. IT adoption issues, as applied to a wide range of business situations, are considered in detail in order to set the study into context.

The current study, which builds on the findings of a previous UK quantitative study, involved ten in-depth interviews with representatives from the three interested groups – tax advisers, tax authorities and software providers - in order to consider broader aspects of e-filing SA tax returns. The interviews identified that IT adoption is usually a ‘top-down’ decision. The availability of suitable and developing IT tax software is important for tax advisers; as is the perception of the user-friendliness of the HM Revenue and Customs (HMRC) IT system. Pre-adoption concerns for tax advisers mainly centred on how e-filing would fit in with their current practice and the benefits, or otherwise of introducing IT. Post-adoption discussion centred on the wider benefits of IT adoption and the ease of use of the e-filing systems.

Tax advisers in the study were clear about areas that could influence their decisions to e-file SA tax returns. Getting over the apprehensiveness of the reluctant IT adopters required good software products that fitted in with other office functions, overcoming any reluctance to trust HMRC IT capabilities and operational efficiencies. Security and privacy were of significant concern to tax advisers but visibility was of little importance.

Overall, there was a positive assessment of e-filing SA tax returns. The study showed that e-filing was expected to expand to all but the most reluctant tax adviser practices within the next five years.

INTRODUCTION

As a result of the growth of Internet availability in the UK to significant levels,² the UK Government has set clear adoption and delivery targets for electronic services by Government departments and agencies. In 1998, the future facility to e-file was included in the modernising government agenda.³ In 1999, Gordon Brown (Chancellor

*Dr Ann Hansford PGCE CTA (Fellow), Senior Lecturer in Taxation, Bristol Business School, Bristol UK; Andrew Lymer BSc, MPhil, MIRS, FAIA, Senior Lecturer in Taxation and Accounting, Birmingham Business School, University of Birmingham, UK; Catherine Pilkington BA ACA, Senior Lecturer in Taxation and Financial Accounting, Lancashire Business School, UCLAN, UK.

¹ We are grateful to an anonymous referee for helpful comments and suggestions for improvement of an earlier version of this article and for the input of the ATTA conference attendees in Melbourne (Faculty of Law) in January 2006.

² 55% (12.9 million) UK households are online as at July 2005 according UK National Statistics Omnibus Survey, October 2005 – see <http://www.statistics.gov.uk/cci/nugget.asp?id=8>.

³ <http://www.cabinetoffice.gov.uk/moderngov/>.

of the Exchequer) confirmed that it would be possible to e-file tax returns and it was part of the Government's commitment to the use of e-services.⁴ The Internet based on-line facility for Self Assessment (SA) returns – referred to as e-filing in this article – was introduced on 31 July 2000 and tax advisers have been able to file on-line on behalf of clients since August 2001.⁵

Prior to e-filing, the Electronic Lodgement Service (ELS) (introduced in 1997) enabled tax advisers⁶ to file SA returns electronically on behalf of clients. HM Revenue and Customs (HMRC) had committed to support ELS until April 2006 but their stated intention was to withdraw ELS once there is confidence in the new Internet based services. This occurred in April 2006 as planned.⁷

The current study extends the previous work⁸ by considering the views of tax advisers, the tax authorities and tax software providers of e-filing SA packages within the UK.

The performance target now requires a take-up rate for SA returns of 25% filed electronically by the filing date for 2005/06, i.e. 2.2m of 8.8m returns by 31 January 2007.⁹ The take-up of on-line filing of SA returns was initially very slow and fell well short of the original targets. However, this trend has been reversed and for 2003/04 tax year the returns e-filed by 31 January 2005¹⁰ numbered 1.6m.¹¹ Nearly 2 million returns were filed online by 31 January 2006 which represented a 38% increase on 2005¹² suggesting that by 2005/06 the revised 25% target will be easily met, if the doubling of submissions in each of the previous two tax years continues to be achieved – as seems reasonable to presume will be the case.¹³

This paper therefore explores the nature of, and processes leading to, adoption of e-filing as a solution decision made by tax advisers in the UK. It's time frame of study is from launch of the e-filing solution option (August 2001) up to and including the 2005/6 tax year in the UK. This study, which builds on the findings of a previous UK

⁴ Ibid.

⁵ The actual timing of availability varying depending on whether the tax advisers' tax return software supported Filing By Internet (FBI – referred to in this paper as e-filing throughout) – i.e. from the start or subsequently.

⁶ In this paper the terms tax advisers, tax agents and tax preparers are used interchangeably to refer to any third party who is engaged in aiding the taxpayer to prepare and file their SA tax return.

⁷ This period was initially announced to be in 2004 (Inland Revenue (2002) Review of Future of Electronic Lodgement Services) but this has been revised twice. However did finally cease in April 2006 – see <http://www.taxation.co.uk/Articles/2005/10/06/50285/Farewell,+ELS.htm>

⁸ Lymer A, Hansford A, & Pilkington C (2005) 'Filing by Internet in the UK: The barriers to adoption of filing Self Assessment tax returns by Internet', *British Tax Review*. Vol 5 pp 544-556.

⁹ Inland Revenue – Spring Department Report 2004 – Government's Expenditure Plans 2004 – 2006 p 22 (<http://www.inlandrevenue.gov.uk/about/dept-report04.pdf>).

¹⁰ This is the last filing date for the UK's 2003/4 tax year returns (i.e. for the tax year ended 5 April, 2004).

¹¹ Hansards, 20 Dec 2005, Column 2806/7W - <http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmhansrd/cm051220/text/51220w42.htm>

¹² see <http://www.hmrc.gov.uk/workingtogether/update-on-sa.htm>.

¹³ Lymer et al (2005) – see footnote 8 above – reported annual numbers of returns e-filed as 38,981 (by 31/1/01), 75,449 (by 31/1/02), 335,639 (by 31/1/03) and 708,345 (by 31/1/04).

quantitative study,¹⁴ and involves ten in-depth interviews with representatives from the three interested groups – tax advisers, tax authorities and software providers - in order to consider broader aspects of e-filing SA tax returns.

The following section reviews the IT adoption strategy literature to explore the principles of adoption of IT solutions gleaned from other domains that are potentially applicable to assisting our understanding of e-filing developments. The UK situation is then compared, briefly, with international experiences of e-filing individual tax returns that have been reported in the literature. The research methods used for the study are discussed and then the results are considered in detail within an IT adoption framework developed from the prior IT adoption literature. Conclusions from the study then form the final section of the article that seeks to draw principles from this study potentially applicable in other domains.

IT ADOPTION STRATEGIES

This section reviews areas of the IT adoption literature potentially relevant to e-filing SA tax returns.

Before attempting to analyse changes in use of filing technologies, the initial starting point for taxpayers and their advisers needs to be considered and factored into their decision to change to e-filing. A recent study¹⁵ addressed the introduction of a website into the existing office practices in order to examine what factors may affect the adoption of a potentially valuable Internet tool. The existing electronic environment in place that was familiar, already well established and working well, impacted heavily on the IT adoption success of the newer technology solution. It is therefore reasonable to assume heavy IT users amongst the tax adviser community (including those who are existing ELS users) may have a different approach to e-filing adoption than those who are not in this category.

Important factors in successful adoption of IT in this patient education helpline context included giving job/task specific examples and cases to illustrate how the tool would be used in specific circumstances and tied to specific job functions and levels of prior IT competence and use.¹⁶ Additionally, individually tailored motivations were offered to encourage wider use of the IT solutions being proposed. While such personalising of the adoption encouragement offered in e-filing's case by HMRC may be harder to achieve than in this specific business's context, given their need to appeal to a wider audience with less direct control over the move into the new technology, the evidence from this case suggests that further support of specific functions common to many businesses may help at least establish a foothold in more businesses from which individual support of new 'champions' may then be fruitful.¹⁷ The patient helpline case paper¹⁸ also makes the point that 'opening the black box' can be a critical element to successful IT adoption in well-established and already successful systems to

¹⁴ See footnote 8 above.

¹⁵ Shelton, B, Turns, J and Wagner, T. (2002) 'Technology adoption as process: a case of integrating an information-intensive website into a patient education helpline.' *Behaviour and Information Technology*, Vol.21, No. 3 pp 209-222.

¹⁶ Ibid.

¹⁷ HMRC illustrate this approach in outline in the establishment of their industry groups with software partners and, most recently, the banking community.

¹⁸ See footnote 15.

demystify the new process and aid understanding of why a new way is better than current practices.¹⁹

In addition to current experiences of well known systems (technology mediated or manual), the expected impact of a change in IT usage/dependency impacts on the success, or otherwise, of a change to a more IT based system of operation. The study by Karahanna et al (1999)²⁰ showed that pre-adoption attitude is based on perceptions of usefulness, ease-of-use, result demonstrability, visibility and trial-ability. Conversely, post-adoption attitude to the new IT is primarily based on beliefs of usefulness and direct perceptions of the enhancements offered by the new tools provided.²¹

These perspectives²² on exploring influencing factors to IT adoption were utilised in an Australian study seeking to explore the factors that have enabled the diffusion, adoption and operationalisation of electronic lodgement within the tax system of that country.²³ This study used an eight factor framework to analyse diffusion and adoption based on IT adoption strategies, such as that outlined in Karahanna et al., and wider social interaction and innovation theories (e.g. Rogers' Diffusion of Innovation Theory).²⁴ These factors were: circulation of ideas, national context, tax policy

¹⁹ An effective feature of the recent HMRC approach has in fact been to make extensive use of industry representation groups in system development and implementation as these results would propose.

²⁰ Karahanna, E, Straub, D and Chervany, N (1999) 'Information technology adoption across time – A cross-sectional comparison of pre-adoption and post-adoption beliefs'. *MIS Quarterly*, Vol 23, No. 2, pp.183-213. This study, in turn, extends and validates Roger's Innovation Diffusion Theory (Rogers, E 1995, *Diffusion of Innovations*, Free Press, New York – originally published in 1962) that was first applied to IT adoption exploration in Moore, G. & Benbassat, I, (1991) 'Development of an Instrument to measure the perceptions of adoption an information technology innovation', *Information Systems Research*, Vol. 1 , No. 3, pp. 192-222 and further developed in Moore, G. & Benbassat, I. (1996) 'Integrating diffusion of innovations and theory of reasoned action models to predict utilization of information technology by end-users', in *Diffusion and Adoption of Information Technology*, Kautz, K and Pries-Hege, J. (eds), Chapman and Hall, London, pp. 132-146.

²¹ Definitions of these characteristics from Moore and Benbassat, 1991 (ibid) p 195, are as follows:

- Perceptions of usefulness : 'the degree to which a person believes that using a particular system would enhance his or her job performance' (Definition taken from Davis, F. (1989) 'Perceived usefulness, perceived ease of use, and user acceptance of information technology', *MIS Quarterly*, Vol. 13, Iss.3, pp. 319-339.)
- Ease-of-use : 'the degree to which an innovation is perceived as being difficult to use'
- Result demonstrability : 'the tangibility of the results of using the innovation including their observability and communicability'
- Visibility : 'the degree to which one can see others using the system in the organisation' – or, by extension, related organisations, client practices and so on.
- Trial-ability : the extent to which exploration and evaluation of results is possible before committing to adoption.

²² See footnote 21.

²³ Turner, L & Apelt, C. (2004) 'Globalisation innovation and information sharing in tax systems: The Australian experience of the diffusion and adoption of electronic lodgement'. *eJournal of Tax Research*, Vol. 2, No. 2, pp.241-269.

²⁴ Specifically Turner and Apelt (2004 - ibid) use Turner's prior extension of Roger's work from an unpublished PhD thesis where an eight factor conceptual framework was developed

context, technological context, path of entry, effectiveness of champions, roles of key constituents and internal and external networks of support. Despite the perspective of this Australian study being more focused on the tax authorities' processes than on the tax advisers' response, this study produced results supporting similar adoption factors to those explored in this paper providing further justification for their use in this study.

The use of this prior IT adoption literature, it is proposed, could suggest alternative strategies for the HMRC as to how they present e-filing to those advisers yet to be convinced of its value to them now this technology has been released. It also emphasises the different starting points for possible adopters and the need to target particular groups accordingly in aiding their particular conversion paths to seeking effective e-filing solutions. It would suggest, for example, that a focused campaign addressing the extra usefulness offered to advisers would be of greater impact in widening adoption of e-filing by tax advisers than a focus on ease-of-use. Similarly, focusing resources on the 'uncommitted' tax adviser rather than the IT-literate user would also reap dividends for IT adoption levels.

Others have called for more focused research on the contextual factors affecting IT adoption success – including the characteristics of the technology, their interaction with the task characteristics, the impact of multiple implementation stages in a process of innovation and so on.²⁵ These are pertinent issues to this particular case of IT innovation where not only the technology characteristics are changing (manual systems through a proprietary ELS to web-based e-filing) but also the fact that this innovation is being seen by tax advisers as part of an ongoing process of change they can choose to adopt, or not and instead just wait for the next phase to come along later enabling them to 'leapfrog' this (albeit perceived) effectively voluntary, intermediate, stage.²⁶

The potential problems associated with IT innovation adoption success are therefore well documented in the wider IT literature.²⁷

that also 'integrated analytical insights from the sociology of translation to enable the analysis and explanation of the diffusion process for policy innovations' (ibid, p243).

²⁵ See, for example, Kwon, T and Zmud, R. (1987) 'Unifying the fragmented models of information systems implementation.' In *Critical Issues in Information Systems Research*, R. Boland and R. Hirschheim (eds) John Wiley & Sons Ltd, Chichester: UK, pp.227-251.

²⁶ At the present time neither ELS use nor e-filing by tax advisers is required by HMRC for any clients see the 'Developments in e-filing' section later for further discussion of the implications of this position so far adopted by HMRC in respect of e-filing development.

²⁷ Other recent papers discussing aspects of IT adoption that provide insight into issues of FBI use amongst UK tax advisers include: Allen, J. (2000) . 'Information systems as technological innovation'. *Information Technology & People*. Vol. 13, (3); p. 210-228; Craighead, C and Laforge, R. (2003) 'Taxonomy of information technology adoption patterns in manufacturing firms'.. *International Journal of Production Research*. Vol. 41(11). pp.2431-2449; McAfee, A. (2002) 'The impact of enterprise information technology adoption on operational performance: An empirical investigation'. *Production and Operations Management*, Vol. 11 (1), Spring 2002. pp. 33-53; Robey, D, and Zmud, R (1992) 'Research on the Organization of End-User Computing: Theoretical Perspectives from Organization Science'. *Information Technology & People*. Vol. 6 (1); pg. 11- 28; Rogers, E. (1995) 'Diffusion of Innovation' (4th Edition) NY: The Free Press; and Ziamou, P and Ratneshwar, S. (2002) 'Promoting consumer adoption of high-technology products: is more information always better?' *Journal of Consumer Psychology*, Vol. 12 Iss. 4 pp.341-351.

In addition to the issues of how IT adoption occurs in practice, a secondary issue in understanding patterns of e-filing adoption is the question of Internet access amongst tax advisers – given this is critical to ease of adoption of the e-filing solution explored here. Information on diffusion of general Internet access levels in the UK would suggest HMRC has timed their roll-out of e-filing innovation well. By the time this system was initially brought into operation (August 2001) 65% of all UK financial services/insurance businesses were considered to have access to, and be regular users of Internet based business solutions.²⁸ This was second only to the computing industry for levels of Internet connectivity. For financial and insurance industry businesses with 10 or more employees, this level of accessibility rose to 91% of all businesses – the highest of any industry classification in the survey, and even higher than the computing industry.

This retrospective national survey²⁹ would, however, have offered some concerns about the initial successful adoption of e-filing had HMRC known some of the other details this report later provides for us to use with hindsight. For example, despite very high Internet accessibility levels, as indicated, the level of integration of this access with wider business processes is significantly less common. Again focusing on the financial and insurance sector, only 6% of all sized businesses in the sector indicated successful integration of the Internet into their production or service operation.³⁰

e-FILING SA RETURNS; EXPERIENCES IN OTHER COUNTRIES

The results of studies in USA, Australia and Malaysia provide useful benchmarks against which to contextualise the UK adoption developments.

In a US study³¹ the range of enthusiasm for e-filing was explored. The results of this study suggested that social influences play a key role in IT adoption and for some IT is considered to be a social irritant.³² An important finding from this US study was that decisions to file tax returns on-line are independent of the decisions to conduct other transactions with the government on-line.

The largest group of respondents choosing to e-file were those ‘driven’ by their tax adviser who were able to offer an efficient on-line filing solution and were therefore more likely to use e-filing for all of their clients, whenever possible. This highlighted the importance of encouraging adoption amongst tax advisers by tax authorities and the benefits of focusing development and change strategies that will appeal to tax advisers as well as taxpayers.

²⁸ National Office of Statistics (2002) Use of Information and Communication Technologies (ICT) by UK businesses in 2001; sectoral and regional analyses – see http://www.statistics.gov.uk/downloads/theme_economy/TBreport.pdf.

²⁹ Ibid.

³⁰ Ibid Table 5.

³¹ Thomas D, Manly T & Ritsema C (2004) ‘Attitudes towards E-Filing in Middle America’ Paper presented at the American Accounting Association Annual Meeting, San Francisco, August 2005.

³² Redmond WH (2003) ‘Innovation, Diffusion and Institutional Change’, *Journal of Economic Issues*, Vol 37, pp 461-474.

The study also found the converse could apply, with some respondents commenting that ‘nothing would prompt them [their tax adviser] to e-file’.³³ The influence of tax advisers can therefore be negative as well as positive.

In a recent Australian study exploring e-filing adoption³⁴ the two factors of ‘path of entry’ and effectiveness of champions located in government officials were crucial in encouraging adoption and implementation of innovation. Issues of ‘policy context’ was also a factor considered to affect the adoption levels (e.g. the fact that personal taxation is a federal tax not state tax meant the federal government had more control and influence over the policy development). Early adopters were also seen to be important in acting as influencers over subsequent adopters.

E-filing of tax returns forms only part of an individual’s interaction with government departments and this study concluded that broader experiences of e-contact with government enhanced the chances of successful adoption of IT.

A Malaysian study into changing to an Electronic Filing system³⁵ concluded that the level of discomfort with emerging technologies must not be ignored when devising the e-filing system. A good e-filing system, they claimed, needs to be user-friendly, easy to gain access to and easy to use in the context of tax compliance. It also highlights the need for tax authorities to be aware of the intended users’ technological readiness to make changes in order to adopt IT systems. These factors therefore feature highly in this study’s exploration of adoption factors in the UK situation.

e -FILING AND SA DEVELOPMENTS IN THE UK

The above studies re-affirm the conclusions of a widely quoted early study³⁶ that tax advisers have an important role to play in achieving compliant taxpayer behaviour. Another joint UK study³⁷ undertaken by Inland Revenue (now part of HMRC) and the Chartered Institute of Taxation (CIOT)³⁸ again highlighted that greater co-operation between tax authorities and tax advisers can make a substantial difference to the development of better tax policy and practice.

In the UK, from April 2005, e-filing SA tax returns have been moved into the wider Agent’s Online Services (AOLS) system. Given a recognition of the important role of the tax advisers in achieving the UK Government’s electronic services target, the HMRC’s focus has now changed from primarily e-filing alone to the range of e-services that they can offer to tax advisers to help manage client relationships. E-filing of SA tax returns is just one of these services and there is an expectation that 90% of

³³ See Thomas, Manly and Ritsema (2004) (footnote 31) , page 13.

³⁴ Turner L & Apelt C (2004) ‘Globalisation, innovation and information sharing in tax systems: The Australian experience of diffusion and adoption of electronic lodgement’ in *eJournal of Tax Research*, Vol. 2, No. 2, pp.241-269.

³⁵ Lai M-L, Obid S & Meera A (2004) ‘Towards an Electronic Filing System: A Malaysian survey’ *eJournal of Tax Research* Vol. 2, No.1, pp.100 – 112.

³⁶ Sandford, C. and Wallschutzky I (1994) ‘Self-Assessment of Income Tax: Lessons from Australia’ *British Tax Review* pp213 - 220 .

³⁷ Hansford A and Jefferies B (2000) *Income Tax Self Assessment Enquiries* London Chartered Institute of Taxation.

³⁸ Golding R and Hansford A (2001) ‘Improving Self Assessment through Working Together on Collaborative Research’, *British Tax Review* Vol. 6 pp 401 – 406.

AOLS work will relate to information management rather than just the e-filing element.³⁹

RESEARCH METHODS

In reviewing the IT adoption strategies literature the main areas for further investigation therefore are: IT Decisions; pre-adoption / post-adoption issues; ease of use; perceived usefulness, result demonstrability, trial-ability and visibility. These factors should be reviewed in the context not just of tax advisers but also from the perspective of tax authorities and software providers working in the e-filing solutions domain to understand the breadth of adoption factors influencing the tax adviser's choices.

A companion study to this paper⁴⁰ detailed a quantitative exploration undertaken with a large number of tax preparers in the UK. While such studies provide good data to describe collective opinions and facts about a population, they are not easily used for in-depth review of issues. The decision was therefore made by the research team to develop the initial perspectives the quantitative study had revealed with an additional qualitative review.

Ten interviews were undertaken, six with tax advisers who had indicated their willingness to be involved in these interviews following completion of the questionnaire survey, two interviews with key HMRC staff involved in the operation of e-filing in the UK and two interviews with software providers. All interviews undertaken were of a semi-structured nature. A framework of questions was prepared for each group, drawing on the relevant literature and this can be made available by contacting the authors. All interviews were conducted during the first half of 2005 (with the exception of the second software provider who was interviewed at the start of October 2005). The results that follow provide a synthesis of notes taken at each interview by the interview team.

RESULTS

In this section, the results related to e-filing adoption decisions are presented. For the purpose of analysing the results the tax advisers have been classified into three types to illustrate the possible different approaches to e-filing adoption decisions that may be found amongst UK tax agents:

1. non-IT users – those who have little or no IT use in their collection, review and submission systems for client SA tax returns (1 interview – small firm)
2. IT users but non-e-filing adopters – those who utilise IT in their collection and review systems but as yet do not use e-filing. (3 interviews – 2 medium sized firms, one large firm)

³⁹ As at January 2006 17,927 agents had registered to e-file on behalf of their clients via the AOLS scheme and had submitted between them over 600,000 tax returns for the 2004/5 tax year – source: <http://www.hmrc.gov.uk/workingtogether/sa-filing-for-agents.htm> - posted 13th January, 2006 (accessed 19/01/06).

⁴⁰ Lymer A, Hansford, A & Pilkington C (2005) 'Filing By Internet in the UK: The barriers to adoption of filing Self Assessment tax returns by internet', *British Tax Review*, Vol. 5 pp.544-556.

3. IT users/e-filing adopters – those who utilise IT in their collection and review systems and who had already adopted e-filing for at least some clients at the time of the interview. (2 interviews – small firm and medium sized firm)

Delivery of service issues

HMRC are aware that some software companies have made a considerable contribution to the IT-adoption process through active involvement at all stages of development of the e-filing solution options. This has resulted in increased overall IT adoption rates through the incentive to extend their market share and thereby encouraging slower IT companies to change their tax software products to maintain their client base. For HMRC this approach is more cost effective than taking the lead on these developments within the wide-ranging taxpayer population.⁴¹

Delegating some of the adoption support work to software companies also means that tax advisers will find that their tax preparation software is better integrated into other accounts preparation software products, to provide a 'joined-up' accounts and tax package. This approach is favoured by all parties as it begins to create the kind of administrative savings that e-filing should be able deliver.⁴²

There is a tension therefore between what is best for tax advisers and what, realistically, can be provided by HMRC within the budget available.⁴³ HMRC took the decision to work with tax software providers as the primary route to support the tax adviser community. In response, the HMRC portal was therefore primarily designed for non-represented taxpayers. However, this system is less appropriate for tax advisers who would benefit from a system that could be integrated into their 'back office' systems and hence will typically opt for third party software provision.

Two interviewees were in offices where there had been a senior decision not to adopt e-filing as yet and so were classified into an 'IT user/non-e-filing adopter' group by default for the purposes of this study. In both cases of non-adopters interviewed for this study, their firms' decisions not to adopt e-filing at this stage was based on an assessment of their client group and confidence in their current review/filing systems. These tax advisers typically collect (and manipulate internally in their review processes) increasing amounts of information electronically, however, this is not extended to the final stage of the process – i.e. the e-filing itself of tax returns. From a practical day-to-day running of the office, they claim that e-filing holds no perceived benefit for them. Their view is that they had a good, well understood and well operated system (ELS or paper-based submissions) and saw no reason to change at this time

⁴¹ HMRC have directly involved 3rd party vendors on both software provision and banking services support related to e-filing services e.g. in 2003 they advertised for IT partners in 'Government Opportunities' and in Dec 2005 in 'The Banker' to seek partners to aid improvements in banking integration related to e-filing support - Hansards 20 Dec 2005, Column 2807W - <http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmhansrd/cm051220/text/51220w42.htm>.

⁴² The extent to which these potential savings are being in fact actually realised by taxpayers is yet to be determined and could be determined by a follow up study with taxpayers.

⁴³ No separable budget figure is available for this aspect of e-filing development or support under the wider e-government programme.

IT Decisions issues

The tax adviser interviewees covered a range of practices – large / small, IT adopters / non-adopters - and so a range of opinions were reported in the analysis. Those we have classed in the 'IT-adopter/e-filing' type explained and justified their approach to e-filing SA tax returns as simply good business sense. There were several comments about e-filing SA returns as being the way forward, and that in their opinion it "must be the future". One interviewee added a caveat to this however, related to having the correct software and being able to e-file as wide a range of clients and client situations as possible.

HMRC reported that they are aware of these added requirements and expectations, but are concerned in particular about the disproportionate additional costs associated with rarer client situations in developing their system.⁴⁴

The software providers are constantly refining and developing their third party products to enhance the benefits of e-filing, which they considered to be: an instant receipt to confirm filing date, repayments being dealt with within days, knowing that the information is in the HMRC system correctly, no postage costs, in-built 'sanity' checks and validation ensuring the return is unlikely to be rejected by IR.

The non-e-filing tax adviser interviewees did not reject e-filing as a matter of principle. Initial scepticism of the benefits of e-filing SA tax returns had been overcome with familiarity of use (some have been using it now for 3 years and have shared this information across their professional networks), an improved service from HMRC and added functionality of the HMRC e-filing system.

Larger accounting firms, who typically use their own, internally developed, back office management systems, have not been effectively targeted by this roll-out strategy. This is supported by our interviewees where there was no evidence of effective conversion occurring in their firms. It would appear that further work by HMRC is clearly needed if this segment is to be converted to e-filing voluntarily over time. The larger accounting firms typically handle the more complex cases and therefore appear to be being left until a later phase of e-filing development for targeting and direct conversion support.

Review of Adoption Factors

Having reviewed the important issues related to the general process of service delivery and the choice of technology to be used, we next review the specific issues indicated by the IT adoption literature as potentially of relevance to understanding the process and extent of IT adoption in this domain. In this section we explore the extent to which these factors appeared present in our interviewee responses in this particular IT adoption decision and use process.

Pre-adoption / post-adoption issues

The non-IT adopter tax adviser interviewee in our group was clear in the reasons for their firm not adopting as, in their assessment, e-filing was 'not good enough to change from the current system used' – i.e. e-filing alone was not going to encourage

⁴⁴ The aim to cover 80% of taxpayers was cited as a target for the HMRC provided online submission system leaving rarer/more complex cases for internally developed systems or 3rd party provider systems.

them to use more IT in the review process, nor did having an e-filing solution at the end of a manual process justify the change in procedures in and of itself.

In looking in more depth at the reasons behind this general comment it is clear that the type of client was a key factor for this interviewee. They reported that e-filing does not fit with their internal review processes, particularly for the ‘complex’ end of the client spectrum. There was a perception that if e-filing enables the firm to ‘skill down’ something may be missed in the review process. Advisers fitting into this group therefore are demonstrating a lack of *perception of usefulness*, *ease-of-use* and *result demonstrability* as pre-adoption attitudes, as proposed by Karahanna et al (1999) as likely key factors to be found in this group of agents. Also, no evidence of *visibility* and *trial-ability* factors affecting their decisions was present.

As was expected, contrary views to the non-IT adopter interviewee were expressed by the e-filing/IT adopters and the non-e-filing/IT adopter interviewees. These latter interviewees reported that, even with complex cases, e-filing was considered to be “the way ahead for personal tax returns” and overall they are very happy with e-filing processes as currently on offer to them.⁴⁵ The use of legacy software that cannot easily be adjusted for new business practices, however, or continued use of older versions of software pre-e-filing adaptations, may explain the failure to use e-filing amongst non-e-filing/IT adopters interviewed. This suggests that, while *perception of usefulness* and *result demonstrability* seemed strong, they were not pre-adoption factors of adequate influence in the case of the non-adopter group to affect their change to adopter status; rather evidence exists that *ease-of-use* and *trial-ability* were the key factors influencing this decision to not adopt e-filing. No evidence for *visibility* as an influencing factor was found for this group.

TABLE 1 – PRE/POST ADOPTION ATTITUDE FACTORS FOR E-FILING⁴⁶

Factors influencing adoption	Pre-adoption (non-e-filers)		Post adoption (e-filers)
	Non-IT users	IT users	IT users
Perceptions of usefulness	X	X	
Ease-of-use	X?	√	
Result demonstrability	X	X	
Visibility	-	-	
Trial-ability	-	√	
Beliefs of usefulness			√
Perceptions of enhancements			√?

A further impacting factor on the adopt/non-adopt position expressed by interviewees related to the merger/de-merger of tax adviser firms in which they have been involved with. Interviewees suggested that this activity can also complicate matters, particularly

⁴⁵ These interviewees are primarily users of either third party management/filing providers or internally developed software.

⁴⁶ Grey boxes represent adoption factors that the wider adoption literature has illustrated are of little or no significance in pre/ or post adoption situations (i.e. were not tested for in our interviews as the literature argues they are not significant).

if insufficient time and effort are spent on integrating systems activities. This may be coded as an *ease-of-use* factor in the classification used in this research and may exist amongst both non-IT adopters and IT adopters.

When asked to identify any areas of change to benefit e-filing, the committed e-filing/IT-adopters elaborated at length on the benefits they perceived to have gained to their firms, and for their clients, from their decision to move to e-filing. This suggests strong evidence for the IT adoption factor of *beliefs of usefulness*. These interviewees also however, highlighted the problem of not being able to e-file all the pages that may be associated with a client's submission and that e-filing is not available for some taxpayers (e.g. non-domiciled clients and non-resident landlords) suggesting some concerns over *perceptions of enhancements* in their entirety.

Overall, the e-filing/IT adopters considered e-filing to be far better than any manual system, and on the whole, approaching acceptable comparison levels with ELS. However, even within these organisations they admitted to some initial resistance from some members of staff, however, once adoption had occurred, going back was not an option, "...to suggest going back to the manual system, I would have had a riot on my hands". This also suggests that *benefits of usefulness* will have influenced post-adoption perceptions of e-filing.

In reflecting on initial concerns and their current experience of e-filing a typical comment offered by the e-filing/IT adopters was "It [e-filing] must be the way forward - I don't want to have to bother with covering letters etc. and the sooner a complete on-line service is available, the better". Some noted their initial reluctance to change from ELS, but now were convinced of the benefits of e-filing which they considered to be the way ahead. The reduction in paperwork and the speed of tax repayments were particularly appreciated. These factors can again be considered to be *benefits of usefulness* or *perceptions of enhancements* factors.

Overall therefore, evidence seems to have been found in our small sample for IT adopters' factors argued to be important in the IT adoption literature. However, the relevant factors from the literature are much less strongly supported in our sample in the case of non-IT users. Further exploration of the generalisability of these results however, will require further research to confirm.

Ease of use issues

Given the above results, this section focuses on the experiences of the e-filing/IT adopter interviewees in using the current HMRC e-filing system. Changes and developments in the HMRC website and software provision have been met enthusiastically by tax advisers who have adopted e-filing. The HMRC website was an important factor in the assessment of the *ease of use* of the new system for those using this system to e-file on behalf of their clients. One interviewee referred to a particular Saturday and having to deal with a large number of returns when she could "knock them off very quickly" as the HMRC system was functioning well and was **not overstretched**. Developments in the HMRC website rated as positive have been particularly noticed during 2005.

Some of our tax adviser interviewees had corporate clients and so were able to compare the corporate tax (CT) online filing system to e-filing SA personal tax returns. It was noted that there is additional functionality on the CT system, such as they can view real time statements on CT clients, but for SA e-filing only the last

client statement is available⁴⁷ and no archive of prior year tax returns is kept in the system.

There were concerns expressed by more than one interviewee about the repeated initiatives coming from the tax authority - 'usually headed up by a different team of HMRC personnel' which would ... "then grind to a halt, or are parked, for whatever reason. The HMRC IT system has been 20, even 30 years in development and bits are added on all the time". Overall, however, the interviewees appreciated recent developments related to e-filing, and an example provided in one case related to partnerships where linking the partnership return to the individual partners' returns is particularly useful.

The time-saving aspects of e-filing were commented on by each of our three interviewee groups – HMRC, software providers and tax advisers.

Perceived usefulness issues

The views expressed on the costs of using e-filing were mixed. The software developer interviewees were promoting a figure of £25 - £100 saving per return compared to non-e-filing solutions, but this required estimates of several potentially wide variables. Comments from our interviewee tax advisers, however, suggested that they expected e-filing to, at best, be a cost neutral exercise, with the costs saved on performing manual calculation and the accompanying administration, being countered by the additional management time spent in reviewing and controlling work flow. Time issues were a big concern for the smaller firm interviewees where manager level staff (and above) have a greater 'hands-on' role than in larger firms.

There continue to be mixed messages from the tax professional bodies, as the collective representatives of the tax adviser community, over the perceived usefulness of e-filing. Some have taken the view that there is a need to disclose everything, including sending in the accounts, in order to counter an HMRC 'discovery' assessment.⁴⁸ This contrasts with the HMRC view who want Standard Accounting Information (SAI) only provided, together with notes for additional items only if relevant. The SAI is a selection from full accounts information typically produced by businesses that HMRC maintain covers the requirements on the tax adviser for full disclosure. Some within the tax adviser community are not convinced that such disclosures are not too general and therefore e-filing adoption strategies are affected by this wider information exchange issue.

The HMRC helpline was considered to be "excellent and as a sophisticated user the problem I presented was complicated – and the helpline was spot-on". Other areas that were commented on in interviews were the 'Working Together' opportunities whereby HMRC and tax advisers were able to discuss issues that arose from their attempts to move to an e-filing solution. While such initiatives were reported as being useful to

⁴⁷ In the UK HMRC provide SA taxpayers with half yearly statements of account shortly before the payment deadlines for half yearly payments in the UK tax cycle (i.e. before 31 January and 31 July each year).

⁴⁸ Where HMRC can use the fact data is missing from a client's submission to request a wide range of potentially relevant material they would perhaps otherwise not request seeing.

those who have used them, they were not necessarily accessible to all tax advisers and for access to HMRC staff.⁴⁹

Visibility issues

The desirability of the visibility of being e-filing adopters within or between organisations, and with clients, had only limited importance for our interviewees. Our interviewees were more concerned about whether there is enthusiasm more generally for IT development within their firm, and the personnel to move along the changes required to utilise e-filing solutions and did not generally report concerns about how they are viewed by competitors, or, to a less degree, their clients.

Developments for e-filing

The final section of our results evaluation addresses issues related to the future of e-filing. We asked our interviewees an open-ended question related to what developments they would like to see occurring related to e-filing.

A range of responses were revealed by this question, however, one that occurred in more than one interview was that e-filing could follow the UK's PAYE and become mandatory. This is, however, unlikely in the foreseeable future, according to HMRC interviewees in our study. Despite this promise, it is worth perhaps noting that legislation brought into force in FA2002 (section 135 – mandatory e-filing) for ePAYE was so presented as to also allow for mandatory e-filing in other areas.⁵⁰

A possible adoption incentive that was again discussed by more than one of our interviewees was a change in the enquiry window to encourage early e-filing. Currently this is 12 months from the final SA filing date (31st January), but changing this fixed 12 month window could mean that for a return e-filed in August, the enquiry window would end the following year in August – i.e. 5 months earlier than at present. This would ensure certainty occurred earlier and would 'reward' early e-filers. Discussion with HMRC interviewees demonstrated an enthusiasm for this proposal, but it was pointed out that such a proposal would need legislation changes. A recommendation of the recent Lord Carter report into e-services of HMRC, however, was to do exactly this and to remove this perceived barrier to filing income tax self assessment returns and company tax returns by linking the enquiry window to the date the return is filed.⁵¹

Changes in the filing deadline would also be particularly welcomed according to more than one of our interviewees due to the significant impact on their work practices of the current, single, 31st January SA filing deadline which "...effectively removes 2 months from the working year". Using an incentive to e-file that also encouraged earlier submission would therefore have a double benefit both to HMRC and to the tax adviser as, by encouraging early filing, the adviser's (and HMRC's, of course) workload would be spread more evenly throughout the year. A further

⁴⁹ See <http://www.hmrc.gov.uk/workingtogether/index.htm>.

⁵⁰ FA 2002 s135 reads, 'The Commissioners of the Inland Revenue may make regulations requiring the use of electronic communications for the delivery by specified persons of specified information required or authorised to be delivered by or under legislation relating to a tax matter' – i.e. much more vaguely applied than just for mandating PAYE submission would have required alone.

⁵¹ Lord Carter of Coles (2006) 'Review of HMRC Online Services' see <http://www.hmrc.gov.uk/budget2006/carter-review.pdf>.

recommendation of the Carter report⁵², to take effect from 2008, is that income tax self assessment returns should be filed by 30 September on paper or by 30 November online rather than 31 January. Lord Carter subsequently announced that he is to modify this advice however, to instead recommend that the date for SA e-filing should remain as 31 January for online returns and the date for paper returns to be brought forward to 31 October.⁵³

The current level of development of e-filing in the UK was considered by the interviewees to be ahead of other EU countries; with only US and Australia more advanced (as they have longer experience of e-filing). Our interviewees were complimentary about the speed of take up of e-filing by taxpayers. Although they were given an “impossible target” for e-filing SA tax returns HMRC is considered to be “one of the best Government departments at internet issues, particularly considering the complexity of the UK tax system”.

The Carter Report⁵⁴ also included the recommendation that from 2007/08, computer generated paper ‘substitute returns’ for income tax self assessment should no longer be accepted. This implies the third party software providers will be required to provide an e-filing solution as the only submissable output by default from their systems by that stage.

LIMITATIONS AND NEED FOR ENHANCEMENTS TO IT ADOPTION STRATEGY MODELS

This paper attempts to use the results of various prior IT adoption research to explore the factors that are influencing adoption of the new SA e-filing systems in the UK amongst tax preparers. Some limited comparability was found however, only one model (built on the Diffusion of Innovations Theory) has been explored. Recently Ventatesh et al (2003)⁵⁵ attempted to integrate eight technology adoption and use acceptance models into what they have called a *unified theory of acceptance and use of technology* (UTAUT). This model distilled the previously proposed IT adoption and use factors (as discussed in this paper from authors such as Karahanna et al, (1999)⁵⁶) into four core ‘determinants’ for technology acceptance. This theory may provide a richer content for exploration of IT adoption and use factors than previous models and is currently the subject of a number of pieces of research exploring the contributions this theory offers to the various models already well tested in the field.⁵⁷ The research presented in this paper is being extended to review the extra insight provided by UTAUT as part of the next round of updating and enhancement of this work.

A further limitation of the work provided here is the limited number of interviews undertaken, and therefore interviewees’ perspective analysed. It is possible that further

⁵² Ibid.

⁵³ Speech given by Lord Carter of Coles at the ICAEW Tax Faculty Wyman Symposium 10 July 2006.

⁵⁴ see footnote 55.

⁵⁵ Venkatesh, V., Morris, M. Davies G. and Davis F. (2003), ‘User acceptance of Information technology: Toward a Unified View’, *MIS Quarterly*, Vol. 27, No. 3, pp. 425-478, September.

⁵⁶ See footnote 19.

⁵⁷ For example, see Ray, A, Culnan, M and Foxman, E (2006) ‘Understanding Home Computer User Security Behavior’, Paper presented at the American Accounting Association Information Systems Annual Meeting, Phoenix, Arizona, January.

interviews could provide a wider range of adoption factors to be reported, however, as discussed in the research method section above, it is not clear that key factors have been missed from the study with the level of interviews currently undertaken and supporting confirmatory exploration of the results has indicated.

CONCLUSIONS

There are tangible benefits to both HMRC and software providers in encouraging tax advisers to change to e-filing for SA tax returns. The focus of this paper has been to consider the reasons why some tax advisers had adopted e-filing, why some are still reluctant to e-file, and the main aspects of the e-filing system as it currently is operating that may need to change in order to persuade the non-adopters to adopt e-filing.

The IT adoption literature has been used as a framework to assess the tax advisers' decisions as to whether or not to e-file their clients' SA tax returns. The findings from the study have clearly identified the two ends of an adopter distribution curve.

At one end of the tax adviser spectrum there are those who are unlikely to adopt e-filing, whatever the incentives, unless required to. These tax advisers are typically practices which have no, or very limited, IT elements to their client management and review processes and therefore fall outside the factors that normally could be said to influence IT adoption decisions. The results of the study as presented above appear to support this from the limited sample used.

At the other end of the IT adopter spectrum there are a similarly small number of tax advisers who consider e-filing to be a core extension of their wider IT framework for their organisation and so they will adopt e-filing, almost irrespective of the costs involved or efforts required to convert. Again, the IT adoption factors provide limited insight into this category of early adopters. The focus of this paper has therefore been on those tax advisers within these two extremes, for whom changes in IT adoption strategies can influence their e-filing decision.

The study demonstrated that the key factors that impact on the decision to e-file for such a diverse group as UK tax advisers are very wide and varied. They include; a conducive working environment with IT being a main delivery vehicle for other office functions, a workforce with an IT motivation – often visible in a firm in the form of an IT champion (overt or covert), and the level and success of experience of working with ELS as an influencing factor on perceptions of usefulness.

Tax advisers interviewed as part of this study were clear about areas that could influence their decisions to e-file SA tax returns. Getting over the apprehensiveness of the reluctant e-filing adopters required good software products that fitted in with other office functions, and overcoming any reluctance to trust the HMRC's IT capabilities and operational efficiencies e.g. attachments and utilising white space effectively. Payments to act as an incentive to e-file, perhaps similar to the 2005 system for PAYE, were considered to be a very effective encouragement and one that tax advisers would welcome. It would go some way to compensate for the added training and equipment costs required to adopt e-filing and address the reluctance of some clients who feel unhappy about adding costs solely for the benefit of HMRC. However, the alternative of offering a revised (shortened) enquiry window was also considered to be potentially of significant impact, even if used without the cash

inducement. Security and privacy were of significant concern to tax advisers but visibility was of little importance.

Overall, for the vast majority of tax advisers, the assessment of the current developments of e-filing SA tax returns was positive. This study has illustrated that e-filing was expected to develop and expand to all but the most reluctant tax adviser practices within the next few years. Payments to encourage e-filing and measures to ensure confidence in HMRC IT systems were the overriding requirements to support widespread adoption of e-filing SA tax returns.