

eJournal of Tax Research

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eJournal of Tax Research

EDITORS' NOTE

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

SUBMISSION OF ORIGINAL MATERIAL

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 Submission of a manuscript is taken to imply that it is an unpublished work and has not already been submitted for publication elsewhere.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



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Editorial Announcements

It is my sad duty to inform you that Professor Michael Walpole has resigned from his position as joint editor of the *eJournal of Tax Research* to take up the joint editorship of *Australian Tax Review*, a leading tax law journal in Australia. Michael felt there could be a perceived conflict of interest if he were to be an editor on both journals simultaneously. Michael became a joint editor of the *eJournal* in August 2004 and has made invaluable contributions to the *eJournal*, especially during the recent ARC journal ranking exercise. On behalf of the *eJournal*, I wish to take this opportunity to acknowledge our thanks to Michael and wish him all the best in his new venture.

As you know, the composition of the Editorial Board of the *eJournal* has remained basically unchanged since its inception in 2003. Over the years the Board lost Justice Graham Hill as a result of his premature passing. In reviewing the future directions of the *eJournal*, it is felt that there is a need to expand the membership of the Editorial Board. I am thus very pleased to announce that Dr Dale Pinto, Professor of Taxation Law at Curtin University, Australia, has accepted an invitation to join the Editorial Board of the *eJournal*. Please join me in congratulating Dale and I look forward to Dale's contributions to the *eJournal* in the near future.

Binh Tran-Nam
Joint editor of the *eJournal of Tax Research*
June 2010

Financial Institutions' Tax Disclosures and Discourse: Analysing Recent Australasian Evidence

Adrian Sawyer *

Abstract

Litigation involving structured finance transactions by New Zealand's largest banks has dominated the tax avoidance scene in New Zealand. Disclosures by these banks in their financial statements have received minimal attention. In this paper I trace the developments in the disclosures from 2004 through to 2009. This study finds that the banks have been defensive in their discourse, arguing that their positions were supported by expert advice, and quick to indicate that they will challenge all assessments and appeal any unfavourable judgments. Financial provision for the impact following the Commissioner's litigation successes and the recent settlement agreement has commenced.

1.0 INTRODUCTION

This paper forms part of a wider project examining the (alleged) tax avoidance activity of New Zealand's largest banks (most of which are Australian owned). The amount of tax and interest in dispute is significant (estimated at \$NZ2.75 billion (excluding any penalties), which is approximately 2 percent of New Zealand's gross domestic product (GDP) and between 4-5 percent of 2009 tax revenues). Earlier work (Sawyer, 2008) has examined the twenty five decisions largely focusing on technical issues (including secrecy issues), prior to the first substantive decision on tax avoidance where the Commissioner of Inland Revenue (Commissioner) was successful against the Bank of New Zealand (BNZ).

This purpose of this paper is to examine the disclosures by the large banks in their financial statements and regulatory disclosure statements with respect to their disputes with the Inland Revenue Department (IRD) over various structured finance transactions. Its motivation is to critically examine, through analyzing financial statements and discourse, the banks' public posturing defending their positions that their structured financing transactions were not tax avoidance (partially on the basis of expert advice supporting their position) and that they would rigorously challenge the Commissioner's assessments.

* Professor of Taxation, Department of Accounting and Information Systems, University of Canterbury, Christchurch New Zealand. Email: adrian.sawyer@canterbury.ac.nz. This paper was prepared while holding the position of Research Fellow in the Australian School of Taxation (Atax), University of New South Wales. The funding and opportunity to undertake this research is gratefully acknowledged. This paper examines the available disclosures of the banks as at 24 December 2009. I am grateful for the useful comments received from the reviewer on an earlier version of this paper.

Future work within the umbrella of the larger project intends to examine the implications of the settlement agreement reached between the banks and Inland Revenue. This is intended to be followed by critical analysis of the impact of the structured finance litigation from economic and jurisprudential perspectives.

The remainder of this paper is organised as follows. Section 2 discusses the disclosures by banks outlining the general issues involved. This is followed in section 3 by a brief overview of the key areas of tax disclosures in financial statements. Section 4 outlines the limited prior literature and details the methodology followed in this paper. Section 5 briefly outlines the banks included in the analysis, namely: ANZ National Bank (part of ANZ Australia), BNZ (owned by National Australia Bank, NAB), ASB Bank (owned by the Commonwealth Bank of Australia, CBA), Rabobank (Netherlands) & Westpac (owned by Westpac Banking Corporation, Australia). Section 6 outlines the essence of the structured finance transactions that were the subject of the disputes with the IRD. This is followed by the focus of the study in section 7, the tax dispute disclosures and discourse of the New Zealand banks. Section 8 provides a brief overview of the surprise settlements reached between the banks and the IRD in late December 2009. Section 9 provides further discussion and analysis, and asks what can we learn from the disclosures and discourse concerning tax disputes? This is followed in section 10 with the conclusions, limitations and areas for future research.

2.0 DISCLOSURES BY BANKS IN FINANCIAL STATEMENTS

Registered banks in New Zealand must report, for financial purposes, in a similar manner to other issuers, but they have a number of different characteristics, including high levels of debt to equity (a result of a small capital base), along with other financial reporting disclosure obligations. In addition to producing financial statements, banks are required to produce general (and specific) disclosure statements as required by the central bank (in New Zealand this is the Reserve Bank of New Zealand, RBNZ).

In the notes to their financial statements, contingent liabilities need to be disclosed as required by applicable reporting standards. In New Zealand the requirements were set out in Financial Reporting Standard (FRS) 15 (*Provisions, Contingent Liabilities and Contingent Assets*). In Australia this was governed by Australian Accounting Standards Board (AASB) Statement 1044 (*Provisions, Contingent Liabilities and Contingent Assets*). With the advent of International Financial Reporting Standards (IFRS), for New Zealand disclosure is now governed by NZ IAS 37 (*Provisions, Contingent Liabilities and Contingent Assets*) and for Australia disclosure is governed by AASB 137 (*Provisions, Contingent Liabilities and Contingent Assets*).

Of particular interest to this study is the level and nature of disclosure, including the position taken by banks with respect to the likelihood of their contingent liabilities from their disputes with the IRD materialising. The study also examines whether the flavour of the disclosures changes with time and new developments.

3.0 TAX DISCLOSURES IN FINANCIAL STATEMENTS

The key disclosures in relation to taxation in financial statements for the purposes of this study (for the banks under review) include:

- Significant accounting policies (including consolidation, income tax, and goods and services tax (GST));
- Income tax expense (including current tax, deferred tax, reconciliation of tax expense to pre-tax accounting profit);
- Deferred tax balances & movements (recognized & unrecognized);
- Imputation Credit Account (Franking Credit Account) balances & movements.

In addition to the Profit & Loss (Income) Statement, Balance Sheet (Statement of Financial Position), and Statement of Cash Flows, tax disclosures may also appear in various notes to the financial statements, such as Provisions, Contingent Liabilities & Contingent Assets. Also in New Zealand FRS 19 (*Accounting for Goods and Services Tax*) applies for financial reporting purposes.

It is important to note that the purpose of this paper is not to relate the disclosures in financial statements of a number of major New Zealand banks to the relevant accounting standards to ascertain the extent to which the banks have complied with the disclosure requirements. Such an exercise would require a study of compliance with reporting disclosure obligations and would need to be wider than merely disclosures with respect to the structured finance disputes. Such a study is also likely to make observations concerning whether the disclosures requirements are sufficient to achieve their purpose, and hence beyond the scope of this paper. With respect to disclosures in financial statements this paper seeks to examine what may be gleaned from the disclosures in financial statements prepared in accordance with the current reporting frameworks of Australia and New Zealand. It does not seek to examine the adequacy of the requirements and suggest whether further obligations or guidance with respect to disclosures is warranted. Neither does this paper intend to analyse the methodology relating to financial statement disclosures other than to examine financial statement disclosures utilising the lens of discourse analysis, which is introduced in the latter parts of the next section.

4.0 PRIOR STUDIES AND METHODOLOGY

Outside of financial reporting studies generally, there is scant prior research on the tax disclosures of banks in Australasia, and unsurprisingly little on the structured finance disputes between the New Zealand banks and the IRD. One important contribution is that of Newberry (2005), who reviews the BNZ's and Westpac's financial statements. She notes that for the BNZ, had it included the additional tax of \$NZ416 million (in dispute with the IRD) for the 1999 to 2005 years, its effective tax rate (ETR), measured as tax expense over net profit, would be on average 33 percent (the applicable statutory rate) for this period. Table 1 from Newberry's (2005) study is reproduced below setting out the BNZ's actual ETRs:

TABLE 1: BANK OF NEW ZEALAND: TAX EXPENSE COMPARED WITH OPERATING PROFIT BEFORE TAX

	Total	2005	2004	2003	2002	2001	2000	1999
\$NZ	\$mill	\$mill	\$mill	\$mill	\$mill	\$mill	\$mill	\$mill
Operating profit before tax	4,375	710	625	752	750	587	513	438
Tax expense	1,046	169	154	204	168	147	124	80
Tax expense as % of profit	24%	24%	25%	27%	22%	25%	24%	18%

With regard to Westpac, Newberry (2005) is unable to clearly determine the appropriate figures since there are discrepancies between Westpac, and Westpac Banking Corporation (the Australian parent - NZ segment). However, for Westpac, for whatever basis is used, if the additional tax is added back to the tax expense, Newberry (2005) reports that the ETR would be at, or above, the statutory rate (33 percent) for each year. I have reproduced only the Westpac table:

TABLE 2: WESTPAC NZ BANKING GROUP: TAX EXPENSE COMPARED WITH OPERATING PROFIT BEFORE TAX

As reported in NZ	Total	2005	2004	2003	2002	2001	2000	1999
	NZ\$mill	NZ\$mill	NZ\$mill	NZ\$mill	NZ\$mill	NZ\$mill	NZ\$mill	NZ\$mill
Operating profit before tax	4,972	917	918	667	786	610	579	495
Tax expense	1,398	292	297	203	168	131	144	163
Tax expense as % of profit	28%	32%	33%	30%	22%	22%	25%	33%

Newberry (2005) summarises her analysis by stating (emphasis added):

“Both [BNZ and Westpac] are required by law to observe financial reporting standards, but those standards do not allow clear identification of actual tax assessed, and tax records filed with the IRD are not publicly accessible. *There is little in their financial reports to help with assessing the banks' tax activities other than the disclosures provided by both banks of the amount of tax under dispute.*”

The highlighted portion taken from Newberry (2005) suggests that improvements in disclosure obligations with respect to important events may be warranted, but as indicated in the previous section of this paper, this issue is beyond the scope of this study. Newberry (2005) notes that both the BNZ and Westpac appear to have stopped engaging in structured financing transactions. This should not come as a surprise given the IRD audit activity, litigation and subsequent change in the legislation enacted during 2005. Nevertheless, Newberry (2005) comments that in late 2005 permissions issued to Westpac by the New Zealand Overseas Investment Commission (OIC) suggest the need to remain alert for the effects of other structured finance arrangements. Details from the OIC approvals reveal that the amounts involved are around \$NZ2 billion.

With respect to the subject matter, the disclosures in financial statements concerning a series of major tax disputes, this study sets a benchmark for comparison with future

studies. It does so in regard to analysing a series of major events (the ongoing investigation and subsequent litigation with the IRD) that affected a number of similarly situated major businesses (major New Zealand trading banks predominately owned by Australian parent banks) and the approach by which these businesses chose to publicly disclose these events and their impact upon their financial statements. It also benefits from a degree of closure in that in the midst of the "battle" the banks have agreed to settle with the IRD, a decision which should significantly impact the 'final' series of disclosures required for the banks' 2010 financial statements.

In terms of the methodology of this paper, it adopts of a form of discourse analysis, supplemented by critique of the statements made by the banks analysed. Discourse analysis is a general term for describing a number of approaches to analysing written, spoken or signed language use. Discourse analysis can be characterised as a way of approaching and thinking about a problem. Discourse analysis will enable the researcher to reveal the hidden motivations behind a text or behind the choice of a particular method of research to interpret that text.

Discourse analysis has been applied to regulatory processes as this is a communicative activity. Black (2002, pp 164-5) makes the following insightful observation:

"Discourse analysis would go one step further in its own justification, for it contends that social action can be comprehended only by comprehending discourse, that discourse is the basis of social action in that it is constitutive, functional, and coordinative. It is constitutive in that it builds objects, worlds, minds, identities, and social relations, not just reflects them. *It is functional in that it is designed to achieve certain ends, for example, to persuade (its rhetorical and argumentative aspect).* It is coordinating in that in the activity of producing meaning and shared senses it requires and produces coordination, and the possibility of coordination is at the basis of social life." (emphasised added)

Discourse analysis is also used in accounting and in relation to financial statement analysis. For example, in Gallhofer et al (1999/2000) the authors argue that accounting is shaped by a culture of spin and that it is important to continue to monitor and critique accounting practice. Craig and Amernic (2004) provide an insightful analysis of Enron discourse as a case study example of micro-discourse. Llewellyn and Milne (2007) provide an overview of accounting as codified discourse. In relation to taxation, Flowerdew and Wan (2006) provide the results of their empirical analysis into the tax accounting discourse community (through examining tax computation letters), utilising business genre analysis (linguistic choices in preparation of communication material). Amernic and Craig (2009) offer a review of empirical evidence of accounting discourse in order to understand accounting as a conceptual metaphor.

In this paper the subject matter is external financial statement information, especially notes to the financial statements. Thus this research forms part of financial accounting analysis, and to this end, the aim is to establish the motivations behind the discourse contained in the financial statement disclosure text of the subject matter (major New Zealand banks) in relation to a significant event (IRD investigations and subsequent disputes over structured financing transactions, leading to a surprise settlement between the parties in late 2009). In this paper I seek to demonstrate that notwithstanding attempts to draw a favourable picture, through a form of public

discourse in financial statements, a defensive approach that does not impartially incorporate all of the evidence can come 'unstuck', and in itself lead to another discourse, namely downplaying the major back down of the banks in agreeing to settle with the IRD.

It is acknowledged that there is support for, and criticism of, discourse analysis as a theoretical paradigm. It is not the intention of this paper to contribute to that debate other than offer another instance of where discourse analysis assists in understanding the message conveyed in financial statements with respect to tax disclosures.

5.0 BANKS INCLUDED IN THE ANALYSIS

5.1 ANZ National Bank

This bank was formerly two banks: ANZ Bank and the National Bank of New Zealand (NBNZ – this was formerly owned by Lloyds TSB – United Kingdom - until late 2003). The tax dispute with the IRD commenced while the banks were separate entities, but the disputes (and associated assessments) have been amalgamated to represent the new banking arrangements. Financial information is now only available for the merged banking operations in New Zealand. The estimated tax in dispute is \$NZ365 million plus \$NZ203 interest and potentially shortfall penalties (ranging from 20 percent to 100 percent).¹ ANZ-National Bank is owned by the ANZ Bank (Australia).

5.2 ASB Bank

There are no separate financial statements prepared for the ASB Bank with all information obtained from the Commonwealth Bank of Australia's (CBA's) financial statements, drawing primarily upon the ASB Bank segmental reporting. The ASB Bank is reported to have \$NZ280 million in dispute (including interest) and potentially penalties (of 20 percent up to 100 percent). CBA is an Australian-owned bank.

5.3 BNZ

Separate financial statements are produced for the BNZ which is wholly owned by National Australia Bank (NAB) – an Australian-owned bank. The BNZ was the first to have its substantive tax avoidance case heard in the High Court in Wellington. It was unsuccessful in defending the Commissioner's allegations of tax avoidance with \$NZ416 million due in additional tax plus \$NZ238 million interest.² This total sum (\$NZ654 million) may go as high as \$NZ830 million with inclusion of the 100 percent abusive tax position shortfall penalty,³ or increase to \$NZ737 million with a 20 percent shortfall penalty (such as for an unacceptable interpretation/unacceptable tax position⁴). This decision was appealed to the Court of Appeal with judgment originally expected in 2010.

¹ Shortfall penalties are provided for in Part IX of the Tax Administration Act 1994 (TAA 1994).

² *BNZ Investments Ltd v CIR*, (2009) 24 NZTC 23,582.

³ This penalty is provided by s 141D of the TAA 1994.

⁴ This penalty is provided for by s 141B of the TAA 1994. The penalty was originally for taking an unacceptable interpretation, but was changed for tax positions taken on or after 1 April 2003.

5.4 Rabobank NZ

Rabobank is a small player for which there are no separate New Zealand financial statements. Limited information (from 2006 onwards) may be obtained from its parent based in the Netherlands. No publicly available figures of the tax assessments have been released.

5.5 Westpac

Separate financial statements are prepared for the New Zealand operations of this bank. Westpac received the decision regarding its substantive tax avoidance case before the High Court in Auckland in October 2009.⁵ It was unsuccessful in defending the Commissioner's allegations of tax avoidance with \$NZ586 million due in tax plus \$NZ325 million of interest, and potentially shortfall penalties (ranging from 20 percent to 100 percent). With shortfall penalties included (and based on current amounts of interest) this could see the total sum fall in the range of \$NZ1.028 billion to \$NZ1.487 billion. The decision was appealed to the Court of Appeal. Westpac is owned by its Australian parent, Westpac Banking Corporation.

One bank (Deutsch Bank A G) settled with the IRD early in the piece and is thus not included in this analysis. The settlement terms are confidential, although public information suggests that the tax in dispute was in the vicinity of \$NZ75 million.

6.0 THE ESSENCE OF THE STRUCTURED FINANCE TRANSACTIONS

While there are a number of subtle differences between the structured finance transactions that are the subject of the various disputes, they have a number of similarities. The following discussion is based on the transactions described in the BNZ High Court judgment.⁶

Essentially the New Zealand banks (ANZ National Bank, ASB Bank, BNZ, Rabobank and Westpac) entered into a number of similar structured financing transactions known as 'repo' deals. Under a repo arrangement, A, the holder of shares or other securities, sells them to B on terms that B will sell them back to A at an agreed time and price. The transaction is regarded as secured collateralized borrowing by financial markets. Economically, a repo is similar to a loan, particularly one secured by a pledge of shares.

Under the repo deals, the New Zealand bank made an equity investment in an overseas entity on terms requiring the overseas counterparty to repurchase that investment when the transaction terminated. The parent of the overseas counterparty would guarantee the repurchase, by its subsidiary, for a fee (the guarantee arrangement fee (GAF) or guarantee procurement fee (GPF)). The New Zealand bank's subsidiary would pay the fee to the overseas counterparty to procure that guarantee from its parent.

The return to the New Zealand bank's subsidiary from this funding arrangement was to come from distributions it would derive, through its equity interest, from the overseas counterparty. The amount actually received would take into account an

⁵ *Westpac Banking Corporation v CIR*, (2009) 24 NZTC 23,834.

⁶ See n 2 above.

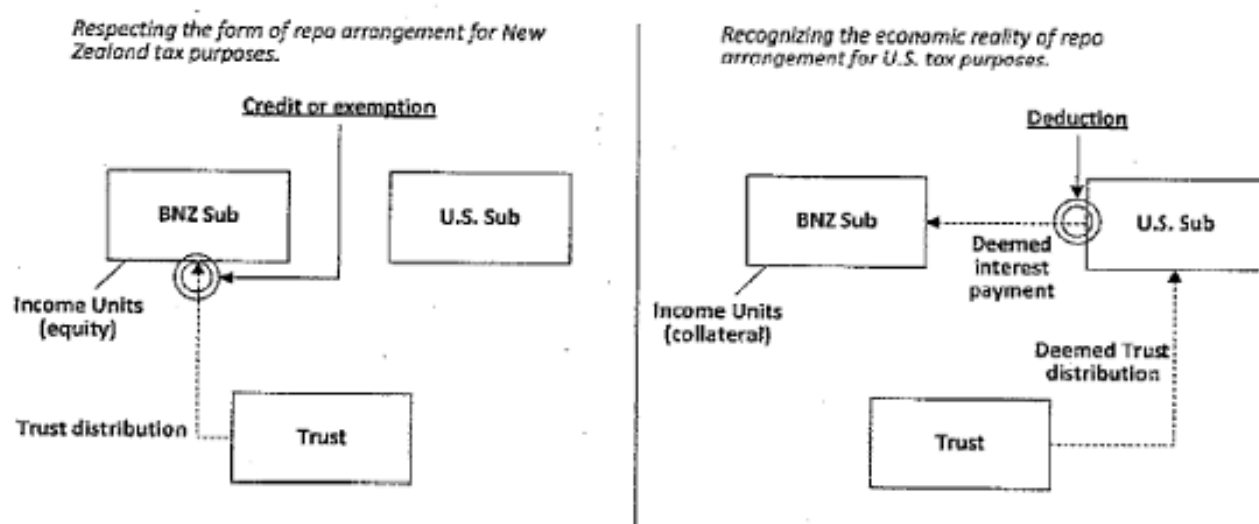
interest rate swap arrangement between the parties included in the transaction, the guarantee fee expense, and the borrowing costs of the taxpayer's subsidiary.

The transactions were structured to enable the New Zealand banks to deduct the cost of borrowing, the guarantee fee expense and the net cost incurred in the interest rate swap. The New Zealand banks would treat the distributions it received as tax exempt income, either as distributions received from an overseas owned company, or under foreign tax credit provisions.

New Zealand tax law treated the transactions as equity investments, the counterparties' jurisdictions (the United Kingdom, United States or elsewhere) treated the transactions as secured loans. This enabled the counterparties to deduct, as interest, the distribution they made which the taxpayer received free of tax in New Zealand.

The following (figure 1) is taken from the BNZ High Court judgment to reflect the essence of the mismatch between the New Zealand and United States treatment of the structured finance transactions. More complex examples are included in the judgment.

FIGURE 1: FORM VS. ECONOMIC REALITY OF THE REPO ARRANGEMENT



7.0 TAX DISPUTE DISCLOSURES AND DISCOURSE BY NEW ZEALAND BANKS

This portion of the study traces the evolution in disclosures by each of the banks individually, up to the latest developments in December 2009. To set the scene, the IRD audited the financial statements of the banks for the 2000-2005 income years (for the BNZ the audits went back to its 1998 financial statements). In 2005 the New Zealand Government amended the income tax law to alter the tax treatment of such transactions (from 1 July 2005), limiting the future impact of such transactions.⁷ Tax disclosures concerning the structured finance transactions audits (and subsequent litigation commenced) in the 2004 financial statements for most of the banks.

⁷ See sections FB 8B to FB 8J of the Income Tax Act 2004 inserted by the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005.

7.1 ANZ National Bank

The first disclosure for the ANZ National Bank appears in its 2004 financial statements in the Notes section: *Contingent Liabilities*. This Note refers to Notices of Proposed Adjustment (NOPAs) received from IRD for one transaction in the 2000 year.⁸ It explains the nature of NOPAs, such that they are not an assessment and do not establish a tax liability. The estimated effect if the IRD took the same position on other transactions is given (\$NZ348 million including interest), with \$NZ116 million of indemnity from Lloyds TSB for the NBNZ as part of the acquisition arrangements). The bank states it has sufficient provisions and downplays the issue through using neutral language.

In the 2005 financial statements, the Notes refer to the Australian Tax Office's (ATO's) risk reviews and other settlements. The Note also refers to NOPAs, with an estimated effect given (\$NZ432 million (including interest), with \$NZ124 million of indemnity from Lloyds TSB). The bank notes other normal audits are underway in the United Kingdom, United States and other jurisdictions. The bank also states that it holds sufficient provisions and downplays the issue again through using neutral language.

There is no separate disclosure available for the 2006 year in the financial statements, which is surprising given the publicity over the ongoing disputes between the bank and the IRD. However, in 2007 the financial statements include similar comments to that which appeared in the 2005 financial statements. The Notes refer to normal audits occurring in New Zealand and other jurisdictions. The Notes also refer to NOPAs, with estimated effect (\$NZ506 million (including interest), with \$NZ142 million of indemnity from Lloyds TSB). The bank states that it holds sufficient provisions and once again it uses neutral language.

In the 2008 financial statements, reference is again made to the ATO reviewing transactions (including structured financing transactions) with some assessments being challenged. The Notes also refer to NOPAs, with an estimated effect (\$NZ541 million (including interest), with \$NZ151 million of indemnity from Lloyds TSB). Further detail is provided on the transactions under dispute. The bank states that it holds sufficient provisions, but that based on advice it is confident its approach is correct. The language used is more defensive than previously adopted.

In the interim 2009 financial statements (the nine months to 30 June 2009), reference is made to the court decision (of 16 July 2009) in favour of the IRD (against the BNZ). The bank refers to disputing its assessments, with an estimated effect (\$NZ568 million (including interest), with \$NZ159 million of indemnity from Lloyds TSB). The bank states that it holds sufficient provisions, and that based on advice they are confident their approach is correct. Reference is made to the possibility of penalties, but that application is inappropriate and unlikely. Defensive language is used once again. The ANZ-National Bank publicly indicated that it is continuing to challenge the Commissioner's assessments notwithstanding events regarding BNZ's and Westpac's court cases. That said the ANZ-National Bank's commitment to challenging the assessments ceased with the settlement reached on 23 December 2009.

⁸ The process for preparing and issuing NOPAs is set out in sections 89B to 89L of the TAA 1994.

7.2 ASB Bank

All information is contained in the parent bank's financial statement (CBA) since there are no separate financial statements prepared for the ASB Bank that are publicly available. The first mention is in the 2004 financial statements in the Note on *Income Tax Expense*. Reference is made to audits by the IRD focusing on structured financing transactions as part of normal IRD procedures, with no assessments issued at this time. Neutral language is used. The 2005 financial statements include a similar statement to the previous year's financial statements.

In the 2006 financial statements reference is made to audits of structured financing transactions as part of an industry-wide review, and of receipt of an assessment for the 2001 year, with NOPAs issued for other years. The bank states that it is confident the tax treatment adopted is correct and any assessments received will be disputed. Thus strong (and defensive) language is used.

In the 2007 financial statements, similar statements are made (using strong, defensive language) as in 2006. The ASB Bank states that assessments have now been received for transactions in 2001 and 2002.

The 2008 financial statements are most peculiar in that there is absolutely no reference in any of the Notes (or elsewhere) to the IRD's NOPAs and assessments. This omission aside it was public knowledge that such IRD activities were continuing with respect to the ASB Bank and the other banks with respect to the structured finance transactions. This failure to make disclosures is very misleading and brings into question the rigour of the reporting standards.

In the 2009 financial statements no reference is made to the NOPAs and the ongoing disputes with the IRD. This would appear to be a failure to make a material disclosure with non-disclosure certainly not going to make the disputes go away. Interestingly the ASB Bank (through its parent CBA) does not provide in the financial statements any quantitative estimates of the tax and interest in dispute. That said the ASB Bank's position regarding its structured finance dispute with the IRD changed with the settlement reached on 23 December 2009.

7.3 BNZ

The first reference to the IRD's actions concerning the BNZ appears in the *Pending Proceedings or Arbitration* section of the 2004 financial statements and in the *Contingent Liabilities* Note. In the Notes the bank advises of receiving assessments from the IRD on its structured finance transactions. Strong language is used such that the bank is confident that its position on the tax law is correct, that it has received independent legal advice supporting its position, and that it is disputing the IRD's position. Note 34 contains extensive detail (emphasis added) in this regard:

“Amended assessment from the Inland Revenue Department – structured finance transactions

The New Zealand Inland Revenue Department (the “IRD”) is carrying out an industry wide review of structured finance transactions. A wholly-owned subsidiary of the Bank, BNZ Investments Limited, together with some of its subsidiaries, have received amended tax assessments from the IRD with respect to three structured finance transactions entered into in the 1998 and

1999 income years. The amended assessments are for income tax of approximately \$36 million. Interest would be payable on this amount, and the possible application of penalties has yet to be considered by the IRD. *In addition, the IRD has also issued amended assessments based on an alternative approach to reassessing the transactions. This alternative approach results in a lower additional tax liability.*

The IRD has not yet issued amended assessments for these three disputed transactions for income years after 1999. Notwithstanding that, based on the assessments received to date, the maximum sum of primary tax which the IRD might claim for the years from 2000 to 2004 is approximately \$240 million.

The IRD is also reviewing further transactions of a similar nature to the disputed transactions. An estimate for the year ended 30 September 2004 of the maximum sum of primary tax that the IRD might assess for these further transactions is approximately \$111 million.

As at 30 September 2004, if the IRD reassessed all structured finance transactions of this nature, the maximum tax liability in dispute is likely to be \$387 million. In addition, interest would be payable on this amount of \$86 million (net of tax).

The Banking Group is confident that its position in relation to the application of the taxation law is correct and is disputing the IRD's position with respect to these transactions. The Banking Group has obtained legal opinions that confirm that the transactions complied with New Zealand tax law.

The financial effect of the unpaid balance of the amounts owing under the amended assessments has not been brought to account in the General Disclosure Statement for the year ended 30 September 2004. The Banking Group will maintain its existing tax treatment of the transactions until amended tax legislation comes into effect on 1 July 2005."

In the 2005 financial statements, similar statements are made to those in the 2004 financial statements (using strong language), with minor wording changes in Note 35. Updated financial information is provided with assessments of \$NZ47 million for the 1998 and 1999 income years, along with information on the NOPAs for the 2000-2002 years. The maximum tax assessed is expected to be \$NZ416 million plus \$NZ117 million interest for all structured finance transactions under review. It is noted that all structured finance transactions *matured or were terminated by 30 June 2005*. Brief mention is made that the IRD had yet to consider the possibility of penalties.

In the 2006 financial statements, once again similar statements are made to the previous year's financial statements, with minor wording changes in Note 42. Updated financial information is provided of \$NZ47 million for the 1998 to 2002 income years (with maximum tax of \$NZ256 million, plus interest for this period). The overall maximum tax assessed is expected to be \$NZ416 million plus \$NZ149 million interest for all structured finance transactions under review. It is noted that the New Zealand

Government introduced legislation effective 1 July 2005⁹ to address the concerns it had with such transactions entered into by banks. The BNZ also notes that all such transactions subject to the investigation *were terminated* by 30 June 2005. The BNZ also advised that it had now commenced legal proceedings to challenge the IRD's assessments. Throughout strong and defensive language is used.

In the 2007 financial statements, once again similar statements were included to the previous year, noting that the IRD had now completed its review of structured finance transactions in the banking industry. The maximum tax assessed is expected to be \$NZ416 million plus \$NZ183 million interest for all structured finance transactions. The BNZ persists with using defensive language in its approach.

In the 2008 financial statements, similar statements are made to those made in 2007, although in 2008 these statements are somewhat briefer in their content. The maximum tax assessed is likely to be \$NZ416 million plus \$NZ217 million interest. Defensive language continues to be used.

In a media release on 28 April the CEO was upbeat, reporting a solid net profit. However, the 2009 financial statements make reference to a number of significant events during the financial year. The bank makes the following comment, using strong language regarding the litigation; see *Pending Proceedings or Arbitration* (emphasis added):

“Certain members of the Banking Group have received amended tax assessments from the Inland Revenue Department (the “IRD”) in respect of certain structured finance transactions. These amended assessments were challenged in the High Court and a judgment was delivered on 15 July 2009, finding against the Banking Group. *The Banking Group considers that elements of the judgment are wrong in fact and law and has lodged an appeal with the Court of Appeal. Penalties, which could possibly be up to 100% of the tax shortfall, have not yet been imposed by the IRD. ...*”

Furthermore, in Note 42, similar comments to those included in the 2008 financial statements are included with respect to the IRD assessments, and to the above statement regarding the court proceedings (a further detail provided is that the appeal lodgement date is 11 August 2009). More importantly, the bank has made a provision of \$NZ661 million (tax \$NZ416 million, and interest and associated costs of \$NZ245 million (net of tax)) in its Income Statement for this period, leaving a loss for the year of \$NZ181 million. At last the defensive approach has given way to “acceptance” and quantification of the impact of the ongoing dispute with the IRD. That said the BNZ remained committed to pursuing its appeal until the settlement reached on 23 December 2009.

Similar disclosures regarding the BNZ's tax dispute over the period of review have been included in the NAB's financial statements. The NAB has made a provision for \$A524 million should the BNZ fail in its appeal. However, in setting up various subsidiaries to issue shares to the public in 2008, no disclosures of the BNZ parent company's disputes and litigation over the structured financing transactions were made in the prospectus or subsequent financial statements. Potential investors would

⁹ See note 2 above.

need to investigate BNZ's financial statements to be appraised of the situation and determine how this may impact upon their decision to invest.

7.4 Rabobank

This bank has provided minimal disclosure, with the first mention of the dispute with the IRD (that I have been able to source) appearing in the 2007 financial statements. However, it is the smallest of the banks subject to investigation for structured finance transactions. The bank concludes with strong language, as evidenced in Note 29 *Contingent Liabilities* (emphasis added):

“The Inland Revenue Department (the “IRD”) is carrying out a review of certain structured finance transactions in the banking industry.

The Bank and its wholly-owned controlled entity have received Notices of Proposed Adjustments (“NOPAs”) for the 2001 to 2004 tax years from the IRD with respect to certain structured finance transactions.

These notices do not create a tax obligation for the Bank, but advise of the IRD's intention to issue amended assessments for those years.

The Bank has obtained independent legal advice that confirms the transactions complied with New Zealand tax law.”

In the 2008 financial statements (to 31 December 2008), the language is more direct in that the bank advises that the IRD was disputing structured finance transactions, with several court cases under way with hearing dates assigned. There is no quantification of the bank's potential exposure. At the time of writing in 2009 no further information is publicly available regarding the structured finance disputes or the bank's position with respect to the 23 December 2009 settlements.

7.5 Westpac

The first reference to the dispute with the IRD is made in the 2004 financial statements. Brief mention also appears in Note 34 *Contingent Liabilities* In Note 6 *Income Tax*, extensive discussion using strong and assertive language is included (emphasis added):

“Westpac has received Amended Tax Assessments (ATAs) and Notices of Proposed Adjustment (NOPAs) from the New Zealand Inland Revenue Department (NZIRD) in respect of three structured finance transactions.

The ATAs relate to 1999 and have a maximum potential tax liability of approximately NZ\$18 million (A\$17 million). Including interest this increases to a tax-effected amount of NZ\$25 million (A\$23 million). The NOPAs relate to 2000-2002 and have a maximum potential tax liability of approximately NZ\$67 million (A\$63 million). Including interest this increases to a tax-effected amount of NZ\$102 million (A\$95 million). Westpac has calculated that the maximum potential overall primary tax liability that would arise if all similar transactions entered into to date were disputed, including 2003-2004, would be approximately NZ\$548 million (A\$513 million). Including interest this increases to a tax-effected amount of NZ\$647 million (A\$606 million).

A binding ruling was obtained from the NZIRD on the initial transaction in 1999 which, following a review by the NZIRD, was confirmed in 2001. The principles that underly the ruling were followed in all subsequent transactions. Independent tax and legal opinions have also confirmed that the tax treatment applied to the transactions is consistent with New Zealand law.

Westpac is confident that the tax treatment applied in each case was correct and that the likelihood of ultimately being required to pay additional tax is low. Accordingly, no tax provision has been raised in respect of these matters.”

In the 2005 financial statements, extensive discussion appears in both the *Overview* section and Note 34 *Contingent Liabilities*. The discussion is marginally more extensive in the *Overview* and this is set out in full (emphasis added):

“New Zealand Inland Revenue Department Investigation

The New Zealand Inland Revenue Department (NZIRD) is reviewing a number of structured finance transactions as part of its audit of the 1999 to 2002 tax years. This is part of a broader NZIRD investigation and review of structured finance transactions in the New Zealand market.

The transactions in question have been progressively run down and have now all been unwound. Potential interest continues to accrue on the core tax if the NZIRD is successful in its challenge.

On 30 September 2004, we received assessments totalling NZ\$18 million (A\$16 million) (NZ\$25 million (A\$23 million) with interest) in respect of three transactions for the 1999 tax year. On 31 March 2005, the NZIRD issued further amended tax assessments relating to the 2000 tax year that will impact three structured finance transactions in place in the 1999 tax year and an additional two structured finance transactions undertaken in the 2000 tax year only. The maximum potential tax liability reassessed for the 2000 tax year is NZ\$61 million (A\$55 million) (NZ\$85 million (A\$77 million) with interest). The potential primary tax in dispute for all five of these transactions for the years up to and including 30 September 2005 is NZ\$220 million (A\$200 million) (this includes the amounts noted above). With interest this increases to NZ\$296 million (A\$269 million) (calculated to 30 September 2005). *The additional tax assessed in respect of the 1999 and 2000 tax years (NZ\$79 million (A\$72 million) tax plus interest as noted above) has been paid to the NZIRD as ‘tax in dispute’ to prevent further interest accruing. This has been recorded in the Financial Statements as a receivable in ‘Other assets’ reflecting our position as noted below.*

The NZIRD is also investigating other transactions undertaken by us, which have materially similar features to those for which assessments have been received. Should the NZIRD take the same position across all of these transactions, for the years up to and including the year ended 30 September 2005, the overall primary tax in dispute will be approximately NZ\$611 million (A\$556 million) (including the amounts noted above). With interest this increases to approximately NZ\$750 million (A\$682 million) (calculated to 30 September 2005).

We sought a binding ruling from the NZIRD on an initial transaction in 1999 which, following extensive review by the NZIRD, was confirmed in early 2001. The principles underlying that ruling are applicable to, and have been followed in, all subsequent transactions.

At the time of entering the transactions, we received independent tax and legal opinions which confirmed that the transactions complied with New Zealand law. Legal counsel has confirmed that the relevant parts of these opinions remain consistent with New Zealand law.

As previously disclosed, we are confident that the original tax treatment applied by us in all cases is correct. We remain of the view that the transactions are legitimate and do not constitute tax avoidance. Accordingly, no tax provision has been raised in respect of these matters.

We do not consider that the outcome of any other proceeding, either individually or in aggregate, is likely to have a material effect on our financial position.”

In the 2006 financial statements the level of detail has been reduced compared to that of 2005, although the impact has been updated (figures for each of the years of assessment are given, along with an estimated total of \$NZ611 million tax plus interest \$NZ182 million). Westpac advises that legal proceedings for the 1999-2001 years have commenced. The language remains strong and defensive.

In the 2007 financial statements the detail is similar to that of 2006, with the impact updated (figures for each of the years of assessment, with estimated total of \$NZ595 million tax plus interest \$NZ220 million – a slightly reduced tax figure!). Westpac advises that legal proceedings for the 1999-2002 years have commenced. Strong language is used once again to convey Westpac's message.

In the 2008 financial statements the level of detail is similar to that of 2007, with the impact updated (figures for each of the years of assessment, with estimated total of \$NZ588 million tax plus interest \$NZ294 million – again a further slightly reduced tax figure!). Westpac advises that legal proceedings have commenced for all amended assessments (years 1999 to 2005) and that there are *no further transactions or tax years subject to review* (other than the transaction in relation to which Westpac received a binding ruling¹⁰).

In the 2009 financial statements the level of detail is similar to that of 2008 with the impact updated. In Note 37, the bank states that the maximum tax assessed is likely to be \$NZ586 million (yet again a slightly reduced tax figure) plus \$NZ332 million interest. Westpac also states (using relatively defensive language) in Note 37 (emphasis added):

“...On 7 October 2009, the New Zealand High Court found in favour of the NZIRD in relation to Westpac's challenge to the amended assessments in respect of four representative transactions. The decision will apply to all transactions unless a party can show any material difference in the transactions not considered at trial. Westpac has lodged an appeal against

¹⁰ Binding rulings are issued by the Rulings Unit of the IRD under Part VA of the TAA 1994.

the decision to the NZ Court of Appeal. No penalties have been assessed by the NZIRD. The possible range of penalties under New Zealand law is up to 100% of the primary tax in dispute. Westpac has not raised a provision relating to penalties. During the year Westpac raised its tax provisions relating to this litigation to NZ\$918 million (A\$753 million)."

Like the BNZ, Westpac remained committed to pursuing its appeal until the settlement reached on 23 December 2009.

Westpac issued two media releases in 2004 when the dispute with the IRD commenced (the second media release is an update of the first). The detail in the first media release made on 6 August 2004 is much more extensive than the financial statement disclosures (such as Westpac had received 12 NOPAs), but it takes a more defensive approach. Two key comments from this media release are set out below (emphasis added):

"Westpac also received independent tax and legal opinions at the time which confirmed that the transactions complied with New Zealand law. These opinions have subsequently been reviewed and confirmed by legal counsel. ..."

The issue of a law change to address transactions of this type in the future is also currently being discussed with the New Zealand Government and the NZIRD. Westpac, along with the rest of the industry, is working cooperatively with the New Zealand authorities in this regard."

In its 30 September 2004 media release, Westpac stated (emphasis added):

"... Westpac is confident that the tax treatment applied in all cases is correct. A binding ruling was sought from the NZIRD on an initial transaction in 1999 which, following extensive review by the NZIRD was confirmed in early 2001."

Westpac therefore does not accept that the reassessments we have now received from the NZIRD with respect to the three 1999 transactions are correct and will contest them. ..."

8.0 SETTLEMENT AGREEMENT – A ‘CURVE BALL’ TO END THE MATTER?

A settlement deal was finalised at approximately 9pm on 23 December 2009, between four of the five banks (ANZ-National Bank, ASB Bank, BNZ and Westpac), the IRD and the New Zealand Solicitor General, for approximately \$NZ2.2 billion. From various media releases, one can ascertain that the deal represents approximately 80 percent of the full amount of tax and interest liabilities owed by the four banks (NZ\$2.75 billion). The payments took effect from 31 December 2009. Of the approximately \$2.2 billion, the amounts agreed were split approximately: ANZ-National Bank \$NZ414 million; ASB Bank \$NZ264 million; BNZ \$NZ658 million and Westpac \$NZ885 million (total \$NZ2.221 billion). Furthermore, it has emerged that no civil penalties will be imposed by the IRD, and the appeals (due to be heard in October 2010) will not proceed. Other details of the settlement remain confidential, although the Minister of Revenue has publicly stated on NZ National Radio that the settlement is "full and final". Interestingly, there is no information, publicly available at least, concerning the position regarding Rabobank's dispute with the IRD and whether it is seeking to settle or not.

Both the Minister of Revenue and the Commissioner have publicly announced that they are pleased with the outcome, with the Solicitor General also reported to be satisfied. Each of the four banks has made their own press release in response to the settlement, and these press releases in themselves offer another interesting insight, providing a further example of a discourse intended to provide closure to the series of events. Before I analyse their responses, a brief comment is warranted in terms of early observations from various experts with respect to the impact that the settlement will have on the cost of the disputes and whether it is a 'good deal'.

David Tripe, director of Massey University's Centre for Banking Studies, is reported as stating (NZPA, 2009c): "Possibly, in terms of the negotiation the Government has done slightly better. I guess 80 percent is a fairly good return."

Tripe assumed 80 percent was 'thrashed out' across the negotiating table and banks had settled because there was the possibility they might not win, even though they thought they were in the right. Tripe goes on to comment that the settlement (NZPA, 2009c):

"... got rid of the uncertainty of things and everybody can get on with life. It certainly isn't a good look for the banks to be engaged in long term litigation. One can understand them wanting to get these sorts of matters tidied up."

Tripe is also reported as stating that if the cases had continued through the courts there would have been considerable and costly delay in getting to a final solution (Parker, 2009): "All of those things mean there is some rational justification behind agreeing to settle."

Media reports¹¹ suggest that the IRD has spent over \$NZ38 million, to date, on pursuing the banks. While this is a considerable sum and will not capture all costs, it is relatively "small" in the context of the amount of tax and interest in dispute (over \$NZ2.4 billion). Prior to the announcement of the settlement, if the outcome of the BNZ and Westpac tax avoidance cases was taken as a guide for future litigation, then this would seem to be a justifiable cost and investment by the IRD in recovering a substantial amount of tax revenue. Interestingly the Solicitor General's office (via the Crown Law Office) and the IRD have set up a Structured Finance Governance Committee that meets monthly during the duration of the structured finance litigation.¹²

The total cost of the disputes to the banks is likely to be higher (in some instances) than the provisions made given the legal costs involved. The IRD has indicated that prior to the settlement it spent \$NZ39.5 million on the litigation, and there will also be legal costs spent by both parties, along with deadweight costs to society as a whole. Tripe commented that while the IRD had spent millions of dollars on the court case

¹¹ See, for example, van den Bergh (2009).

¹² The responsibilities of this Committee include: considering any settlement related matters; ensuring effective budget management and allocation; and ensuring effective development of litigation strategy and legal arguments. See Protocols between the Solicitor General and Commissioner of Inland Revenue (2009); available at: http://www.cch.co.nz/CA_DocumentLibrary/protocol.pdf; and the Proposed Relationship Structure of the IRD and Crown Law Office (2009); available at: <http://www.ird.govt.nz/resources/3/b/3bce83804f32a3cc9190d342d98f1b86/ir-protocols.jpg>. Post the 23 December 2009 settlements the future of this Committee is uncertain.

this amount is a fraction of the discount and thus (NZPAC, 2009): "This is a very good return in terms of the investment made to pursue them."

What have the banks to say regarding the settlement? ANZ-National Bank's CEO Jenny Fagg stated on 24 December 2009 (Scoop, 2009a):

"We are pleased to have reached a commercial settlement in relation to six out of the seven disputed tax transactions which largely puts this matter behind us. We have operated in New Zealand for over 150 years. It has always been our approach to pay all appropriate tax and we believed the transaction structures were appropriate given the independent advice received on the relevant law and rulings held by the industry. Given recent legal cases however, it is clear we need to approach these transactions differently and today's settlement reflects this. ANZ has not entered into any of these types of structured transactions since 2003 and since late 2005 all of these transactions have either matured or been terminated."

Of seven transactions undertaken by ANZ-National Bank which were under dispute, one residual transaction involving \$NZ27 million in income tax remains subject to commercial dispute with the Commissioner. The ANZ-National Bank advises that it will continue to work through the issues with Inland Revenue in relation to this transaction. The settlement includes an amount of \$NZ105.8 million related to three transactions for which ANZ holds an indemnity from Lloyds Banking Group plc associated with The National Bank of New Zealand. The ANZ-National Bank also advises that it holds adequate provisions for the settlement with the Commissioner and advises that there will be no negative impact on ANZ-National Bank's 2010 financial results.

The ASB Bank announced on 24 December 2009 that it has reached a settlement with the Commissioner relating to four structured finance transactions. The ASB Bank's CEO Charles Pink said that the ASB Bank has settled the disputed assessments by agreeing to pay NZ\$264 million, which represents 80 percent of the full amount of tax and interest in dispute (Scoop, 2009b):

"ASB entered into the transactions on the basis of the best tax and legal advice available, and accepted banking practice at the time. However, in light of the High Court's recent decisions in cases involving structured finance transactions of other banks, we have decided to conclude this matter by negotiation with the [Commissioner]."

Pink also stated that ASB Bank's existing provision is adequate to cover the settlement.

In a statement on 24 December 2009 the BNZ said it had reached agreement covering disputed tax assessments for six structured finance transactions entered into between 1998 and 2005. The BNZ's CEO Andrew Thorburn stated (Scoop, 2009c):

"This is a complex and technical issue, and it has been the subject of much debate. Simply put; we acted in good faith at the time, the High Court has delivered a judgment, and now it is time to settle so that we can move on and move forward."

Collectively, these payments fall within the provision of \$NZ661 million raised by BNZ in August 2009 to reflect the High Court decision in which it lost its challenge against the Commissioner. The BNZ also indicated that the interest component of the settlement will be tax deductible.

Westpac announced on 24 December 2009 that it will pay the amount agreed in the settlement (that is, 80 percent of the full tax and interest), with its New Zealand CEO George Frazis stating (Scoop, 2009d):

“We entered these transactions relying upon expert advice and a ruling issued by the IRD in relation to a similar transaction, but we accept the court has ruled and that, on balance, it is best that we accept this industry settlement and move on.”

Westpac fully provided for the value of income tax and interest claimed by the Commissioner as part of its 2009 result, and as a result there will be a write back in 2010 of approximately \$NZ190 million.

Thus the remaining matter of interest will be how each of the four banks makes its disclosures with respect to their settlement in their 2010 financial statements due out in the latter half of 2010. In terms of financial statement disclosures this should bring ‘closure’ to the matter. That said the situation with Rabobank remains unclear.

9.0 DISCUSSION AND ANALYSIS – WHAT CAN WE LEARN FROM THE DISCLOSURES AND DISCOURSE CONCERNING TAX DISPUTES?

It would come as a surprise if the IRD, as part of its regular review of large corporates’ financial and tax positions, undertook financial analysis including that of calculating ETRs for the banks. Assuming such analysis, the IRD would discover that the ETRs were considerably lower than the statutory rate, justifying further investigation to establish the cause. The reason for such low ETRs could not be attributed to declining profits or bringing previous years’ losses to account (indeed over the period of the structured finance transactions (1998-2005) the banks were reporting increased profits), so there would need to be other explanations. As Newberry (2005) observes, the use of structured finance transactions largely explains the ETRs being lower than the statutory rate for the BNZ and Westpac. Similar analysis would naturally have led the IRD to investigate these transactions, and made indeed have lent support to the New Zealand Government to introduce (and subsequently enact) remedial legislation to remove the effectiveness of such transactions for the banks going forward from 1 July 2005.

The IRD (2008) has included a note in its financial statements for the year ending 30 June 2008 concerning the structured finance transactions, in which it takes a conservative approach:

“Note 8: Structured finance transactions

The Crown is currently in dispute with a number of financial institutions regarding the tax treatment of certain structured finance transactions. Taxation revenue from these transactions has not been recognised as revenue or a contingent asset. At this stage, revenue of \$1,589 million has been assessed. This includes use of money interest in some cases.”

A more extensive disclosure is offered by the IRD (2009a) in its 2009 financial statements (which were issued prior to the settlement agreements):¹³

“Note 8: Structured finance transactions

The Crown is currently in dispute with a number of financial institutions about the tax treatment of certain structured finance transactions. Due to a favourable High Court ruling for one structured finance case, all structured finance assessments have been recognised as revenue, \$1,423 million in the 2008–09 financial year. However, as legal proceedings are still ongoing for other structured finance cases and there is the likelihood of appeal, we have also recognised the assessed tax as a contingent liability of \$1,423 million.

A contingent asset of \$1,191 million has also been recognised in relation to the structured finance transactions. This relates to use-of money-interest due on all structured finance cases as at 30 June 2009. The interest has been calculated based on the maximum amount which the taxpayers are due to pay to Inland Revenue at that date. However, some of these taxpayers may have money in the tax pooling account which they could transfer at an earlier date. As this is at the taxpayers' discretion, the exact amount of use-of-money-interest is not quantifiable until all cases are resolved and taxpayers have made final payment to Inland Revenue.

Shortfall penalties that Inland Revenue may impose have not been quantified because it is too uncertain at this stage. These penalties would not meet the asset definition or recognition criteria due to the fundamental uncertainty as to what penalty would be applied and the value of the penalty that Inland Revenue would impose. Penalties would be recognised following a final court decision when all appeals are exhausted.”

The IRD (2009b) has indicated in its Compliance Focus 2009-10 that it will continue to focus on large institutions (including banking and finance industry) with respect to their compliance with structured financial arrangements. The IRD (2009b, p 21) states that: “[o]ur investigation focus will be on structured finance arrangements that financial institutions either take part in or facilitate for their customers.”

Both Standard and Poor's (S&P)¹⁴ and Moody's¹⁵ have affirmed the credit ratings of ANZ-National Bank, ASB Bank, BNZ and Westpac following the BNZ High Court tax avoidance decision, notwithstanding that major provisions will need to be made by the banks in their financial statements. S&P recognises that these payments will be one off, and that the payments are able to be sustained within the banks' capital bases. One potential repercussion of the BNZ and Westpac tax avoidance decisions (assuming there had been no settlement, the appeals were continued with the High Court decisions upheld on appeal, and similar findings emerge for the other banks) is that the banks would be likely to seek to keep their margins high to recuperate some of

¹³ Other references to structured finance transactions appear throughout the IRD's 2009 Annual Report under various headings including: tax revenue, litigation, use of money interest as a contingent asset, and accounting policies.

¹⁴ See, for example, NZPA (2009a).

¹⁵ See, for example, NZPA (2009b).

this loss over the next few years, and perhaps reduce their level of competition with one another.

Overall this analysis would suggest that the approach to disclosure by the banks is to provide as little information as possible in the early stages, and then provide more information that supports their position, including that their approach is supported by expert legal and tax opinions. Furthermore, the approach taken with respect to the additional assessments is far from conservative. None of the banks (with the exception of Westpac) indicated (prior to the 23 December 2009 settlements) that they have paid up to half of the disputed tax (an approach no longer mandated by legislation but one that minimise the potential future impact while not being an admission of the correctness of the Commissioner's position), an approach which would limit their exposure to interest should they ultimately be unsuccessful. As events unfolded the banks were unsuccessful to the extent that they have agreed to pay 80 percent of the tax and use of money interest, but have been 'successful' through saving 20 percent (of the tax and use of money interest) and will not face the risk of shortfall penalties being imposed. In contrast the IRD's approach is conservative through not recognising any revenue in its financial statements. This is appropriate given that in preparing its 2008 financial statements there had not been any court decisions on the substantive issue. Nevertheless, this situation has changed in 2009 with the BNZ and Westpac High Court decisions, with the IRD recognising an asset of \$NZ1.43 billion of tax revenue for the 2009 financial year, counterbalanced by a contingent liability of the same amount.

When something adverse occurs (such as an unfavourable court decision) the banks are quick to indicate they will be challenging and appealing the outcomes. Overall a defensive style is adopted. This is typical of 'repo' deals although usually it is impossible to obtain a favourable tax ruling (Bradford, 2008). In this codified discourse, the banks appear to be exploiting the flexibility in interpretation and application of accounting judgment with their selection of inclusion of relevant information on the structured finance transaction disputes and litigation in their financial statements. Further analysis that could lead to recommendations regarding tightening or providing greater guidance with respect to judgments associated with the content of disclosures is beyond the scope of this paper. That said, as a result of the surprise settlement agreements, the four banks involved have been quick to downplay the matter in a somewhat defensive manner and seek to "move on".

Disclosure in the notes to the financial statements may be overlooked by shareholders and analysts; even if information is disclosed, there is a variable level of detail for readers to digest. To this end, BNZ and Westpac provide the most informative detail in terms of their financial statement disclosures, while Rabobank provides the least (and arguably less than would be required by NZ IFRS if it applied – exploration of this issue is beyond the scope of this paper). However, even when figures are provided, readers are left to "crunch the numbers" to assess the potential impact of the disputes in the financial statements.

To this end both the BNZ and Westpac in their 2009 financial statements include the effect of their disputes with the IRD, taking a huge "hit" (both the tax, interest and legal costs are included for the full amount for the periods reassessed). Interestingly there is no prior period adjustment to "correct" or "restate" previous years' financial statements.

Reference to penalties in the financial statement disclosures is limited although the BNZ and Westpac both indicate in their 2009 financial statements that penalties may be up to 100 percent (this would result if the abusive tax position shortfall penalty¹⁶ were to be imposed). A penalty of this magnitude is unlikely (and indeed no penalties will be imposed following the 23 December 2009 settlement). Indeed I would suggest that this statement reflects the approach of taking the maximum “hit” (or “Big Bath”¹⁷), and “painting a gloomy outcome” with the intention of allowing more positive news to be presented once the dispute is finalised and penalties determined. This is a further example of adopting a particular accounting discourse. It is more likely, had there been no settlement, that if shortfall penalties were imposed, they would be in the 20-40 percent range (either for not taking reasonable case (20 percent),¹⁸ taking an unacceptable interpretation/tax position (20 percent)¹⁹ or gross carelessness (40 percent)²⁰).

10.0 CONCLUSIONS, LIMITATIONS AND FUTURE RESEARCH

The enormity of the tax in dispute (for each of the banks individually and collectively), plus the amount of interest and legal costs is substantial (estimated at over \$NZ2.75 billion or 2 percent of New Zealand's GDP). Absent the 23 December 2009 settlements, this sum would have grown further (assuming the court decisions yet to be heard and delivered found or upheld the actions to be tax avoidance) if shortfall penalties were imposed (which may be from 20 percent to 100 percent of the tax in dispute). Indeed, the amount of penalties could have ranged from an estimated \$NZ330 million (20 percent) to as high as an estimated \$NZ1,650 million (100 percent). Table 3 below summarises the tax and interest in dispute based on reported figures, and the December 2009 settlement figures:

TABLE 3: SUMMARY OF BANKS' DISCLOSED TAX (PLUS INTEREST) IN DISPUTE: 2004 TO 2009 (BASED ON REPORTING YEAR)

Bank / Year	2004 NZ\$m	2005 NZ\$m	2006 NZ\$m	2007 NZ\$m	2008 NZ\$m	2009 NZ\$m	Settlement NZ\$m
ANZ National Bank	348 (116)	432 (124)	N/D	506 (142)	541 (151)	568 (159)*	414 (106)
ASB Bank	N/D	N/D	N/D	N/D	N/D	N/D	264
BNZ	473	533	565	596	633	661	658
Rabobank NZ	N/D	N/D	N/D	N/D	N/D	N/D	N/D
Westpac	647	750	793	815	882	918	885
Total (est)	1,468	1,715	1,358	1,917	2,056	2,147^	2,221

(Figures in () for ANZ-National Bank is the indemnity from Lloyds TSB; N/D - no disclosure of amount; ^ when the estimate for ASB Bank (NZ\$280) is added, this comes to NZ\$2,427m.)

The banks have been very confident about having taken correct tax positions, backed by legal and tax expert opinions. This stance only changed for the BNZ (to some degree) in its 2009 financial statements, taking a provision for the full impact of the High Court's tax avoidance decision (\$NZ416 million tax plus \$NZ245 million

¹⁶ See section 141D of the TAA 1994.

¹⁷ In the context of earnings management see, for example, Jordan and Clarke (2004).

¹⁸ See section 141A of the TAA 1994.

¹⁹ See section 141B of the TAA 1994.

²⁰ See section 141C of the TAA 1994.

interest and costs). Westpac's approach to its High Court decision eventually led it to take (reluctantly) a similar position to the BNZ and provide for tax and interest of approximately \$NZ911 million in its 2009 financial statements. That said the scene changed late on 23 December 2009 with the settlements, a stark contrast to the bank's prior public discourse with respect to their structured finance disputes.

Statements made by the banks in their financial statements (and in their relatively few separate media releases prior to 24 December 2009) have generally been defensive, underplaying the seriousness of the potential impact, should the banks ultimately be unsuccessful. Indeed the BNZ and Westpac High Court tax avoidance decisions would suggest that the banks have been underplaying the likelihood of failing to win their litigation against the IRD. The settlements reached on 23 December 2009 support this contention.

Instead of taking a very conservative approach and making an early provision, the banks have disclosed a contingent liability with the impression that they will be successful and have no liability. Provision for the tax impact arising in their financial statements has been left until their court action against the IRD is unsuccessful (BNZ and Westpac) and following the settlements for ANZ-National Bank and ASB Bank. The position regarding Rabobank is unclear since there have been no recent public disclosures. Arguably this approach by the banks has been misleading for investors and raises once again the 'thorny' issue (investigation of which is beyond the scope of this paper) of whether accounting standards need to be tightened with respect to disclosures and making provisions for contingencies. Nevertheless, the positions taken may be representative of the market place reality that the banks operate in.

It is important to note that this paper has limitations. First, it adopts discourse analysis, a research paradigm that is not without its criticisms and limitations. Second, this paper forms part of a larger project and thus only examines part of the picture that is emerging as a result of the banks' structured finance litigation. This larger picture includes: analysis of the structured financing litigation leading up to the first major tax avoidance decision,²¹ a discourse analysis of the financial statement disclosures resulting from the investigation and subsequent litigation between the IRD and the five banks (this study); an examination of the impact of the 23 December 2009 settlement; and a critical analysis of the impact of the structured finance litigation from economic and jurisprudential perspectives.

The implications of the BNZ's and Westpac's tax avoidance decisions have yet to be examined thoroughly in academic and related research; however, this is only a matter of time. Such analysis is expected to emerge in the near future, in the context of recent anti-avoidance decisions in key cases such as *Ben Nevis*²² and *Penny v CIR; Hooper v CIR*.²³ An early commentary on these leading decisions is offered by Elliffe and Keating (2009).

²¹ For an early analysis forming part of this project see the analysis of the cases prior to the substantive avoidance case against the BNZ and Westpac in Sawyer (2008).

²² *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,503 (SCNZ).

²³ *Penny v CIR; Hooper v CIR* (2009) 24 NZTC 23,406 (HC). The Court of Appeal judgment was delivered on 4 June 2010, overturning the High Court judgment; see *CIR v Penny and Hooper*, [2010] NZCA 231.

Future research in this area needs to incorporate the remaining parts of the wider investigation, namely at least two further studies: the first an examination of the impact of the 23 December 2009 settlement; and the second a critical analysis of the impact of the structured finance litigation from economic and jurisprudential perspectives.

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Fairness Perceptions and Compliance Behaviour: The Case of Salaried Taxpayers in Malaysia after Implementation of the Self-Assessment System

Natrah Saad*

Abstract

This study investigates the role of fairness in tax compliance decisions among taxpayers in Malaysia. The impacts of tax knowledge and tax complexity on fairness perceptions are also examined employing the Theory of Planned Behaviour. To test the model, a questionnaire was administered among a sample of salaried taxpayers across Malaysia. The findings revealed that taxpayers perceived the current income tax system as fair but there was no conclusive evidence that such a perception had an influence on compliance behaviour. Instead, attitudes and subjective norm were found to be most influential. Furthermore, tax knowledge and tax complexity were shown to affect fairness perceptions.

1. INTRODUCTION

The shift from the official assessment system (OAS) to self-assessment system (SAS) in 2004 has seen considerable changes take place in the tax system in Malaysia. Obviously, the major transformation with the new system is that the Inland Revenue Board (IRB) now functions more as a tax auditor than as a tax assessor. From the taxpayers' perspective, the change is more burdensome as the responsibility to compute and file tax returns rests solely with them (or with their tax preparers), which undoubtedly requires good knowledge of the tax system and reduced tax complexity. In short, SAS has imposed additional compliance costs to taxpayers. To facilitate taxpayers in their new role, seminars on SAS were conducted across the country and e-filing was introduced, providing options for taxpayers to file either manually or electronically.

Yet, after five years of SAS, taxpayers' perceptions on the new system are not fully understood. Thus, this study investigates taxpayers' perceptions with regard to

* Natrah Saad, is a PhD student in the Department of Accounting and Information Systems, University of Canterbury, Christchurch, New Zealand. E-mail: nbs24@uclive.ac.nz. The author wishes to thank her supervisors, Prof. Adrian Sawyer and Andrew Maples, and anonymous reviewer for their assistance and valuable comments on earlier versions of this paper. The appreciation also goes to the participants at the ATTA PhD Colloquium 2009 and 2010 for their constructive comments. Funding from the College of Business and Economics at the University of Canterbury, and the Education New Zealand through the Postgraduate Study Abroad Awards, and assistance with the survey by the organisations' representatives are gratefully acknowledged.

fairness; how tax knowledge and complexity influence fairness perceptions; and how these elements subsequently affect taxpayers' compliance behaviour.

I believe this study contributes to the literature in several ways. First, from a theoretical perspective, this study adds to the limited literature available in the Asian region. To date, there have been two major studies on fairness perceptions undertaken in Malaysia (Azmi & Perumal, 2008; Mustafa, 1996). Even though these two studies are quite recent, Mustafa (1996) for example, only focused on the tax rate structure as the element of tax fairness. He does not comment on the determinants of such judgments. The other study, on the other hand, attempted to identify the fairness dimensions among Malaysian taxpayers by replicating the Gerbing's (1988) developed questionnaire.

Second, this study extends the well-established Theory of Planned Behaviour (TPB) in compliance behaviour studies. While TPB appears to be the dominant model in explaining an individual's behaviour, the inclusion of fairness perceptions in tax settings has strengthened the model to a certain extent.

Third, from a practical perspective, the information on taxpayers' fairness perceptions and compliance behaviour can assist policy makers, particularly tax authorities in reviewing and modifying current tax systems, where necessary. In addition to this, the findings on the impact of tax knowledge and tax complexity on fairness perceptions and compliance behaviour are also useful for policy makers to tailor tax education and simplification programs.

The remainder of this paper is organized as follows. Section 2 provides an overview of the income tax system and compliance environment in Malaysia while Section 3 reviews the relevant literature and develops the research hypotheses. In Section 4, the conceptual model is proposed, while Section 5 describes the methods used in this study. The results are presented in Section 6, followed by a discussion in Section 7.

2. OVERVIEW OF THE INCOME TAX SYSTEM AND COMPLIANCE LEVELS IN MALAYSIA

The income tax system in Malaysia commenced in 1948 under British colonization. It was introduced to legitimise the collection of taxes from individuals and corporations. Since its inception, Malaysia has adopted OAS which requires taxpayers to furnish relevant information pertaining to their incomes and expenses to the IRB. Under the system, the duty to compute the tax payable lies with the IRB as taxpayers are assumed to have limited knowledge on taxation.

However, with effect from 2001,¹ SAS was implemented. Under the new system, the responsibility to compute the tax payable shifted from the IRB officers to the taxpayers. Unlike OAS, SAS requires taxpayers to be well-versed with the existing tax laws and provisions since they are answerable to the tax authorities in the case of a tax audit. Another prominent attribute of SAS is voluntary compliance, as the tax return submitted by taxpayers is deemed to be their notice of assessment. In other words, penalty mechanisms will be applied if taxpayers do not submit a correct tax return within the stipulated period.

¹ SAS was implemented in stages, beginning with companies in 2001, followed by non-companies in 2004, and was fully put into practice in 2005.

Subsequent to the full implementation of SAS in 2005, the IRB successfully recorded tax collection of RM56.85 billion in direct taxes in the year 2005.² This amount is 17.6 percent higher than the Government's revised estimate of RM48.35 billion for the year 2005. The IRB Chairman claims that the IRB has never collected such a large amount before (Inland Revenue Board of Malaysia, 2005). At a glance, this provides some evidence that the shift from OAS to SAS made by the IRB is 'financially rewarding'. However, he further notes that the rise in tax collection is also attributable to favourable national economic condition that grew by five percent in 2005, which in turn creates a conducive climate for all sectors in Malaysian economy.

Notwithstanding the favourable tax collection recorded during the year, the IRB's report also documented the following 'alarming' statistics relative to the previous year:³

- (1) the IRB visited 1,113 individuals' premises and discovered tax in arrears of RM37.5 million;
- (2) 9,066 individuals were banned from leaving the country in accordance with Section 104 of the Income Tax Act 1967⁴ (Malaysia) with outstanding tax payments of RM245.09 million;⁵
- (3) 466 cases filed in the courts for RM30.65 million tax; and
- (4) 39 bankruptcies were filed for individuals involving RM9.85 million tax (Inland Revenue Board of Malaysia, 2005).

The increasing trend of non-compliance indicated in the IRB's report may give the impression, that either (1) taxpayers' negative response on tax compliance behaviour is rising gradually; or (2) the concerted effort of the IRB officers (such as an increase in audit work, etc.) has been fruitful in discovering non-compliance behaviour. From both perspectives, it appears that non-compliance behaviour is 'alarming' in Malaysia.

The discussion above provides a clear indication that the existing income tax system under SAS is not well understood, with unintentional or deliberate non-compliance by taxpayers.⁶ The reason(s) for such non compliance has (have) yet to be explored, but it

² Direct taxes comprise company income tax, petroleum income tax, individual income tax, cooperative income tax, stamp duty, real property gains tax (RPGT), withholding tax, International Offshore Financial Centre (IOFC) tax and other taxes.

³ The 2004 Annual Report suggests that: (1) the IRB visited 566 individuals' premises and discovered tax in arrears of RM6.05 million; (2) 6,736 individuals were banned from leaving the country in accordance with Section 104 of the Income Tax Act 1967 (Malaysia) with outstanding tax payments of RM226.77; (3) 121 cases filed in the courts for RM15.35 million tax (Inland Revenue Board of Malaysia, 2004).

⁴ This section stipulates that the Director General of the IRB (DGIR) has the right to ban a person from leaving Malaysia if he/she did not pay all tax payable by him/her, including tax penalties, tax on emoluments or pensions, tax on interest or royalties, and special classes of income derived from Malaysia (Inland Revenue Board of Malaysia, 2008).

⁵ There is a possibility that individuals whose premises were visited by the IRB partly forms the number of individuals who were being banned from leaving the country. However, no further information available in the IRB's Annual Report to confirm this.

⁶ Taxpayers with unintentional non-compliance would feel that they have fully complied with the tax law in filing their tax returns but may end up filing incorrectly inadvertently. In other words, they have the

(they) may be associated with the tax fairness perceptions (as indicated by numerous overseas studies, eg. Gilligan & Richardson, 2005; Turman, 1995; Bordignon, 1993; Etzioni, 1986).

3. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

This section provides an overview on the relevant literature on tax fairness perceptions, tax compliance and the variables under investigation, and is followed by hypotheses development.

3.1 Tax Fairness Perceptions

Previous studies indicate that fairness perceptions can take various forms. First, vertical fairness, which asserts that taxpayers with different economic situations should be taxed at different rates (Erich et al., 2006). This would result in higher income earners paying tax at higher rates than low-income earners. Another component is horizontal fairness, defined as 'the equal treatment of equally circumstanced individuals' (Michael, 1978). In other words, horizontal fairness recommends that taxpayers of similar economic positions should pay the same amount of tax. These two dimensions of fairness are derived from the Distributive Justice Theory (DJT) which asserts that for a system to be perceived as fair, it needs to treat people in similar circumstances in equivalent manner, without neglecting the individuals' needs. In other words, the theory is suggesting that a compromise has to be made between these dimensions of fairness to accomplish positive perceptions on the fairness of an income tax system.

In addition to vertical and horizontal fairness, Bobek's (1997) study on the US tax system is also concerned with procedural fairness and policy fairness. Procedural fairness relates to the process employed to reach distribution outcomes while policy fairness deals with the content of the tax law. Another significant fairness dimension is exchange fairness (Gilligan & Richardson, 2005; Gerbing, 1988), which represents the exchange of contribution and benefit between taxpayers and government. This dimension of fairness holds that taxpayers will have fair perceptions of the tax system if the benefits received from the government are equitable compared to their tax contributions.

Other dimensions of fairness include a preference for either progressive or proportional taxation (Turman, 1995), personal fairness, tax rate fairness, special provisions and general fairness (Gilligan & Richardson, 2005; Richardson, 2005a; Christensen & Weichrich, 1996; Christensen et al., 1994; Gerbing, 1988).

The above review on studies of tax fairness suggests approximately ten dimensions of fairness. However, in this study, seven dimensions are identified to be important in assessing the fairness of the income tax system. The dimensions are: general fairness, exchange fairness, horizontal fairness, vertical fairness, retributive fairness, personal fairness and administrative fairness.

willingness to comply but possibly their lack of knowledge may lead to them being non-compliant. In contrast, taxpayers with deliberate non-compliance have the intention not to comply with the tax law. They purposely act against the tax law by either understating their incomes, overstating their expenses and even not submitting their tax returns. This intentional non-compliance is of interest in this study.

General fairness simply measures individuals' judgments whether the (income) tax system is generally fair or not. While exchange fairness is concerned with a reciprocal exchange between taxpayers and the government, horizontal fairness considers equal tax treatment among taxpayers in similar economic positions. Vertical fairness is assessed based on the ability to pay and preference for tax rate structure, either flat rate or progressive. Retributive fairness deals with the fairness of punishments imposed. Personal fairness concerns individual's self interest while administrative fairness, on the other hand, relates to the content of the tax law (policy fairness) and procedures employed by the tax authority (procedural fairness). Thus, based on the prior literature, it is therefore hypothesised that:

H₁: Malaysian taxpayers perceive the fairness of the income tax system as multi-dimensional.

3.2 Tax Compliance

In this study, tax compliance is assumed to take place when a taxpayer files all required tax returns at the proper time and that these returns accurately report tax liability in accordance with the tax law (which include the Internal Revenue Code, regulations, and court decisions) applicable at the time the return is filed. This definition is adopted from Roth et al. (1989), as it provides a better definition when compared to the definition used by Jackson and Milliron (1986) (refer to Richardson & Sawyer, 2001), which has been criticised for not taking into account court decisions in their definition of tax compliance.

Numerous studies have been published on the relationship between tax fairness perceptions and tax compliance. Survey data from 1960-1980 by Etzioni (1986) documented that the fairness perception was more likely to affect tax compliance rather than tax rates. Turman (1995) and Roth et al. (1989) confirmed that fairness perceptions influence tax compliance behaviour. Similarly, Gilligan and Richardson (2005), Roberts (1994), Hite and Roberts (1992), Porcano and Price (1992), Harris (1989), and Song and Yarbrough (1978) found tax compliance to be significantly associated with perceptions of an improved tax system.

A recent cross-cultural study by Richardson (2005b) on tax fairness perceptions and tax compliance behaviour in Australia and Hong Kong documented that tax fairness perceptions about general fairness had a significant impact on tax compliance behaviour in both countries. Additionally, in Australia, it was found that tax fairness perceptions about special provisions, tax rate structure and self interest had some significant relationships with tax compliance behaviour. Given the foregoing discussion, it is further hypothesised that:

H₂: Malaysian taxpayers perceive fairness dimensions_{1 to k} positively and significantly influence tax compliance behaviour.⁷

⁷ In this study, fairness perceptions, tax knowledge and tax complexity are treated as multi-dimensional. Thus, *1 to k* in the relevant hypotheses refers to the number of dimensions of that variables. For instance, in Hypothesis 2, *1 to k* denotes seven dimensions of fairness that are hypothesised to positively and significantly influence tax compliance behaviour.

3.3 Tax Knowledge

Tax knowledge is an essential element in a voluntary compliance tax system (Kasipillai, 2000), particularly in determining an accurate tax liability (Palil, 2005). Without tax knowledge, there is a tendency for taxpayers not to comply with the tax law either intentionally or unintentionally. This was postulated by McKerchar (1995) who studied small business taxpayers. She suggested that small business taxpayers were not even aware of their tax knowledge shortfall and this might lead to unintentional non-compliance behaviour.

The influence of tax knowledge on fairness perceptions was documented by Schisler (1995), who carried out a study comparing tax preparers and taxpayers. Schisler found that taxpayers had significantly lower fairness perceptions compared to tax preparers. The result might be due to the absence of tax knowledge among taxpayers compared to tax preparers. Fallan (1999) later confirmed Schisler's (1995) findings that tax knowledge significantly changed attitudes towards the fairness of the tax system. In that experimental study, the author measured tax knowledge through an additive index of 12 questions concerning tax allowances and tax liabilities.

Unlike Fallan (1999), who simply focused on technical knowledge of tax, an earlier study by Harris (1989) separated tax knowledge into fiscal awareness and technical knowledge, in order to observe the impact of each type of knowledge on fairness perceptions. The findings revealed that types of tax knowledge impacted fairness perceptions and consequently compliance behaviour. This study was supported by White et al. (1990), who suggested that a formal class in taxation would enhance the knowledge about the law and appreciation of fiscal policy goals, thus increasing perceived fairness.

Despite the evidence that fairness is a multi-dimensional construct, these prior studies tend to focus on the effect of tax knowledge on the overall fairness of the tax system rather than on each dimension of fairness. To critically assess the role of tax knowledge on fairness perceptions of the tax system, I believe it is essential not only to distinguish the types of knowledge, but also the dimensions of fairness that the type of knowledge has affected. Having said that, this study examines the impact of tax knowledge on seven dimensions of fairness as discussed earlier. Thus, it is hypothesised that:

H₃: Tax knowledge_{1 to k} positively influences the dimensions of fairness perception_{1 to k} of Malaysian taxpayers.

3.4 Tax Complexity

Tax complexity arises due to the increased sophistication in the tax law (Richardson & Sawyer, 2001). Some researchers agree that a certain degree of complexity in the income tax system is necessary to ensure the system is fair (for example, Forest & Sheffrin, 2002; Sawyer, 1996; White, 1990). This is particularly applicable to the perceptions of the tax authority and tax professionals, suggests White (1990). Applying four scenarios of tax complexity, she asserts that both the tax authority and tax professionals (tax lawyers and tax accountants) prefer complexity in the tax law but at different levels. The tax authority prefers tax complexity that will increase their probability to win the cases in disputes, while tax lawyers on the other

hand are in favour of tax complexity that gives rise to a higher probability that the taxpayers will win the case. Similarly, tax accountants' preferences are also towards a high level of tax complexity as it will increase the demand for their tax services. In his critique and extension of White's study, Sawyer (1996) suggests that the tax authority prefers a lower level of tax complexity than indicated in White (1990), and the tax authority may benefit most when the level of complexity is close to zero in some circumstances.

Notwithstanding preferences by the tax authority and tax professionals, tax complexity actually causes negative perceptions of fairness among taxpayers (Cialdini, 1989; Carroll, 1987). Milliron (1985) claimed in her study of jurors that the participants viewed complexity and fairness as distinct but incompatible features of the income tax system. Erich et al. (2006) share a similar view on the inverse relationship between complexity and fairness perceptions. In their study on Australian taxpayers and tax officers, Erich et al. (2006) claimed that complexity in tax law resulted in a negative perception of the tax system and consequently encouraged an unwillingness to comply. Based on the foregoing discussion, it is therefore hypothesised that:

H₄: Tax complexity_{1 to k} negatively influences the dimensions of fairness perception_{1 to k} of Malaysian taxpayers.

3.5 Theory of Planned Behaviour

The Theory of Planned Behaviour (TPB) is the extended version of the Theory of Reasoned Action (TRA), and is a dominant theoretical framework used in explaining human behaviour (Ajzen, 1991). The TPB model depicts that behavioural intention is the immediate determinant of the actual behaviour. Behavioural intention is, in turn, determined by attitudes towards behaviour, subjective norm and perceived behavioural control. Some examples that have successfully applied TPB in predicting behaviours include speeding (Paris & Broucke, 2008), adolescent smoking (Guo et al., 2007) and cardiopulmonary resuscitation (CPR) involvement (Dwyer & Williams, 2002). In a taxation context, Bobek (1997) applied the TPB model with the inclusion of the moral obligation variable.

3.5.1 Attitudes towards compliance

Ajzen (1991) stipulates that attitudes towards compliance reflect feelings of favour and disfavour towards compliance behaviour. The contention has been shown by Davis et al. (1989) in information technology studies. In a taxation context, Bobek (1997) found that attitudes explained compliance behaviour when the belief-based attitudes measure was used. A recent study by Loo et al. (2007) also emphasized that attitudes towards the tax system positively influenced compliance behaviour. Thus, it was anticipated in this study, that a positive attitude towards the tax system would encourage taxpayers to comply and vice versa. In this study, I consider two dimensions of attitudes, namely affective attitude and instrumental attitude. Affective attitude deals with emotions such as feeling happy, sad or guilt if performing certain behaviour while instrumental attitude refers to a more cognitive consideration to which performing a behaviour would be advantageous (Breckler & Wiggins, 1989).

It is also believed that a positive attitude towards the tax system is in fact the result of positive fairness perceptions. In other words, positive fairness perceptions may act as

the antecedent of a positive attitude. Thus, it is anticipated in this study, that taxpayers with positive perceptions on the fairness of the tax system are more likely to have positive attitudes towards the tax system and consequently encourage them to comply.

3.5.2 Subjective norm

Subjective norm reflects motivation to conform with significant referents either to comply or not comply with tax obligations. A review of factors affecting compliance from 1986 to 1997 reveals compliance with peers as significantly related to compliance behaviour (Richardson & Sawyer, 2001). This view is consistent with Bobek (1997) who found that subjective norm significantly affected compliance behaviour in a business deduction scenario. A comparative study in Australia, Singapore and the US by Bobek et al. (2007) also found subjective norm as an influential factor in explaining tax compliance behaviour. Based on the literature, I expect subjective norm would positively influence taxpayers in their compliance decisions.

3.5.3 Perceived behavioural control

Perceived behavioural control reflects an individual's perception on the ease or difficulty in performing a particular behaviour. Ajzen (1991) stipulates that a behaviour that is easy to perform is high in perceived behavioural control, while one that is difficult to perform is low in perceived behavioural control. Furthermore, the author suggests that an individual with high perceived behavioural control will be more likely to perform the behaviour in context than an individual with lower perceived behavioural control. For instance, individuals who have high perceived behavioural control over performing a daily physical exercise are more likely to do the exercise than those with lower perceived behavioural control (Ajzen, 2006).

In tax compliance behaviour research, when a taxpayer believes that he or she can successfully complete and file the tax return forms with Inland Revenue without any mistakes, the person seems to have a high perceived behavioural control and is more likely to comply with their tax obligations. Likewise, if a taxpayer believes that he or she can avoid paying tax without being caught by a tax audit, the person also seems to have a high perceived behavioural control over non-complying, and thus, is more likely to avoid paying tax.

In this study, I am interested in respondents' perceived behavioural control over non-complying with tax obligations. In particular, I anticipate that the higher the perceived behavioural control, the more likely that the taxpayers would avoid compliance. Based on the foregoing discussion on TPB, it is therefore hypothesised that:

H_{5a}: Attitudes_{1 to k} towards compliance and subjective norm positively influence tax compliance behaviour of Malaysian taxpayers;

H_{5b}: Fairness perceptions positively influences attitudes_{1 to k} towards compliance of Malaysian taxpayers; and

H_{5c}: Perceived behavioural control negatively influences tax compliance behaviour of Malaysian taxpayers.

As indicated earlier, perceived behavioural control deals with how taxpayers perceive relative easiness and difficulty in non-complying with tax obligations. As taxation is inherently a complicated matter, it is more likely that taxpayer’s control over non-complying with tax obligations is influenced by resources and obstacles. Based on this argument, it is appropriate to investigate the impact of tax knowledge (resources) and tax complexity (obstacles) on perceived behavioural control. Therefore, it is hypothesised that:

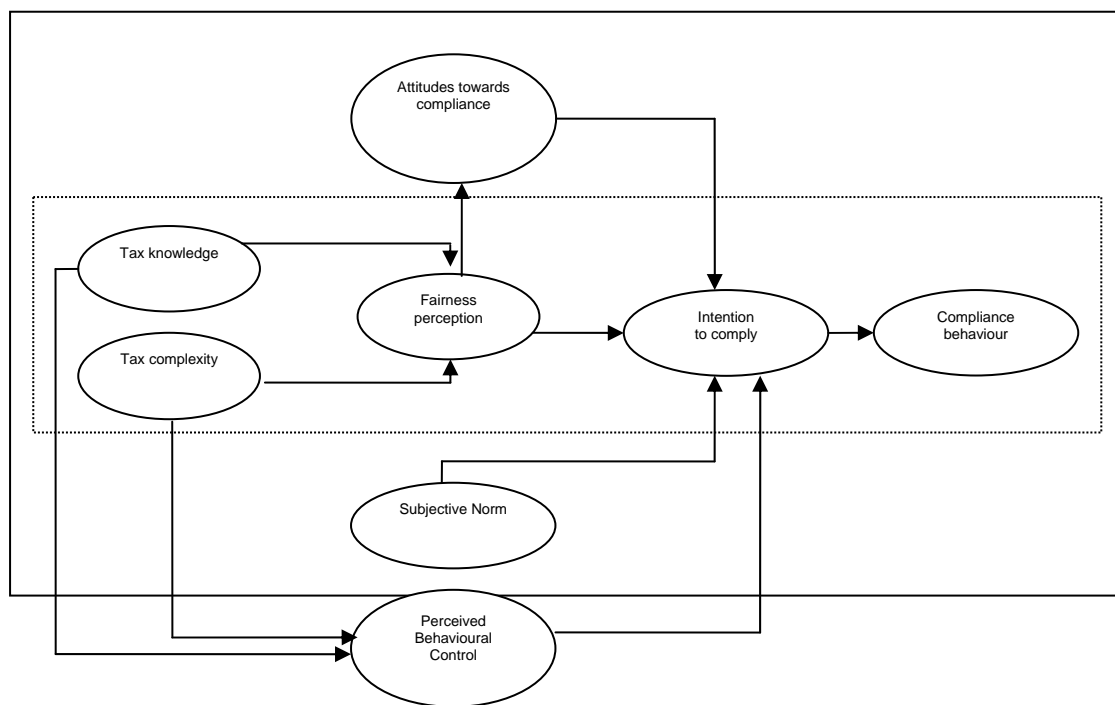
H_{6a}: Tax knowledge positively influences perceived behavioural control of Malaysian taxpayers.

H_{6b}: Tax complexity negatively influences perceived behavioural control of Malaysian taxpayers.

4. PROPOSED MODEL

I now propose a model, as set out in Figure 1, that incorporates the factors that may influence fairness perceptions and compliance behaviour as discussed earlier. A description of each construct employed in the model is also presented.

FIGURE 1: FACTORS AFFECTING FAIRNESS PERCEPTIONS AND COMPLIANCE BEHAVIOUR



5. METHODOLOGY

This section outlines the data collection and sampling characteristics, measurement techniques, demographic information, descriptive analysis and data analysis.

5.1 Data Collection and Sampling

Data was collected through survey questionnaires which were distributed to a sample of 2,267 persons with the help of Human Resource Personnel or Head of Department in the respective organizations.⁸ A total of 85 items were asked in the questionnaire. However, some of those items were not included in the analysis within this study. As an effort to increase the response rate, phone call reminders were made to the representatives requesting them to remind the potential respondents to return the questionnaires. In addition, the potential respondents were given a University of Canterbury book-mark to encourage them to complete the questionnaires as suggested by Dillman (2007). Overall, 852 usable responses were received, giving a response rate of 37.58 percent.

5.2 Measurement Techniques

Twenty items were used to measure the seven dimensions of fairness, namely general fairness, exchange fairness, horizontal fairness, vertical fairness, retributive fairness, personal fairness and administrative fairness. General fairness relates to an overall fairness evaluation of the income tax system. Exchange fairness is concerned with reciprocal exchange between taxpayers and the government, horizontal fairness deals with equal tax treatment among taxpayers in similar economic positions. Vertical fairness is assessed based on the ability to pay principle and preference for tax rate structure, either a flat rate or progressive rate. Retributive fairness is concerned with the fairness of punishments imposed while personal fairness, leads to individuals' judgments about whether the income tax system is favourable to them. Finally, administrative fairness relates to the content of the tax law (policy fairness) and procedures employed by the tax authority (procedural fairness). Out of these twenty items, six were adapted from the previous study (Gilligan & Richardson, 2005) while the remaining items were self-developed with reference to the concept of fairness in Equity Theory and the Malaysian income tax system. The items were scaled such that a higher number reflects a fairer perception.

For compliance behaviour, a hypothetical tax scenario relating to understating other income was developed. Following the scenario, 17 statements relating to the TPB variables (intention, attitudes, subjective norm and perceived behavioural control) were generated and the respondents were requested to express their opinions on the statements. Intention, attitudes and subjective norm were scaled such that a higher number corresponds to more compliance with tax obligations. In this study, compliance behaviour was measured through its proxy, intention to comply. Perceived behavioural control, on the other hand, measures control over non-complying with tax obligations and was scaled such that a higher number reflects higher control over non-compliance.

⁸ Sixteen organisations (inclusive of public and private) were selected in Malaysia.

Nine items to measure tax knowledge were developed based on various definitions available in previous studies. These items were classified into general knowledge, legal knowledge and technical knowledge. General knowledge relates to a broad idea of the income tax system such as its purpose and the tax structure. Legal knowledge emphasises taxpayers' knowledge on the regulation aspects of the income tax system, such as responsibility to submit their tax return forms timely and the penalty for non-compliance. Technical knowledge concerns with taxpayers' ability to fill and file their tax return forms themselves. To measure tax complexity, seven items were developed measuring both content and compliance complexity. Content complexity relates to difficulty in understanding tax-related materials while compliance complexity concerns with taxpayers' difficulty to comply with their tax obligations. Tax knowledge was coded such that a higher number reflects higher tax knowledge. Tax complexity, on the other hand, was scaled such that a higher number corresponds to a lower level of tax complexity.

All items were developed based on the 7-point Likert Scale, from strongly disagree (1) to strongly agree (7). In addition, respondents were also asked to provide demographic background information, including age, gender, ethnicity, education level, annual income, working sector and filing experience.

5.3 Demographic Information

The relevant demographic information of the sample is set out in Table 1. Table 1 shows that the majority (84.7 percent) of respondents were in the 30-59 age bracket. It was not a surprise that only one respondent was in the group of 60 or over as the mandatory retirement age for Malaysians is 58.⁹ While male and female respondents were almost equally represented, 64 percent of them were at least, holders of a diploma or bachelor degree. With regard to filing experience, the majority (54.3 percent) had filed their tax returns for more than five times.

A t-test analysis of the early and late responses was performed and results showed no response bias. The late responses were used as proxies for non-respondents (Leong, 1980). Similarly, comparison between population and survey responses in terms of gender, median income and employment sector also indicated that the responses were representatives of the total population of salaried individuals.

⁹ This mandatory retirement age is only applicable to public servants. However, they can continue to work with either public or private sector on a contract basis. There is no specific retirement age for those employed in the private sectors.

TABLE 1: SUMMARY OF DEMOGRAPHIC DATA (N = 852)

Variable	Frequency	Percent	Variable	Frequency	Percent
Age (years)			Annual income (MYR)		
Under 30	125	14.7	Less than 40,000	396	46.5
30-39	271	31.8	40,000-50,000	190	22.3
40-49	292	34.3	50,001-60,000	91	10.7
50-59	159	18.6	60,001-70,000	63	7.4
60 or over	1	0.1	70,001 or more	86	10.1
Missing	4	0.5	Missing	26	3.0
Gender			Working sector		
Male	422	49.5	Public	565	66.3
Female	426	50.0	Private	273	32.0
Missing	4	0.5	Missing	14	1.7
Ethnicity			Filing experience		
Malay	794	93.2	Never	133	15.6
Chinese	28	3.3	Once	63	7.4
Indian	22	2.6	2-5 times	147	17.3
Others	6	0.7	More than 5 times	463	54.3
Missing	2	0.2	Missing	46	5.4
Education level					
SPM/MCE	207	24.3			
STPM/MHCE	89	10.5			
Diploma or degree	422	49.5			
Masters or PhD	128	15.0			
Missing	6	0.7			

5.4 Descriptive analyses

Descriptive analyses are normally used to describe the basic features of the data, as set out in Table 2, Table 3 and Table 4, respectively. Table 2 describes respondents' perceptions on the fairness of the income tax system. The mean values of each item suggested that taxpayers generally had positive perceptions on vertical fairness, personal fairness and administrative fairness. In other words, taxpayers believed that the current tax system has treated individuals with different economic positions in a fair manner. In addition, taxpayers were of the opinion that they were paying a reasonable amount of tax under the current tax system. For the other dimensions of fairness, the views on each item were mixed, but leaning towards positive perceptions. In general, the mean values of these constructs clearly indicate positive perceptions on all dimensions of fairness.

TABLE 2: DESCRIPTIVE STATISTICS ON FAIRNESS PERCEPTIONS (N = 852)

Measures	Code	Min	Max	Mean	Std. Dev.
General fairness	GF	1	7	4.23	0.968
I believe the government utilizes a reasonable amount of tax revenue to achieve social goals, such as the provision of benefits for low-income families.	GF1	1	7	4.34	1.460
I believe everyone pays their fair share of income tax under the current income tax system	GF2	1	7	4.66	1.394
I think the government spends too much tax revenue on unnecessary welfare assistance.	GF3R	1	7	3.73	1.572
Exchange fairness	EF	1	7	4.42	0.849
I receive fair value from the government in return for my income tax paid (e.g. benefits).	EF1	1	7	4.34	1.361
It is fair that low-income earners receive more benefits from the government compared to high-income earners.	EF2	1	7	5.63	1.412
The income taxes that I have to pay are high considering the benefits I receive from the government.	EF3R	1	7	3.33	1.373
Horizontal fairness	HF	1	7	4.03	1.450
It is fair for individuals with similar amounts of income to pay a similar amount of income tax.	HF1	1	7	3.85	1.993
I believe it is fair for me to pay a similar share of income tax compared with other taxpayers earning an equivalent amount of income.	HF2	1	7	4.21	1.737
It is fair that 'equals before tax are equals after tax'. For example, if a person earning MYR100,000 before tax pays MYR20,000 tax, everyone earning MYR100,000 income before tax should be left with MYR80,000 after tax.	HF3	1	7	4.12	1.611
Vertical fairness	VF	1	7	5.16	0.965
It is fair that high-income earners are subject to tax at progressively higher tax rates than middle-income earners.	VF1	1	7	5.62	1.318
It is fair that middle-income earners are taxed at a lower rate than high-income earners.	VF2	1	7	5.80	1.291
The share of the total income taxes paid by high-income earners is much too high.	VF3R	1	7	4.11	1.492
Retributive fairness	RF	1	7	4.60	0.920
It is fair that individuals who deliberately evade paying their taxes should be penalised with the same amount of penalty regardless of the amount of tax evaded.	RF1R	1	7	3.86	1.876
To be fair, the degree of punishment for evading tax should depend on the degree of non-compliance.	RF2	1	7	5.41	1.330
I believe the initial late payment penalty on the unpaid tax, imposed on non-compliant taxpayers under the current tax system, is fair.	RF3	1	7	4.59	1.504
Personal fairness	PF	1	7	4.93	0.866
I believe that I pay my fair share of the tax burden under the current income tax system.	PF1	1	7	5.39	1.337
Compared to other taxpayers, I pay more than my fair share of income tax.	PF2R	1	7	4.08	1.464
Middle-income earners pay their fair share of income tax.	PF3	1	7	5.35	1.288
Administrative fairness	AF	1	7	4.62	1.053
There are a number of ways available to me to correct errors in the calculation of my tax liability, if necessary, at no additional cost.	AF1	1	7	4.71	1.279

The administration of the income tax system by the Inland Revenue Board is consistent across years and taxpayers.	AF2	1	7	4.58	1.392
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With regard to perceptions of taxpayers' tax knowledge and complexity of the tax system, results in Table 3 suggest that taxpayers generally perceived themselves as having good knowledge of tax except in two knowledge indicators, which had low mean values. In relation to complexity of the tax system, the majority of the content complexity items had mean values of below 4.0, indicating that taxpayers perceived the content of the income tax system as complex. However, observing these items as one construct (content complexity), with a mean value of 4.06 showed slightly improved perception. Despite this perception, taxpayers felt that it was relatively less complex to comply with the income tax system.

TABLE 3: DESCRIPTIVE STATISTICS ON TAX KNOWLEDGE AND TAX COMPLEXITY (N = 852)

Measures	Code	Min	Max	Mean	Std. Dev.
General knowledge	GK	1	7	4.47	1.101
The income tax system is a legitimate way for the government to collect revenue to manage an economy.	GK1	1	7	5.58	1.224
To my knowledge, individuals are subject to a single flat rate of income tax under the current tax system.	GK2R	1	7	3.60	1.566
Legal knowledge	LK	1	7	4.99	1.077
As far as I am aware, non-compliant taxpayers can be imprisoned, if found guilty of evading tax.	LK1	1	7	4.67	1.594
Similar to other criminal offences, I believe that individuals can also be prosecuted for not complying with the Income Tax Act.	LK2	1	7	5.30	1.347
I believe that I do not have to abide by the deadline for the submission of tax return form (s) as the deadline is only a guideline and does not result in penalties.	LK3R	1	7	5.03	1.715
Technical knowledge	TK	1	7	4.54	0.886
As far as I am aware, everyone who earns income sourced in this country needs to register with the Inland Revenue Board, regardless of whether that person is resident or not.	TK1	1	7	5.48	1.281
I am sure that I am not required to file a tax return on interest income that I earn from money deposited in a bank account in Malaysia as it will be subject to income tax at source.	TK2	1	7	4.77	1.621
To my knowledge, I can deduct all personal expenses in calculating my tax liability.	TK3R	1	7	4.01	1.819
I have little idea about the deductions that I can claim as a taxpayer in the computation of my tax liability.	TK4R	1	7	3.98	1.629
Content complexity	CT	1	7	4.06	1.127
I think the term used in tax publications (eg. IRB guide books) and in tax return forms are difficult for people like me to understand.	CT1R	1	7	3.89	1.491
The sentences and wording in the Individual Income Tax Return Guide are lengthy and not user-friendly.	CT2R	1	7	3.76	1.468
The rules related to individual income tax are clear.	CT3	1	7	4.73	1.266
Most of the time I need to refer to others for assistance	CT4R	1	7	3.97	1.733

in dealing with tax matters.

	Code	Min	Max	Mean	Std. Dev.
Compliance complexity	CM	1	7	4.25	1.124
I do not have a problem with completing and filing the tax return form(s).	CM1	1	7	4.84	1.487
I find it tedious to maintain all my relevant records for the whole year for tax purposes.	CM2R	1	7	3.42	1.614
I do not have to make a lot of effort to understand the explanations given in Inland Revenue Board guide books and other similar explanatory material.	CM3	1	7	4.53	1.448

Table 4 exhibits a higher mean for intention (except for one item, INS3R) and affective attitude, indicating respondents' likelihood to greater compliance behaviour. Meanwhile, a lower mean for instrumental attitude and subjective norm suggests a lower degree of compliance in Malaysia. Other than that, the perceived behavioural control of slightly above 4.0 also reflects that Malaysian taxpayers have less difficulty to avoid tax, thus resulting in low compliance.

TABLE 4: DESCRIPTIVE STATISTICS ON THEORY OF PLANNED BEHAVIOUR ITEMS (N = 852)

Measures	Code	Min	Max	Mean	Std. Dev.
Intention	INS	1	7	4.23	1.342
I would report my income fully, including the amount of MYR10,500 from the sales of handicrafts.	INS1	1	7	4.17	1.701
I would not attempt to cheat by omitting to report the extra amount of MYR10,500 in my tax return form.	INS2	1	7	4.63	1.481
I would not declare the MYR10,500 because that amount arises from trading goods with friends and neighbours.	INS3R	1	7	3.91	1.700
Affective Attitude	AFS	1	7	4.23	1.362
I would be upset if I did not declare the extra amount of MYR10,500.	AFS1	1	7	4.29	1.636
I would feel guilty if I did not declare that extra amount of MYR10,500.	AFS2	1	7	4.30	1.644
I would feel pleased if I did not declare the extra amount of MYR10,500.	AFS3R	1	7	4.12	1.585
Instrumental attitude	ISS	1	7	3.80	1.184
The likelihood of being audited by the Inland Revenue Department is high.	ISS1	1	7	4.13	1.539
It would be financially beneficial for me not to declare the extra amount of MYR10,500.	ISS2R	1	7	3.50	1.540
Subjective norm	SNS	1	7	3.91	1.231
My family and peers would think that I should not declare the extra MYR10,500.	SNS1R	1	7	3.85	1.645
My family and peers would think that I should declare the extra MYR10,500.	SNS2	1	7	4.28	1.536
My family and peers would approve of my decision to understate my income by MYR10,500.	SNS3R	1	7	3.73	1.471
My family and peers would not declare the extra MYR10,500 if faced with a similar situation.	SNS4R	1	7	3.82	1.483
Perceived behavioural control	PBS	1	7	4.17	1.070
Due to my limited knowledge, skills and resources, it					

is hard for me to omit the MYR10,500 in my tax return form successfully.	PBS1R	1	7	4.02	1.474
With my tax knowledge, skills and resources, it would be definitely easy for me to not declare the extra amount of MYR10,500 in my tax return form successfully.	PBS2	1	7	4.13	1.482
I would successfully omit the extra amount of MYR10,500 in my tax return form if I wanted to.	PBS3	1	7	4.36	1.560
With my tax knowledge, skills and resources, I would have no difficulty to omit the extra MYR10,500 in my tax return form successfully.	PBS4	1	7	4.23	1.518
There are no barriers that would prevent me from understating my income by MYR10,500 successfully.	PBS5	1	7	4.20	1.521

5.5 Data Analysis

The hypothesised model was analysed using the Partial Least Square (PLS) approach. This approach is suitable for models with latent variables which cannot be measured directly. The model was tested by performing a bootstrap procedure in PLS.¹⁰

This model consists of six exogenous variables (subjective norm, three dimensions of tax knowledge and two dimensions of tax complexity) and 11 endogenous variables (seven dimensions of fairness, intention to comply, perceived behavioural control and two dimensions of attitudes). Of these variables, six are formative constructs (with 18 items) and 11 are reflective constructs (with 35 items). While formative constructs do not measure the same underlying phenomenon and do not expect to correlate, reflective constructs are latent variables that measure “the same underlying phenomenon” (Chin, 1998, p. 305). It is vital to distinguish these two types of constructs because they require different methods in evaluating the measurement model.

5.5.1 Validity of formative constructs

To assess the validity of the formative constructs, indicator weights and the t-values were obtained from the bootstrapping procedure in Partial Least Square (PLS). A review on the results in Table 5 reveals that one item measuring retributive fairness (RF1R), two items of technical knowledge (TK3 and TK4R), and three items of content complexity were insignificant. While Diamontopolous and Winklhofer (2001) suggest that it is proper to eliminate any non-significant items to achieve all significant paths, other researchers (Bollen & Lennox, 1991; and Roberts & Thatcher, 2009) advise to retain them so as to preserve content validity. Thus, a compromise was made between these two views, where only three insignificant items (that is, RF1R, TK3 and CT1), measuring retributive fairness, technical knowledge and content complexity, respectively, were deleted. This cautious decision was made after a thorough review on those items to ensure that the construct is still measuring the entire domain and content validity is preserved (Petter et al., 2007).

¹⁰ The software used for the analysis was PLSGraph Version 3.0 developed by Professor Wynne Chin of the University of Houston.

TABLE 5: FORMATIVE CONSTRUCTS, INDICATORS AND WEIGHTS

Construct and Items	PLS Weights	T-Statistics	Significance Level
General fairness			
GF1	0.7219	5.8746	0.005
GF2	0.4878	3.1588	0.005
GF3R	-0.2008	1.4343	0.100
Retributive fairness			
<i>RF1R</i>	<i>-0.1158</i>	<i>0.7226</i>	<i>not sig.</i>
RF2	0.8468	5.0245	0.005
RF3	0.3230	1.9857	0.025
Administrative fairness			
AF1	0.3191	2.9465	0.005
AF2	0.8842	14.8294	0.005
General knowledge			
GK1	0.9173	17.1679	0.005
GK2R	-0.2873	2.8055	0.005
Technical knowledge			
TK1	0.8847	11.1842	0.005
TK2	0.2653	2.5829	0.005
<i>TK3</i>	<i>-0.1538</i>	<i>0.8563</i>	<i>not sig.</i>
TK4R	-0.1163	0.8433	not sig.
Content complexity			
<i>CT1</i>	<i>-0.1079</i>	<i>0.8139</i>	<i>not sig.</i>
CT2	-0.1318	0.9706	not sig.
CT3	1.0548	44.1376	0.005
CT4	-0.1275	1.2761	not sig.

* Italicised items are candidates for deletion

5.5.2 Validity of reflective constructs

For reflective constructs, both convergent and discriminant validity were observed (refer Table 6). Convergent validity of the reflective constructs was examined by looking at two indices: (1) the individual item loadings on the constructs; and (2) the average variance extracted (AVE). From 18 items measuring fairness perceptions, tax knowledge and tax complexity, the individual item loadings on 12 items were all highly significant at 0.7 and above (Dibbern & Chin, 2005) with a significant t-value of 0.005 level (Gefen & Straub, 2005). One item (EF2) had a loading of 0.5419 while the remaining five items had very low loadings. In relation to tax compliance behaviour constructs, all items except for two items were highly significant with individual loadings of 0.7 and above. One item (ISS2R) measuring instrumental attitude had loading of 0.5835, while another item on perceived behavioural control (PBS1R) had very low loading of below 0.3. Chin (1998) suggests that items with loadings of 0.5 and 0.6, may still be acceptable if there are other additional indicators for that construct. Based on his recommendation, the two items (EF2 and ISS2R) were retained for further analysis, while other items with loadings below 0.5 were deleted.

In terms of AVE, four constructs (exchange fairness, vertical fairness, personal fairness and legal knowledge) had values below the threshold of 0.5, providing support to remove several items in the construct, as suggested by the item loadings.

TABLE 6: REFLECTIVE CONSTRUCTS, INDICATORS AND LOADINGS

Construct and Items	PLS Loadings	T-Statistics	Significance Level
Exchange fairness		AVE = 0.373	
EF1	0.8391	4.1319	0.005
EF2	0.5419	1.7733	0.050
EF3R	0.3483	0.8488	<i>Not sig.</i>
Horizontal fairness		AVE = 0.661	
HF1	0.8130	34.0252	0.005
HF2	0.8154	22.4026	0.005
HF3	0.8115	26.1232	0.005
Vertical fairness		AVE = 0.463	
VF1	0.8164	26.3240	0.005
VF2	0.8258	27.7621	0.005
VF3R	0.2034	1.8185	0.050
Personal fairness		AVE = 0.410	
PF1	0.8404	26.9001	0.005
PF2R	-0.0506	0.3933	<i>Not sig.</i>
PF3	0.7220	17.6894	0.005
Legal knowledge		AVE = 0.494	
LK1	0.7127	12.4842	0.005
LK2	0.9223	68.0397	0.005
LK3R	0.3492	3.1737	0.005
Compliance complexity		AVE = 0.535	
CM1	0.9200	68.6230	0.005
CM2R	0.1211	0.9739	<i>Not sig.</i>
CM3	0.8622	30.3890	0.005
Intention		AVE = 0.670	
INS1	0.8883	95.6698	0.005
INS2	0.7907	30.8406	0.005
INS3R	0.7721	30.2272	0.005
Affective attitude		AVE = 0.711	
AFS1	0.9043	78.9188	0.005
AFS2	0.9034	72.0915	0.005
AFS3R	0.7063	20.7253	0.005
Instrumental attitude		AVE = 0.570	
ISS1	0.8943	29.8622	0.005
ISS2R	0.5835	7.1217	0.005
Subjective norm		AVE = 0.642	
SNS1R	0.8386	47.8350	0.005
SNS2	0.7443	29.1542	0.005
SNS3R	0.7884	30.7893	0.005
SNS4 / SNS4R	0.8313	44.9107	0.005
Perceived control		AVE = 0.533	

<i>PBS1R</i>	<i>0.2293</i>	<i>2.9023</i>	<i>0.005</i>
PBS2	0.7672	26.9629	0.005
PBS3	0.7575	23.4037	0.005
PBS4	0.8786	63.8594	0.005
PBS5	0.8236	39.4065	0.005

* Figures in bold indicate loadings or AVE below 0.6 or 0.5 respectively; while italicised item represents items to be deleted.

The re-run test on the remaining indicators showed better loadings and AVEs (refer Table 7), which satisfied the convergent validity condition (Fornell & Larcker, 1981).

TABLE 7: REFLECTIVE CONSTRUCTS, INDICATORS AND LOADINGS (REVISED MODEL)

Construct and Items	PLS Loadings	T-Statistics	Significance Level
Exchange fairness		AVE = 0.528	
EF1	0.7924	7.9051	0.005
EF2	0.6540	4.8302	0.005
Horizontal fairness		AVE = 0.661	
HF1	0.8133	32.3795	0.005
HF2	0.8109	22.1034	0.005
HF3	0.8151	25.3093	0.005
Vertical fairness		AVE = 0.674	
VF1	0.8165	27.2260	0.005
VF2	0.8258	25.3514	0.005
Personal fairness		AVE = 0.617	
PF1	0.8437	32.5484	0.005
PF3	0.7227	15.9622	0.005
Legal knowledge		AVE = 0.710	
LK1	0.7471	18.2436	0.005
LK2	0.9282	65.8648	0.005
Compliance complexity		AVE = 0.798	
CM1	0.9201	76.5415	0.005
CM3	0.8658	43.9460	0.005
Intention		AVE = 0.670	
INS1	0.8884	99.4664	0.005
INS2	0.7921	27.8647	0.005
INS3R	0.7707	27.5944	0.005
Affective attitude		AVE = 0.711	
AFS1	0.9055	84.4308	0.005
AFS2	0.9044	81.4470	0.005
AFS3R	0.7038	25.2547	0.005
Instrumental attitude		AVE = 0.570	
ISS1	0.8953	35.6605	0.005
ISS2R	0.5818	8.4530	0.005
Subjective norm		AVE = 0.654	
SNS1R	0.8492	55.4851	0.005

SNS2	0.7896	40.3286	0.005
SNS3R	0.7866	31.5517	0.005
Perceived control		AVE = 0.676	
PBS2	0.7843	37.1882	0.005
PBS3	0.7756	33.2751	0.005
PBS4	0.8898	77.4915	0.005
PBS5	0.8336	42.2967	0.005

Discriminant validity demands a strong correlation between an indicator and its associated construct but weak correlation with all other constructs (Gefen & Straub, 2005). The two procedures used to assess discriminant validity were (1) item cross-loadings; and (2) the ratio of the square root of the AVE of each construct to the correlations of this construct to all other constructs (Gefen & Straub, 2005). The results revealed that all item cross-loadings load higher on their corresponding constructs than any other construct and every construct had a square root of AVE bigger than its correlations with other constructs. This suggested that each measure did not tap the different concepts, and therefore confirmed the discriminant validity. Detailed item cross-loading and inter-construct correlations are presented in Tables 8 and 9, respectively.

TABLE 8: LOADING AND CROSS-LOADING MATRIX

	INS	AFS	ISS	SNS	PBS	GF*	EF	HF	VF	RF*	PF	AF*	GK*	LK	TK*	CT*	CM
INS1	.888	.650	.508	.616	-.348	.210	.155	.058	.029	.070	.100	.165	.065	.008	.016	.158	.084
INS2	.792	.554	.409	.479	-.226	.153	.172	.021	.150	.139	.126	.117	.112	.077	.071	.199	.103
INS3R	.771	.558	.370	.665	-.478	.045	.064	-.069	.001	.012	.029	.034	-.008	-.011	-.046	-.041	-.004
AFS1	.629	.905	.445	.501	-.272	.167	.109	.114	.050	.060	.101	.114	.040	.009	.003	.112	.070
AFS2	.616	.904	.453	.501	-.295	.136	.123	.128	.045	.063	.082	.133	.062	.017	-.007	.119	.079
AFS3R	.571	.704	.345	.606	-.467	.031	.082	-.049	.007	.052	.088	.017	.059	.021	-.022	.001	-.016
ISS1	.477	.455	.895	.472	-.274	.173	.064	.220	.051	.043	.080	.084	-.020	-.053	.009	.113	-.016
ISS2R	.297	.265	.582	.323	-.434	-.007	.008	.053	-.067	-.062	-.064	-.044	-.063	-.115	-.049	-.055	-.075
SNS1R	.594	.509	.409	.849	-.493	.079	.065	.010	-.008	.034	-.024	.022	-.036	-.005	-.059	-.030	-.077
SNS2	.623	.551	.513	.790	-.259	.183	.117	.155	.061	.168	.048	.120	.040	.056	.071	.152	.006
SNS3R	.527	.468	.364	.787	-.464	-.026	-.012	-.035	-.055	-.005	-.083	-.072	-.087	-.033	-.086	-.075	-.067
PBS2	-.386	-.333	-.294	-.450	.784	-.085	-.020	.026	.047	.034	.034	-.004	.026	.120	.034	.004	.031
PBS3	-.276	-.234	-.341	-.320	.776	-.068	-.017	-.076	.056	.090	.061	-.027	.036	.104	.063	-.002	.061
PBS4	-.371	-.350	-.396	-.418	.890	-.080	-.030	-.019	.069	.089	.049	.009	.063	.083	.071	.082	.088
PBS5	-.377	-.385	-.358	-.421	.834	-.066	-.059	-.028	.091	.103	.058	.013	.060	.060	.137	.066	.105
GF1	.174	.177	.122	.119	-.108	.865	.410	.164	.058	.046	.269	.380	.232	.062	.030	.213	.122
GF2	.073	.024	.091	.032	-.026	.722	.287	.217	.139	.101	.368	.323	.189	.087	.200	.296	.139
GF3R	-.023	.027	-.033	-.011	-.002	-.114	-.040	-.117	-.115	-.077	.015	.026	-.003	-.023	-.048	-.067	-.011
EF1	.149	.125	.049	.050	-.058	.543	.792	.113	.057	.079	.315	.399	.182	.093	.031	.204	.114
EF2	.072	.050	.031	.060	.008	.055	.654	.144	.485	.171	.250	.141	.157	.192	.202	.136	.051
HF1	.010	.058	.163	.055	-.020	.165	.118	.813	.062	.024	.104	.168	.050	.026	.072	.097	-.006
HF2	-.019	.041	.132	.022	-.013	.195	.153	.811	.111	.040	.109	.157	.108	.010	.089	.101	-.055
HF3	.019	.096	.199	.066	-.028	.234	.150	.815	.140	.083	.113	.180	.100	.043	.059	.123	.054
VF1	.088	.055	.026	-.014	.049	.135	.226	.135	.816	.156	.257	.161	.255	.163	.241	.162	.134
VF2	.024	.014	-.005	.018	.083	.082	.330	.081	.826	.178	.289	.098	.271	.141	.275	.120	.048
RF2	.053	.043	-.015	.064	.108	.055	.138	.028	.213	.952	.272	.135	.324	.350	.299	.178	.130
RF3	.127	.099	.064	.099	.003	.153	.138	.122	.056	.539	.129	.247	.111	.175	.106	.227	.161
PF1	.098	.086	-.001	-.033	.052	.360	.277	.053	.199	.204	.844	.270	.332	.247	.256	.266	.226
PF3	.058	.083	.069	.006	.043	.205	.352	.174	.345	.240	.723	.295	.230	.163	.217	.239	.126
AF1	.066	.015	.072	.043	.062	.258	.241	.135	.145	.113	.246	.497	.106	.149	.108	.164	.171
AF2	.123	.116	.030	.025	-.022	.391	.352	.187	.126	.181	.313	.951	.287	.196	.125	.318	.249
GK1	.065	.060	-.076	-.039	.062	.216	.227	.059	.336	.321	.359	.270	.966	.406	.330	.344	.221
GK2R	-.023	-.028	-.100	-.025	.001	-.232	-.088	-.201	-.029	-.076	-.117	-.139	-.394	-.145	-.184	-.209	-.108
LK1	-.021	-.020	-.045	-.022	.048	.067	.152	.069	.084	.192	.150	.128	.279	.747	.141	.138	.108
LK2	.048	.036	-.104	.026	.122	.085	.168	.007	.201	.378	.274	.225	.402	.928	.327	.263	.249
TK1	.066	.023	-.003	.019	.052	.116	.159	.033	.292	.296	.305	.141	.350	.322	.957	.213	.212
TK2	-.149	-.093	-.083	-.145	.148	.045	.000	.138	.186	.118	.117	.067	.147	.066	.484	.102	.094
TK4R	.059	.048	-.091	.037	-.068	-.083	-.029	-.199	-.015	.038	.035	.002	.003	.057	-.062	-.019	.296
CT2R	.034	-.001	-.072	-.015	-.042	.023	.021	-.127	-.007	-.004	-.006	.050	.000	-.007	-.057	.013	.404
CT3	.124	.094	.031	.018	.039	.295	.229	.075	.165	.228	.314	.329	.360	.252	.201	.958	.564
CT4R	-.014	.028	-.140	-.028	.009	-.040	-.010	-.194	.020	.088	.066	.002	.021	.094	.006	.012	.389
CM1	.082	.082	-.035	-.030	.072	.147	.104	-.014	.148	.158	.237	.266	.246	.228	.205	.386	.920
CM3	.044	.007	-.051	-.074	.086	.134	.106	.020	.036	.134	.167	.220	.162	.179	.110	.428	.866

* = formative constructs, therefore loadings are not interpreted.

TABLE 9: CORRELATION OF LATENT CONSTRUCTS AND THE SQUARE ROOT OF AVE

	INS	AFS	ISS	SNS	PBS	GF	EF	HF	VF	RF	PF	AF	GK	LK	TK	CT	CM
INS	0.819*																
AFS	0.680	0.843															
ISS	0.518	0.474	0.755														
SNS	0.657	0.541	0.508	0.809													
PBS	-0.339	-0.283	-0.348	-0.433	0.822												
GF	0.204	0.153	0.154	0.086	-0.074	0.654											
EF	0.168	0.120	0.061	0.034	-0.045	0.440	0.727										
HF	0.037	0.076	0.191	0.042	-0.011	0.238	0.177	0.813									
VF	0.041	0.029	-0.008	-0.033	0.099	0.107	0.329	0.121	0.821								
RF	0.105	0.089	0.008	0.066	0.138	0.122	0.213	0.068	0.292	0.773							
PF	0.127	0.109	0.046	-0.030	0.061	0.376	0.403	0.134	0.353	0.322	0.785						
AF	0.149	0.115	0.053	-0.007	0.020	0.424	0.395	0.212	0.161	0.235	0.360	0.759					
GK	0.080	0.092	-0.036	-0.037	0.095	0.273	0.291	0.131	0.363	0.362	0.409	0.333	0.738				
LK	0.035	0.048	-0.094	-0.019	0.141	0.110	0.219	0.036	0.245	0.428	0.327	0.247	0.499	0.843			
TK	0.041	0.019	-0.042	-0.021	0.148	0.123	0.179	0.093	0.377	0.374	0.348	0.202	0.428	0.411	0.620		
CT	0.163	0.130	0.061	0.008	0.081	0.309	0.246	0.116	0.181	0.261	0.349	0.341	0.396	0.314	0.274	0.553	
CM	0.073	0.068	-0.050	-0.099	0.126	0.169	0.142	-0.005	0.131	0.217	0.263	0.283	0.277	0.303	0.243	0.480	0.893

* Diagonal elements are square root of average variance extracted.

5.5.3 Reliability of the constructs

Reliability of the constructs involved multicollinearity test (formative constructs) and composite reliability and AVE (reflective constructs). With regard to formative constructs, no presence of multicollinearity was expected to confirm the reliability of the measures, as high multicollinearity suggests an unstable model (Petter et al., 2007). For this purpose, variance inflation factor (VIF) and condition index were used as the reference, with statistics of greater than 3.3 (Diamantopoulos & Siguaw, 2006) and 30 respectively, representing multicollinearity problem. The result in Table 10 revealed that the VIF and condition index figures were below the threshold levels, which suggested no multicollinearity problem existed and thus confirmed the reliability of the measures.

TABLE 10: VARIANCE INFLATION FACTOR (VIF) AND CONDITION INDEX

Item	Un-standardized Coefficients		Standardized Coefficients		Collinearity Statistics			Condition Index
	B	Std. Error	Beta	T	Sig.	Tolerance	VIF	
Constant	0.000	0.034		0.000	1.000			1.000
GF	0.127	0.038	0.127	3.309	0.001	0.775	1.290	1.455
RF	0.065	0.037	0.065	1.763	0.078	0.844	1.185	1.531
AF	0.049	0.039	0.049	1.271	0.204	0.751	1.332	1.798
GK	-0.013	0.040	-0.013	-0.335	0.738	0.727	1.376	1.845
TK	-0.039	0.037	-0.039	-1.054	0.292	0.832	1.202	2.006
CT	0.068	0.038	0.068	1.775	0.076	0.772	1.296	2.054

For reflective constructs, the figures in Table 11 suggest that all constructs met the minimum value of 0.7 (Chin, 1998; Igbaria et al, 1997; Suraweera et al., 2005), except for exchange fairness with a slightly lower value, at 0.69. Other than that, most constructs had an internal consistency of above 0.8.

TABLE 11: INTERNAL CONSISTENCY OF THE CONSTRUCTS

Construct	Composite Reliability
Exchange fairness (EF)	0.689
Horizontal fairness (HF)	0.854
Vertical fairness (VF)	0.805
Personal fairness (PF)	0.762
Legal knowledge (LK)	0.829
Compliance complexity (CM)	0.888
Intention (IND/INS)	0.859
Affective attitude (AFD/AFS)	0.879
Instrumental attitude (ISD/ISS)	0.717
Subjective norm (SND/SNS)	0.850
Perceived behavioural control (PBD/PBS)	0.893

In addition to composite reliability, the AVE scales used to determine reliability of the measures also indicated that all the scales performed acceptably on this standard (exceed 0.5) and thus confirmed the reliability of the measures (refer Table 12).

TABLE 12: AVERAGE VARIANCE EXTRACTED OF THE CONSTRUCTS

	AVE
Exchange fairness (EF)	0.528
Horizontal fairness (HF)	0.661
Vertical fairness (VF)	0.674
Personal fairness (PF)	0.617
Legal knowledge (LK)	0.710
Compliance complexity (CM)	0.798
Intention (INS)	0.670
Affective attitude (AFS)	0.711
Instrumental attitude (ISS)	0.570
Subjective norm (SNS)	0.654
Perceived behavioural control (PBS)	0.676

The evaluation on measurement model implies that the measures used in this study work appropriately. Thus, the next step is to test the explanatory power of the entire model in explaining tax compliance behaviour.

6. KEY RESULTS

Figure 2 presents the results. The R^2 value of 0.664 for the intention to comply indicated that fairness perceptions, affective attitude, instrumental attitude, subjective norm and perceived behavioural control accounted for 66.4 percent of the variance of the construct. The predictive power of this model is a considerable improvement over the reported R^2 in Bobek (1997), who studied the determinants of non-compliance behaviour.

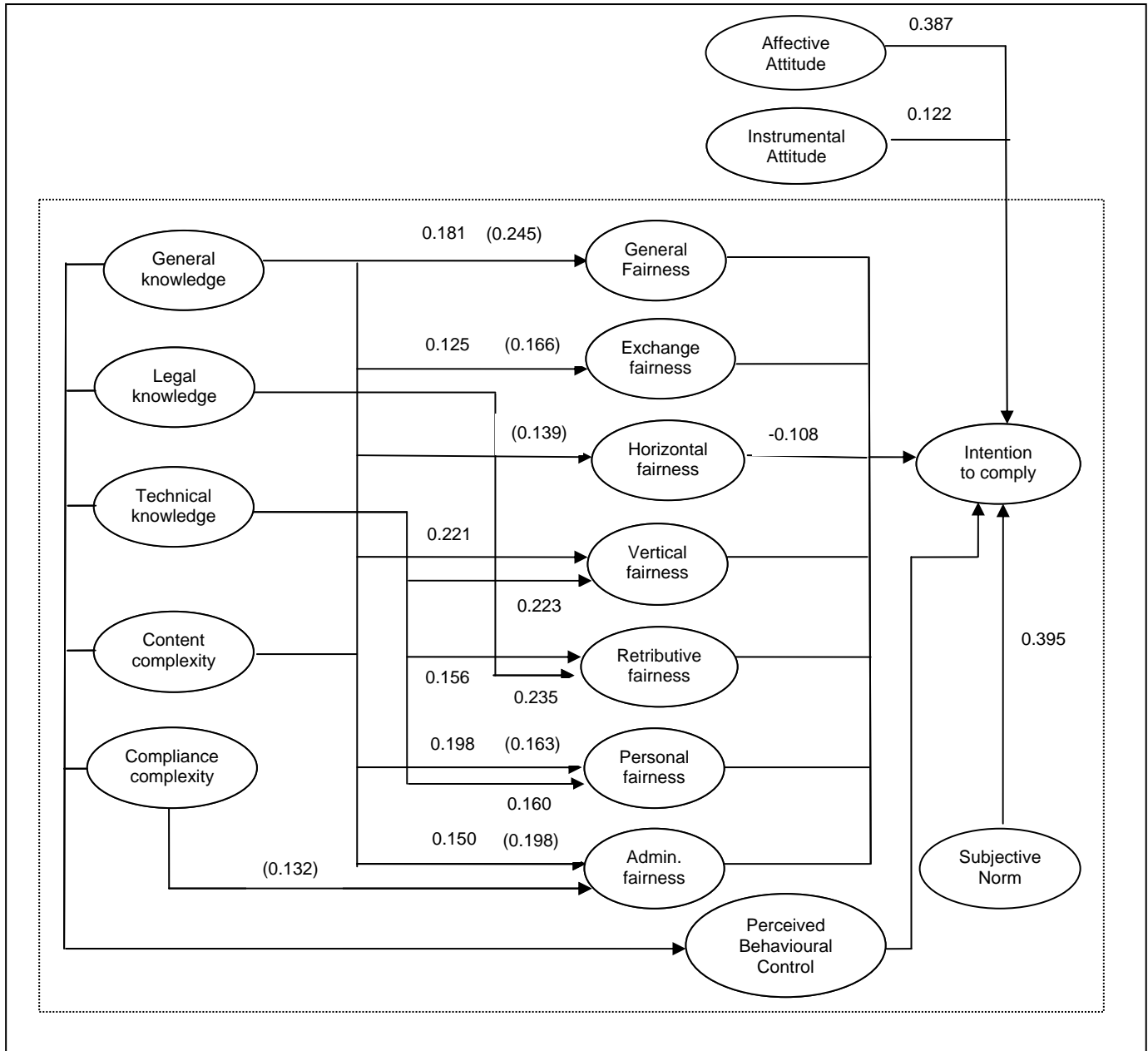
The path coefficients on variables under study are also provided. In relation to the direct effects of fairness perceptions on compliance behaviour, it was found that horizontal fairness was the only dimension that was significant, at the 0.005 level. Surprisingly, however, the path coefficient was in the opposite direction to that expected.

The TPB variables (attitudes and subjective norm) were highly significant at the 0.005 level. As expected, attitudes (both affective and instrumental) and subjective norm positively influenced compliance behaviour. Further, results suggested that instrumental attitude was significantly influenced by the perceptions on horizontal fairness.

The model also describes the path coefficients for tax knowledge and tax complexity on fairness perceptions. The results showed that generally, tax knowledge had effects on fairness perceptions to a certain degree, except for horizontal fairness. In particular, general knowledge had a significant positive influence (at the 0.005 level) on five dimensions of fairness (excluding horizontal fairness and retributive fairness). Technical knowledge was found to have significant influence on vertical fairness, retributive fairness and personal fairness, while legal knowledge was only significant in shaping taxpayers perceptions on retributive fairness. All paths were in positive directions.

With regard to the effect of tax complexity, results revealed that tax complexity had no significant influence on vertical fairness and retributive fairness. Other than that, content complexity was found to have effects on all dimensions of fairness perceptions, while compliance complexity only had an effect on administrative fairness. With regard to the effects of tax knowledge and tax complexity on perceived behavioural control, no significant influence was reported.

FIGURE 2: PATH COEFFICIENTS



Notes:

For simplistic purpose, only significant path coefficients are displayed in the model.

Figures in parentheses are path coefficients for the influence of tax complexity on fairness perceptions.

$R^2 = 0.664$

7. DISCUSSION

The purpose of this study was to examine the fairness perceptions of Malaysian taxpayers on the income tax system and how their perceptions influence their compliance behaviour. In so doing, I used a well-established model of TPB. The TPB model provides a theoretical framework of behavioural determinants consisting of attitudes, subjective norm and perceived behavioural control. For the purpose of this study, fairness perceptions were included to extend the existing TPB model, particularly in the tax compliance environment. Overall, the results suggest that the TPB model fits the data well.

This study reveals that taxpayers view fairness of the income tax system from various perspectives, namely general fairness, exchange fairness, horizontal fairness, vertical fairness, retributive fairness, personal fairness and administrative fairness. This is consistent with previous studies which contend that fairness perceptions are multidimensional (Gilligan & Richardson, 2005; and Gerbing, 1988). Also, the results extend the three fairness dimensions¹¹ documented by Azmi and Perumal (2008). Thus, the findings provide support for Hypothesis 1 that fairness perceptions are multidimensional.

Hypothesis 2 predicts that fairness perceptions will positively influence compliance behaviour. Specifically, the hypothesis suggests that the fairer taxpayers perceive the tax system, the more likely they will comply with their tax obligations. However, the findings provide no support to this contention. The possible explanation for such findings is the fact that taxation lies within a highly legalised environment. In such environment, whether a system is perceived fair or not, taxpayers have no choice but to comply. Otherwise, they will be subject to penalties. In other words, despite their resentment with the income tax system, they still need to pay tax which is compulsory on them.

Surprisingly, horizontal fairness is found to have a negative effect on compliance behaviour. This suggests that the fairer taxpayers perceive the income tax system, the less likely for them to comply. A possible explanation for this is the belief that taxpayers should not be taxed equally with sole reference to their annual incomes without considering their financial responsibilities and social welfare. For instance, a single person earning an annual income of MYR100,000 should not be taxed at similar rate with a married taxpayer with three children even though he is earning similar amount of incomes, due to their different circumstances. In other words, taxpayers were suggesting that if all others remain constant, horizontal fairness will motivate them to not comply.

Implicitly, the results suggest that horizontal fairness cannot be observed as a stand alone dimension of fairness. It should be complemented by other dimensions of fairness, particularly vertical fairness, as suggested by the Distributive Justice Theory. To recap, the Distributive Justice Theory asserts that in order to be fair, a system needs not necessarily treat people in similar circumstances in equivalent manner, but rather it depends on individuals' needs. Having said that, a further test was conducted by combining the horizontal fairness and vertical fairness dimensions (known as

¹¹ The dimensions are general fairness, fairness on tax structure and self-interest.

distributive fairness) and examining their effects on intention to comply. From that analysis, the results suggested no significant relationship was present. In other words, taxpayers did not perceive distributive fairness (horizontal and vertical fairness) as an important motivation to either comply or not comply.

Among three dimensions of tax knowledge, general knowledge of the income tax system was proven to have an influence on all dimensions of fairness, with the exception of horizontal fairness and retributive fairness. While legal knowledge only had a significant influence on retributive fairness, technical knowledge was found to have significant effects on vertical fairness, retributive fairness and personal fairness. Overall, the findings provide partial support to Hypothesis 3 which predicted that tax knowledge will positively influence fairness perceptions. Also, the findings, to a certain degree, are consistent with previous studies (Fallan, 1999; White et al., 1990; and Harris, 1989), which claimed that tax knowledge would increase fairness perceptions.

With regard to tax complexity, the findings indicated that general fairness, exchange fairness, horizontal fairness, personal fairness and administrative fairness were highly influenced by the complexity of the content of the income tax law (content complexity). In addition, complexity to comply (compliance complexity) with the income tax law was reported to have a significant influence on administrative fairness. These findings are consistent with Hypothesis 4, which suggests that tax complexity has an inverse relationship with fairness perceptions. Specifically this study confirms that a lower level of tax complexity positively influenced fairness perceptions as reported in previous studies (Erich et al., 2006; Cialdini, 1989; Carroll, 1987; and Milliron, 1985).

The use of the TPB model in tax compliance behaviour offers a good explanation of taxpayers' behaviour. Attitudes (both affective and instrumental) and subjective norm proved to be significant factors but not the perceived behavioural control. While attitudes and subjective norm had positive coefficients, the perceived behavioural control had a negative coefficient (but not significant). In other words, the results suggested that the higher the attitudes towards compliance, the more likely a taxpayer would comply with his or her tax obligations. Similarly, the higher a taxpayer's motivation to comply with his or her referent group, the higher would be their compliance. The findings provide support to Hypothesis 5a. This suggests that the TPB model is not limited to predicting unethical behaviours in information systems (Dwyer & Williams, 2002) and other human behaviours (Paris & Broucke, 2008; Guo et al., 2007; and Chang, 1998), but is also useful in explaining tax compliance behaviour.

Hypothesis 5b that concerns with the influences of fairness perceptions on attitudes is mainly rejected except in the case of horizontal fairness. The result suggested that better perceptions on horizontal fairness would improve taxpayers' instrumental attitude towards compliance. Other than that, the findings generally suggest that fairness perceptions do not necessarily form taxpayers' attitudes towards compliance.

The final hypothesis predicts that tax knowledge and (tax complexity) will positively and (negatively) influence perceived behavioural control. Specifically, I anticipate a higher level of tax knowledge will result in a higher perceived behavioural control while a higher level of tax complexity will result in a lower perceived behavioural

control. The findings on these variables, however, showed insignificant results, thus suggesting rejecting hypotheses 6a and 6b.

8. CONCLUSION, LIMITATIONS AND FUTURE RESEARCH

The study provides evidence that Malaysian taxpayers perceive fairness of the income tax system in several dimensions. However, such dimensions, with the exception of horizontal fairness, seem to have no significant influence on their compliance behaviour. On the contrary, attitudes and subjective norm as highlighted in TPB have been significantly influential. This empirical evidence should add to the literature on compliance behaviour. In Malaysia particularly, the findings would provide an important update on the existing evidence documented by Mustafa (1996) and Azmi and Perumal (2008). Furthermore, the findings should be beneficial to policy makers and the tax authority as they highlight the fairness dimensions and relevant factors that need attention.

This study should also help tax researchers generally to understand the role of tax knowledge and tax complexity in fairness perceptions. For policy makers, the empirical evidence offers guidance in developing tax education and simplification programmes. Last, but by no means least, this study provides clear evidence that the TPB model has significant potential to contribute to the tax compliance literature. The extension to the TPB model in a tax environment seems to be a fruitful area for future research.

This study, however, is not without limitations. The convergent validity analysis on the constructs indicates lower item loadings than the recommended threshold of 0.7 for some of the items. Notwithstanding the low loadings, the items are still acceptable for further analysis (Chin, 1998). Future research should continue to extend the theoretical model of TPB in the tax literature as it offers a good explanation of compliance behaviour. Possibly researchers could decompose the TPB variables to gain a better insight into the determining factors. In addition, a survey on fairness perceptions among tax professionals would also be an interesting area for research.

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GST Tax Avoidance: A New Zealand Perspective on the Application of Div 165

Mark Keating*

Abstract

The GST regime has now been operating in Australia for a decade.¹ During that period there has been only one reported case on GST tax avoidance. The absence of other cases indicates either the GST regime is working as intended, and there is no avoidance of GST, or the ingenuity of taxpayers seeking GST benefits has simply not been detected by ATO.

A New Tax System (Goods and Services Tax) Act 1999 (“GST Act”) contains a number of measures to combat avoidance of GST. There are a range of specific anti-avoidance provisions to counter particular instances of tax avoidance. These specific rules are narrowly targeted provisions to prevent foreseeable instances where taxpayers may otherwise attempt to defeat the normal or expected operation of the relevant statute².

More importantly, Div 165 GST Act contains a broad-ranging general anti-avoidance provision (“GAAR”) to prevent abuse of the GST regime.³ Unlike the specific anti-avoidance rules, Div 165 is widely-worded with open-ended application. Such provisions⁴ are designed to apply to the unanticipated and unforeseen behaviour by taxpayers that, although contrary to neither the substantive provisions of the Act nor any applicable specific anti-avoidance provisions, nevertheless breach the scheme and purpose of the relevant statute.

Despite the lack of case law, it can be presumed that tax avoidance is as much a part of the landscape of GST as it is for income tax. But while there have been many income tax avoidance cases litigated over the past decade, there is an understandable dearth of GST cases.

The Australian Administration Appeals Tribunal heard the sole GST avoidance case under Div 165 in 2006. Following the enactment of a GST regime in New Zealand in 1986, it took 15 years for the first case to be considered by the courts under s 76 *New Zealand Goods and Services Tax Act 1985* (NZGSTA). Those initial cases, involving fairly blatant schemes to obtain unwarranted tax benefits, were decided in favour of the Commissioners in both jurisdictions.

It was not until 2007 that New Zealand’s Court of Appeal heard two GST avoidance cases, upholding the Commissioner’s assessment of tax avoidance in both instances. The decision in one of those cases was subsequently appealed to New Zealand’s newly formed Supreme Court,⁵ which eventually upheld the assessment of tax avoidance.

* Senior Lecturer, University of Auckland Business School. The author would like to thank the advice and support given by Kirsty Maclaren.

¹ GST is imposed under *A New Tax System (Goods and Services Tax) Act 1999*, which came into effect on 1 July 2000.

² Commonly specific anti-avoidance provisions stipulate taxpayers must act at market value on normal commercial terms in a timely manner. Examples are found throughout the GST Act, such as s 29-25 (timing for particular taxable supplies and creditable acquisitions), s 9-75 (value of supplies not expressed in money) and s 66-10 (purchases of second-hand goods) and s 72-70 (supplies between associated persons).

³ Division 165 *A New Tax System (GST) Act 1999*.

⁴ See Part IVA *Income Tax & Assessment Act 1937*. The equivalent provisions in New Zealand for income tax is s BG1 *Income Tax Act 2007* and for GST is s 76 *Goods & Services Tax Act 1985*.

⁵ As a reflection of its British colonial history, from 1840 – 2005 New Zealand’s highest court of appeal was the Privy Council in London. The right of appeal to the Privy Council was finally abandoned in

These New Zealand cases, involving very different schemes, are the first consideration of GST avoidance by higher courts in either jurisdiction.⁶ Accordingly the reasoning of those decisions provides a useful guide to the potential application of Div 165 in Australia. The cases demonstrate that, like the equivalent GAARs for income tax, Courts are willing to apply anti-avoidance provisions wherever they believe taxpayers' conduct abuses the GST regime. The decisions give the anti-avoidance provisions teeth and provided the Commissioner in both countries with a strong weapon against abusive conduct by taxpayers.

This article examines the GST tax avoidance cases decided in both Australia and New Zealand. It compares them with the application of the income tax general anti-avoidance provisions. Finally the paper provides some guidance on when Div 165 may be applied to schemes, given the different requirements of the GST regime.

1. ROLE OF GENERAL ANTI-AVOIDANCE RULES

General anti-avoidance rules ("GAAR") render void against the Commissioner any arrangement that has the purpose or effect of tax avoidance. The role of this type of provision was explained in the venerable Australian case *FCT v Newton*:⁷

"[The GAAR] is not aimed at fraudulent conduct or at pretended as distinct from real transactions. Such cases need no statutory provision. It is aimed at transactions that are in themselves real and lawful but which the Legislature desires to nullify so far, and only so far, as they may operate to avoid tax."

A GAAR is designed to protect Government revenue from schemes that have in all other respects fully complied with the relevant law but which nevertheless contravene the normal or expected operation of the Act. In the so-called *Trinity* case, the New Zealand Supreme Court explained this reasoning in the following terms:⁸

"Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise be a permissible arrangement into a tax avoidance arrangement. ... Thus tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps of an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement. ... [The GAAR's] function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract."

Not surprisingly, the operation of a GAAR is both controversial and uncertain. By definition, the general nature of the provision makes its scope and application less certain. This has led some commentators⁹ to draw comparison between the operation of a GAAR and Article 58 of the Soviet-era Russian SFSR Penal Code enacted under

2005, to be replaced by the New Zealand Supreme Court, whose members are all members of New Zealand's own judiciary.

⁶ The sole Australian case to date is *Case 14/2006* 2006 ATC 187, involving almost identical facts to those in New Zealand's *Ch'elle* case.

⁷ (1957) 96 CLR 577, at 646 - 647

⁸ *Ben Nevis Forestry Ventures Ltd & Ors v CIR* [2008] NZSC 115, at para [104], known as the "*Trinity scheme*".

⁹ *Legislation with Retrospective Effect, with Particular Reference to Tax Loopholes and Avoidance*, Prof John Prebble et al, (2006) 22 NZULR 17.

Stalin.¹⁰ This infamous Article made illegal all “counter-revolutionary” or “anti-Soviet” activities, and formally introduced the notion of “enemy of the workers”. It was under this Article that Stalin’s show trials were conducted and many victims of the Great Purge were convicted.

The breadth of Article 58, with its deliberately wide and imprecise meaning, obviously undermined the rule of law. “Article 58 was *carte blanche* for the secret police to arrest and imprison anyone deemed suspicious, making for its use as a political weapon.”¹¹ Most odiously, its lack of clarity made it impossible for defendants to reasonably establish whether any particular conduct was in breach.

While obviously hyperbole,¹² it is submitted that a similar criticism can be made against a GAAR. Taxpayers who have carefully complied with all other provisions of the Revenue Acts, including existing specific anti-avoidance provisions, may nevertheless find themselves in breach of a deliberately ill-defined GAAR. As was explained by the New Zealand High Court in *Miller v CIR*:¹³

“It is the very nature of tax avoiders to manoeuvre skilfully around the express rules of the general law and the tax legislation and end with the innocent submission - as I have not infringed them I have succeeded. That is the very reason for generally expressed anti-avoidance provisions which being their operation when other provisions have had their effect.”

Criticism of the vagueness of a GAAR is common. As one commentator complained:¹⁴

“the problem is an obvious one; how do you know when you have crossed an imaginary line?”

Responding to taxpayer criticism about the difficulty of complying with such nebulous provisions, the Court of Appeal noted:¹⁵ “certainty and predictability are important but not absolute values” and therefore a GAAR must be left as flexible as possible. The criticism by taxpayers was finally addressed in the two most recent¹⁶ New Zealand Supreme Court decisions.^{17 18} In those cases the taxpayers contended the GAAR should be read-down in the interests of taxpayer certainty – but with the result that it would be so narrow as to make it virtually inoperative. In rejecting such a narrow interpretation, the Court of Appeal noted:¹⁹ “this approach does not leave much scope

¹⁰ Article 58 Russian SFSR Penal Code, operative from 25 February 1927.

¹¹ See [http://en.wikipedia.org/wiki/Article_58_\(RSFSR_Penal_Code\)](http://en.wikipedia.org/wiki/Article_58_(RSFSR_Penal_Code)), as at 12 Jan 2009.

¹² See footnote 48 where Prebble et al express disavow any moral equivalent between tax avoidance and the crimes against humanity committed by dictatorial regimes in reliance on such criminal codes.

¹³ (1996) 17 NZTC 13,001

¹⁴ *Role of a General Anti-Avoidance Rule in GST*, E Trombitas, NZJTLTP Vol 13, Sept 2007, at 463.

¹⁵ *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 at [40].

¹⁶ Both judgments were delivered simultaneously on 19 December 2008. The Supreme Court is New Zealand’s highest Court, following the abolition of the right to Appeal to the UK Privy Counsel in 2004.

¹⁷ *Ben Nevis Forestry Ventures Ltd & Ors v CIR* [2008] NZSC 115, Elias CJ, Tipping, McGrath, Gault and Anderson JJ – dealing with income tax. It is referred to as the *Trinity* case because of the name of the charitable trust used at the centre of the scheme.

¹⁸ *Glenharrow Holdings Ltd v CIR* [2008] NZSC 116, Elias CJ, Blanchard, Tipping, McGrath and Anderson JJ – dealing with GST.

¹⁹ *Accent Management and Ors v CIR* [2007] NZCA 230, at [116]

for a general avoidance provision” and criticised the taxpayers’ arguments as “sometimes coming close to maintaining that general anti-avoidance provisions have no role at all”.

In the *Trinity* case, the taxpayers argued they were entitled to make commercial choices to take advantage of the tax benefits available, and the income tax GAAR should be interpreted as narrowly as possible to give taxpayers reasonable certainty in tax planning. In *Glenharrow* the taxpayer argued the GST GAAR ought not be permitted to interfere with a bargain honestly reached by arms-length parties, as to do so would create unwelcome uncertainty for taxpayers.

The New Zealand Supreme Court dismissed both arguments. The Court noted the wording used in the GAARs was deliberately imprecise and the judiciary should not create greater certainty than Parliament has chosen to provide. It reasoned a GAAR must remain deliberately vague because, no matter how carefully such a provision is drafted, the ingenuity of taxpayers cannot be predicted, making it impossible for Parliament to enact a more specifically-worded provision with the flexibility to anticipate future arrangements. Therefore the use of wide and imprecise language is required for a GAAR to regain the flexibility to be applied to novel arrangements.

With regard to the GST GAAR, in *Glenharrow* the Court explained:²⁰

“Uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act. There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificial arrangements. It is simply not possible to meet the objectives of a general anti-avoidance provision by the use, for example, of precise definitions”.

With a notable lack of sympathy for taxpayers, the Court acknowledged that, while there may be difficult cases on the margins, generally an examination of the facts and the economic substance of each arrangement “will make it possible to decide on which side of the line a particular arrangement falls.”²¹

Finally, for taxpayers seeking certainty, the Supreme Court recommended that they utilise the statutory Binding Ruling process²² to test the Commissioner’s view as to the tax effectiveness of their arrangements, prior to entering into them. That may be unwelcome advice to taxpayers who have experienced the increasing cost and extended delays typical of the Binding Ruling regimes in both Australia and New Zealand.²³ This somewhat harsh attitude was justified by a leading commentator:²⁴

²⁰ *Glenharrow Holdings Ltd v CIR* [2007] NZSC 116, at [48]

²¹ *Ben Nevis Forestry Ventures Ltd & Ors v CIR* [2008] NZSC 115, at [112]

²² A procedure contained in New Zealand’s *Tax Administration Act* whereby taxpayers may apply to have a proposed transaction approved by the Commissioner. Once issued, the Ruling is binding upon the Commissioner. However, the process has been widely criticised for its delay and expense.

²³ See Div 359 *Australian Taxation Administration Act 1953* and Part V *New Zealand Tax Administration Act 1994*.

²⁴ “Retrospective Legislation: Reliance, the Public Interest, Principles of Interpretation and the Special Case of Anti-Avoidance Legislation”, Prebble et al, *NZULR*, Vol 22, Dec 2006, at 281.

“Despite their claims to the contrary, people caught by such provisions generally do intend to minimise tax. What they are relying on in such situations is ... a hope or expectation that their arrangements will pass as effective for tax. When an assessment catches such transactions a sense of moral outrage seems inappropriate.”

The result of this muscular interpretation of the GAAR is to deliberately create uncertainty for taxpayers so as to give them pause before embarking on possibly abusive tax arrangements. The uncertainty over the precise scope of the GAAR may therefore serve a second purpose of discouraging such abusive behaviour.

This approach contrasts with the requirements stipulated by the European Court of Justice in *Halifax plc v Commissioners of Custom and Excise*.²⁵ that “the requirement of legal certainty must be observed strictly in cases of rules liable to entail financial consequence, in order that those concerned may know precisely the extent of the obligations which they imposed on them.”²⁶ As such it appears the wide Australasian application of GAARs would be contrary to the European Community Sixth Directive restricting the use of anti-avoidance powers in the UK VAT legislation.

2. STATUTORY TESTS FOR GAARS

The Australian and New Zealand GAARs adopt somewhat different tests for what constitutes tax avoidance.

- In Australia the GAAR applies to any scheme with the sole or dominant purpose of providing a tax benefit.
- In New Zealand the GAAR applies where obtaining a tax benefit is more than merely incidental.

On their face the two provisions appear to adopt different thresholds as to what constitutes tax avoidance. While the Australian provision requires a dominant purpose, the NZ provision applies the somewhat lower standard of being more than merely incidental. However, this difference in the applicable standard may be more apparent than real, as schemes that come before the courts generally include uncommercial features that make their tax avoidance purpose obvious, whatever standard is used. Furthermore, the Australian courts have recognised that a genuine commercial rationale for a transaction can nevertheless constitute tax avoidance if that scheme is “tax driven”. This was made clear in *Spotless Services Ltd v FCT*²⁷ where the High Court explained that:

“A particular course of action may be ... both ‘tax driven’ and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether ... [the scheme has a] ‘dominant purpose’ of enabling the taxpayer to obtain a ‘tax benefit’.”

²⁵ [2006] BTC 5308.

²⁶ As summarised in “European Court of Justice and the Principle of Prohibiting Abusive Practices in VAT”, Ben Terra *NZJTL*, Vol 13, Sept 2007, at 384.

²⁷ 96 ATC 5201 (HCA)

This approach is mirrored in the New Zealand definition of “tax avoidance” that stipulates it can include arrangements involving “ordinary business or family dealings”²⁸ if the tax benefits of the scheme are more than merely incidental. As a result, it is apparent that both GAARs catch schemes regardless of any underlying commercial rationale. A tax-driven transaction may therefore constitute tax avoidance under the GAAR in both jurisdictions even if it also has a genuine business purpose.

Interestingly, this result clearly conflicts with the ECJ requirement that only arrangements with the sole purpose of obtaining tax advantages with no normal commercial operation may be struck down for VAT purposes.²⁹

Div 165 requires four factors to be satisfied before the Commissioner can negate a tax avoidance scheme. These are:

1. One or more of the steps in the arrangement is a “scheme”,³⁰
2. A “GST benefit”³¹ arises under the scheme,
3. An entity gets a benefit from the scheme, and
4. It is reasonable to conclude, taking into account the statutory factors, that the dominant purpose or principal effect of entering the scheme was to get the GST benefit.

To determine whether the scheme has a dominant purpose or principal effect of tax avoidance, s 165-15 contains a list of factors against which the scheme must be measured. These factors are:

- The manner in which the scheme was entered into,
- The form and substance of the scheme,
- The purpose and object of the GST Act and any relevant provisions,
- The timing of the scheme,
- The period over which the scheme was carried out,
- The effect of the scheme,
- Any change in the participants’ financial position,
- Any other consequences on the participants,
- The nature of the connection between the participants,
- The circumstances surrounding the scheme, and
- Any other relevant considerations.

²⁸ See s 76(2) NZ GSTA.

²⁹ See *Halifax and Cadbury Schweppes plc v IRC* [2007] STC 980.

³⁰ As defined in s 165-10(2).

³¹ As defined in s 165-10(1).

These factors mirror the explicit criteria in Part IVA of the *Income Tax Assessment Act* and therefore cases decided under that Part can provide direct guidance on the scope and application of the GST GAAR. As noted in the only Australian case to consider the application of Div 165:³²

“there had been a number of cases in the Australian courts considering Part IVA of the ITA Act. It is clear from the scheme of Div 165 that it is built on principles that are very similar to those found in Part IVA.”

By contrast, the New Zealand legislation contains no signposts to measure the tax avoidance purpose of an arrangement. Instead, the current New Zealand legislation simply leaves it to the Court’s discretion regarding what factors may be relevant to whether an arrangement had the purpose or effect of tax avoidance. However, the courts have themselves identified a number of factors or indicia that, if present, would be indicative of tax avoidance. These factors are, not surprisingly, similar to the statutory criteria prescribed in Div 165 for determining whether an arrangement constitutes tax avoidance.

Perhaps more than any other area, tax avoidance will depend upon the facts determined in each case. The Supreme Court in *Trinity* noted “whether an arrangement is an artifice or involves a pretence will often be highly relevant to whether there is an arrangement that has a purpose or effect of tax avoidance.”³³

Facts which, objectively viewed, appear to demonstrate a lack of commerciality, circularity, or pretence will therefore be just as relevant as the actual arrangement entered into by taxpayers. The Court therefore considered all relevant factors regarding the structure and implementation of the arrangement by the taxpayers.³⁴

“The general anti-avoidance provision does not confine the Court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists. Hence the Commissioner and the courts may address a number of relevant factors.”

These include:

- the manner the arrangement is carried out,
- the role of the relevant parties and any association they may have,
- the economic and commercial effects of the various steps,
- the duration of the arrangement, and
- the nature and extent of the fiscal consequences.

In *Glenharrow* the Supreme Court warned against “transactions that have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act.”³⁵ Specifically with regard to GST, the New Zealand

³² See *Case 14* 2006 ATC 187, at para 153.

³³ *Trinity* at [97].

³⁴ *Trinity* at [108].

³⁵ *Glenharrow* at [48]

Courts have identified a range of factors that will be relevant to whether the GAAR should apply.³⁶ These factors are:

- the relationship between the parties, whether arms-length or associated,
- the amount of GST at issue and the degree to which any supposed commercial transaction to which it relates is dependent upon that GST treatment,
- the normal commerciality of the arrangement,
- the perceived purpose of the particular section being exploited (i.e., the scheme and application of that provision of the Act),
- the experience and substance of the parties in fulfilling the transactions.

These factors are similar to those identified by the ECJ in VAT tax abuse cases such as *Ermsland Starke*.³⁷ VAT avoidance requires a two-step test.³⁸ First there must be an examination of the scheme according to objective factors to determine whether the tax advantage obtained was contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. This “essential aim” must be determined by considering “the real substance and significance of the transactions concerned” taking account of “the purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden”.³⁹

As with Div 165, the “essential aim” is not a sole purpose test. There can be a finding of an abusive practice when obtaining a tax advantage constitutes the principal aim of the transaction or transactions at issue.⁴⁰ Furthermore, that aim is determined from the objective facts of the case rather than the subjective aim or intention of the parties engaged in those transactions.

2.1 Role of Scheme and Purpose in Tax Avoidance

It is trite law that not all tax benefits enjoyed by taxpayers constitute tax avoidance. This position is made explicit in the Australian GST Act, which identifies a number of specific choices provided to taxpayers that are protected from the application of Div 165.⁴¹ Taking advantage of these choices therefore cannot constitute tax avoidance, on the grounds the exercise of those choices all conform to the intended operation of the Act. By contrast attempts to take advantage of other supposed choices or incentives beyond those provided in the Act would remain vulnerable to Div 165.

While the corresponding NZ legislation doesn’t specifically identify similar protected choices, the courts have confirmed it will examine whether an arrangement

³⁶ These factors were first identified by the TRA in *Case W22* (2003) 21 NZTC 11,211 and were endorsed by the High Court on appeal in *Ch’elle Property (NZ) Ltd v CIR* (2004) 21 NZTC 18,618.

³⁷ *Ermsland-Starke GmbH v Hauptzollamt Hamburg-Jonas* [2000] ECR I-11569.

³⁸ See *Halifax* at para 86, and UK Revenue and Customs Brief 56/09 at para 4: see <http://www.hmrc.gov.uk/briefs/vat/brief5609.htm>, as 15 Feb 2010.

³⁹ See *Halifax* at para 81.

⁴⁰ See *Parts Services Case*, at para 45 and 62.

⁴¹ See s 165-5(1)(b).

contravenes the intent and application of the Act before finding the resulting tax benefit constitutes avoidance. For instance, in *Glenharrow* the Supreme Court acknowledged:⁴²

“The intention of the Act will be defeated if an arrangement has been structured to enable the avoidance of output tax, or the obtaining of an input deduction in circumstances where that consequence is outside the purpose and contemplation of the relevant statutory provisions. ... An arrangement of this kind is not in accordance with the overall purpose of the Act because it produces a “tax advantage” not within the contemplation of the statute.”

Later the Court confirmed:⁴³

“That is of course consistent with the neutrality and efficiency of the revenue collection rationales that underlie the Act. The corollary is that registered persons should, by the same token, not obtain unacceptable windfall gains from the regime.”

Therefore, only after reviewing the proper operation of the Act was the Court able to conclude the scheme in *Glenharrow* breached the scheme and purpose of the relevant provisions:⁴⁴

“The whole premise of the Act generally and of the secondhand goods provisions in particular is that transactions will be driven by market forces: that their commercial and fiscal effects will be produced by those forces and will not contain distortions which affect (ie defeat) the contemplated application of the GST Act. It is when market forces do not prevail that s 76 is available to the Commissioner.”

In both countries taxpayers retain the right to exercise choices either expressly or implicitly contained in the Act. It is only when those choices give rise to a tax benefit contrary to the scheme of the Act that the GAAR will apply.

3. AUSTRALIAN CASE APPLYING DIV 165

To date, the only Australian case applying Div 165 is *Re VCE*.⁴⁵ That case involved the sale of commercial real estate from an individual to the company he controlled. The property was valued at approximately \$250,000 but was sold to the company for \$768,000, with settlement to take place in 15 years. A deposit of \$550 was paid immediately with two further small instalments payable at 5-yearly intervals until the bulk of the outstanding price was payable in 2018.

The individual was personally registered for GST on the cash basis, and the company was registered on the accruals basis. This meant the company was technically entitled to an immediate input tax credit for the full \$70,000 GST, while the individual was not liable for the equivalent GST output tax for 15 years. Not surprisingly the ATO invoked Div 165 and declared the arrangement void for GST purposes.

⁴² *Glenharrow*, at [40]

⁴³ *Ibid*, at [43]

⁴⁴ *Ibid*, at [47]

⁴⁵ AAT Case 14/2006, reported at 2006 ATC 187

The AAT confirmed the ATO's view. Relying on the interpretation of the similar criteria for income tax avoidance in Part IVA by appellate courts,⁴⁶ the AAT confirmed that Div 165 adopted an almost exclusively objective test, by reference to the statutory criteria in s 165-15, and not a subjective test of the purpose of the participants of the scheme. The AAT then undertook a lengthy analysis of the statutory factors in s 165-15 to be taken into account when determining tax avoidance and concluded that, under virtually all criteria, the transaction "is outside the range of normal commercial dealings. The time between the date of the Agreement and the date of settlement is unusually lengthy".⁴⁷

Most importantly the AAT found that the scheme breached two general requirements implicit in the operation of the GST regime. First, the inordinate delay in settling and paying the purchase price under the transaction contrasted with the normal temporal operation of the Act.

"While not making any reference to the time at which the GST is payable on the supply, the clear intention is that a person claiming an input tax credit on the acquisition of the thing cannot claim more than is payable on the supply of that same thing."⁴⁸

And later:

"It is apparent from the scheme of the GST Act that there is meant to be some degree of conformity between the GST that is paid on a taxable supply and the input tax credit on that taxable supply."⁴⁹

Second, claiming an input tax credit today for the expected future value of the property undermined the usual requirement that transactions take place at current market value.

"It is an outcome that favours [the individual] as the net present value of the money in 2003 in the hand is significantly greater than the same amount promised for the payment five and ten years, let alone fifteen years later. In the meantime, the company will have had the advantage of being able to use the \$70,000 paid as a refund by the Commissioner."⁵⁰

Accordingly, the AAT concluded the requirements of Div 165 were made out. Having reached that conclusion, the AAT made a number of additional remarks regarding why Div 165 is necessary to prevent abuse of the GST Act and counteract taxpayers claiming unwarranted input tax credits under such schemes.

"The burden of GST is intended to fall according to its terms which are framed on the basis of there being commercial transactions of some type. ... It is equally clear that GST is not intended to be a source of bounty. ... There is

⁴⁶ At para 78 – 86, referring to the High Court decisions in *FCT v Spotless Services Ltd* 1993 ATC 4104 and *FCT v Hart* (2004) 217 CLR 216. The AAT also noted at para 153 that "there had been a number of cases in the Australian courts considering Part IVA of the ITA Act. It is clear from the scheme of Div 165 that it is built on principles that are very similar to those found in Part IVA."

⁴⁷ At para 122.

⁴⁸ At para 73.

⁴⁹ At para 153.

⁵⁰ At para 118.

an assumption that there will be some correlation between payment of GST and input tax credit. ... An input tax credit does not represent some sort of bounty that the Commissioner bestows upon a person. It is more appropriately regarded as an alleviation of the burden that person has borne in paying the price of the goods or services. In this case the burden and its alleviation have not fallen as the GST Act intended.”⁵¹

Only at the conclusion of its decision, when dealing with penalties, does the AAT acknowledge the similarity in both the facts and principles between *Re VCE* and the New Zealand decision in *Ch’elle Properties Ltd v CIR*.⁵² Nevertheless, the approach of the courts to this type of deferred settlement arrangement is clearly consistent. The fact no appeal was ever heard from *Re VCE*, and no similar arrangements have come before the Australian courts, may indicate that Australian taxpayers have recognised the strong stance likely to be taken by the ATO against this type of GST abuse.

4. NEW ZEALAND CASES APPLYING THE GST GAAR

Given the lack of Australian case law, cases decided under the equivalent New Zealand legislation may provide some guidance to the application of Div 165. In 2008 the New Zealand Court of Appeal and finally the Supreme Court considered the vexed question of when proper GST tax planning crosses the line into impermissible tax avoidance. Although the Courts found the taxpayers correctly applied the black letter GST law in each case, their arrangements nevertheless constituted tax avoidance. In each instance the Court issued strong judgments against arrangements it considered were artificial and lacking commerciality, finding that such arrangements breached the intent and application of the GST Act and were therefore void for tax purposes.

4.1 *Ch’elle*

The impugned arrangement in *Ch’elle Properties (NZ) Ltd v CIR*⁵³ involved 114 companies that each had the same individual shareholder/director. None of the companies had any assets or even bank accounts. Each company registered for GST on a payments basis, as permitted if it had an annual turnover below \$1million.⁵⁴

Simultaneously, a friend of the promoter of the arrangement incorporated *Ch’elle Properties (NZ) Ltd*, another shell company without assets or bank account. Although the friend had no experience in the property market, *Ch’elle* registered for GST on an invoice-basis claiming to conduct the taxable activity of “property trading”.

In late 1998 each of the 114 companies entered into conditional sale and purchase agreements with a third party developer for the purchase of vacant subdivided lots. Each property was purchased for \$70,000. In early 1999 each company then on-sold the land to *Ch’elle* for an average of \$700,000 – a ten-fold increase in the cost of the property or \$80million in total. Settlement of the sale to *Ch’elle* was deferred for

⁵¹ At para 136.

⁵² *Ch’elle Properties Ltd v CIR* [2007] NZCA 256 (CA)

⁵³ (2007) NZCA 256.

⁵⁴ Under s 19 NZ GST Act, the equivalent of s 29-40.

between 10 and 20 years but Ch'elle immediately paid a \$10 cash deposit thereby triggering the time of supply for GST purposes.⁵⁵

As an invoice-basis taxpayer Ch'elle claimed an input tax credit of \$9 million. Because the 114 companies were registered on a payments-basis, they would not be required to return output tax on the transactions until they settled in 10 to 20 years time.

While the arrangements technically complied with the relevant GST provisions the Commissioner disallowed the input tax claim on the ground that the arrangement was contrary to the intent and application of the GST Act, in breach of the GAAR.

The TRA⁵⁶ ruled the total lack of commerciality of the various transactions meant that the arrangement constituted tax avoidance.⁵⁷ The High Court subsequently rejected the taxpayer's appeal,⁵⁸ finding that the arrangement offended the intent and application of the Act in two ways:

- the underlying legislative intention is that an overall balance should be maintained between the outputs and inputs of a registered person; and
- there should be some reasonable correspondence between the time at which outputs and inputs in relation to a particular supply are accounted for.

The arrangement was therefore void for tax purposes under the GAAR and the taxpayers were not entitled to the input tax credits claimed. The taxpayers again appealed to the New Zealand Court of Appeal.

4.1.1 Court of Appeal decision in Ch'elle

The Court of Appeal unanimously rejected the taxpayer's appeal,⁵⁹ on the basis that, while small mismatches in timing are an inherent feature of the GST regime, input tax claims "will ultimately be balanced by the payment of output tax ... and in the circumstances of this case the balance between outputs and inputs is grossly distorted. ... [Therefore] the 10 to 20 year delay in all circumstances defeats the intent of the Act and accordingly triggers [the GAAR]."⁶⁰

Likewise, while the choice of different accounting basis for GST may result in mismatches between some taxpayers, "that does not mean that a gross mismatch in timing is irrelevant ... The Act seeks to limit the nature and degree of such mismatching."⁶¹

⁵⁵ S 9 GST Act 1985 the equivalent of s 29-5. .

⁵⁶ Taxation Review Authority, New Zealand's specialist tax disputes authority established under the *Taxation Review Authority Act 1994*. It is the initial forum for most tax cases, with appeals from the TRA to the High Court, then onwards to the Court of Appeal and finally (if granted leave) to the Supreme Court.

⁵⁷ Case W22 (2003) 21 NZTC 11,211.

⁵⁸ *Ch'elle Properties (NZ) Limited v CIR* (2004) NZLR 274.

⁵⁹ (2007) 23 NZTC 21,442.

⁶⁰ *Ibid*, at [42]

⁶¹ *Ibid*, at [50]

By using 114 different companies so that each had a turnover below the \$1million statutory threshold for taxpayers to remain on a payments basis, the arrangement effectively circumvented the sections prescribing registration and accounting basis. “As a result, the degree of mismatch contemplated and tolerated by the Act escalated to a level which could never have been intended”.⁶²

On this point the Court concluded:⁶³

“The wider the temporal gap between the taxpayer’s eligibility for an input tax credit and its liability for output tax, the less likely the arrangement conforms to the intent of the Act. We do not suggest that the Act intends that there be no delay, but that significant delay can indicate a crossing of the line into tax avoidance.”

Of particular importance was the unanimous endorsement of the High Court’s finding that the GAAR involved an objective test. The Court of Appeal stated:⁶⁴

“Mr Hayes, for the appellant, contended that s 76 required a subjective intent. This cannot be the case. This would lead to the anomalous situation where an identical transaction might in one case be sustainable, but in another struck down as tax avoidance because in the first instance the operator mistakenly, naively, unrealistically or opportunistically was of the view that what was being done was unassailable. The second, however, which involved a more confident person who thought it was worth ‘having a go’, would be struck down. It is the objective assessment of the arrangement which will provide the answer as to whether it defeats the intention and application of the Act and is therefore void.”

This finding had particular relevance to the subsequent *Glenharrow* decision (discussed below). Although the *Ch’elle* taxpayers applied for leave to appeal the case to the New Zealand Supreme Court, their application was rejected. Accordingly that decision stands as the leading decision on this type of arrangement, which seeks to exploit the mismatch between taxpayers who use a payments and invoice basis. The Court of Appeal’s reasoning in *Ch’elle* has been applied in subsequent decisions on this type of arrangement in both New Zealand⁶⁵ and Australia.⁶⁶

4.2 Glenharrow

The *Glenharrow* arrangement dealt with a much more contentious transaction. It involved the claim for a second-hand goods input tax credit on the purchase of a 10-year mining license.⁶⁷

⁶² Ibid, at [51]

⁶³ Ibid, at [41]

⁶⁴ Ibid, at [25]

⁶⁵ *Case X23* (2006) 22 NZTC 12,290 and *Case X25* (2006) 22 NZTC 12,303.

⁶⁶ *Case 14/2006* 2006 ATC 187.

⁶⁷ Secs 3A and 20(3) NZGSTA permit taxpayers to claim input tax credits (and potentially cash GST refunds) on the purchase for taxable purposes of second-hand goods (i.e., those owned by persons not registered for GST) to the extent of “payment” for those goods.

The mining license was issued in 1990 but had not been operated by its original holder. In 1994 the license was sold to local prospectors for \$100. In 1996 it was on-sold for \$10,000. In 1997 Glenharrow Holdings Ltd, a \$100 shelf company, purchase the license for \$45million. The purchase price was satisfied in two ways:

- \$80,000 was paid in cash by Glenharrow; and
- the remaining \$44,920,000 was provided as vendor finance, which was secured by a mortgage over the shares in Glenharrow and the mining license.

The parties agreed that interest and principle repayments would be funded out of profits derived from the successful exploitation of the license. No additional security or guarantee was given for the outstanding purchase price.

Glenharrow began to exploit the license but, due to both legal and practical difficulties, conducted only minimal mining. From that limited operation Glenharrow made further payments of only \$210,000.

The vendor was not registered for GST while Glenharrow was registered. Glenharrow therefore claimed a second-hand input tax credit of \$5million on the purchase of the mining license.⁶⁸ The Commissioner disallowed the input tax claim on the ground the arrangement breached the GAAR. The taxpayers challenged the assessment in the High Court.⁶⁹

Although the Commissioner contested the taxpayer's entitlement to an input tax credit under the black letter law, the High Court found that the arrangement was (putting aside the GAAR) effective for GST. The agreement to purchase the license was genuine and the parties intended to implement it according to its terms. Although the purchase price of \$45million was "grossly inflated" it was a genuinely agreed price based on the parties' extremely optimistic valuation.

On the question of whether the arrangement had any real business purpose, the Court found Glenharrow had acquired the license for the principle purpose of making taxable supplies and therefore met the criteria for an input tax credit.⁷⁰ Based on those factual findings, the Commissioner's technical arguments failed.

Nevertheless the Court ruled the arrangement defeated the intent and application of the NZGSTA and was therefore void. While acknowledging the honesty of the taxpayers, the Court stated:⁷¹

"I have difficulty in accepting that the legislature intended s 76 to be governed by the personal motives of the taxpayer when entering into the arrangement. Apart from producing an erratic application of the section ..., such an

⁶⁸ NZ GST is charged at a standard rate of 12.5%, so input tax of 1/9th of the purchase price of goods purchased for the principle purpose of making taxable supplies may be claimed as an input tax credit, under s 3A.

⁶⁹ *Glenharrow Holdings Ltd v CIR* (2005) 22 NZTC 19,319.

⁷⁰ This is the equivalent statutory provision to Division 11-15 of Australia's *A New Tax System (Goods and Services Tax) Act 1999* that permits an input tax credit for purchases "to the extent that you acquire it in carrying on your enterprise".

⁷¹ *Glenharrow Holdings Ltd v CIR* [2008] NZSC 116, at [35]

interpretation would almost certainly render the section virtually useless and destroy its anti-avoidance purpose.”

4.2.1 Court of Appeal decision in Glenharrow

From the wording of the Court of Appeal judgment, it is apparent that the members of the Court of Appeal were somewhat uneasy with the High Court’s findings regarding the taxpayers’ credibility, especially as the license had previously been sold for only \$100 and \$10,000. The Court found that the price of \$45million was “artificial” and “totally unrealistic”.

Both *Ch’elle* and *Glenharrow* considered the former wording of the GST GAAR. That old version applied to arrangements that “defeat the intent and application” of the GST Act. The GAAR was rewritten in 2000 to now apply to arrangements that “have a purpose or effect of tax avoidance”, thus bringing it into line with the wording of the income tax GAAR.⁷²

Despite the different wording the Court of Appeal applied the same reasoning as that applicable for income tax and adopted an objective test of whether the arrangement defeated the Act, therefore ignoring the taxpayer’s honest purpose.

“We are satisfied that [GAAR] does not incorporate a subjective test. To give such an interpretation would render the section, which is intended to operate as a ‘backstop’ provision, virtually inoperative.”⁷³

Glenharrow had argued that, once the parties agreed the license was worth \$45million, it should preclude the application of the GAAR, regardless of whether that price was mistakenly excessive. This argument relied upon the venerable decisions of *Europa Oil*⁷⁴ and *Cecil Bros*⁷⁵ that neither the Commissioner nor the Court may tell taxpayers how to run their business or how much to pay for their assets. The requirement that transactions be undertaken at market value for GST purposes applies only between persons who are “associated” for tax purposes under the NZGSTA and therefore prices set at arms-length should not be disturbed by the GAAR.

The Court of Appeal rejected this argument on the grounds the scheme of the GST regime required transactions to be undertaken at (approximately) market value and that “a grossly inflated” transaction therefore defeated the intent and application of the Act. While only associated persons are explicitly required to transact at market value,⁷⁶ that specific rule reflects the general policy of GST that transactions be conducted at realistic prices, which is normally self-policing between non-associated parties. Thus transactions at non-market value were likely to frustrate the scheme of the NZGSTA.

The Court also found the GST regime generally requires neutrality between supplier and recipient. While mismatches between the timing of input and output tax will occasionally arise, particularly between taxpayers who account for GST on different

⁷² See s BG1 *Income Tax Act 2007*.

⁷³ *Glenharrow v CIR* (2007) 23 NZTC 21,564 at [79].

⁷⁴ *Europa Oil (NZ) Ltd v CIR* (No 2) (1976) 2 NZTC 61,066.

⁷⁵ *Cecil Bros Pty Ltd v FCT* (1964) 11 CLR 430.

⁷⁶ S 10 GST Act 1985.

bases, those mismatches may not be exaggerated. In fact, the very existence of “significant temporal mismatches can indicate a crossing of the line into tax avoidance”.⁷⁷ Likewise, transactions with unregistered person must always bear closer scrutiny because they have obvious potential to disturb GST neutrality.

The Court of Appeal found that the vendor-finance of \$44,920,000 in this instance was so totally unrealistic that it did not amount to “payment” for GST purposes. Accordingly, the assessments of tax avoidance were confirmed.

Given the express findings the taxpayers had acted honestly, if over-optimistically, in reaching their bargain that the mining license was worth \$45m, the Supreme Court granted leave for Glenharrow to appeal. This case was therefore the first time the Supreme Court considered the scope and application of the GST GAAR.

4.2.2 Supreme Court decision in Glenharrow

First, the Supreme Court reiterated that the GST GAAR involved an objective test of the purpose of the arrangement and not a subjective review of the state of mind of the participants:⁷⁸

“Whether or not a particular arrangement constitutes tax avoidance should not depend on difficult judgments about what the taxpayer had in mind. If it did, a scheme which was void if devised and implemented by one taxpayer could be immune from s 76 if developed by another ... It requires the Commissioner and the Court to ask what objectively was the purpose of the arrangement, which in turn requires an examination of the effect of the arrangement.”

On that reasoning a taxpayer can honestly but mistakenly commit tax avoidance. If two persons who knowingly inflated the purchase price of second hand goods are guilty of tax avoidance (because their arrangement when viewed objectively gives rise to a tax advantage never intended by the Act), so too must two innocent persons who have mistakenly agreed on an inflated price for the same goods.

This conclusion follows an unbroken line of cases, starting with *Newman v FCT*,⁷⁹ stipulating that the purpose or effect of the arrangement must be determined objectively and not by reference to the motives of the taxpayers, which are irrelevant.⁸⁰ The GAAR “was concerned not with the purpose of the parties but with the purpose of the arrangement. This is a crucial distinction.”⁸¹ In this regard the Australasian GAARs are consistent with the reasoning of the ECJ⁸² that the test of tax abuse is objective in character. Nevertheless the finding of tax avoidance against an apparently honest taxpayer is the most contentious aspect of the *Glenharrow* decision. Many commentators expressed concern the result was too harsh and if taxpayers have a genuine business purpose, the GAAR should not be applied.⁸³

⁷⁷ *Glenharrow Holdings Ltd v CIR* (2007) 23 NZTC 21,564, at [91]

⁷⁸ *Glenharrow Holdings Ltd v CIR* [2008] NZSC 115, at [35]

⁷⁹ [958] AC 450.

⁸⁰ See also the New Zealand case of *Ashton v CIR* [1975] 2 NZLR 717.

⁸¹ *Glenharrow* at [38].

⁸² In cases such as *BLP Group plc v Commissioner of Customs & Excise* [1995] STC 424.

⁸³ *Role of a General Anti-Avoidance Rule in GST*, E Trombitas, NZJTLF Vol 13, Sept 2007.

The Supreme Court ruled that the unusual wording of former s 76 did not alter its scope and application as a general anti-avoidance provision, because “the current version of the section merely states expressly what was implicit in the former version.”⁸⁴

Applying that reasoning to the facts, the Supreme Court asked whether “the intention of the Act will be defeated if the arrangement has been structured to enable the avoidance of output tax or the obtaining of an input deduction in circumstances where that consequence is outside of the purpose and contemplation of the relevant statutory provisions.”

After reviewing the history and role of GST in New Zealand, the Court concluded:

- there will usually be, over time, some balancing of inputs and outputs by a supplier;
- taxpayers should not obtain unacceptable windfalls in their dealings with unregistered persons;
- parties should generally be dealing with each other at approximately market value; and
- timing differences between input and output tax ought not to be exploited.

The Supreme Court stated:⁸⁵

“GST was intended to be broad-based, efficient and neutral. Nevertheless ... tax avoidance opportunities notably remain at the boundaries between taxable and non-taxable transactions and between registered and unregistered persons. Accordingly, the general anti-avoidance provision was considered necessary.”

Considering the facts in *Glenharrow*:⁸⁶

“there is potential for registered taxpayers knowingly or otherwise to create distortions at the boundary between themselves and unregistered persons. The same can occur where transactions are between those registered on a payments basis and those registered on an invoice basis (as in *Ch’elle* and *Nicholls*). The general anti-avoidance provision is available to stop or counteract both these distortions.”

Given the clearly inflated purchase price and the unusual method of payment by way of vendor-finance, the Court confirmed the arrangement constituted tax avoidance in breach of the GAAR.

5. SHOULD DIV 165 OVERRIDE OTHER PROVISIONS OF THE GST ACT?

A common complaint and regular difficulty with the application of Div 165 is how it should operate beside the other provisions of the GST Act. Tension arises as to whether it should be applied widely in such a way as to potentially make all tax

⁸⁴ *Glenharrow*, at [36]

⁸⁵ *Ibid*, at [42]

⁸⁶ *Ibid*, at [46]

advantages vulnerable to attack as tax avoidance, even if the relevant Act's specific provisions have been complied with, and even when no specific anti-avoidance rule embedded in the relevant tax concessions has been contravened.

This problem arises most commonly in relation to income tax, which includes a range of incentives and concessionary provisions that Parliament intended be available to taxpayers.⁸⁷ Many commentators question the extent to which a GAAR should be used to prevent taxpayers accessing those legitimate tax benefits.⁸⁸

Australian courts have previously struggled with this question regarding what became known as "the doctrine of choice" that effectively granted taxpayers the right to structure their affairs specifically in order to take advantage of incentives or omissions in the Act. In *WP Keighery Pty Ltd v FCT*⁸⁹ the Australian High Court stated:⁹⁰

"Whatever difficulties there may be in interpreting [GAAR], one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them."

It was the Court's adherence to this doctrine that ultimately led the Australian Parliament to effectively legislate it away by the effective replacement of former s260 with the more toothsome current version in Part IVA.⁹¹ Nevertheless, it must be recognised that a general anti-avoidance provision "lives in an uneasy compromise with other specific provisions ... it is not the function of GAAR to defeat other provisions of the Act or to achieve a result which is inconsistent with them."⁹² This reasoning was followed by a subsequent Court of Appeal judgment *BNZI*.⁹³

The Supreme Court in the recent *Trinity* tax avoidance case⁹⁴ finally determined that two competing interests must be balanced in the application of GAAR:

- the operation of specific provisions, many of which provide a legitimate incentive to which taxpayers are properly entitled to avail themselves, and
- the principle that even strict compliance with specific provisions will not abrogate the application of GAAR.

The Court stated:⁹⁵

"We consider Parliament's overall purpose is best served by construing specific provisions and the GAAR so as to give appropriate effect to each. They are meant to work in tandem ... Neither should be regarded as

⁸⁷ Known to economists as "tax expenditure".

⁸⁸ See *Judicial Techniques for Controlling the NZ General Anti-Avoidance Rule; the Scheme and Purpose Approach, from Challenge Corporation (1986) to Peterson (2005)*, Paper presented at the Tax Administrators Conference held in Sydney 20-21 April 2006, D Dunbar.

⁸⁹ (1957) 100 CLR 66

⁹⁰ *Ibid*, at 93 – 94.

⁹¹ See the recent decisions under Part IVA, such as *FCT v Spotless Services Ltd* 96 ATC 5201 and *FCT v Hart* (2004) 217 CLR 216.

⁹² *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, per Richardson J, at 549.

⁹³ *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (referred to as the *BNZI* case).

⁹⁴ *Ben Nevis Forestry Ventures Ltd v CIR* [2008] SC 116.

⁹⁵ *Ibid*, at [103].

overriding. Rather they work together. The presence in New Zealand legislation of a GAAR suggests that our Parliament meant it to be the principal vehicle by means of which tax avoidance is addressed.”

On that reasoning it is apparent not everything that comes within the literal wording of Div 165 will properly constitute “tax avoidance”. So when will a taxpayer’s conduct “cross the line”⁹⁶ between legitimate tax planning (based on the use of specific provisions) and become tax avoidance?

6. NEW ZEALAND EMPHASIS ON ECONOMIC REALITY

In its two recent decisions the New Zealand Supreme Court ruled that the single most important indicia of tax avoidance is whether the tax consequences of the transaction are at odds with its economic effect. Although the *Trinity* and *Glenharrow* cases involved very different factual scenarios under different Acts⁹⁷, the decisions apply consistent principles and clear sign-posts regarding tax avoidance, which may give guidance to the application of Div 165.⁹⁸

The Supreme Court stressed taxpayers must bear the true economic cost of any tax benefit they claim. In doing so the Court freely permitted itself to analyse the economic substance of the arrangement to determine whether it fell properly within the black letter law or was caught as tax avoidance.

The starting point of this economic analysis was the Privy Council’s decision in *Challenge Corp*. There Lord Templeman found “a tax avoidance arrangement was one where a taxpayer derived a tax advantage from a transaction without suffering the reduction in income, loss or expenditure which Parliament intended those qualifying for a reduction in tax liability to suffer.”⁹⁹

The Supreme Court expressly adopted the reasoning in the *Challenge* case that the appropriate test of tax avoidance is whether the commercial reality of a transaction is consistent with its legal form. In *Trinity* the Court considered the use of promissory notes payable in 50 years to purchase intangible property (which the taxpayers immediately depreciated for income tax) meant the purchase price had not really been paid by the taxpayers. It therefore concluded:¹⁰⁰

“the purported payment did not give rise to any economic consequences on either side. ... The payment of the insurance premium by means of the promissory note was, in commercial terms, no payment at all.”

⁹⁶ “Crossing the line” is a metaphor used repeatedly by New Zealand Courts: see *BNZI* at [40] which talks of “line drawing and setting of limits”, and *Accent Management* at [146] which refers to “an exercise in line-drawing” and the *Trinity* scheme as “well and truly across the line” into tax avoidance.

⁹⁷ *Trinity* dealt with depreciation of intangible property under the Income Tax Act 2007 while *Glenharrow* dealt with second-hand goods input tax under the GST Act 1985.

⁹⁸ Indeed, the *Glenharrow* judgment repeatedly cross-refers to the reasoning in the *Trinity* decision to support its conclusions.

⁹⁹ *Challenge Corp* at 561.

¹⁰⁰ *Ben Nevis*, at [147]

In a statement that could apply directly to claims for a creditable acquisition under Div 11, the Supreme Court ruled:¹⁰¹

“the appellants will receive the benefits of tax deductions but probably never incur the real expenditure. ... The Court is permitted, when considering the question of tax avoidance, to examine the commercial nature of the incurred cost and any factors that might indicate that the expenditure will never be truly incurred.”

In *Glenharrow* the Supreme Court considered the use of vendor finance did not amount to actual payment for the mining license for GST purposes.

“In reality the only part of the price which in economic terms would ever be paid” was the \$80,000 deposit and the further \$210,000. The vendor finance amounted to “a ‘pay as you go’ transaction so as to produce an artificial effect with consequent tax advantage, contrary to all economic reality. In economic terms there was no consideration in money given by Glenharrow because of the commercial impossibility of payment by it in the circumstances where it was virtually uncapitalised and not supported by its shareholders. The terms of the arrangement ... had no reality as a ‘cash’ transaction, despite being structured as if it were.”¹⁰²

It is important to note that in neither *Trinity* nor *Glenharrow* did the Court focus upon the inflated amounts the taxpayers agreed to pay as being crucial to the tax avoidance analysis – rather it was the lack of actual payment of the agreed amount that was decisive. In *Glenharrow* the Court expressly stated “it is not the price but the ‘payment’ that created the distorting effect.”¹⁰³

Accordingly, these cases expressly did not over-turn the long-standing rule in *Cecil Bros Pty Ltd v FCT*¹⁰⁴ and *Europa Oil (NZ) Ltd v CIR*¹⁰⁵ that it is not for the Commissioner or the Court to tell a taxpayer how much to spend in obtaining its income. Those cases remain good law. Rather, when considering whether a taxpayer is entitled to a creditable acquisition, the criteria should be whether it has actually paid the amount it claimed. The taxpayer must have truly suffered the economic cost of the purchase it has claimed. Anything less may not be sufficient.

7. SHOULD GAAR BE APPLIED DIFFERENTLY FOR GST?

Until the Supreme Court delivered the *Glenharrow* decision there was some debate as to whether the GAAR should be applied differently for GST and Income Tax. At the time of the introduction of the GST regime, leading Australian tax jurist Justice Hill speculated that differences between the underlying principles and operation of direct

¹⁰¹ Ibid, at [127] – [128]

¹⁰² Ibid, at [53]

¹⁰³ Ibid, at [51]

¹⁰⁴ (1964) 111 CLR 430.

¹⁰⁵ (1976) 2 BZTC 61,066 (PC).

and indirect taxation could require a different approach.¹⁰⁶ Likewise, the New Zealand Inland Revenue Department's own Policy Advice Division noted:

“There are conceptual differences between GST and income tax, and differences in the avoidance tests in the GST Act and the Income Tax Act (which will continue to exist in the reworded section 76). For example, as the Court of Appeal stated in *CIR v New Zealand Refining Co Ltd*:

‘It is fundamental to the GST Act that the tax is levied on or in respect of supplies. It is not a tax on receipts or on turnover; it is a tax on transactions...’¹⁰⁷

In *Ch'elle* the TRA acknowledged the “fundamentally different philosophy of the GST legislation compared with that of the Income Tax Acts”.¹⁰⁸

“It points to a significant difference in the way in which the GST avoidance provision is intended to operate. Uniquely, any GST avoidance provision must deal both with escaping from a liability to pay output tax and the right to claim an input deduction. The amended s 76 attempts to meet this requirement.”

Nevertheless, the Courts have subsequently given little thought to whether there are unique features of the GST regime that would impact upon the application of the GAAR. As a result, New Zealand Inland Revenue has now recommended that the two GAARs be interpreted consistently in order to “allow a similar analysis and application of case law when determining avoidance has occurred.”¹⁰⁹

Despite that view there are a number of different features between GST and income tax that ought to impact how and when Div 165 will apply.

First, the intent and application of the GST Act must be gleaned from the scheme and purpose of the relevant legislative provisions the taxpayer has sought to exploit. There are many cases concerned with how tax legislation should be interpreted and what it is intended to achieve.¹¹⁰ The basis of statutory interpretation is determining what Parliament intends in relation to the specific provision. In effect, the Courts must determine whether Parliament intended particular sections to be used by the taxpayers in that way. This analysis is always a difficult.

A number of cases have examined the scheme and purpose of the NZ GST Act.¹¹¹ Interestingly, the cases that have devoted most attention to the intended operation of

¹⁰⁶ *GST – An Income Tax to be Interpreted by Reference to Income Tax Principles or Just Another Consumption Tax*, DG Hill, Australian Tax Forum (2002) Vol 17:3 at 229.

¹⁰⁷ *GST: A Review - A Government Discussion Document*, NZ Inland Revenue Department, March 1999, at 6.22

¹⁰⁸ *Case W22* (2003) 21 NZTC 11,212, at [173]

¹⁰⁹ TIB Vol 12:12 December 2000.

¹¹⁰ In New Zealand see *CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175 which requires a purposive interpretation of tax legislation, under s 5 *Interpretation Act 1999*. In Australia see *Marsh v FCT* 85 ATC 4345 which requires an interpretation that best promotes the purpose or object underlying the Act, under s 15AA *Acts Interpretation Act 1901 (Cth)*

¹¹¹ Examples include *Databank Systems Ltd v CIR* (1989) 11 NZTC 6,093 regarding exempt supplies, *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 regarding what supplies fall within the Act, and *Wilson & Horton v CIR* (1995) 17 NZTC 12,325 regarding zero-rating.

the GST regime as a whole have been those concerning tax avoidance in order to determine whether the taxpayer's conduct has contravened the Act. For instance, prior to the decisions in *Ch'elle* and *Glenharrow* there were no cases assisting with the interpretation of the registration threshold or second hand goods rules.

But mere compliance with the specific provisions does not mean Div 165 will not apply. In *Ch'elle* the taxpayer attempted to argue that:¹¹²

“as the Act had been complied with, neither its intent nor its application had been defeated. ... that, if the arrangement complies with the legislation, it should not be found to have defeated its intent and application”.

But, as in all tax avoidance cases, this argument was rejected.¹¹³ In fact, unless there has been complete compliance with all those other sections, the arrangement will fail on technical grounds and the Commissioner need not resort to the GAAR to counteract the tax benefits obtained.

Unfortunately, whether the scheme and purpose of the Act has been defeated may come down to what is colloquially referred to as a “sniff test”. Is the transaction carried out in the same way as other similar transactions? Is there an understandable commercial aspect to the transaction? If the transaction differs from ordinary commercial practices, how does it differ? Is it this particular difference that generates the tax advantage?

8. A SUGGESTED METHOD FOR APPLYING DIV 165

One way of determining whether Div 165 should apply is to consider the nature of GST as a comprehensive Value Added Tax. GST is a broad-based consumption tax applying to virtually all transactions. Unlike most countries, Australia applies GST at a single rate of 10%.¹¹⁴ The definition of “supply” is “any form of supply whatsoever”.¹¹⁵ Only narrowly prescribed supplies are exempted or excluded from GST.

When examining the all-encompassing nature of a GST regime, the New Zealand Court of Appeal has noted it “breathes comprehensiveness and one of the outstanding features of the legislation compared with direct tax regimes elsewhere is the breadth of the cover and the limited number of exceptions.”¹¹⁶

The philosophy behind the operation of any GST regime was explained thus:¹¹⁷

“GST is a broad based consumption tax. The objective is to levy a tax on total consumption expenditure. To keep the administration of the tax as simple as possible it will be charged at a single rate and will apply, with very few exceptions, to all goods and services”.

¹¹² *Ch'elle Properties (NZ) Ltd v CIR* (2004) 21 NZTC 18,618, at [35] (HC)

¹¹³ For instance, see the Supreme Courts discussion on this point in *Glenharrow*, at [31] – [32].

¹¹⁴ S 9-70.

¹¹⁵ S 9-10.

¹¹⁶ *CIR v Databank Systems Ltd* [1989] 1 NZLR 422, at 431.

¹¹⁷ NZ IRD PIB No 143, *Broad Principles of GST*, October 1986.

The broad nature of GST was also explained in the leading New Zealand text, *GST – A Practical Guide*.¹¹⁸ In the Introduction, the author recognises:¹¹⁹

“The comprehensiveness of the tax complements its underlying simplicity, virtually all commodities and transactions are subject to GST principles. Also, GST is generally charged at a single standard rate.”

McKenzie then goes on to describe how the entire framework of the Act is intended to support this broad application.

“Despite the underlying simplicity of the tax and its comprehensiveness, the implementation and maintenance of the GST regime has necessitated detailed legislation. The GST Act embodies the basic principles discussed above. It also provides both for supporting concepts, which are required to ensure that the tax works in practice, and for an administrative framework for the tax.”¹²⁰

This view was confirmed by the Supreme Court in *Glenharrow*:¹²¹

“GST was intended to be broad-based, efficient and neutral. Nevertheless, compliance and administration costs preclude perfect neutrality ever being achieved. Tax avoidance opportunities notably remain at the boundaries between taxable and non-taxable transactions and between registered and unregistered persons. Accordingly, a general anti-avoidance provision was considered necessary.”

In short, a GST regime is intended to establish the frame-work and give effect to a broad-based consumption tax. While the Australian legislation contains a limited number of concessions and exemptions,¹²² the over-all scheme of the GST Act is coherent, in that it neither favours nor adversely affects any particular type of supply. The intention of the regime is to be virtually non-distortionary to individual taxpayers and the economy as a whole. In theory then, GST should not have any impact on the spending or investment decisions of taxpayers. If a taxpayer receives any supply, it will pay GST based on the value of that consumption, and taxpayers should generally not take GST into account when making business or consumption decisions. Thus, any time GST does become a motive for action, the taxpayer may have breached the principle of tax neutrality underlying the Act.

Unfortunately, taxpayers are ingenious in their methods of seeking to exploit or misapply the Act in order to obtain tax benefits. In the cases that have come before the Courts, the taxpayers have arranged their affairs so as to ensure they qualify for some GST benefit.

But by taking those steps the taxpayers obviously gave GST too great a consideration in their decision-making. In light of the broad scope of GST, taking those steps in order to obtain a tax benefit should contravene the theoretically neutral nature of the

¹¹⁸ *GST – A Practical Guide*, A McKenzie, CCH (NZ) Ltd, Ed 5, 2007.

¹¹⁹ *Ibid*, at p IX.

¹²⁰ *Ibid*, at X

¹²¹ At [42]

¹²² Mainly for supplies of food, health or education which are classified as “GST-free” and get the same GST treatment as zero-rated exports.

tax. As such, any scheme that requires additional or unusual steps in order to obtain a GST benefit may indicate it breaches the intent and application of the Act. The Commissioner may then negate any tax benefit achieved under such a scheme.

An additional feature is the nature of GST as a transaction tax. Income tax incorporates a number of different treatments for income, deductions, and timing. It creates a range of different regimes for various entities or transactions. In doing so, there are many provisions that either seek to encourage or discourage particular behaviour. These are the incentive regimes Courts are careful not to permit a GAAR to negate.

By contrast, the GST regime is almost entirely homogenous in its application. It contains few express choices, and these are all expressly identified and protected from the application of Div 165.¹²³ Attempting to take advantage of other supposed choices or incentives beyond those provided in the Act would remain vulnerable to Div 165.

The broad based and flat rate of GST show it is intended to neither favour nor adversely affect any particular type of supply. The GST regime does not contain the type of incentive provisions that make the Income Tax GAAR so difficult to apply. So taxpayers generally cannot claim to have structured their affairs so as take advantage of any type of GST concession. For instance, in *Re VCE* the AAT ruled that the taxpayer's choice of GST accounting basis did not constitute a choice or election under the GST Act so as to exclude Div 165.

9. SHOULD FEATURES OF TAX AVOIDANCE REQUIRE DISCLOSURE?

The factors listed in s 165-15 provide tools to determine the purpose of the taxpayer and/or the effect of the scheme. However, schemes that obviously have a tax avoidance purpose or effect under those factors are not automatically void. It requires the intervention of the ATO to invoke Div 165. Accordingly, schemes that are not detected remain in place and the relevant tax benefits are wrongfully retained by participants.

To assist with the detection of such schemes, in 2004 the UK revenue authority introduced a disclosure regime¹²⁴ in relation to arrangements that are intended to give any person a VAT advantage. The main obligation for disclosure rests with those taxable persons who are party to the scheme, whether or not they obtain the tax advantage. If disclosure is not made, then any benefits otherwise available under the scheme (whether otherwise permissible or not) are automatically withheld. In effect, disclosure of the scheme to the authorities is a pre-requirement for the tax benefit to be claimed, whether or not that scheme ultimately constitutes tax avoidance.

Disclosure is required in two broad categories:

¹²³ See s 165-5(1)(b).

¹²⁴ Her Majesty's Revenue and Customs Notice 700/8 (August 2004), superseded by Notice 700/8 (February 2006).

- Listed VAT avoidance schemes: these are schemes that are described in the relevant legislation. Currently, ten schemes have been listed.
- Hallmarked schemes: these are schemes that include or are associated with a hallmark of avoidance prescribed in the relevant legislation. Currently, there are eight hallmarks of avoidance.

The listed schemes are certain arrangements that have previously been identified by the revenue as constituting tax avoidance or, at best, tax aggressive behaviour. Such schemes involve lengthy settlement periods, particular types of supplies and certain cross-border transactions. All similar schemes are therefore presumed to be suspect by Her Majesty's Revenue and Customs (HMRC), which requires all taxpayers involved in those schemes to declare their involvement.

In addition to the particular schemes, another category requiring disclosure are any transactions of whatever kind involving one or more of a number of "hallmarks" of tax avoidance. So any supply of any kind of goods or services that involve such a hallmark immediately becomes subject to disclosure to HMRC. The hallmarks are:

- confidentiality agreements;
- agreements to share a tax advantage;
- contingent fee agreements;
- prepayments between connected parties;
- funding by loans, share subscriptions or subscriptions in securities;
- off-shore loops;
- property transactions between connected persons; and
- issue of face-value vouchers.

Disclosure of participation in any relevant scheme is required to be made either by the promoter (if one exists) or the taxpayer within 30 days of the due date of the affected VAT return. Disclosure must be made to a designated "Anti-Avoidance Group". It effectively requires taxpayers conducting these types of schemes to identify themselves to HMRC. Presumably the effect is to make participation in this type of tax aggressive scheme less desirable on the grounds the attention of authorities is virtually guaranteed.

New Zealand flirted with the introduction of a similar scheme for income tax arrangements in 2002.¹²⁵ The proposal would have required registration with Inland Revenue (IRD) of certain schemes and notification of that registration to investors.

¹²⁵ Inland Revenue Department Officials Paper : Mass-marketed Tax Schemes, 14 January 2002.

Unless the scheme was registered, no tax benefits flowing under that scheme could be claimed by participants.

Ultimately the proposal requiring registration of schemes with IRD was abandoned and any GST benefits obtained under such schemes must be countered using the GAAR. Interestingly, the tax benefit obtained in *Re VCE* exhibits one of the hallmarks of tax avoidance identified by the UK revenue, namely a property transaction between connected persons, which would have required the taxpayer to bring its scheme to the notification of the ATO.

10. CONCLUSION

Both the *Ch'elle* and *Glenharrow* decisions support the broad interpretation and application of a GAAR for GST. They stipulate that artificial arrangements involving inflated valuations devised in order to take advantage of a mismatch between different categories of taxpayer will not be permitted. Furthermore, the GST Act is premised on actual payments made at (approximately) market value in a timely manner. So arrangements that involve deferred settlements (as in *Ch'elle*) or that are funded by money-go-rounds (as in *Glenharrow*) will not be allowed for GST purposes.

These unanimous decisions clearly put New Zealand and Australian taxpayers on notice that, if their schemes lack commerciality or they do not suffer the true economic cost of a creditable acquisition, they will not be permitted to take advantage of the resulting GST benefit. In its newsletter to clients in December 2008 international accounting firm PriceWaterhouseCoopers explained:¹²⁶

“the Supreme Court’s decisions raise the bar for all taxpayers.”

If Australian Courts follow the New Zealand decisions on GST tax avoidance, the opportunity for taxpayers to abuse the GST Act will be greatly reduced.

¹²⁶ PWC Tax Tips, “Tax Avoidance – A New Era?”, Issue 13/2008, at: http://www.pwc.com/en_NZ/nz/tax-tips/taxtips13_2008.pdf