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Foreword

The study of federal tax law in Australia has been described by some as daunting and complex. In his 1987 Foreword to the first edition of *Australian Taxation Law*, Graham Hill, QC recognised that the "torrent of decisions, judicial and administrative, . . . together with the outpourings of the legislature, have made the study of taxation almost unmanageable."

Over twenty years on, federal taxation law continues to expand and students continue to face difficulties in identifying and understanding the areas of the law they require for their specific taxation courses.

While **Australian Taxation Law 2011** provides a comprehensive coverage of the tax law, many tax courses can only properly cover a portion of the law. As a result, large parts of the book are often not required for a particular course. Students studying tax cannot simply rely on commentary books for a complete understanding of the tax law. It is essential that they read the actual legislative provisions that underpin the commentary.

To help address these challenges, CCH is pleased to publish this second edition of **Australian Taxation Law Select — Legislation & Commentary**. This customised book combines, in a single volume, key legislative provisions dealing with Australian income tax along with carefully selected commentary from **Australian Taxation Law 2011**. The book is ideal for students studying introductory tax courses and provides a relevant and handy alternative to purchasing full volumes of Australian income tax legislation and the complete version of the **Australian Taxation Law** text.

This edition includes selected provisions from the *Income Tax Assessment Act 1936*, the *Income Tax Assessment Act 1997*, the *Income Tax Rates Act 1986*, *A New Tax System (Goods and Services Tax) Act 1999* and the *Taxation Administration Act 1953*.

This edition also includes the *full* **Australian Taxation Law 2011** chapters on:

- Introduction to income tax law
- Non-assessable income
- Tax accounting
- Small business entities and concessions
- Goods and services tax, and
- Rates and tables.

Australian Taxation Law Select — Legislation & Commentary 2011 further contains selected parts of chapters covering:

- Tax formula, tax rates and tax offsets
- General principles of assessable income including income from property and business
- CGT
- General and specific deductions

- Capital allowances and capital works
- Trading stock
- Taxation of partnerships and trusts
- Taxation of corporate entities and their members
- Corporate tax losses, net capital losses and bad debts
- Special taxpayers and incentive schemes
- Superannuation
- FBT.

This edition incorporates legislative, case law and administrative reforms that have taken place in taxation law up to 1 July 2010, as well as various major developments that have occurred since that date.

Note that there will be cross-references to paragraphs that are contained in this customised version and also to paragraphs that have not been selected for inclusion in this edition.

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ABOUT THE AUTHORS

Robin Woellner is Pro-Vice Chancellor (Law, Business and the Creative Arts) at James Cook University. He has practised in taxation in the private sector and in the Australian Taxation Office, and taught revenue law and advanced revenue law courses to undergraduates as well as lecturing in other commercial law subjects. He is the author/co-author of numerous books, articles and conference papers.

Stephen Barkoczy is a Professor of Law in the Faculty of Law at Monash University and a Consultant with Blake Dawson. Stephen is the author/co-author of several books and articles on taxation law and is a former editor of the *Journal of Australian Taxation*. In 2008, he received the Prime Minister's Award for Australian University Teacher of the Year.

Shirley Murphy has taught in the areas of taxation and superannuation law at a number of tertiary institutions and has acted as a taxation and superannuation consultant to industry groups. She has written in the areas of taxation and superannuation for many years, is the co-author of the *Australian Master Superannuation Guide*, and has contributed over many years to a wide range of publications including the CCH *Australian Master Tax Guide*.

Chris Evans is a Professor of Taxation and former Director of the Australian School of Taxation (ATAX) at the University of New South Wales. He is also an International Research Fellow at the Centre for Business Taxation at Oxford University. He is the author/co-author of numerous books, articles and conference papers, and is the editor of the *Australian Tax Review*.

Dale Pinto is a Professor of Taxation Law at Curtin University in Western Australia. Dale has been a member of CPA Australia's Centre of Tax Excellence and is currently Chair of the Taxation Institute of Australia's Education, Examinations and Quality Assurance Board (EEQAB). He is the author/co-author of numerous books, refereed articles and national and international conference papers, and is on the editorial board of a number of journals as well as being the Editor-in-Chief of several refereed journals. Dale was appointed to the National Tax Practitioners Board in October 2009 for a three-year term.

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CHAPTER 1

Introduction to income tax law

¶1-000 Overview

Before proceeding to a technical analysis of tax law in later chapters, it is useful to provide a broader context and perspective on income and other taxes. This overview involves a brief analysis of the history of taxation and an overview of its socio-economic and political role and implications, and the present structure of taxation in Australia.

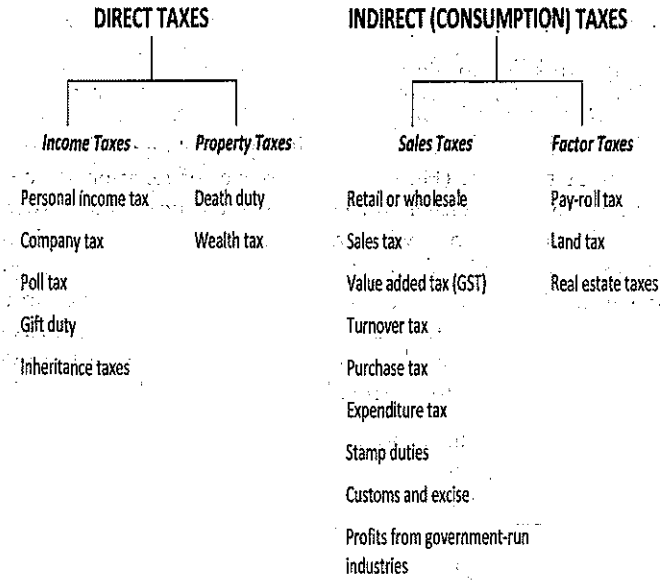
It is all too easy to lose sight of these wider aspects, and to focus exclusively on the increasingly intricate technical principles and practices of taxation law. However, tax is a social process and, without some understanding of how and why taxation develops and changes, it is difficult to understand the present system, the dynamics which precipitate change, or to develop a feeling for likely future changes and directions.

What is a tax?

There are technical definitions of a "tax" for constitutional law and other purposes which are discussed at ¶1-550. However, at a general level, the *Concise Oxford Dictionary* defines a "tax" as a "contribution levied on persons, property or business for the support of government", while the OECD defines a tax as "a compulsory, unrequited transfer made by institutional units to the general government sector".[1]

Allan prefers the wider view of tax as "any leakage from the circular flow of income into the public sector, excepting loan transactions and direct payments for publicly produced goods and services up to the cost of producing these goods and services".[2] This view would regard profits made by nationalised postal services as taxes levied on postage; and would also cover "taxes in kind", such as the loss or "cost" to the owner of property compulsorily acquired by a government at less than free market prices. On this view, pensions and subsidies would also be seen as (negative) taxes.

There is a wide range of possible taxes — one possible categorisation of common taxes is set out below.[3]



1 OECD definition — "institutional units" would include all taxpayers. The OECD definition continues: "[taxes] are described as unrequited because the government provides nothing in return to the individual unit making the payment, although governments may use the funds raised in taxes to provide goods or services to other units, either individually or collectively, or to the community as a whole" [essa.un.org.unsd/sna1993/introduction.asp], (created Sept 25, 2001; accessed 10 September 2010); RF Warburton and PW Hendy, *International Comparison of Australia's Taxes* (2006) 17–22.

2 CM Allan, *The Theory of Taxation* (Penguin, 1971) 24; R Posner, "Taxation by Regulation" (1981) 2 (1) *Bell Journal of Economics* 22.

3 Adapted from Allan, ibid 29.

Historical background (¶1-020 – ¶1-071)

¶1-020 Introduction

It has long been recognised that a democratic government needs to raise revenue in order to govern effectively, and that one of the most effective means of doing so is by the imposition and collection of taxes. As Warburton and Hendy observe:[4]

"In liberal democratic societies, the community makes choices about how they want their society and economy to operate. One of the most fundamental choices is the balance between private and public provision of services" — which inevitably affects the extent and structure of the taxation system.[5]

It is therefore not surprising that attitudes to tax vary. At one extreme, Justice Oliver Wendell Holmes (Jr) observed in *Compania de Tobacos v Collector*[6] that "taxes are what we pay for civilised society". A more cynical view is that the "art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing",[7] and that "there is one difference between a tax collector and a taxidermist — the taxidermist leaves the hide".[8]

At a different level, Mills encapsulated the tension inherent in taxation in his observation that:

> "It is one of the empirical certainties of history that no structural society has ever arisen without taxation. [However, the] power of taxation is one which is particularly liable to abuse, either in the hands of an individual autocrat or of a sectional oligarchy such as may wield the sceptre of authority even under the forms of a modern Parliamentary system; but without that power no Government, as we understand the term, is possible. 'The power to tax is the one great power upon which the whole national fabric is based. It is as necessary to the existence and prosperity of a nation as is the air he breathes to a natural man. It is not only the power to destroy, but the power to keep alive.'"[9]

Equally, there is no doubt that, in a modern society, "tax laws affect the shape of nearly every business transaction."[10]

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4 Above, 20.

5 *Star City Pty Ltd v FC of T* 2007 ATC 5216, 5239 (Gordon J), quoting *Frank Lyon Co v United States* 435 US 561 (1978), 580, and Gummow and Hayne JJ in *FC of T v Hart* 2004 ATC 4599.

6 (1904) 275 US 87, 100.

7 Jean Baptiste Colbert in JP Smith, *Taxing Popularity: The Story of Taxation in Australia* (Canberra: Federalism Research Centre ANU, 1990).

8 MM Capwell, *Time Magazine*, 1 February 1963; compare McPherson JA in *Macpherson v FC of T* 99 ATC 4014, 4021.

9 S Mills, *Taxation in Australia* (London; Macmillan, 1925) 1, quoting Isaacs J in *R v Barger* (1908) 6 CLR 41; originally attributed to a US Supreme Court judge in *Nichols v Ames*, 173 US 509 (1898), 515; cf *First Uniform Tax Case (The State of South Australia v The Commonwealth)* (1942) 65 CLR 373, 423.

10 Warburton and Hendy, above, 20.

An understanding of the history and dynamics of taxation is therefore important — the lessons of the past can be instructive for modern proposals and reforms, and many of the older taxes have their modern equivalents. The politicians and citizens of different countries and different times have shared many of the visions and problems which still bedevil modern taxation — questions of tax equity, simplicity, incidence and efficiency have been perennial difficulties, as have the existence and implications of tax avoidance and evasion.

The main focus of this book is on income tax, and the following segment accordingly deals mainly with the development and introduction of the income tax. The goods and services tax (GST) which changed the face of taxation in Australia is dealt with in Chapter 27; state taxes are dealt with in Chapter 28, while CGT and FBT are dealt with in Chapters 7 and 26 respectively.

¶1-030 Early developments

Tax has been part of organised society for much of recorded history.[11] In ancient Persia, for example, taxes included tribute paid as a proportion of produce and provision of personal service, as well as dues paid at ferries and market places.

In early times, the emphasis was on indirect taxes. Customs duties (*portoria*) were levied by Roman kings up to the 7th century BC, reintroduced together with a broad-based excise tax by the Emperor Augustus in the Roman Empire,[12] and brought by the Romans to Britain upon its conquest. Other Roman taxes included consumption taxes and, under Julius Caesar, a 1% general sales tax, as well as a "head" tax (later extended to land holdings) and temporary property taxes levied in times of war to support the state's military needs.

Other taxes followed: in England a "subsidy" on goods and land was levied in the early Middle Ages, while the "Danegeld" (a form of land tax based on the amount of land held) was originally levied in times of emergency as a direct tax on landowners,[13] but later became a regular tax under the Norman kings until abolished in the 12th century.[14]

Other taxes levied in medieval England included "scutage" ("shield money" 1159–1332), which was payable by a feudal landowner in lieu of undertaking military service in the King's army. There were also taxes on movable goods, beginning with the "Saladin tithe", which was levied in 1188 to fund the Crusade against the Saracens and was the forerunner of modern property taxes.

In the early 17th century, "Ship Money" was levied by the Stuart kings for the defence of the realm, and poll taxes were also levied from time to time as required.[15]

11 JP Smith, *Taxing Popularity: The Story of Taxation in Australia* (Canberra: Federalism Research Centre ANU, 1990), and cf S James, *Self-Assessment and the UK Tax System* (London: The Research Board of the Institute of Chartered Accountants in England and Wales, 1995) 11–19.

12 Mills, above, 3–4, where he observes that although the Roman people were nominally untaxed during the intervening period, they "voluntarily" contributed large amounts for public purposes.

13 For example, in the 10th century in order to raise funds to buy off Scandinavian pirates.

14 It was replaced by the "carucage", a regular tax levied on a similar basis.

15 For example, the poll tax of 1380 was levied to meet the cost of the King's bad financial management and military extravagance: BEV Sabine, *A History of Income Tax* (George Allen & Unwin, 1963) 12.

¶1-040 Beginnings of the modern tax system

The heavy reliance in England on indirect taxation of goods continued up to the end of the 18th century. In 1715, customs and excise duties produced some 73% of total English tax revenue, a proportion which had grown to 82% by 1755.

Direct taxation and income tax did not become a regular feature of English life until the 19th century, and even then direct taxes were usually imposed only when additional revenue was needed for extraordinary purposes, for example during times of war or other social upheaval.

Up to the 19th century, English taxes were levied mainly on the external indicia of wealth. Thus, the Window Tax of 1696 levied a progressive tax based on the number of windows in a house, while the Assessed Taxes were levied on carriages, female servants, racehorses, hair powder, clocks, watches and the like.

One reason for the ad hoc nature of taxes up to the 19th century may have been a lack of the administrative infrastructure and expertise necessary for efficient control of an ongoing broad-based system of taxation. Indeed, until the 17th century, it was not uncommon for the Crown to sell the right to collect taxes to private individuals ("farming the Revenue"), as had been the case in Ancient Rome. It was not until the reign of Charles II in the latter half of the 17th century that the practice ceased, and government officials ("Inspectors") were appointed to administer and collect the revenue.

Gradually, through experience gained in the administration and collection of such taxes, an efficient staff and system of taxation administration began to develop in England. By the end of the 18th century the administrative machinery for regular taxation was in place. However, as so often happens in the history of tax, the final impetus came from a national emergency.

Introduction of income tax

By 1798 the French armies of Napoleon Bonaparte controlled continental Europe, and England was hard pressed to resist. The 1797 Triple Assessment on "taxable establishments" had failed to produce adequate revenue to support the war, primarily because of widespread evasion by taxpayers.

William Pitt, who was Prime Minister of England at the outbreak of the Napoleonic Wars, disliked the idea of a tax on incomes, which he felt would be "repugnant to the customs and manners of the nation". Nevertheless, the desperate military situation forced Pitt to impose a general tax "on all the leading branches of income".

Ironically, in light of subsequent developments, Pitt justified the move to an income tax on the basis of the need "to prevent all evasion and fraud" which had plagued the Triple Assessment.

The first income tax Act was only moderately successful in its revenue-raising aims, yielding some 50% of targeted revenue. With the temporary peace following the Treaty of Amiens in 1802, the tax was abolished, but renewed hostilities saw the reintroduction of income tax under the pseudonym of "Duties on Land and Property".

This Act introduced the concept of the five schedules or categories of taxable property which still characterise the English tax system. The Act also introduced the concept of deduction of tax at source for certain classes of income.[16] The 1803 income tax was repealed in 1816, apparently because it was feared that the tax might become a permanent feature, and a "potential instrument of tyranny".

England remained free of income tax until the next period of social crisis, in 1842. Then, at a time of great commercial depression and social unrest, Sir Robert Peel reluctantly felt compelled to impose a tax on incomes at a maximum rate of some 3%. The tax was intended to be an experiment for three years only, but the "experiment" has survived (with various modifications) to the present day — a story by no means unusual in the taxation context.

These developments set the scene for the introduction of similar taxes into the British colony of Australia.

¶1-050 History of income tax in Australia

Early taxes

Although the different Australian states levied taxes of various types from the time of their establishment, the first income tax in Australia (in fact a tax on land and incomes) was introduced by the *South Australian* Government in 1884. The history of income tax in Australia began with commendable moderation, with the South Australian tax imposing a flat rate of 1.25% on income from personal exertion, 2.5% on income from property, and 0.2% on landholdings.

Victoria imposed an income tax in 1895 through the *Land and Income Tax Assessment Act 1895*, motivated by economic necessity — Victoria had a huge deficit of more than £650,000, almost 10% of total revenue.

New South Wales had attempted to introduce an income tax in 1886, but opposition was so vehement that the proposal was dropped. Indeed, one member of parliament is quoted as saying that: "If the Devil had sent a representative here to institute a means of destroying the morality of the people, he could have found no better instrument than an income tax."[17]

However, an income and land tax was successfully introduced into NSW in 1895, again following heated debate. Economic necessity also seems to have played a part in the introduction of that tax, as the NSW Government faced a large revenue deficit.[18] The NSW income tax was levied at a flat rate of 2.5%, with a general exemption for non-corporate incomes up to £200 pa, and a number of specific exemptions. The land tax was levied at a flat rate of 0.42%, with a threshold of £240.

16 A principle which is still used in the Australian tax legislation today (eg in the PAYG system (¶32-405ff)).

17 Quoted in Mills, above, 66; compare Smith, above, 40–41.

18 Said to be some £350,000: Open Letter to Members of the NSW Legislature 1895 at para 6.

In 1899, *Western Australia* introduced a tax on company dividends and profits at a rate of 5%, and ultimately introduced a general income and land tax in 1907 with a flat rate of tax on incomes at 1.66% for residents (2.49% for non-residents), and on land at 0.42%.

Tasmania had introduced a tax on dividends as early as 1880, but did not introduce a general income tax until 1902, when income tax was levied at progressive rates on property income between £100 and £400 and above that amount at a flat rate of 5%. Personal exertion income was taxed by reference to the actual or imputed rental value of the taxpayer's residence, with differential rates applying to occupiers of ordinary dwellings, adult lodgers, and persons whose residence was situated on income-producing land (eg farmers).

Queensland followed in 1902 with an income tax at progressive rates up to a maximum of 5% on personal exertion income and a flat rate of 3.75% on property income. A land tax levied at progressive rates from 0.42% up to 2.5% on holdings over 75,000 acres was introduced in 1915.

¶1-060 Federal government and income tax

The federal government did not impose an income tax until 1915. Until then, the revenues derived from customs and excise duties had sufficed to meet the fledgling government's revenue needs. Moreover, many of the early federal cabinet ministers had been ex-state premiers, and were not initially sympathetic to the idea of a centralised federal income tax.

Once again, however, the pressures of war led to a fundamental change. In 1915 the Commonwealth was forced to intervene in the income tax field in order to raise the additional revenue needed to successfully maintain Australia's efforts in World War I. Accordingly, the federal government introduced an Act[19] which imposed tax at differing rates on:

- income from personal exertion (at progressive rates from 1.25% up to a rate of approximately 13% for amounts below £7,600, and 25% thereafter)
- income from property (taxed under a complex formula with a maximum of 25% for amounts over £6,500), and
- income of companies (taxed at a flat rate of 7.5%).

In introducing the Act, the Commonwealth Attorney-General observed that:

> "This Bill, of course, is frankly a War measure designed to meet the present circumstances . . . No doubt this Bill reaches the high-water mark of income taxation, but it does not do so without ample warrant . . ."[20]

19 The *Income Tax Assessment Act 1915* (Cth), modelled on the state Acts, was intended to tax "surplus wealth", and consisted of 22 sections covering 65 pages.

20 Commonwealth, House of Representatives, *Hansard*, Vol lxxvii 5845.

These words echoed the sentiments of many English statesmen in the early 19th century. However, the lesson of history is that income taxes tend to take root once in place, and the rates imposed rarely fall in real terms. The 1915 Act was no exception: despite the circumstances of its birth, the tax survived the ending of the war, and the "high-water mark" of the 1915 tax rates was soon eclipsed.

¶1-070 Between World Wars

Following the end of World War I in 1918, the Commonwealth continued to levy its own income tax. The various states also continued to impose their income taxes, though there was little uniformity in the states' legislation (a problem aggravated by the introduction of the Commonwealth Act in 1915), and the differing bases and rates used by the various governments created difficulties.

It gradually became clear that an optimal system could only be achieved if the state and federal governments cooperated in respect of income taxes. Accordingly, a series of conferences was held between federal and state ministers from 1916 to 1921, aimed at creating greater uniformity in the revenue laws. Little was accomplished — draft uniform income tax legislation was put forward in 1917, but was not adopted by any of the states, and only partially by the Commonwealth.

Little more was done to encourage uniformity between the income tax laws of the states and the Commonwealth until another major social crisis intervened. This time the catalyst was not war, but the coming of the Great Depression of 1930, which exacerbated the problems created by having both state and Commonwealth income taxes.

Driven by economic pressures, the Commonwealth Government appointed a Royal Commission on Taxation (1932–1933) to investigate Australian taxation. The Commission ultimately developed a draft Uniform Tax Bill which was adopted in substance by the Commonwealth and the states in 1936.

However, differences gradually developed between the Acts of the various states and the Commonwealth, though it was not until 1942 and the pressures generated by World War II that the Commonwealth Government seized sole control of income tax, ousted the states from the income tax field and introduced the "Uniform Taxation Scheme" which still operates today. The political mechanism by which the Commonwealth Government achieved this result is discussed further at ¶1-600.

¶1-071 Historical trends

From Federation in 1901 through to the mid-1970s, the primary focus of tax policy in Australia was mainly mechanical — ensuring that taxes generated an adequate revenue base to fund government obligations and initiatives. However, since then, there has been an increasing focus on improving the tax system's efficiency, equity and simplicity,[21] and its use for "social engineering" (¶1-170).

21 *Architecture of Australia's tax and transfer system* report, Commonwealth of Australia, 18 August 2008, 191–195.

Tax resistance

¶1-080 Tax resistance through the ages

From the earliest biblical times, taxes and tax collectors have been unpopular, and historical commentaries suggest that some people have always tried to evade or avoid the payment of taxes.

Not surprisingly therefore, taxes and taxing systems have regularly been the cause of heated (and sometimes violent) controversy from the earliest to the present times. The Boston Tea Party, with its slogan of "no taxation without representation", is perhaps the best-known "revolt" against perceived tax injustices. However, the Stuart "Ship Money" taxes were a factor contributing to the outbreak of the English civil wars in the 1640s; the imposition of miners' licence fees was a factor in the Eureka Stockade rebellion on the Australian goldfields at Ballarat in 1854; and frustrated tax reform was a factor in the onset of the French Revolution, while the "poll tax" introduced by the British Thatcher Government was widely seen as a factor in that government's fall.[22]

A more subtle but equally significant revolt against taxation has often taken place through *tax avoidance* (the creation by legitimate means of a situation in which a taxpayer is able to pay less or no tax) or *tax evasion* (the wrongful non-declaration of income or over-claiming of expenditure).

In a sense, tax avoidance and evasion "is the Siamese twin of the charge to tax in any system based upon certain statutory enactment. No other area of the law touches human activity at so many points, so that it is scarcely surprising that tax avoidance should be so widespread and ingrained in our consciousness".[23]

Examples of tax avoidance and evasion are found throughout the centuries. The actions of 17th century English taxpayers who sought to avoid the Window Tax by simply blocking up windows until the tax collector had gone and then re-opening them were merely somewhat less subtle predecessors of the Australian and other tax avoidance schemes of modern times.

However understandable they may be from some perspectives, it is important to appreciate that tax avoidance and evasion can have serious consequences for the equity of the system. For example, the underground or untaxed "cash" economy in Australia has been estimated at up to 5% of GDP. This means that several billion dollars in tax revenue is lost each year, and must then be recovered — one method being for the government to impose higher rates on those who do pay tax.[24]

Chapter 25 considers tax evasion and tax avoidance in more detail, and also examines acceptable forms of tax planning and mitigation.

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22 These reactions were more restrained than during the 14th century "Peasants' Revolt", when a group of citizens aggrieved at the then poll tax and its oppressive collection methods cut off the Chief Justice's head and paraded it round Bury St Edmunds on a pike!

23 A Thompson, "Some Thoughts on Tax Avoidance", *New Law Journal*, 29 June 1978, 629.

24 24 ABS (2003); Breusch estimated the amount lost at between 1% and 2%: cited in the *Architecture of Australia's tax and transfer system* report, 10.

Taxation in Australia (¶1-100 – ¶1-122)

¶1-100 Introduction — tax and the social process

The revenue system is an intrinsic part of, and affected by, the broader social process. For example:

- political changes (such as the election of a new federal government with a different ideology)
- economic developments (such as the onset of a recession or "boom"), and
- social factors (such as an ageing population) inevitably affect the tax system — and vice versa.

Modern governments have recognised the impact that taxation can have upon social behaviour patterns, and from time to time intentionally use the tax system not only for direct financial purposes such as the generation of revenue, but also indirectly to influence or modify aspects of society or societal behaviour for "social engineering". Thus, a government may seek to discourage certain activities it deems undesirable by imposing a high tax for socially beneficial purposes (ostensibly at least). For example, a high tax on petrol to reduce consumption and thus conserve a scarce social resource; or by increasing tax on lump sum retirement benefits to encourage retirees to take out annuities rather than relying on the government age pension; or providing tax benefits for a Carbon Pollution Reduction Scheme, to reduce damage to the environment.[25] Alternatively, a government may seek to encourage activities which it sees as desirable by offering tax incentives or benefits, for example to those engaging in petroleum exploration, primary production and the like; or to people prepared to live in remote areas.[26]

The relationship between the tax system and its environment is complicated by the possibility that taxation may also have unintentional and sometimes undesirable results. These issues are discussed more fully below (¶1-130 to ¶1-170).

¶1-110 Incidence of taxation in Australia

In outlining the impact of taxation, it is important to identify the real "incidence" of taxation (loosely, the "burden" of taxation).

A tax is said to be *regressive* if it takes a *decreasing* proportion of income as income rises, so that its impact is proportionally greatest on lower income earners. Many indirect consumption taxes (including the GST) are prima facie regressive: for example, if the tax component of the price of a loaf of bread is $1, this will represent tax at 10% to a taxpayer on an income of $10, but only 1% to a taxpayer on an income of $100.

25 M Dirkis and J Morris, "CPRs for the environment or the tax system? Exploring the tax aspects of the Green Paper" (2008) 12 (1) *The Tax Specialist* 2. J Farrell, "Strange bedfellows? Tax administration and human rights brought together", (2009) 44 (3) TIA 147.

26 GS Cooper, "The Benefit Theory of Taxation", (1994) 11 (4) *Australian Tax Forum* 397, 400ff; the *Architecture of Australia's tax and transfer system* report, 174, 278–290.

A tax is *proportional* if it takes the *same* proportion of income at all levels, so that all persons pay the same "flat rate" of tax: for example a tax at a flat rate of 20% on all income.

A tax is *progressive* if it takes an *increasing* proportion of income as income rises, so that the tax impacts proportionally more heavily on higher income earners. For example, income tax in Australia is currently levied at progressive rates varying from 0% on the first $6,000 of taxable income to 45% (plus Medicare levy of 1.5%) on taxable income over $180,000. Australian personal income tax is therefore highly progressive in theory, though experts disagree on its actual progressive impact in practice.

A distinction must also be drawn in the income tax context between marginal rates and average rates of tax. The *marginal (or nominal) tax rate* is the rate of tax payable on certain levels of income: for example, income between $35,001 and $80,000 might fall into the 30% tax bracket. The *average or effective rate* of tax, by contrast, is the rate paid overall on total income and, because of tax-free thresholds and the like, the average rate on a taxable income of between $55,000 and $80,000 might be only around $10,050 or some 18.3%.

The other aspect of incidence is the *financial impact* of a tax, ie who actually bears the burden of paying the tax. In this context, it is important to distinguish between "formal" (or nominal) incidence and "effective" (economic or actual) incidence. As the Henry Tax Review observed, "All taxes ultimately bear on people, not businesses or other entities. It is the economic burden of taxes that is important for equity, not who remits the tax".[27] Thus, although X may be nominated by the legislation as the taxpayer (formal incidence), if X can shift the impact of the tax forwards or backwards to Y, the effective (or actual) incidence of the tax will fall on Y. For example, a manufacturer may be the nominal taxpayer, but may be able to shift the effective incidence of the tax *forward* on to consumers (by increasing the price of the goods sold). Employees may be able to shift an income tax *backward* on to employers by demanding higher wages.

The actual incidence of a tax must therefore be taken into account in evaluating taxes and in determining tax policy. However, the issues are complex, and it is sometimes hard to determine the actual incidence of a tax (eg the ability to shift incidence may depend on how easily other items can be substituted for the taxed item).

¶1-120 Overview of the Commonwealth tax system

Until 2000, comparatively small reliance had traditionally been placed on indirect taxes, such as sales tax, as a source of Commonwealth revenue. This situation has changed somewhat with the introduction of the GST, as the following table indicates.

Historical tax data

The following table sets out key Commonwealth revenue data for selected years over the period 1949/50 to 2008/09.

27 Discussed in the Australia's Future Tax System Report to the Treasurer (Final Report of the Henry Tax Review) ("AFTS Report"), Commonwealth of Australia, December 2009, CanPrint Communications Pty Ltd, 2010, 19; see also Chart 2:2 AFTS Report, 20.

Year	Gross PAYE/ PAYG $m	%	Gross other individuals $m	Companies $m	%	Sales tax $m	%	Excise $m	%	GST $m	%	Customs duties $m	%	Other* $m	%	Individual refunds $m	Total tax
1949/50	392	38.7		167	16.5	85	8.4	132	13.0			155	15.3	83	8.2		1,014
1954/55	720	38.4		343	18.3	201	10.7	286	15.3			202	10.8	122	6.5		1,874
1959/60	884	35.1		455	18.3	328	13.0	504	20.0			168	6.7	179	7.1		2,518
1964/65	1,569	41.1		722	18.9	363	9.5	631	16.5			268	7.0	266	7.0		3,819
1969/70	2,855	44.7		1,187	18.6	569	8.9	939	14.7			414	6.5	416	6.5		6,380
1974/75	7,966	54.9		2,566	17.7	1,105	7.6	1,765	12.2			770	5.3	347	2.4		14,519
1989/90	50,027	65.8		12,926	17.0	10,132	13.3							395	0.5		75,983
1994/95	51,239	58.0	9,481 (10.7%)	15,588	17.7	11,624	13.2							8,298	9.4	(7,924)	88,306
1999/00	79,731	52.2	13,370 (8.7%)	24,346	15.9	16,560	10.8	19,811	12.9					5,985	3.9	(10,946)	153,744
2004/05	97,304	45.0	22,554 (10.4%)	40,404	18.7	-10		21,888	10.2	35,063	16.3			9,260	2.9	(13,734)	216,097
2005/06	103,120	44.0	24,895 (10.6%)	48,960	20.9	-16		21,814	9.4	37,442	16.1			13,615	5.8	(15,244)	234,568
2006/07	107,119	42.8	25,797 (10.3%)	57,104	22.8	-6		22,749	9.2	39,560	15.9			14,832	5.9	(17,145)	250,010
2008/09	115,899	43.8	30,030 (11.4%)	60,391	22.8	1		24,373	9.2	41,159	15.6			6,788	2.5	(23,569)	264,534

* Due to a change to the calculation method which occurred in 2007/08 (and was applied retrospectively), the data prior to 1999 is not directly comparable to the data after 1999.
Basic figures have been reproduced from Commissioner of Taxation, *Annual Report 2007–08*, Table 2.2.2 — because of the effect of refunds and the like, the percentages may sum to over 100%.
The collections data presented in this table has been adjusted to exclude expenses and better align with the ATO's financial statements and the Final Budget Outcome.

Trends in Australian taxation over time are revealing. For example:

- while there are some 125 taxes imposed in Australia (99 by the Commonwealth Government, 25 by the states, and one by local government), over 90% of total tax revenue at all levels is generated by just 10 taxes — including, in rank order, personal income tax, company tax, GST, excise, payroll tax and stamp duties[28]
- total taxation revenue collected in Australia rose $14,524m (5.5%) between 2007/08 and 2008/09. Taxes on income increased by $2,422m (2%) while taxes on the provision of goods and services decreased by $1,240m (3%)
- the Commonwealth in 2006/07 collected some 82% of these total taxes ($262.5 billion), with the states ($48.9 billion) and local government ($9.4 billion) collecting the balance
- taxes and transfers rose from around 5% of GDP in 1902/03 to some 30% of GDP in 2006/07
- the total tax collected annually by the ATO had been rising steadily until the Global Financial Crisis caused the total tax to drop by $6,328 billion in 2008/09. However, over time the total tax take has risen significantly by around $112 billion or some 73% over the period 1999/00 to 2008/09. In fact, total tax collections have almost trebled in the last 15 years (from $88,306 billion in 1994/95 to $264,534 billion in 2008/09)
- Australia is similar to most advanced western countries in that it raises the majority of its taxation revenue through direct taxes on income. Taxes on wages, salaries and profits contributed some 69% of total revenue in 2007/08, with the remainder (31%) raised from indirect taxes (GST, excise and property taxes). In 2006/07, the tax burden in Australia on capital was around 11% (fourth highest in the OECD), 12% on labour and 9% on consumption (each fourth lowest in the OECD)
- in 2008/09, individuals contributed 46.3% of total revenue; companies 27.8%; GST 15.6%; excise 9.2%; superannuation 3.6%; FBT 1.3%; resource rent 0.8%; and other indirect taxes 0.4%[29]
- the largest single collection is through the PAYG withholding system, which accounted for around 43.8% of total tax collected by the ATO in 2008/09
- historically, Australia has generally not been heavily taxed *overall* by international standards, being regularly placed within the bottom third of OECD countries in terms of *overall* tax burden and comparatively low in respect of taxes on goods and services. However, Australia is among the highest OECD countries in levels of personal income and company tax[30]

28 The *Architecture of Australia's tax and transfer system* report, 14.

29 Commissioner of Taxation, *Annual Report 2008-09*, 11.

30 The OECD *Revenue Statistics* (2008) indicates that at 30.6% of GDP, Australia had the eighth lowest tax burden of the 30 OECD countries, with the average being 35.9%, and only Mexico, Japan, Korea, US, Switzerland, Ireland and the Slovak Republic lower than Australia.

- in 2007/08, taxation per capita in Australia was $16,401, an increase of 7.1% from 2006/07[31]
- collections from companies increased by some 248% between 1999/00 and 2008/09, and some 8.0% between 2006/07 and 2007/08, but dropped by 2.2% between 2007/08 and 2008/09
- the GST in 2008/09 accounted for 15.6% of all taxes collected by the ATO (but GST collections dropped in monetary terms by around 3.6% compared to 2006/07)
- Australia's GST rate of 10% is significantly below the unweighted OECD average of 18% and was the equal fourth lowest rate of the OECD in 2008. Hungary, Norway and Sweden, for example, impose a VAT rate of 25%
- the highly centralised nature of the Australian tax system, resulting from the federal government's effective control over major revenue sources (¶1-600), means that the system has considerable potential for use as an instrument of economic stabilisation and the achievement of equity and social engineering (even if for various reasons the present system does not usually achieve these ideals: ¶1-185ff).

¶1-122 Impact of GST on Commonwealth/state tax relations and the vertical fiscal imbalance

The Commonwealth Government's exclusive de facto imposition of income tax has resulted in a vertical fiscal imbalance ("VFI") — ie the dominance of the Commonwealth over the states, which do not have access to taxes which generate such large revenues.

The VFI has fluctuated significantly over time, though the Commonwealth continues to wield significant fiscal dominance over the states.

The fact that the revenue generated by the GST is transferred by the Commonwealth to the states (in 2007/08, the Commonwealth Government collected $42.4 billion in GST for the states) gives the states access to a "growth" tax (ie a tax whose revenues will increase over time) — the GST "take" has risen from some $23,788m (14.5%) of total federal tax collections in 2000/01 to $42,399m (15.7%) in 2007/08.

It is by no means clear that the transfer of GST revenues has "freed" the states or corrected the VFI, because the GST remains a federal tax under the Commonwealth's ultimate control. In addition, to balance the GST revenues flowing to the states, various state taxes have been abolished (¶1-610) and the Commonwealth Government has indicated that it will reduce its "general" (ie non-tied) grants to the states (¶1-550).[32]

31 ABS Catalogue number 5506.0 — Taxation Revenue, Australia, 2007–08, Australian Bureau of Statistics.

32 P Mellor, "Reform of Federalism: The GST and State income taxation" (2008) 11 (4) *The Tax Specialist* 272. The states received some $29 billion in specific purpose payments in 2006/07: the *Architecture of Australia's tax and transfer system* report, 297.

Functions and objectives of taxation (¶1-130 – ¶1-170)

¶1-130 Conventional view of the tax system

In seeking to explain the current role of the tax system, conventional theorists such as Allan, or Musgrave and Musgrave, begin from the proposition that in a perfectly competitive economy, the problems of production, distribution and exchange would be solved by the competitive process itself — "the free actions of men pursuing their personal desires in free markets".[33]

On this theory, entrepreneurs in a free market would attempt to maximise profits, but would be restrained by market forces from over-exploiting their position. Similarly, workers would attempt to maximise pay and conditions, but again market forces would restrain them from obtaining more than the value of their labour and its products.

In these circumstances, the self-regulating market would find its own balance. By definition, the exchanges between persons in such a market would be "fair", because unless both parties to a transaction received an acceptable benefit they would refuse to exchange money for goods (or vice versa).

If this is so, why then do governments impose taxes? The conventional answer is that the market is *not* in fact in a state of perfect competition, and there are three main factors which create a need for taxation:

(1) the need for governments to provide social and merit goods (¶1-140)

(2) the need for governments to support those for whom a free market would not otherwise provide (¶1-150), and

(3) the intentional use of taxation to correct other free market imperfections (¶1-160).

¶1-140 Provision of social and merit goods

Allan argues that the free market operates upon two principles:

(1) *exclusion*: ie those who do not pay the market price for goods are excluded from the consumption of those goods, and

(2) *revealed preference*: ie the market operates upon information revealed by consumers about consumption preferences. Consumers reveal their preferences for particular goods through their consumption patterns. That is, if people want to eat a roasted chicken, they must buy one, thus "revealing" their preference for chicken rather than other food such as hamburgers. The market then organises itself to supply those revealed preferences.

33 CM Allan, *The Theory of Taxation* (Penguin, 1971) 13; RA and PB Musgrave, *Public Finance in Theory and Practice* (McGraw-Hill, 2nd ed, 1976) 50ff.

The principles of exclusion and revealed preference will tend to be effective in organising the production, distribution and exchange of "private consumption goods", ie those goods where supply is limited and consumption by one person excludes others from consumption of the same goods (eg eating a chicken). Market forces are able to cater for the supply of such goods because the principles of exclusion and revealed preference provide the market with the necessary information about consumer demand.

However, market forces will be less able to provide efficiently for goods which do not trigger the exclusion and revealed preference principles, and thus do not provide the necessary market information. Two such categories are *social* and *merit* goods.

Social goods

Social goods are characterised by "joint" (or "non-rival") consumption and "non-excludability". An example is street lighting, because the more street lighting that one person receives, the more benefit *everyone* in that area receives. Hence individuals do not have the same incentive to "pay" for street lighting, and as a result the market may not obtain accurate information on the extent to which potential consumers want, need or value street lighting, and therefore may tend not to supply appropriate street lighting.

On this view, social goods therefore need to be provided by the state rather than by the private sector/market.

Merit goods

In the case of merit goods (ie simplistically, goods which are deemed to be "beneficial" to their user, such as education, health foods and exercise), the problems in ensuring adequate supply through free market forces arise mainly because of the factors of ignorance and externalities.

Ignorance

People may be expected to make rational consumption choices in relation to goods which generate easily comprehended benefits and costs. It is comparatively easy, for example, for people to perceive that clothing or housing provides warmth and protection, and thus to calculate the extent of their needs for such products.

However, other goods may have costs and benefits which are less easily perceived or evaluated. There may be difficulties because, for example, the nature of the costs and benefits of a particular product may not easily be understood by consumers, or else because there might be a significant time gap before the consumer can evaluate the cost/benefit of the product (eg the benefits of education or the dangers of smoking may not become apparent to the consumer until many years after the opportunity for consumption arises).

Externalities

The free market's effectiveness in supplying merit goods is also reduced by difficulties in perceiving and evaluating externalities (the effect of one person's actions upon others).[34]

As noted above, to correct for consumers' perceived inadequate analyses of the effects of their behaviour, a government might attempt to discourage consumption of certain ("demerit") goods, for example, by imposing heavy discriminatory taxes upon those goods or their component materials (a heavy tax on cigarettes or tobacco[35]); on the other hand, it might attempt to encourage consumption of other ("merit") goods by providing subsidies or tax benefits (eg tax rebates on health foods).

This is an example of the way in which taxation may be used either *directly* (to fund the supply of goods) or *indirectly* (through onerous taxation on the one hand, or benefits or subsidies on the other) to modify patterns of supply and consumption of goods and intangible items.

¶1-150 Support for those not provided for by the free market

Taxation is also required to enable governments to support those persons whom a free market might otherwise ignore (eg the poor).

Even where free market forces do make available necessary goods (such as food, clothing, housing and education), there may be persons who cannot pay the market price for these goods. If society deems it desirable that all citizens have food, clothing and education, the taxation system can be used to achieve this aim; for example, by using tax revenues to fund low-cost housing or by making cash grants to those in need.

¶1-160 Correction of other free market imperfections

Free market forces may create what a political or wider social perspective regards as other market imperfections requiring correction. Examples might include at one extreme *monopolies*, which may cause prices to be set arbitrarily at excessive levels or, at the other extreme, *wasteful competition*, as where competing airlines use the same routes at the same time, with each company operating at less than optimal capacity.

Similarly, a government may use taxation in an attempt to:

- *accelerate the rate of economic growth* — by using taxation subsidies to counteract investors' ignorance of long-term external benefits of investment, or

34 "... when an externality is present there is a divergence between private and social cost": CJ Dahlman, "The Problem of Externality" (1979) 22 *The Journal of Law and Economics* 141.

35 AFTS Report, 56 stated that a "Tobacco tax raises prices and reduces both smoking rates and smoking intensity". It is not clear, however, that such taxes are always as effective as legislators hope.

- *maximise economic stability* — by using increases or decreases in tax levels to smooth out trade cycles, or to reduce inflation or unemployment (eg increasing taxes or lowering subsidies when excess private expenditure threatens to cause inflation).

Of course, taxation is not the only method of correcting free market imbalances or imperfections, nor is it necessarily always the best method. More direct methods might include:

- correcting consumer ignorance through advertising and labelling laws (as with notices warning of the damage caused by tobacco products)
- controlling demerit goods through production quotas, or food and other health law restrictions
- controlling the location of dangerous industries in cities through zoning laws
- controlling or prohibiting monopolies, price fixing and other "undesirable" market dealings through trade practices and similar legislation, and
- using the criminal law as a control mechanism or deterrent.

¶1-165 Tax expenditures

A "tax expenditure" is a tax concession that is designed to provide a benefit to a specified activity or class of taxpayer.[36] Tax expenditures are generally positive, ie they usually confer a benefit, such as the lower taxation of funded superannuation payments. However, a tax expenditure may be negative — where the arrangements impose a higher cost rather than a benefit.

Tax expenditures can be provided through a tax exemption, tax deduction, tax rebate, reduced tax rate or by deferring a tax liability.

Tax expenditures in many cases provide governments with an alternative to direct expenditure — a substitute method of providing benefits or assistance to taxpayers or meeting government objectives. Thus, a government could either seek to encourage primary production by paying direct monetary subsidies to farmers, or, alternatively, could use tax expenditures to achieve the same broad aim by providing farmers with tax concessions such as lower tax rates (eg via "averaging" of income) and special tax rebates or deductions (eg for fences and farm equipment). Sometimes direct subsidies and tax expenditures may be used at the same time.

A tax expenditure inevitably changes the distribution of tax between taxpayers — those benefiting from a positive tax expenditure pay less tax, but those excluded from the benefit will generally need to pay more tax in order to enable the government to raise the same total revenue.

There are important differences between direct payments and tax expenditures. Tax expenditures may be subject to less scrutiny and harder for voters to "see" or identify than direct government expenditures because: (i) they generally involve forgoing

36 *Tax Expenditures Statement 2008-09*, Treasury, Commonwealth of Australia, 13.

revenue which is never received, rather than expenditure which is received and then publicly expended; and (ii) in contrast to direct payments, which must generally be approved again in each government budget, a tax expenditure "once legislated becomes part of the tax law with a recurring fiscal impact and does not receive regular scrutiny through the budget process".[37]

The benefits of tax expenditures are said to include encouragement of economic growth, investment and entrepreneurial activity. However, cynics might argue that using a tax expenditure rather than a direct payment may be an attractive option offering some political advantages to a government that wishes to provide benefits to a particular group of taxpayers without drawing attention to what it is doing. Whatever the reason, tax expenditure promises (such as superannuation concessions) have featured in many election campaigns.

In its *Tax Expenditures Statement 2009*, 2010 CanPrint Communications Pty Ltd, the Treasury listed the largest positive tax expenditures as including:[38]

• CGT main residence exemption — discount component	$17,500m
• CGT main residence exemption	$14,500m
• superannuation — concessional taxation of employer contributions	$11,400m
• superannuation — concessional taxation of superannuation entity earnings	$9,800m
• CGT discount for individuals and trusts	$5,380m
• GST:	
food — uncooked, not prepared, not for consumption on premises of sale and some beverages	$5,600m
health — medical and health services	$2,700m
education	$2,550m
financial supplies; input taxed treatment	$2,120m
• Exemption of Tax Bonus for Working Australians	$2,070m
• exemption of Family Tax Benefit, Parts A and B, including expense equivalent	$2,010m

The largest *negative* tax expenditures were:

• customs duty	$2,950m
• higher rate of excise levied on cigarettes with not less than 0.8 gram of tobacco	$1,395m

Measured tax expenditures as a proportion of GDP were projected to fall from 10.2% in 2007/08 to 8.5% in 2008/09 and 6.3% in 2009/10 mainly as a result of the impact of the Global Financial Crisis on superannuation returns and Australia's housing market. Nonetheless, tax expenditures are projected to climb back to 6.9% by 2011/12. Moreover, in absolute terms, tax expenditures are continuing to rise: from $50,240m in 2004/05 to a projected $102 billion in 2010/11.[39]

37 Treasury, Commonwealth of Australia, *Tax Expenditures Statement 2004* (2005) 1. See also *Tax Expenditures Statement 2009* (2010) 1.

38 Treasury, Commonwealth of Australia, *Tax Expenditures Statement 2008* (2009) 12.

39 Ibid 3.

¶1-170 Problems in using taxation for social engineering

Taxation is a powerful and intrusive tool, which can sometimes be effective in modifying private behaviour to more closely reflect a government's policy objectives (at least where there is some elasticity of demand). However, the use of taxation in this way has a number of problems, including:

(1) Taxation is a *blunt instrument* — tax rules are usually framed in general terms and apply to broad groups or classes of persons (such as spouses, primary producers, employees), who are generally all treated in the same way.

The tax system is not inherently well-suited to dealing differently with unique individuals in a single category (eg an individual "employee"), although granting broad discretions to the Commissioner enables solutions to be tailored to individuals in some cases.

(2) Taxation is an *indirect* instrument — thus it is sometimes difficult to predict how effective a tax will be in achieving its stated aims.

(3) Taxation may create *unintended or undesirable side effects*. For example, it has been argued that a high level of income taxation lowers the incentive to work and save because the bulk of additional earnings are lost in taxation,[40] and it has even been suggested that tax may impact on birth rates.[41] However, such issues are rarely straightforward. For example, the relationship between progressivity and incentive is complex — studies tend to show that people *think* tax is a disincentive *for others*, but not necessarily for themselves, and while progressivity may be a disincentive for some, for others (such as persons with fixed levels of post-tax outgoings), progressivity may actually *increase* work effort.[42]

Criteria for evaluating a tax system (¶1-180 – ¶1-230)

¶1-180 General outline

Assuming that a society has (or is considering creating) a particular tax system, how does it evaluate the performance of that system — ie how does one identify a "good" tax system? It is probably true to say that, as Alexander Pope sagely observed, "Whoever hopes a faultless [tax] to see, hopes what ne'er was, or is, or e'er shall be

40 "The Costs of Taxation", CCH *Tax Week* Issue 26 (2005) ¶429.

41 JCA Dique, "Australia's declining birth rate: its relationship to increasing taxation", (1984) Veritas, Bullsbrook, W.A. More recently, it has been suggested that higher child payments may have led to higher pregnancy rates.

42 DJ Collins, "The Issue of Progressivity in Personal Income Tax Reform: A Case Against Flat Rate Income Tax", in PD Groenewegen (ed), *Australian Taxation Policy* (Melbourne: Longman Cheshire, 1980) 254.

More optimistically, Hugh Dalton suggested that the ideal tax system is one under which "the rich should pay more taxation than they think, while the poor should think that they pay more than they do. This double illusion . . . will keep the rich contented and the poor virtuous, and will tend to maximise work and saving by all".

However, structuring a tax system appropriately is important because, as Parsons observed:

"A tax will not have respect, and will not deserve respect, unless it is coherent in principle and has a claim to fairness . . ."[43]

Accordingly, it is important to identify some guidelines or criteria which can be used to judge the performance of a tax system, as well as any proposed reforms.

A number of functional criteria have been suggested — eg the Henry Tax Review applied design criteria of equity, efficiency, simplicity, and sustainability.[44] Several of these criteria are discussed in the following paragraphs (¶1-185–¶1-225). However, a problem in evaluating criteria is that often there can be an inherent tension between the needs of individual taxpayers or groups and the need to protect the revenue for the benefit of the community as a whole. Simplifying the rules for some taxpayers could impose additional burdens on others.[45]

¶1-185 Fairness or equity

"Equity, or fairness, is a basic criterion for community acceptance of the tax system", and people would generally expect a taxation system to be fair (ie "equitable").[46]

Indeed, fairness is a practical as well as moral necessity — a system which is perceived by taxpayers generally as basically unfair or discriminatory is unlikely to enjoy widespread support. Perpetuating an unfair system may eventually provoke an informal "taxpayer revolt" in which significant numbers of taxpayers seek to avoid or evade their tax liabilities, or a more formal revolt in which taxpayers seek to remove (perhaps forcibly) the tax or the government which imposed it (¶1-080).

General problems in measuring "fairness"

One problem is that there is a wide diversity of views on how to measure the "fairness" of a particular tax system, and views invariably also differ on whether a particular system is *sufficiently* fair. As the Asprey Committee pointed out long ago, "in tax matters [fairness] is an ideal exceedingly difficult to define and harder still to measure".[47]

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43 Prof RW Parsons, "Income Taxation — An Institution in Decay" (1986) 3 (3) *Australian Tax Forum* 233, 258.

44 AFTS Report, above, 17. The Ralph Committee prioritised the major objectives as being: optimising economic growth and neutrality, promoting horizontal and vertical equity, and promoting simplification and certainty: Review of Business Taxation, *A Tax System Redesigned* (1999) 104; cf The Inspector-General of Taxation, *Issues Paper No 2: Policy Framework for Review Selection* (2003) 1; M D'Ascenzo, Commissioner, Australian Taxation Office, "Building a Better Australia", address to the Committee for Economic Development in Australia, Sydney, 19 June 2008.

45 Inspector-General of Taxation, *Issues Paper No 1: Context for Scoping Review* (2003) 5.

46 Ralph Review of Business Taxation, *A Strong Foundation: Establishing objectives, principles and processes* Discussion Paper (1998) para 39; *A Tax System Redesigned* (1999) 105; AFTS Report, above, 29.

47 Commonwealth Taxation Review Committee (Asprey Committee), *Full Report* (1975) 12.

A divergence of views on the meaning of fairness is significant, because different perspectives may lead to support for markedly different types of tax systems. For example, persons defining fairness in terms of merit and reward for effort may tend to favour a system with low marginal rates of income tax, and no capital gains, death or wealth taxes. By contrast, persons viewing fairness from a social equality or "needs" perspective are likely to favour a system with high personal income taxes as well as wealth, death and capital gains taxes designed to redistribute wealth.

Even if agreement could be reached on a definition of "social justice", there remains the question of *how much priority* social justice should be given in taxation policy — assuming the better-off should pay more tax, *how much more* should they pay? Again there is no definitive or objective answer to this question.

Particular difficulties with horizontal and vertical equity

Traditionally, two particular aspects of equity are identified: *horizontal equity* (people in similar positions should be treated similarly, eg entities carrying on business activities), and *vertical equity* (persons in different positions should be treated differently, with those who are better off bearing an appropriately heavier burden).

The problem with ***horizontal equity*** as an ideal is that, while persons with the same taxable income can be required to pay the same amount in income tax, this will only produce "fairness" if taxable income is the appropriate measure of a taxpayer's economic wellbeing. However, two persons (X and Y) each earning $50,000 pa may not be in the same overall economic position, for example, because X has no dependants, whereas Y has a dependent spouse and three young children. In these circumstances, X arguably is in a stronger financial position, even though earning the same income as Y.

The Asprey Committee pointed out a number of other difficulties facing those attempting to increase horizontal fairness:[48]

(1) It is difficult to determine the appropriate taxing unit — should economic wellbeing be measured by reference to individuals, or to the average or total income of all members of a family?

(2) Persons whose incomes are the same may be dissimilar in other respects, for example the essential outgoings which they must incur may differ significantly (one taxpayer may have a chronic illness which costs $20,000 pa for treatment).

(3) While it is administratively convenient to calculate and levy taxes on an annual basis, this may not be equitable. For example, with a progressive rate income tax and the impact of such things as zero tax thresholds, progressive tax rate thresholds mean that a person whose taxable income varies markedly from year to year (eg $50,000 in Year 1, $15,000 in Year 2 and $40,000 in Year 3) will usually pay more tax in total under a progressive tax system over a given period of years than a person earning the same total income by way of equal annual sums over the same period (eg $35,000 each year).

48 Commonwealth Taxation Review Committee, *Full Report* (1975) 12–14; AFTS Report above, 19–21.

Thus, on the basis of 2010/11 income tax rates (including the Low Income Tax Offset), the "irregular income" taxpayer would pay a total of around $12,990 in income tax for the three years, whereas the taxpayer earning $35,000 pa would pay only $9,150.[49]

(4) The effects of inflation may also reduce the practical equity of a system which is conceptually fair.

Vertical equity is also intrinsically meritorious, but it too is often difficult to achieve in practice, for reasons analagous to those discussed above in relation to horizontal equity. Moreover, views may differ as to the appropriate degree of unequal treatment which the tax system should prescribe (eg how much more income tax should be paid by a person deriving taxable income of $80,000 pa than by a person earning $50,000 pa).

Overall, then, it may be said that while most persons would see equity or fairness as an essential attribute of a revenue system, it is often quite difficult to structure a taxation system in such a way as to ensure that both horizontal and vertical equity are simultaneously maximised.

¶1-190 Simplicity

The Asprey Committee referred to "simplicity" as being, after equity, "perhaps the next most universally sought after of qualities in individual taxes and tax systems as a whole . . .".[50]

A tax may be described as "simple" if the cost of official administration and collection and the "compliance costs" (the costs in money, effort and stress involved in taxpayers meeting their obligations) are low. These costs will be minimised if both the assessor and the taxpayer can establish easily and with certainty the tax payable, and the system minimises the number of dealings that taxpayers must have with government departments or others in order to complete their tax obligations.

On the other hand, the Henry Tax Review also observed that the costs of complexity are that it reduces transparency, which impedes optimal decision-making by businesses and individuals and may cause people inadvertently to pay the wrong amount of tax; and reduced transparency also has a regressive impact, because it affects mostly people least able to deal with it and with least access to professional tax help.[1]

49 The Asprey Committee remarked that in its widest sense, equity requires that taxation be the same for individuals whose total life-time "well-being" is the same. Indeed, "more than a single life-time is relevant when the fairness of taxation upon an individual's capacity to do his duty to his heirs is considered . . .": ibid 14.

50 Commonwealth Taxation Review Committee, *Full Report* (1975) para 3.19 and 3.20. Compare the AFTS Report, 17; Review of Business Taxation, *A Strong Foundation: Establishing objectives, principles and processes* Discussion Paper (1998) Overview, para 41–43; and *A Tax System Redesigned* (1999) 106.

1 AFTS Report, above, 21.

Complexity is also a problem because it makes it harder for people to understand their taxation rights and obligations without incurring additional expenses for professional advice. The Ralph Committee in its Final Report suggested that:

> "Complexity is one consequence of continually building the business tax system upon a foundation deficient in policy design principle . . . reflected in unintended or inconsistent statutory interactions, as well as excessively specialised provisions which lack general application and adaptability. Such structural complexity fuels a dynamic process of exploitation and anti-avoidance response that generates escalating complexity. .
>
> A separate issue . . . is that of administrative complexity. Complexities in the administrative arrangements add to business (and government) costs, and do little to promote voluntary compliance."[2]

The Australian income tax law has certainly become much less simple over time. First, it has become much more voluminous: the original 1915 Act contained 24 pages, while the 1936 Act originally comprised 265 sections and was a mere 126 pages, whereas the 1936 and 1997 tax Acts are now some 5,700 pages in length.

In addition, the legislation has also become inherently more complicated, with even the High Court commenting some time ago on the "extraordinarily complex" CGT provisions which "must be obscure, if not bewildering, both to the taxpayer who seeks to determine his or her liability by reference to them and to the lawyer called upon to interpret them".[3] This may be somewhat ironic, since some commentators have seen the tendency of courts at times to interpret legislation in ways that allowed artificial tax avoidance schemes to succeed as one of the factors which contributed significantly to the perceived need for more complex legislation.[4]

Reducing complexity

The Ralph Committee observed that because of the inherent complexity in many business transactions, it is not possible to remove all complexity from tax legislation.

In its view, the objective of simplification therefore needs to be "approached from two perspectives:

- The business tax system should be designed in as simple a manner as possible, recognising economic substance in preference to legal form.

2 Review of Business Taxation, *A Tax System Redesigned* (1999) 106.

3 In *Hepples v FC of T* (1991–1992) 173 CLR 492, 521; 91 ATC 4808, 4824, Toohey J commented that "even allowing for the difficulties inherent in legislating for a capital gains tax, these provisions are unduly labyrinthine"; cf CLR 546; ATC 4839 (McHugh J). Hill J observed in *FC of T v Cooling* (1990) 22 FCR 42, 61; 90 ATC 4472, 4488 that the provisions in question there were "drafted with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms".

4 GS Cooper, "The Political Economy of Taxation and the Roles of the High Court", (1993) 23 (1) *University of Western Australia Law Review* 101, 102. See also N Brooks, "The Role and Responsibilities of a Judge in Interpreting the Legislation and Preventing Tax Avoidance" in GS Cooper (ed) *Tax Avoidance and the Rule of Law* (Amsterdam: IBDF, 1997) 123–129.

- Where the tax treatment of particular transactions is likely to be complex, such additional complexity in the tax law should be justified by the improvement in the equity or economic growth that may be achieved.

The Committee suggested that the preferable approach to reducing complexity was the adoption of a "principles-based" approach to policy development and its legislative expression and administration.[5]

Federal governments have attempted to reduce complexity by introducing various reforms from time to time, and these have had some impact. Other proposals now being adopted by the federal government include removal of the need for many people to lodge tax returns[6], and to reduce the complexity of information required for "ordinary" taxpayers (eg by allocating standard deductions to taxpayers in certain categories or introducing a simpler "short form" return for taxpayers with simple affairs).[7]

In 2006, the federal government introduced the *Taxation Laws Amendment (Repeal of Inoperative Provisions) Act 2006*, which aimed to help simplify the tax system (by reducing the volume of income tax legislation by over 30%) through repealing 4,100 pages of provisions which have no application after a prescribed date, or whose operation is "spent" and will not apply in future.

However, the inherent difficulties in keeping tax laws simple are increased by the government's continued use of the tax system for complex "social engineering" purposes, and for distribution of political concessions (¶1-100, ¶1-170).

Progressive reforms of the tax system

The process of simplification and reform is not new — as long ago as 1932 Royal Commissioners were appointed to report on the simplification and standardisation of the income tax laws. Over the past decade or so, Commonwealth governments seem to have become more concerned about the erosion of simplicity in the tax system and have introduced a variety of measures designed to reduce complexity.

Thus, the federal government introduced the Tax Law Improvement Project (TLIP) in 1993, which was intended to simplify the wording and structure of tax legislation significantly, and render it more user-friendly.[8]

5 Cf I Young, "Inconsistencies between the tax systems", CCH *Tax Week* (2004) ¶441.

6 P Hill (ed), "The death of common sense" (2004) 33 AT Rev 69–70.

7 The Federal Treasurer indicated in November 2009 that "we shouldn't be content with a system that's so complex that an average person with simple tax affairs feels unable to do their own tax return . . .", "Swan flags controversial Tax Reforms": www.ABC.net.au/News /stories/2009/11/05/2734576.htm (accessed 10 Nov 09).

8 See A Towler, "Tax Law Improvement Building the New Income Tax Law" (1995) 7 (2) *CCH Journal of Australian Taxation* 46; A Towler, "Tax Law Improvement — An Overview", (1994) 6 (5) *CCH Journal of Australian Taxation* 14.

This was replaced in 1998 by the more general Tax Reform project, and subsequently, by "coherent principle based" drafting in 2005,[9] ie legislative drafting which is designed to "write the law in a series of operative rules or statements of principle about what the law is intended to do — rather than details about the mechanism that gets it there".[10]

However, Sir Anthony Mason warned that principles-based drafting requires "... legislation which is clearly thought through and clearly expressed ...".[11] This has not always been the hallmark of Australian tax legislation.

¶1-193 Compliance costs

A taxpayer's compliance costs will include costs of collecting tax revenue, accounting for tax owing and remitting it to the collecting authority. These costs may be:

- *monetary* (eg fees for advice or assistance paid to professional advisers)
- *time* (eg in keeping records or completing returns), or
- *psychological* (eg anxiety caused by inability to understand complex laws).

Compliance costs may be:

- "regular" (ie ongoing)
- "temporary" (as where an existing tax is changed)
- "commencement" (once only start-up costs), or
- mandatory or voluntary,

and may be offset to some extent by benefits flowing from compliance, as where information obtained during compliance procedures enables taxpayers to manage their business or personal affairs more efficiently.[12]

Sandford[13] identified several key characteristics of compliance costs:

- they tend to be more diffuse, less visible and more likely to be overlooked than administrative collection costs
- they are often capricious in their incidence, and regressive in their impact, and
- they tend to be resented more by the taxpaying population than administrative costs.

9 Review of Income Tax Self-assessment, *Discussion Paper — Review of Aspects of Income Tax Self-assessment* (2004) Appendix 3.

10 Quoted in M Dirkis, "Senior Tax Counsel's report — Clarifying and Simplifying the Law through Coherent Principles Drafting" (2005) 39 (10) TIA 510. The government emphasised that it was not the same as "plain English" or the TLIP approach.

11 Sir Anthony Mason, "Global challenges in tax administration" (2005) 40 (4) TIA 197, 199.

12 N Rametse and J Pope, "Start-up Compliance Costs of the GST: Empirical Evidence from Western Australian Small Business" (2002) 17 (4) *Australian Tax Forum* 407.

13 C Sandford, M Goodwin and P Hardwick, *Administrative and Compliance Costs of Taxation* (Bath: Fiscal Publications, 1989) 9–12.

Tax compliance costs vary significantly, with the average tax compliance costs for small to medium enterprises (SMEs) in Australia of around US$8,922 being the third lowest among selected OECD countries, with Finland and New Zealand (US$3,706) lower, and Austria, Belgium, Ireland (around US$10,000), Norway, Spain (US$20,000) and Portugal (US$25,500) being higher.[14]

The other side of taxpayers' compliance costs is the cost to government of collecting tax owing. The OECD found that in 2006, Australia's costs per $100 of tax collected amounted to $1.06 in 2001, $1.07 in 2002 and $1.05 for 2003 and 2004. This placed Australia's costs in 2004 above the USA ($0.56), the UK-Ireland ($0.97) and New Zealand ($0.81), but below Canada ($1.17), and Japan ($1.58). Of all the OECD countries, Poland had the highest cost at $2.62 and Norway had the lowest cost at $0.56.[15]

The Commissioner of Taxation, Annual Report 2008–09, 174, found that the net cost to the ATO on average of collecting $100 in tax dropped from $1.25 in 1992/93, to around $0.81 in 1998/99 (excluding excise), rising to about $0.92 in 2002/03 (including excise), decreasing to $0.84 in 2008/09, and increasing again to $0.85 in 2008/09.

¶1-195 Certainty

The Ralph Committee, in its final report on reform of the business tax system, commented that because the collection of (business) tax relies largely on voluntary compliance by taxpayers:

> ". . . compliance should be fostered by making the business tax system as simple, inexpensive and certain in its application as possible.
>
> Tax laws should be designed from the perspective of those who must comply with and administer them. Taxation laws should be as clear and concise, and provide as much certainty as possible. They should be framed in plain English and based upon a consistent set of stated design principles. Their structure should be able to accommodate continuing change."

There are four aspects of "certainty":[16]

(1) *Certainty of incidence*: the degree of certainty with which taxing authorities can predict who will actually bear the burden of the tax. There can often be a significant difference between the intended and actual incidence of a tax (¶1-110).

(2) *Certainty of liability*: the ease and accuracy with which liability to tax can be assessed. Retrospective legislation causes particular difficulties in relation to certainty.[17]

14 RF Warburton and PW Hendy, *International Comparison of Australia's Taxes* (2006) 389.

15 The OECD, Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006). Table 24, 110.

16 CM Allan, *The Theory of Taxation* (Penguin, 1971) 38–40.

17 P Cowdroy, "Ineptitude in tax law tardiness", (1995) 30 (4) TIA 171.

(3) *Evasion ratio*: the extent of evasion and avoidance, and the extent to which the taxing authorities can overcome avoidance and evasion techniques and extract the intended revenue from taxpayers.

(4) *Fiscal marksmanship*: the certainty with which taxing authorities are able to predict the revenue which will be collected in a particular year.

Each of these aspects of certainty can affect the extent to which tax legislation achieves its policy and revenue aims.

¶1-200 Efficiency/neutrality

One important aspect of efficiency is administrative efficiency, ie minimisation of administrative and compliance costs.

Neutrality is another key aspect of efficiency. That is, in general, the impact of tax should not influence individual or business choices by artificially distorting or altering the costs (and therefore attractiveness) of alternative goods, different modes of investment or different activities.[18] For example, ideally tax should not affect the choice of operating through a partnership versus a company, or buying orange juice versus soft drink.

Governments may nevertheless intentionally use taxation to interfere in free market dealings in order to increase — or discourage — output or consumption of goods or services (¶1-140, ¶1-170). The Asprey Committee was of the view that such non-neutralities should be introduced only "in a deliberate and explicit way for proven, explicit and quantified purposes", after it had been shown that other approaches (such as tariffs, subsidies, monetary control, marketing organisations and the like) were likely to be less effective.[19]

¶1-205 Flexibility

If the taxation system is to be effective in achieving non-fiscal objectives, then the tax structure and rates need to be easily adjustable, and changes in a tax should have a speedy and decisive impact on revenue yields and taxpayers' behaviour.

Indirect taxes tend to be "flexible", since changes in rates can be made readily, and have a relatively swift impact upon taxpayers' behaviour (an increase in tax on petrol will lead almost immediately to price increases at the petrol pump). On the other hand, death duties and capital gains taxes tend to have a delayed impact, since it may be many years before a liability for tax arises.

18 See Commonwealth Taxation Review Committee (Asprey Committee), *Full Report* (1975) 16.

19 Review of Business Taxation, *A Tax System Redesigned* (1999) 105.

¶1-210 Evidence

"Evidence" is the extent to which taxpayers "know about" or are made aware of their tax liabilities.

An argument for high evidence in taxes is that, in a democratic society, citizens should have full information about the actual impact of various taxes, so that as voters they can decide upon the extent to which they wish to support or subsidise a government's programs and objectives. Income tax has high "evidence" — each PAYG taxpayer knows or can ascertain how much tax is taken from their earnings, because it is shown on wages and withholding slips and is reinforced in annual return calculations. In contrast, the GST has lower "evidence" in Australia, because the tax payable tends to be "hidden" in the total price of goods.

¶1-215 Fiscal adequacy

A tax should generate the requisite amount of revenue needed by the government.

¶1-220 Political acceptability

The tax should not provoke political difficulties, either within Australia or with other tax jurisdictions.

¶1-225 Suitability for achieving macro-level objectives

The tax should promote the macro-level economic objectives which a government is seeking to achieve. These could include, for example, the optimising of economic stability and growth, redistribution of income or wealth, raising of employment levels and the lowering of inflation.

¶1-230 Conflict and compromise between objectives

There is considerable potential for tension or conflict between the above "ideal" criteria, and it is unlikely that anyone will ever create a tax system which simultaneously maximises each of these criteria.

In practice, there need not be any significant conflict between simplicity and neutrality: a simple, broad-based tax at uniform rates on all consumption goods and services would be both simple and neutral. However, the potential conflict between simplicity and equity is often significant — taxes which aim to maximise equity often tend to be complex — the Australian CGT being a good example. One reason is that many fine distinctions and exceptions/exclusions may be deemed necessary to try to achieve equity among a great many disparate taxpayers and groups. Another reason may be that the need for greater equity requires more complex anti-avoidance legislation, and as anti-avoidance provisions increase, the tax and the overall system become correspondingly more complex.

Tax reform initiatives (¶1-235 – ¶1-250)

¶1-235 Criticisms of the current tax system

A number of criticisms highlighting the lack of simplicity in the current tax system were discussed above, and subsequent chapters outline various defects and problems in specific areas of the current Australian tax system. Some general criticisms of the current system include suggestions that:

- the system is not sufficiently equitable, because taxable income is not the best measure of economic wellbeing
- the neutrality of the system has been unduly eroded over time by successive governments' tendencies to appease sectional interests by granting them ad hoc tax benefits, and
- the system has comparatively low political acceptability.

Other "main systemic tax administration issues and concerns" identified include:[20]

- the complexity of the tax laws, and the capability of tax administration officials
- the way that clarification of the tax laws is achieved when taxpayers dispute tax administration decisions
- unsympathetic tax debt collection procedures and policies
- lack of commercial orientation in aspects of tax administration, and
- the ATO's approach to aggressive tax planning.

¶1-240 Guidelines for further tax reform

In evaluating possible future reforms, it is useful to bear in mind the comments of Mathews, who suggested as long ago as 1980 that tax reform is effective only if it achieves the "overriding requirement" that the tax system's intended and actual effects are the same. This in turn requires that opportunities for avoidance, evasion and other manipulations be minimised.

The criteria that Mathews suggested for evaluating reform proposals include:[21]

- The revenue bases should be easily identifiable and measurable, and should as far as possible be determined by reference to market or other objectively verifiable values.

20 Inspector-General of Taxation, *Identification of the Main Systemic Tax Administration Issues and Concerns Facing Taxpayers* (2003) para 12; cf *Issues Paper No 1: Context for Scoping Review* (2003) 5.

21 R Mathews, "The Structure of Taxation", in J Wilkes (ed) *The Politics of Taxation* (Hodder and Stoughton, 1980) 82, 108–112.

- Transactions and transfers should so far as possible be taxed at the time they take place, to avoid the need for cumulative records of transactions and to enable tax liabilities to be finalised when the transactions occur, for example by deduction of tax at source.
- Transactions and transfers should be taxed at proportional rates. Exemptions and concessional allowances should be consistent with social security arrangements and be paid direct to eligible taxpayers.
- Tax bases should be consistent (eg between business and personal taxation).
- Generally, the broadest possible revenue base should be used, except where specific taxes are intentionally imposed to achieve vertical equity or other particular distributional, stabilisation or allocative objectives.
- As far as possible, internal checking mechanisms should be built into the tax system as a means of verifying tax liability.

The Ralph Review suggested that, in designing a tax system, account also needs to be taken of international factors.[22]

¶1-250 Options for further reform

The Henry Tax Review: "Australia's Future Tax System"

In 2008, the federal government commissioned Dr Ken Henry, Secretary to the Treasury, to lead a comprehensive "root and branch" review of the Australian taxation system. The terms of reference for the Henry Tax Review included that the Review provide recommendations for a (partially) integrated tax and transfer structure that will:

- position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes
- enhance Australia's overall economic, social and environmental wellbeing, with a particular focus on ensuring there are appropriate incentives for: workforce participation and skill formation; individuals to save and provide for their future, including access to affordable housing; investment and the promotion of efficient resources allocation to enhance productivity and international competitiveness; and reducing tax system complexity and compliance costs.

A fundamental constraint for the Review was the government's direction that the GST base was not to be increased or broadened, and untaxed superannuation payments for individuals aged over 60 were to be preserved, as were the aspirational personal income tax goals.

22 Review of Business Taxation, *An International Perspective* Discussion Paper (1998) para 1.3.

The Review was not comprehensive, in that it did not consider industry policy, carbon pollution policy and most aspects of tax administration.[23]

The Review released preliminary reports — *Architecture of Australia's tax and transfer system* and *Pensions review background paper*, and also relied on the *Intergenerational Report 2007* (Aust Govt 2007).

The Review proceeded on the basis that Australia's current tax and transfer system is basically sound, and a "good starting point" for the Review,[24] but that many current taxes are inefficient and lower the efficiency of the overall tax system — a number of key reforms would therefore equip the Australian tax system to cope better with the future needs of the nation. The Review took a long-term perspective over the next 40 years and noted that over that period it expected to see a number of significant changes with which the new tax system would have to cope — for example:

- a new world economic order based on ever-deepening international integration
- the transformation of business, commerce and personal lives by technological advances
- ageing of the population, reducing some tax bases and raising the costs of health, aged care and dependency
- strong growth and cultural diversification of Australia's population with high demands for economic infrastructure, education and infrastructure spending
- deepening stresses between human activities and wider ecosystems, globally and locally, and
- further stresses on housing affordability and urban amenity.[25]

Objectives

The Henry Tax Review set out its key objective as being to develop a tax and transfer system that is:

(1) responsible and accountable

(2) acting with high integrity

(3) robust and efficient

(4) "as responsive as possible to problems experienced by taxpayers"

(5) more transparent and understandable to citizens

(6) able to adapt to changing future circumstances[26], and "most of all"

23 AFTS Report, v.

24 AFTS Report, 23.

25 Ibid, xv.

26 Including changing economic, social and environmental circumstances flowing from population demographics, globalisation, increased mobility of capital and labour, and other factors (Ibid, xvi, 3–11).

(7) oriented to supporting strong and sustainable economic growth[27] and environmental sustainability — noting that company income tax has the largest adverse effects on economic growth, followed in rank order by broad based taxes on personal income, consumption and land[28].

To achieve this, the Review identified nine design features of the "new architecture" needed for an optimal 21st century tax and transfer system.[29]

Key design principles applied by the Henry Tax Review

The Henry Tax Review indicated that key design principles for the reformed Australian tax and transfer system should be:

- equity (or fairness) (¶1-185)
- efficiency (¶1-200)
- simplicity (¶1-190)
- sustainability, and
- policy consistency (rules in one part of the tax system should not contradict those in another part of the tax system or in the transfer system).

The Review noted that, for a variety of reasons, it is neither possible nor desirable to make changes too quickly — in essence, the political process is slow, policy changes rarely produce immediate results, and people need time to rearrange their affairs in order to adjust to major policy changes.[30]

Against this background, the Review provided the following key directions and proposals.

1. A "strategic priority" is to reduce the number of taxes levied in Australia (¶1-120)[31] and find less "complicated ways of delivering multiple policy objectives through the tax and transfer systems."[32]

   The number of taxes imposed and the revenue generated by them is set out in Chart 1.4 below.[33]

27 Ibid, 15–22

28 Accordingly, the Review favoured lighter tax burdens on more mobile bases, particularly investment, ibid, 18.

29 Ibid, xvii–xx.

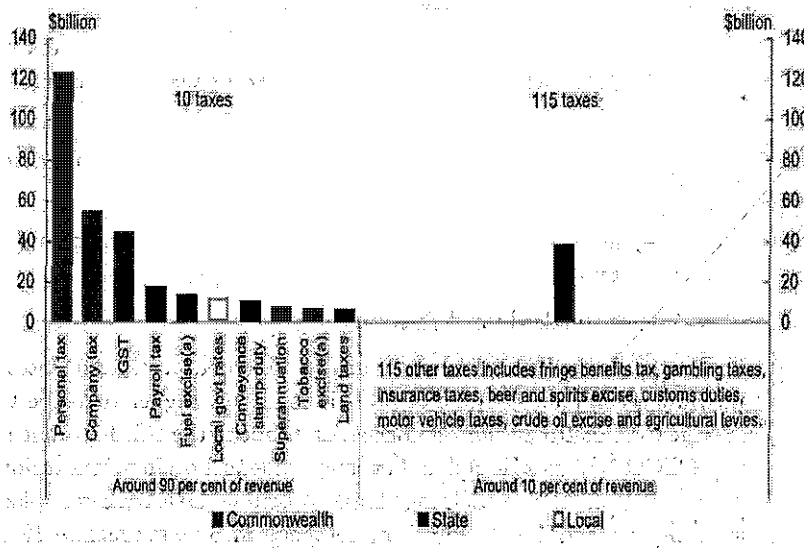
30 Ibid, xxiv–xxvi.

31 Ibid, xvii.

32 Ibid, 11.

33 Copied with permission of the Commonwealth Copyright Administration, AFTS Report, 12.

Chart 1.4: Ranking of Australian taxes by revenue in 2009–10



(a) Fuel excise and tobacco excise includes excise equivalent customs duties for these products.
Source: Treasury estimates.

2. Revenue raising should be concentrated on four robust and efficient tax bases.

   (i) ***Personal income tax*** — assessed on a broader basis[34] A fair and efficient personal income taxation is essential for a 21st century tax system, but this aim needs to operate in tandem with tax transfer policy settings.

The tax and transfer system has become "inordinately complex". It should be simplified and be the dominant source of progressivity in the tax system.[35]Progressivity should be increased by:

- introducing a broad definition of "income"[36] including all work remuneration in taxable personal income (including key fringe benefits)[37] and employer superannuation contributions
- incorporating the Medicare levy and structural offsets for low-income, pensioner and beneficiary tax into the progressive rate structure, and

34 Ibid, 26.

35 Ibid, 25, 26, 30.

36 Ibid, 30.

37 That is, those fringe benefits which are readily valued and attributable to individual employees should be taxed in the employee's hands. Ibid, 30.

- introducing a simple and transparent tax integrated with technology and with:
  - a two-step tax scale applying a constant marginal tax rate of 35%, which would apply to 97% of taxpayers and a rate of 45% for the remaining 3%
  - taxable threshold around $25,000, with deductions and offsets rationalised
  - all pensions, allowances and other transfer payments being tax-free, and
  - a standard tax deduction.[38]

(ii) *Business income* — with more growth-oriented rates and bases. The Australian company tax rate of 30% is some 5% higher than the OECD average for small/medium economies, and indeed the third highest rate in the OECD.[39] Accordingly, a key step in encouraging innovation and entrepreneurship, and helping keep Australia an attractive place for investment would be to reduce the company income tax rate to 25% over the short to medium term as economic and other circumstances permit.

Australia should adopt a broader, more uniform company income tax base, streamlined and enhanced capital allowance arrangements, and allowance of carry-back of corporate tax losses for one year to offset the prior year's income, together with simplified arrangements for small business. This would ensure that investment would be targeted to its most productive uses, reduce biases against risk-taking, and encourage entrepreneurial activity (which is important for economic growth.[40]

The dividend imputation system should be retained for the time being, though its benefits are declining, and possible alternatives should be explored.[41]

In the longer term, Australia should consider moving towards a business level expenditure tax, as the models for such taxes improve.[42]

(iii) *Private consumption* — The Henry Tax Review noted that Australia has a number of inefficient taxes on consumption (including the luxury car tax and narrow payroll taxes).[43] However, consumption spending is potentially an efficient and robust tax base if broadly defined — and one of the least damaging to economic growth.

38 Ibid, 31–32.

39 Ibid, 40.

40 Ibid, 40, Table 5.1.

41 Ibid, 41–42.

42 Ibid, 42–43.

43 Ibid, 51.

While the GST is an efficient tax relative to most other taxes levied in Australia, it is less efficient than it could be because it does not tax consumption on a truly comprehensive basis (eg by including residential homes) and is operationally complex and costly for (particularly small) business.[44]

In the Review's opinion, the GST and inefficient state consumption taxes on insurance and payroll taxes should gradually be replaced by a low-rate, broad, destination cash flow tax which covers returns from labour, but excludes business export sales. This would be a highly efficient and relatively simple tax.

(iv) *Economic rents from natural resources and land* — The immobile nature of these natural resources mean that they provide an efficient tax base, where they are imposed on a comprehensive base.

The Henry Tax Review saw reform in this area as important because current narrowly-based and variable rate land taxes and stamp duties are inefficient. An efficient broad-based land tax should apply equally to all land uses (including the family home) and aggregate a taxpayer's holdings, but would have an appropriate threshold and rates varying according to value per square metre rather than use, and with thresholds set to ensure that most lower-value use land (eg agricultural) would not trigger a land tax liability, and applying moderate rates (say 1%) to most other land.

Similarly, Australia has very significant non-renewable resources, such as petroleum and minerals, which are a significant asset of the Australian community, and current resource royalty taxes distort investment and production decisions.[45]

The Review therefore recommended the introduction of a project-based uniform resources tax (excepting low-value commodities) at a rate of 40% to replace existing resource royalties. This would encourage proper levels of exploration and extraction and encourage private sector participation.

3. Beyond these four "robust" taxes, the only additional taxes which should be retained would be specific taxes imposed in order to:

(a) efficiently address social outcomes or market efficiency through better price signals, eg taxes on tobacco, alcohol and gambling; taxes to improve the environment, such as the Carbon Pollution Reduction Scheme; and road user charges, including congestion taxes[46].

44 Ibid, 51. Using input taxation as a proxy for GST results in business being overtaxed by some $500m and consumption being undertaxed by some $2.5 billion — indeed, in the Review's opinion, taxing consumption of financial services is inherently problematic, ibid, 52.

45 Ibid, 47–48.

46 Ibid, 25, 52, 53–56. Though the Review observed that, while it believed that taxes on cigarettes, road use and environmental activities could be effective, tax might not be an appropriate mechanism to address problem gambling, as it is not clear how problem gamblers will react to increases in tax levels, ibid, 57.

(b) improve market or social outcomes by addressing spill over costs and benefits, or

(c) help counteract self-control problems.

Accordingly, current taxes, such as payroll taxes, stamp duties,[47] property transfer taxes and other taxes which do not meet the above criteria should be abolished over time.

4. There is considerable evidence that tax differences can have significant effects on the assets in which taxpayers choose to invest their savings.[48] For example, there is a bias in the personal income tax against savings and interest which arises because interest is fully taxed, whereas shares and rental properties receive tax discounts of various types. This bias adversely affects people who choose to defer consumption in order to save, and encourages investors to take on too much debt and thus distorts the rental property market.

To remove this bias, the tax system should:[49]

- introduce a 40% discount for income from bank deposits, bonds, rental properties, capital gains, etc, and consider extending the uniform discount to dividends and business income
- simplify the CGT rules by excluding low revenue-generating assets, removing grandfathering rules and using a principles-based rewrite of the legislation, and
- rationalise and streamline small business entity CGT concessions, and abolish the active asset reduction and 15 year exemption concessions.

5. Australia has an ageing population and rapidly increasing demands for governmental support. This will create a major challenge for the future, as the proportion of Australians aged 65 years or older is projected to increase from 13% of the total population to 22% by 2050, while the proportion of Australians in work or looking for work is projected to stabilise and then decrease. As a result, in 40 years' time there might be only 2.7 people of working age for each person aged 65 years or older, compared with 5.0/1 today and 7.5/1 some 40 years ago.

The Henry Tax Review observed that these changes will cause rising costs in new infrastructure, health and aged care and dependency.[50]

To achieve a better outcome and improve retirement incomes, the tax on superannuation contributions in a fund should be abolished, and instead — among other things — all the income and gains of superannuation funds should be taxed at 7.5%, and employer superannuation contributions included in the

47 The Review observed that current stamp duties are highly inefficient, and conveyance stamp duties are highly inefficient and inequitable, ibid, 49.

48 Ibid, 33.

49 Ibid, 32–34.

50 Ibid, 29 — though proposed increases in population might affect these figures.

employee's taxable income.[1] To improve retirement incomes, privately funded superannuation funds should continue to receive concessional tax treatment — distributed more evenly between high and low income earners.[2] As a complementary measure, the government should support the development of products such as long-dated bonds and income-stream products, which would allow people to manage longevity risks.[3]

6. While the Henry Tax Review regarded the complete integration of the tax and transfer systems as impracticable, in order to cope with its ageing population (and other issues) Australia needs an efficient transfer system to complement the tax system in achieving fairness and support for those who are disadvantaged, in an "efficient, sustainable, simple and transparent . . . internally consistent" way.[4]

   Accordingly, the pension system should be refined to provide only three levels of income support to groups unable to support themselves through work or savings:

   (i) Support for *aged, the disabled and carers* who are not expected to work. The pension should be sufficient to provide an adequate standard of living

   (ii) *Participation allowances* for people of working age, who are able and expected to work now or in the near future. Payments should provide a basic level of adequacy, with a means test set at a level which provides an incentive to work, and

   (iii) *Assistance payments* for young people and students. Payments to this group would be lower than the *participation allowance* rate, because some students have the capacity to work part-time. However, students should not be expected to work so much that it interferes with their study, and they should therefore be able to obtain loans to provide income up to the participation rate.[5]

   In addition, the system should abolish the current income and assets tests for pensions and introduce a comprehensive definition of "means" and a tailored means test for all income support systems (such as Housing and Aged Care), with common indexation arrangements.

7. Family assistance should be provided through a single programme based principally on the real costs of children (increasing with age)[6].

8. Globalisation makes it essential to ensure that Australia remains an attractive place for investment, and that this investment is directed towards its most productive uses. Increasing capital mobility will create strong competition for

1 Ibid, 34–35.
2 Ibid, 34.
3 Ibid, 36.
4 Ibid, 59.
5 Ibid, 59–60.
6 Ibid, 63–65.

capital (especially direct investment), and comparative international tax rates may also affect peoples' choices about where to work (especially for highly skilled groups).[7] Part of the remedy would be the reduction in the company tax rate over time to 25%.

9. Institutions, governance and administration. To run the Henry Tax Review's 21st century tax and transfer system effectively, an efficient and citizen-centric administrative system would be needed, which creates a supportive environment by being:
   - transparent
   - trusted
   - aligned with the "natural systems" of individuals and businesses ("the things they do anyway"), and
   - using technology to make compliance easier (online client accounts, providing default pre-filled tax returns).

Recommendations

Dr Henry delivered the Henry Tax Review's report — Australia's Future Tax System Report to the Treasurer (Final Report of the Henry Tax Review) ("AFTS Report") — on 23 December 2009, with 138 recommendations.[8] The Review suggested that adoption of its recommended reforms could potentially increase national output by around 2–3%, or some $25–40 billion (in 2010/11 values) over the long term[9].

At the date of writing, the federal government had attempted to implement only one of the Review's recommendations (Recommendation 45) — ironically, the highly controversial proposal for a mining resources rent tax which featured prominently in the 2010 federal election campaign. However, after discussion with the Independents holding the balance of power following the 2010 federal election which produced a "hung" federal parliament, the Labor minority government announced that it would review all the AFTS Report recommendations.[10]

Wealth tax

The Henry Tax Review suggested that a wealth tax had merit, but that it was politically unacceptable at the present time.

However, it is worth examining the concept of a wealth tax further.

7 Ibid, 8 — though the Review pointed out that the ageing Australian population and other countries may increase competition for skilled labour, and thus create opportunities for Australians to work abroad.

8 Ibid, 80–106.

9 Ibid, 74. The shape of the new tax architecture which the Review's recommendation would create is set out in Chart 11.1, of the AFTS Report, 76.

10 During the 2010 federal election campaign, the leader of the LNP Opposition had announced that in government they would review and consider implementing all of the Review's recommendations.

A wealth (or net worth) tax usually involves a tax levied on the annual value of all property owned by the taxpayer, less the value of their liabilities.[11] Exemptions are often provided on the basis of considerations of equity, efficiency and administrative expediency. For example, there are often exemptions for persons with net wealth below a prescribed threshold, and for household effects.[12]

Wealth tax is generally levied at progressive rates, but may be proportional. Rates are usually very low (0.5% to 2.0%), and the resulting revenue often forms only a small proportion of overall tax revenues (0.5% to 5.4%). Wealth taxes are often aimed at social equity objectives rather than large revenue returns.[13] The legislation will usually contain safeguarding provisions to ensure that the combined burden of income tax and wealth tax does not exceed a stipulated proportion of total wealth.

Australia's failure to tax wealth as such has been criticised by those who see a wealth tax as particularly desirable in the light of perceived inequalities in the distribution of wealth in Australia. This inequality was highlighted in a study which estimated that in the 1980s:

- some 10% of Australians owned almost 60% of personal wealth in Australia
- of these, the "top" 1% owned between 9% and 22% of total wealth, and
- the "bottom" 50% owned only 9% to 15% of personal wealth.[14]

There are a number of factors usually identified as supporting the introduction of a personal tax on net wealth:

(1) A personal net wealth tax increases the overall equity of the tax system. It reduces the concentration of wealth by catching amounts not taxed by income tax, including such items as the imputed value of services rendered and the imputed rent on owner-occupied dwellings.

(2) Detailed information on the ownership of wealth would be of value in national economic planning and policy planning, and would enable cross-checking in areas where income tax avoidance or evasion is otherwise difficult to detect or prevent.

(3) Because a wealth tax is normally paid from property income, imposition of the tax with no exempt categories of assets may cause taxpayers to switch from low yield and speculative investment in assets which do not produce income to assets generating a return greater than the wealth tax rate plus the relevant marginal rate of income tax. This would tend to encourage more productive use of resources, and thus help to increase economic growth, by channelling investment into more productive enterprises.

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11 See generally MRG Fiedler, *A Wealth Tax — A Study of its Economic Aspects with Special Reference to Australia* (Australian Tax Research Foundation, 1983) Section 2; R Mathews, above, 112–117; R Vann, "Agenda for tax reform" (1997) 67 (10) *Australian Accountant* 38.

12 Commonwealth Taxation Review Committee (Asprey Committee), *Full Report* (1975) 505 para 26.1; and PD Groenewegen, "The Feasibility of a Federal Net Worth Tax", in PD Groenewegen (ed) *Australian Taxation Policy* (Melbourne: Longman Cheshire, 1980) 305, 311.

13 Asprey Committee, ibid 505; and see also CS Shoup, "Wealth Taxation Today", in JG Head (ed) *Taxation Issues of the 1980s*, (Australian Tax Research Foundation, 1983) 385, 386.

14 P Saunders, "An Australian Perspective on Wealth Taxation" in *Taxation Issues of the 1980s*, ibid 397, 404; see www.abs.gov.au/ausstats.

(4) A wealth tax on individuals is difficult to "shift" from one taxpayer to another, so that its legal and economic incidence would tend to be the same. Moreover, a wealth tax without exemptions tends to be fairly neutral.

(5) Although revenue yields from a wealth tax would be modest, they might enable some reduction to be made in marginal tax rates.

On the other hand, there are a number of disadvantages identified in the operation of a personal wealth tax, including the following:

(1) A wealth tax may tend to discourage savings and thus have unfavourable effects on investment and economic growth.

(2) A wealth tax involves "double taxation", because it is levied initially upon the full capitalised value of estimated future income flows, and the income derived from that wealth is then subjected to income tax when the income is actually derived. Moreover, a Commonwealth tax could result in double taxation of land already subjected to state land taxes or local council rates.

(3) A wealth tax involves significant administrative difficulties, particularly in the identification and consistent valuation of relevant assets under inflationary conditions, and the need for procedures to detect avoidance and evasion.

(4) A wealth tax may create inefficiencies in resource allocation, by discouraging investment in enterprises where initial returns are low but where longer-term prospects may be good (eg primary production).

(5) A wealth tax may inhibit the capacity or willingness of persons to take entrepreneurial risks, thus reducing levels of employment and productivity, with consequential detriments outweighing the tax's re-allocative benefits.

To date, these advantages and disadvantages remain theoretical, because no Australian government in recent times has shown any strong inclination to introduce a wealth tax — partly, no doubt, because of the potential voter backlash identified by the Henry Tax Review.

The current Australian legal system (¶1-310 – ¶1-520)

¶1-310 Sources and principles

The tax consequences of a given transaction (eg the question whether a deduction is available or a receipt assessable for income tax purposes) will invariably depend upon whether or not that transaction falls within a particular provision of the tax laws.

It is therefore necessary to have a basic understanding of:

- the sources of taxation law, and
- the legal principles which the Commissioner, and ultimately the AAT and courts, apply when they seek to resolve taxation questions or disputes.

¶1-320 Sources of Australian taxation law

There are in effect three sources of taxation law in the Australian context:

(1) *statute law (or legislation)*: ie the law made by parliament and contained in statutes such as ITAA36 and ITAA97 and ancillary legislation, including regulations made under such Acts (¶1-330, ¶1-520), and

(2) *case law (or common law)*: ie the law created by the decisions of courts and tribunals (¶1-340).[15]

These are the two *formal* sources of law in the taxation context. There is, however, a third *informal* but de facto source of what might loosely be regarded as "law", namely:

(3) *the practice of the ATO*: ie the way in which the ATO administers and applies the law day to day, through day-to-day administration practices, binding and non-binding rulings and advice, assessment and enforcement practices and the like (¶1-490 – ¶1-510).

It is useful to examine these categories more closely.

¶1-330 Statute law

Australia is a federation with two main levels of government, each of which has its own parliament which passes appropriate legislation. The federal or Commonwealth Government is responsible for governing the whole of Australia and tax statutes passed by the federal or Commonwealth Parliament include the income tax legislation (ITAA97, ITAA36), the FBTAA, TAA and the *A New Tax System (Goods and Services Tax) Act 1999*. The various state and territory governments are responsible for governing their particular state or territory. Tax legislation passed by state and territory governments traditionally included the various stamp duties, land tax and pay-roll tax Acts (Chapter 28).

There is also a third "local" level of government: local councils which govern municipalities or districts and levy taxes usually in the form of land rates and various other service charges pursuant to authority conferred by the various local government and other enabling Acts.

Given the amount and complexity of tax legislation, a key issue is how courts/tribunals use the principles of statutory interpretation to resolve disputes as to the meaning of legislative provisions.

15 Decisions of the AAT may be said to be a source of law, at least as between the particular parties to a reference, though, as an administrative body, the AAT does not create "law" in the strict sense.

¶1-340 The two main roles of courts

The courts have two main roles in relation to the operation of the taxation system.

(1) Creation of law to fill a legislative vacuum

The courts *create* law in situations not covered by legislation — an example in the tax context is the issue of availability of legal professional privilege as a defence in tax audits, where there is as yet no definitive provision in the general tax legislation (¶29-210ff).

Some have been concerned that judges may at times take too proactive a role. For example, Hill J suggested that:

> "It is hard to avoid the conclusion that the adoption by the [High] Court of a more activist role is, in part, a consequence of inactivity on the part of the legislature to protect civil rights and, in part, and far more importantly, an insidious erosion of those rights . . . [Citizens] . . . have a legitimate complaint if the High Court changes its mind retrospectively . . . ".[16]

However, the increasing trend over recent times towards introducing very detailed legislation to deal with problems that arise in relation to taxation means that the legal "vacuum" where courts are required to create law to fill gaps in the law is shrinking. Increasingly, as discussed below, the courts' role instead involves the second area, ie legislative interpretation — "to an ever greater extent, the energies of the superior courts are devoted to . . . the intellectually exacting, but spiritually sterilising duty of interpreting [Acts of Parliament]" which are often ambiguous.[17]

(2) Statutory interpretation (interpretation of legislation)

In modern times, the amount of statute law — particularly in a complex and contentious area such as taxation — has increased enormously.

However, parliaments cannot always make their legislation so perfectly clear that there can be no possible argument as to a provision's intended meaning (a problem which tends to increase with the complexity of the legislation). Many English words have more than one possible meaning, and as Hill J noted, ". . . the English language is seldom so clear and unambiguous that only one construction [of a provision] is open."[18]

In a complex area such as taxation, where contentious tax arrangements are often sophisticated and sometimes artificial, it can be particularly difficult to achieve the dual aims of comprehensively covering all relevant aspects of a problem area, and at

16 Cf DG Hill, "Great Expectations: What do we expect from judges in tax cases?" (1995) 30 (1) TIA 21, 27–29. See also DG Hill, "A Judicial Petspective on Tax Law Reform" (1998) 72 ALJ 685. Indeed T Lonnqist argued that the purposive approach, threatens taxpayers and human rights: "The Trend Towards Purposive Statutory Interpretation: Human Rights at Stake" Rev L Jnl, Vol 13 Issue 1, 2003,17.

17 Compare Hon Murray Gleeson, "Justice Hill Memorial Lecture — statutory interpretation", TIA Vol 44 No 1 (July 2009), 3, 25.

18 *MLC Ltd & Anor v DFC of T* 2002 ATC 5105, 5112; (2002) 126 FCR 37, 47.

the same time ensuring that the legislation is clear and unambiguous. Indeed, Wheatcroft observes that "no country has yet succeeded, or is likely to succeed, in framing its tax laws in such a way that it is clear how the tax liability will be calculated on any conceivable set of facts. Even the most accurate draftsman of a law will not always be able to find precise language to convey his meaning and the wisest legislator cannot foresee every possible situation that may arise".[19] Some neutral body is therefore needed to interpret legislation when disputes arise: that is, to determine what a particular piece of legislation means in a given context, and "the task of statutory construction is to expose the meaning of the words which Parliament has enacted".[20]

Under the common law system, that task of interpretation falls ultimately to the courts and the judges who preside in them. Indeed, "most of the work of modern courts consists of applying and, where necessary, interpreting Acts of parliament".[21]

In determining the meaning of a statutory provision judges apply principles of statutory interpretation which have been developed over time and supplemented by statutory provisions.[22]

In determining the meaning of a statutory provision, the judges apply principles of statutory interpretation which have been developed over time and supplemented by statutory provisions.

The principles of statutory interpretation and their application, as well as the doctrine of precedent are dealt with in *Australian Tax Law* 20th edition, ¶1-350 to ¶1-480.

Practice of ATO as source of "law"

¶1-490 Introduction

The practice of the ATO is applied through its assessment and review procedures, its day-to-day decisions in formal and informal dealings with practitioners and the public, its public and private rulings and its objection and review (litigation) procedures.

19 Quoted in GS Cooper (ed), *Tax Avoidance and the Rule of Law* (IBDF Publications, 1997) 17; compare Gleeson (above) 30 "Drafting income tax legislation is a difficult and thankless task . . .."; J Steyn, "The Intractable Problem of the Interpretation of Legal Texts" [2003] Syd L Rev, 1.

20 *CPH Property v FC of T* 98 ATC 4983, 4995 (Hill J); cf Cooper, ibid 19–20.

21 The Hon M Gleeson, Justice Hill Memorial Lecture, "Statutory Interpretation" (2009) 44 (1) TIA 25; the Hon MD Kirby, "Towards a Grand Theory of Interpretation: the Case of Statutes and Contracts" (2003) 24 Statute Law Review, 95–97.

22 JM Macrossan, "Judicial Interpretation" (1984) 58 ALJ 547, 552; GL Davies QC, "The Role of Courts in Construing the 'Income Tax Assessment Act' " (1980) XVI (8) TIA 749, 750; Mason CJ, Speech to the Sydney Institute, quoted by DG Hill, "Great Expectations: What do we expect from judges in tax cases?" (1995) 30 (1) TIA 21, 27; P Brazil, "Reform of Statutory Interpretation — The Australian Experience of Use of Extrinsic Materials: With a Postscript on Simpler Drafting" (1988) 62 ALJ 503; Sir Anthony Mason, "Global challenges in tax administration" (2005) 40 (4) TIA 197, 199; and AH Slater QC, "What Decisions Should a Court Follow?" (1995) 7 (6) *CCH Journal of Australian Taxation* 45.

In many situations, ATO interpretations or actions create informal "law", in that practitioners and their clients accept ATO practices or rulings without formal challenge, and structure their affairs accordingly.[23]

Rulings

ATO rulings are in an unusual situation, because since 1 July 1992 specified ATO rulings are binding on the ATO in the sense that a taxpayer relying upon an appropriate and relevant ruling is protected by statute from penalty or other adverse action by the ATO. Thus, under the "self-assessment" system, these rulings have moved closer to "formal" law (¶30-472ff).

Regulations

The Commissioner is given a limited formal power to "make law" through the powers granted to him under the Income Tax Regulations 1936 and the Income Tax Assessment Regulations 1997 (¶1-520).

Discretions

To the extent that the determination of an element of the taxpayer's assessable income or other element is left within the discretion of the Commissioner or their delegate,[24] the Commissioner does, in a sense, have a power to "make" law.

¶1-500 Issues in relation to rule-making by use of Commissioner's discretion

To enable the tax law to apply to a myriad of different taxpayers and situations, Commonwealth Governments have conferred various discretionary powers upon the Commissioner and his delegates.

The Commissioner's formal discretions may be divided loosely into three broad categories:

(1) "Machinery" discretions (relating to time, factual or operational matters) designed to enable the Commissioner to administer the day-to-day operation of the tax law, and to grant relief to bona fide taxpayers falling technically within provisions which were not "intended" to catch them (or vice versa).[25]

(2) "Anti-avoidance" discretions designed to enable the Commissioner to thwart or negate "improper" tax avoidance. There were 212 such discretions in the legislation as at June 2007.

23 R Tomasic and B Pentoney, "Tax Compliance and the Rule of Law: From Legalism to Administrative Procedure?" (1991) 8 (1) Australian Tax Forum 85. On the issue of whether ATO actions can create an "estoppel", see *Inglis v FC of T* 87 ATC 2037; *Ellison v DFC of T* 99 ATC 4576.

24 See, for example, *Trustees of the Post Office Staff Superannuation Scheme v FC of T* 99 ATC 4926; s 99A(2), (3) ITAA36; s 123(4)–(6); 124 FBTAA.

25 For example, by granting a deferment of tax: *Elias v FC of T* 2002 ATC 4579.

(3) "Discretions used in the calculation of elements of taxable income" (eg empowering the Commissioner to determine a reasonable amount, deem certain events to occur, and so on). There were 114 such discretions in the legislation as at June 2007.

However, the reliance on discretions increases uncertainty for taxpayers, since they often cannot be sure how the Commissioner will exercise that discretion in particular circumstances. Because of the uncertainty created by the use of the third group of discretions and their importance to the preparation of a taxpayer's tax return, the federal government commissioned a review of these discretions to determine which can be replaced by a provision that increases certainty by substituting an objective test of either:

- fact (eg "the taxpayer acquired the property for the purpose of profit-making" rather than "where the Commissioner is satisfied that . . ."), or
- reasonableness (eg "the amount that is reasonable in the circumstances" rather than "the amount that the Commissioner regards as reasonable . . ."),[26]

and aims to reduce the number of discretions.

¶1-510 Review of Commissioner's discretions by the AAT and courts

There are significant differences between the powers available to courts and administrative bodies such as the AAT to review an exercise of the Commissioner's discretion.

Review of discretions by AAT

Broadly speaking, the AAT, in reviewing a decision of the Commissioner, stands in the shoes of the Commissioner, and may exercise all the powers and discretions which the Commissioner has under the legislation. Thus, the AAT can review the *merits* of the decision, consider whether the Commissioner's exercise of a discretionary power was the correct or preferable one in the circumstances, and override that decision where it feels that a different decision is preferable (¶31-570).

Review of administrative discretions by courts

By contrast, a court has a far more limited power to review discretions.[27]

In broad terms, a court will overturn an exercise of the Commissioner's discretion only where the Commissioner has:

- based a determination upon an error of law
- taken into account irrelevant factors, or excluded relevant factors

26 Commonwealth of Australia, "Review of Discretions in the Income Tax Law" *Discussion Paper* (2007) 18–23.

27 *Ferris v FC of T* 88 ATC 4755.

- acted in bad faith, or
- exercised a discretion arbitrarily or fancifully.[28]

Thus, taxpayers seeking to challenge an exercise by the Commissioner of a statutory discretion on the basis that it is unduly harsh or inappropriate (but not wrong in law) may only be able to effectively challenge that decision in the AAT (¶31-500ff).

¶1-520 Role of taxation regulations

Section 266 ITAA36 and 909-1 ITAA97 empower the Governor-General to make regulations (delegated legislation)[29] dealing with relevant matters, and prescribing penalties not exceeding $550 for any breach of those regulations. Regulations provide the practical detail needed to render the broader legislative provisions operational, and prescribe the forms and procedures, eg for registration (and deregistration) of tax agents.

Constitutional aspects of taxation (¶1-530 – ¶1-610)

¶1-530 Distribution of legislative powers

Each level of government in Australia (Commonwealth, state and local) has only limited (defined) power to make laws, and cannot make laws of unlimited scope on any topic it might wish.[30] For example, the Commonwealth Government can only legislate on a limited number of topics (¶1-540), while state governments can generally only legislate for the "peace, order and good government" of that state.[31] Significantly, the Commonwealth does not have the exclusive power to impose taxes. The states have a concurrent power to tax, subject to the constraints of provisions such as s 90 and 109 of the Commonwealth Constitution (¶1-570). Nevertheless, it has always been clear that the Commonwealth taxation power is potentially very broad in scope (¶1-580) and that the Commonwealth's s 51(ii) power, for example, "extends to 'any form of tax which ingenuity may devise' [and] the Parliament may select such criteria as it chooses, subject to any express or implied limitations prescribed by the Constitution, irrespective of any connection between them".[32]

28 *Giris v FC of T* 69 ATC 4015, 4018, 4024; (1969) 119 CLR 365, 374, 384.

29 See further DC Pearce, *Delegated Legislation in Australia and New Zealand* (Butterworths, 1977).

30 This is illustrated in *Austin v Commonwealth of Australia* 2003 ATC 4042.

31 See I Killey, "Peace, Order and Good Government: A Limitation on Legislative Competence" (1989) 1 MULR 17, 25–29.

32 *MacCormick v FC of T* (1984) 158 CLR 622, 655, Brennan J.

¶1-540 Commonwealth's power to make laws with respect to taxation

The Commonwealth Government is a government of "enumerated powers". That is, it can only exercise those powers which are specifically or impliedly granted to it by the terms of the Constitution.

Accordingly, for a Commonwealth law to be valid, it must be possible for the court to "pigeon-hole" that law within one of the heads of power granted to the Commonwealth.[33] These heads of power are contained mainly, though not exclusively, in s 51 of the Constitution, which gives the Commonwealth Government power to make laws "with respect to" 38 specific areas, together with an express incidental power to legislate with respect to "matters incidental to the execution" of any of those powers.

The Commonwealth's taxation power is contained primarily in s 51(ii), which provides that: "The [Commonwealth] Parliament shall . . . have power to make laws with respect to . . . (ii) Taxation; but not so as to discriminate between States or parts of States".

Accordingly, for a Commonwealth law to be valid under s 51(ii), it must be possible to characterise that law as being one which both satisfies the positive test of being a law "with respect to . . . taxation . . ."[34] and also one which does not offend the prohibition against discrimination between states or parts of states. A law which fails either of these tests is invalid.

Not surprisingly, there have been a number of constitutional challenges to tax laws over the years — some raising unusual issues. In *Melkman v FC of T*,[35] the court held that certain tax legislation did not breach the *Racial Discrimination Act 1975* (Cth). In *Skyring v FC of T*,[36] the Full Federal Court rejected an argument that by requiring taxpayers in effect to pay income tax out of property owned by them, ITAA36 was unconstitutional because it violated rights allegedly guaranteed by Magna Carta.

The taxpayer in *Re Burrowes; Ex parte DFC of T*[37] put forward the ingenious argument that they should be excused from any liability to pay tax because they held a conscientious objection to paying taxes which might be used for military expenditure.

33 See *SGH v FC of T* 2002 ATC 4366, 4374 (Gummow J); *Pape v FC of T & Ors* 2009 ATC ¶20-116, 9813 (French CJ).

34 *Mutual Pools & Staff v The Commonwealth of Australia* 94 ATC 4103, 4105; (1994) 179 CLR 155, 166, (Mason CJ); *Leask v Commonwealth of Australia* 96 ATC 5071; (1996) 187 CLR 579.

35 87 ATC 4855; (1987) 15 FCR 311; see also *Ellenbogen v FC of T* 88 ATC 2012; (1988) EOC ¶92-219.

36 92 ATC 4028, 4030.

37 91 ATC 5021.

They also relied on legal principles arising from the Nuremberg War Trials, international conventions, and the defence of necessity. Heerey J rejected all of these arguments.[38] The taxpayer in *Atkinson v FC of T*[39] argued that they had paid the tax owing by tendering a number of shovels. Heerey J rejected this argument on the basis that the ITR required payment by legal tender rather than shovels (¶32-040).

The taxing power in s 51(ii) raises a number of issues which are worthy of closer examination, namely:

(a) the concept of a tax in the context of s 51(ii) (¶1-550), and

(b) the prohibition against discrimination between states (¶1-560).

¶1-550 The concept of a "tax" in s 51(ii)

Two definitions of "tax" traditionally applied in early cases in the context of s 51(ii) of the Constitution are: "a compulsory exaction of money by a public authority for public purposes enforceable by law",[40] and the process of "raising money for the purposes of government by means of contributions from individual persons".[41]

In *MacCormick v FC of T*; *Camad Investments Pty Ltd v FC of T*, Gibbs CJ, Wilson, Deane and Dawson JJ in the High Court identified the following characteristics of a "tax":[42]

- it is a compulsory payment
- the moneys are raised for government purposes
- the moneys do not constitute fees for services rendered[43]
- the payments are not penalties[44]
- the exactions are not arbitrary or capricious,[45] and
- the exaction should not be "incontestable".[46]

38 Ibid 5023–5024. See also *DFC of T v Keenan* 99 ATC 4465, 4465–4466.

39 2000 ATC 4332.

40 *Matthews v The Chicory Marketing Board (Vic)* (1938) 60 CLR 263, 276 (Latham CJ), applied by Gibbs J in *The State of Victoria v The Commonwealth* (1971) 122 CLR 353, 416.

41 *R v Barger* (1908) 6 CLR 41, 68 (Griffith CJ, Barton and O'Connor JJ).

42 84 ATC 4230, 4236–4237; (1983–1984) 158 CLR 622, 639–641; cf Brennan J ATC 4242; CLR 649; cf *FC of T v Futuris Corpn Ltd* 2008 ATC ¶20-039, 8509; *WR Carpenter Holdings Pty Ltd v FC of T* [2008] HCA 33; 2008 ATC ¶20-040.

43 *Queanbeyan City Council v ACTEW Corporation Ltd* [2009] FCA 943 (Buchanan J); L Waterson and P Willoughby Case Note, (2009) 44 (4) TIA 211, 211–212.

44 *R v Barger* (1908) 6 CLR 41, 97–99; cf *Woodhams v DFC of T* 97 ATC 5119.

45 *FC of T v Hipsleys Ltd* (1926) 38 CLR 219, 236.

46 *Futuris Corpn Ltd*, above, 8509 (Kirby J).

Some later cases took a broader approach and avoided the use of "checklists" of relevant factors.[47] In *Air Calédonie International v The Commonwealth of Australia*,[48] it was held that a compulsory payment under statutory powers could still be a "tax" within s 51(ii) even though "it was to a non-public authority or for purposes which could not properly be described as public". Similarly, it was held in *Northern Suburbs General Cemetery Reserve Trust v The Commonwealth of Australia*[49] and *Australian Tape Manufacturers Association v The Commonwealth of Australia*[50] that moneys need not be paid into consolidated revenue in order to be a "tax".[1]

Subsequently, in *Luton v Lessels*,[2] the High Court held that child support legislation did not impose a "tax" for the purposes of s 51(ii). The court confirmed that the features set out above were not an exhaustive definition of a tax. Gaudron and Hayne JJ commented that while all these factors are important, the presence or absence of any of them is not determinative. It is necessary, in every case, to consider all the features of the legislation.[3]

It has been said that a taxation law will "rarely, if ever" be at the same time an acquisition of property on unjust terms within s 51(xxxi) of the Constitution, since "if it is in truth a tax, its very nature prevents it amounting to an acquisition of property. It is no more than the imposition of a pecuniary penalty".[4] Whichever approach is applied, it is now clear that characterisation is based on the substance of the law, rather than mere form.[5]

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47 Indeed, it has been said that in light of these later decisions, "the core understanding of tax" in *Matthews v Chicory Marketing Board (Vic)* (1938) 60 CLR 263 and *MacCormick v FC of T* 84 ATC 4230; (1983–1984) 158 CLR 622 is "no longer a reliable guide in practice": G Brysland, "What is a Tax?" (1993) 5 (3) *CCH Journal of Australian Taxation* 23; V Morabito and S Barkoczy, "What is a Tax? The Erosion of the 'Latham Definition' " (1996) 6 *Revenue Law Journal* 43.

48 (1988) 165 CLR 462, 467.

49 93 ATC 4118, 4124; (1993) 176 CLR 555, 574–575.

50 (1993) 176 CLR 480, 503.

1 "provided the moneys raised by the imposition of the tax form part of the [Consolidated Revenue] Fund from which they must be appropriated by law": ibid 506.

2 2002 ATC 4311, 4313 (Gleeson CJ), McHugh J agreeing at 4324.

3 Ibid 4319–4320, 4321 (Gaudron and Hayne JJ) and 4326ff where Kirby J referred also to the importance of the historical context; cf *Pape v FC of T & Ors* 2009 ATC ¶20-116, 9838–9839 (Gummow, Crennan and Bell JJ); Hayne and Keifel JJ indicated that the law in question there was not authorised by s 51(ii) to the extent that it entitled a person to payment of a tax bonus greater than the amount of a person's adjusted tax liability.

4 *MacCormick v FC of T* 84 ATC 4230, 4236; (1983–1984) 158 CLR 622, 638.

5 *Ha v State of NSW* 97 ATC 4674; (1997) 189 CLR 465.

Implied limitation on the Commonwealth taxation power from the nature of federalism

In *Austin & Anor v Commonwealth of Australia*,[6] the Full High Court (Kirby J dissenting) held that the Commonwealth power to impose taxation under s 51(ii) is wide but is constrained by the essential nature of the Australian federal structure, which assumes the ongoing effective operation of both the Commonwealth and the states as separate political bodies.[7]

¶1-560 Prohibition against discrimination between states

The terms of s 51(ii) expressly require that a federal tax law must not discriminate between states or parts of states.[8]

Generally, the prohibition on discrimination has been interpreted as meaning that a law must not impose a differential liability to tax upon persons merely because they live or have property in different states or parts of states.

However, s 51(ii) prohibits direct legal discrimination, not indirect/consequential discrimination in the law's operation. Thus, the test for s 51(ii) is whether the law *inherently* discriminates in its necessary *legal* operation. So long as the law itself does not discriminate in its necessary legal effect, it does not matter that its practical operation will disadvantage some taxpayers in particular locations.

Thus, in *Cameron*, regulations applied different methods of valuing livestock depending upon the state in which the livestock was located. The legislation was struck down as discriminatory, because its legal effect necessarily discriminated between taxpayers in different states:[9]

> "the only test supplied by the regulations for determining . . . the value of livestock is the State or part of a State in which it is found . . . I find it difficult to conceive of a clearer case of discrimination between States."[10]

6 2003 ATC 4042, 4048 (Gleeson CJ), 4055 (Gaudron, Gummow and Hayne JJ), 4084 (McHugh J), 4053 (Gleeson CJ), 4088–4089 (Gaudron, Gummow and Hayne JJ).

7 Ibid 4042, 4048 (Gleeson CJ), cf 4084–4085 (McHugh J), 4096 (Kirby J).

8 This restriction was placed in s 51(ii) to protect "weaker" states. Sections 99 and 117 impose analogous limits. Regions or Commonwealth places within states are parts of states for the purposes of s 51(ii): *Permanent Trustee Australia v Commr of State Rev (Vic)* 2004 ATC 4996, 5017, 5025 (McHugh J dissenting).

9 Ibid 5018–5024; *Cameron v DFC of T (Tas)* (1923) 32 CLR 68, 79.

10 Cameron, ibid 72; cf *WR Moran Pty Ltd v DC of T (NSW)* (1940) 63 CLR 338; *Conroy v Carter* (1968) 118 CLR 90; *Clarke v FC of T* [2009] HCA 33; (2009) 72 ATR 868.

By contrast, a Commonwealth law which imposed a tax on certain minerals at a uniform rate throughout Australia would be valid because it is *legally* neutral in its impact, even though it would have an uneven impact in practice in different states because of the fortuitous geographical fact that some states have richer deposits of the taxed minerals.[11]

¶1-570 Other constitutional provisions

Section 99: prohibition on tax preferences

Section 99 of the Constitution complements s 51(ii) by prohibiting the giving of a tax preference — though there is unlikely often to be a significant difference in practical operation between the concepts of discrimination and preference. In *James v Commonwealth*,[12] Higgins J observed that while s 99 uses the word "preference", not "discrimination", he could not conceive of any preference without discrimination. In *Elliott v The Commonwealth*[13] Latham CJ suggested that "[p]reference necessarily involves discrimination or lack of uniformity, but [the latter does not] necessarily involve preference". Latham CJ also noted that unlike s 51(ii), there is nothing in s 99 that prevents the Commonwealth from giving preference to one part of a state over other parts of the same state.[14]

Other provisions of the Constitution relevant to a consideration of the federal taxing power include s 51(xxxi), 52(i), 53, 55, 90, 92, 96 and 114.

Section 51(xxxi): Power to acquire property

This section gives the Commonwealth power to acquire property "on just terms from any State or person in respect of which the Parliament has power to make laws" (¶1-550).[15]

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11 This was the example given by the Privy Council in *WR Moran Pty Ltd* (1940) 63 CLR 338, 347–348. Compare *FC of T v Clyne* (1957–1958) 100 CLR 246 and *Conroy*, above 101; *Halliday v The Commonwealth* [2000] FCA 950. The issues are considered by G Brysland "Interchase to Kurc — the Australian GST cases so far" (2004) 4(6) *Australian GST Journal*, 1; D Cominos and T Dwyer "Constitutional problems in the goods and services tax" (1999) 28 AT Rev 69; CJ Bevan "Constitutional aspects of the goods and services tax" (1999) 28 AT Rev 173.

12 (1928) 41 CLR 442, 460.

13 (1936) 54 CLR 657, 668.

14 *Permanent Trustee Australia v Commr of State Rev (Vic)* 2004 ATC 4996, 5010–5011.

15 *Bank of New South Wales v Commonwealth* (1948) 76 CLR 1, 349–350 (Dixon J); *A-G (Cth) v Schmidt (No 1)* (1961) 105 CLR 361, 372; *Clunies-Ross v Commonwealth* (1984) 155 CLR 193, 202; *Commonwealth v Tasmania* (1983) 158 CLR 1; *TJM Products Pty Ltd v Industry Research & Development Board* 98 ATC 4569, 4576; (1998) 83 FCR 379, 388; *Fieldhouse v Commissioner of Taxation* (1989) 24 FCR 187, 194, 209; *Hart v DFC of T* 2005 ATC 5022, 5048.

Section 52(i): Exclusive power over seat of government

Section 52(i) gives the Commonwealth Parliament exclusive power to make laws with respect to the seat of government and all places acquired by the Commonwealth for public purposes.[16]

In *Chief Commr of Stamp Duties (NSW) v Paliflex Pty Ltd*, Austin J held that a law which affects a Commonwealth place in a "real and tangible" way, or that has a "direct, practical and real connection" with a Commonwealth place, will be a law "with respect to" that place and therefore within the scope of s 52(i).[17]

Section 53: Senate may not introduce or amend tax laws

This section provides that laws imposing taxation may not be introduced or amended by the Senate, although the Senate may return such laws to the House of Representatives with a *request* that nominated items or provisions be amended or omitted from the legislation.

Section 55: Laws imposing taxation are to deal only with the imposition of taxation and only with one subject of taxation

For a law to be one "imposing" taxation, it must create a liability to tax.[18]

As a measure to protect the Senate in light of its inability to amend taxation legislation, s 55 limits laws imposing taxation to dealing only with the imposition of taxation, and one subject of taxation only (except laws imposing duties of customs or excise, which must deal only with duties of customs or excise respectively).[19]

(1) Laws imposing taxation shall deal only with the imposition of taxation

A law which prescribes matters such as the persons who are to pay tax and the classes of income on which they are to be taxed, and the assessment, collection and recovery of tax would be one "dealing with the imposition of taxation" even though it does not actually impose a tax.[20]

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16 It has been held that the s 52(i) power is plenary. It is separate from, and additional to, the concurrent powers conferred by s 51, and is not subject to the express limitation imposed by s 51(ii) against discriminating between parts of states: *Allders International v Commr of State Revenue (Vic)* 96 ATC 5135; (1996) 186 CLR 630. Section 52(i) has been held to invalidate imposition of a state stamp duty on a lease of land within an area originally acquired by the Commonwealth Government for public purposes: *Allders International v Commr of State Revenue (Vic)*; see V Morabito, "State taxes and Commonwealth places" CCH *Tax Week* Issue 33 (1997) ¶491.

17 99 ATC 5053. His Honour's reasoning was cited with apparent approval by the Full High Court in separate proceedings relating to land tax liability imposed on Paliflex after the transfer: *Paliflex v Chief Commr of State Revenue (NSW)* 2003 ATC 4983, 4985, 4987–4989, 4992–4993.

18 Hely J in *O'Meara v FC of T* 2003 ATC 4406, 4408 (Fed Ct); *State Chamber of Commerce and Industry v Commonwealth of Australia* 87 ATC 4745; (1987) 163 CLR 329.

19 Under s 55, a law imposing customs duties may deal with as many separate categories of goods as is deemed necessary or appropriate, provided the law remains "pure", ie does not contain a mixture of customs with other duties. Similar principles apply to excise duties.

20 *Permanent Trustee Australia v Commr of State Rev (Vic)* 2004 ATC 4996, 5008–5009.

The first paragraph of s 55 is designed to combat the legislative technique known as "tacking". If this paragraph was not there, it might be possible for the House of Representatives to pass a law which imposed an essential tax, but then "tack" or add on to it provisions dealing with some other more controversial or objectionable non-tax matter, and thus face the Senate with an "all or nothing" choice which would effectively prevent the Senate from amending any portion of the composite Bill.[21]

The s 55 restriction does not limit the effective reach of the s 51(ii) power, but rather the means by which it may legitimately be exercised.[22] To avoid breaching this restriction, the Commonwealth Parliament, when imposing a tax, has traditionally passed two separate Acts:

- a Rating Act, which does little more than impose the tax and stipulate the rates of taxation, and
- a separate Assessment Act, which contains the myriad of provisions setting out the criteria for liability for taxation, eligibility for deductions and the like, and the various administrative and machinery provisions necessary to make the imposition of tax effective (such as those relating to returns and assessments, objections and appeals, anti-avoidance provisions, and the like).

However, this legislative dichotomy is unduly conservative, and many matters traditionally contained in Assessment Acts could legitimately be dealt with in the Rating Act itself.[23]

(2) Laws imposing taxation shall deal only with one subject of taxation

The second limb of s 55 precludes a law imposing taxation (other than a customs or excise law) from dealing with more than "one subject of taxation". This is intended to prevent the House of Representatives from presenting the Senate with a single Bill containing a number of separate taxes (some being essential or acceptable to the Senate and others not), and thus forcing the Senate to pass all the taxes if it wishes to pass any of them.[24]

The test of whether a law deals with more than one subject of taxation is "whether a general consideration of the law reveals on the basis of common understanding and general conceptions" two or more subjects of taxation broadly "distinguishable from one another".[25] That is, whether — looking at political rather than economic consequences or impacts on legal rights — the subject Parliament has chosen to tax is "a single unit rather than a collection of matters necessarily distinct and separate".[26]

21 See *Buchanan v Commonwealth* (1913) 16 CLR 315, 328.

22 *Air Caledonie International v The Commonwealth of Australia* (1988) 165 CLR 462; *Australian Tape Manufacturers Association v The Commonwealth of Australia* (1993) 176 CLR 480; *Woodhams v DFC of T* 97 ATC 5119.

23 *Northern Suburbs General Cemetery Reserve Trust v The Commonwealth of Australia* 93 ATC 4118; *Austin v Commonwealth of Australia* 2003 ATC 4042, 4082; *Permanent Trustee Australia v Commr of State Rev (Vic)* 2004 ATC 4996, 5004–5005, 5007–5009.

24 *Resch v FC of T* (1942) 66 CLR 198, 222–223.

25 *MacCormick v FC of T* 84 ATC 4230, 4244 (Brennan J).

26 *Austin v Commonwealth of Australia* 2003 ATC 4042, 4082 (Gaudron, Gummow and Hayne JJ).

This test gives the concept of a "subject of taxation" a broad operation. Thus, in *O'Meara* (above), Hely J rejected the taxpayer's argument that the GST dealt with more than one subject of taxation (both goods and services), characterising the GST instead as a law dealing with a single subject of taxation, namely "final private consumption in Australia". Therefore, the GST did not breach s 55.[27]

Section 90: Duties of customs and excise

The Commonwealth Parliament already has clear power under s 51(ii) to impose duties of excise, customs and bounties on the production or export of goods. The effect of s 90 therefore is not to confer legislative power, but rather to prohibit the states (and territories) from imposing such duties.[28] Exclusive Commonwealth legislative power in this area was seen in the Constitution Debates as a necessary step in the "creation and maintenance of free trade areas throughout the Commonwealth and uniformity in duties of customs and excise and in bounties".[29]

Section 90 is thus a crucial provision, because it defines the limits of state taxation powers in a key revenue-generating area, and plays an important role in determining the federal/state financial balance. The broad interpretation of s 90 generally applied by the High Court has expanded the Commonwealth's exclusive taxing power, and correspondingly limited the effective scope of states' taxing powers, the amount of revenue which they could generate and, thus, the degree of their economic independence.

Defining a duty of excise

A duty of "excise" has been described as "a tax directly related to goods, imposed on some step in their production or distribution before they reach the consumer": *Mutual Pools & Staff Pty Ltd v FC of T*.[30]

In *Ha v State of NSW; Walter Hammond v State of NSW*,[31] a majority of the High Court expanded the scope of s 90 in holding that a state levy on retail tobacco sales by two duty-free stores was a duty of excise. In reaching this conclusion, the majority held that in determining whether or not a tax is an excise, the court must consider both the substantive operation of the tax as well as a textual analysis of the legislation imposing it. The majority applied the points made by Brennan CJ and McHugh J in *Philip Morris v Commr of Business Franchises (Vic)*[32] that:

(1) there was close proximity between the licence period and the period in respect of which the tax is calculated

27 *O'Meara v FC of T* 2003 ATC 4406, 4409–4410 (Fed Ct). For similar reasons, it was held that the FBT legislation "as a matter of common understanding" did not deal with one subject of taxation merely because it taxed a number of different fringe benefits: *State Chamber of Commerce and Industry v Commonwealth* 87 ATC 4745; (1987) 163 CLR 329.

28 *Capital Duplicators v Australian Capital Territory (No 1)* (1992) 177 CLR 248.

29 Ibid 277–278.

30 92 ATC 4016, 4017 (Mason CJ, Brennan and McHugh JJ); T Grant and S Jones, "Sales Tax and the Constitution: If Thine Eye Offend Thee . . ." (1991) 3 (5) *CCH Journal of Australian Taxation* 44.

31 97 ATC 4674.

32 (1989) 167 CLR 399, 463, 501 (Brennan CJ, McHugh, Gummow and Kirby JJ).

(2) the licence period was short

(3) the tax imposed was large and was borne once only in the course of distribution, and

(4) it exhibited a revenue-raising rather than regulatory purpose.

It is clear that a s 90 duty of excise may be imposed on the production, manufacture, sale or distribution of goods, and is not limited to duties on production or manufacture. Thus a sales tax, as well as a value added tax such as the Australian GST, may be a duty of excise.[33]

It has been held in several cases that a licence fee imposed under a regulatory regime as a prerequisite to carrying on a business is not an excise duty.[34] However, in *Capital Duplicators Pty Ltd v Australian Capital Territory (No 2)* the majority of the High Court made it clear that a levy described as a licence fee may still be a duty of excise if it is really "directed to . . . raising . . . revenue rather than to the creation of a regulatory regime designed to protect the public".[35]

The effect of the decision in *Ha* was to "significantly erode the tax base and financial autonomy of New South Wales and the other States and thus narrow the scope for the introduction of new State taxes".[36]

Section 96: The grants power

Under s 96, the Commonwealth Parliament "may grant financial assistance to any state on such terms and conditions as the Parliament thinks fit". These conditions are not limited to financial matters, nor to areas in respect of which the Commonwealth itself has legislative powers, and are also not subject to the prohibition on discrimination/preference which applies to s 51(ii) and 99. It would seem that the only restrictions on the power are that:

- any action required of the state government must be within its constitutional capacity
- the state cannot be compelled to take the Commonwealth grant, or to observe the conditions, and
- the exercise of the s 96 power must not be "merely colourable", that is, an attempt by the Commonwealth to evade a constitutional limitation on its legislative powers.

33 G Williams, "New battles over State taxation — a State GST?" CCH *Tax Week* Issue 17 (1997) ¶225; *Kithock v Commr for ACT Revenue* 2000 ATC 5026, 5036 (Miles CJ).

34 *Hughes and Vale v New South Wales (No 1)* (1953) 87 CLR 49.

35 93 ATC 5053, 5062.

36 Sir Harry Gibbs, "The Tax System: Seriously Wrong in Principle" (1993) 28 (1) TIA 31, 36. The trend towards a broad interpretation of "excise" has continued: *Queanbeyan City Council v ACTEW Corporation Ltd* (2009) FCA 943, L Waterson and P Willoughby, Case Note: "*Queanbeyan City Council v ACTEW Corporation Ltd*" (2009) 44 (4) TIA 211.

The grants power has enabled the Commonwealth Government to make financial grants to states conditional upon those funds being used for a wide variety of prescribed purposes — and "the practical effect [of s 96] . . . has been that in the revenue field the Commonwealth has established an overlordship".[37]

Indeed, it is significant that traditionally over half the Commonwealth grants to the states have been made through s 96 "tied grants", under which grants are made to states on condition that they be used for specified purposes (eg roads, hospitals, or the like). To the extent that a grant is conditioned on purposes of legitimate concern to the Commonwealth, the fiscal balance between state and Commonwealth is not disturbed. However, commentators have argued that where grants are made conditional on a state taking action in an area solely within the states' legislative power (ie outside the Commonwealth's legislative power):[38]

> "The power of the States to control their own affairs is seriously diminished, and the State Governments are rendered less accountable . . . The system leads to a lack of efficiency. Forward financial planning is made difficult for the States by uncertainty as to the amount of future grants. What is perhaps worse, from a national point of view, is that the ability of the Commonwealth to pursue policies in matters which are strictly of State concern has resulted in an expensive duplication of bureaucracies . . ."

Section 114: Tax on state/Commonwealth property

Under s 114, the states are prohibited from imposing tax on property of any kind belonging to the Commonwealth[39] without the Commonwealth's consent, and similarly the Commonwealth is not to impose any tax on property of any kind belonging to a state.[40] Section 114 has been used successfully on a number of occasions by state authorities to protect them from Commonwealth taxes: *DFC of T v State Bank of New South Wales*[41] (bank exempt from sales tax on printed material for the bank's own use); *South Australia v The Commonwealth*[42] (state superannuation body exempt from CGT — but not "ordinary" income tax — on disposals of property).

In the *State Bank* case, the High Court held that, in order to attract the s 114 immunity, it is not necessary that the entity in question represent the Crown in right of a state (or the Commonwealth as the case may be). Instead, the terms "State" and "Commonwealth" refer to:[43]

37 Former Prime Minister Sir Robert Menzies, quoted in PH Lane, *The Australian Federal System* (Sydney: Law Book Company, 1979) 853.

38 Sir Harry Gibbs, "The Need for Taxation Reform" (1993) 10 (1) *Australian Tax Forum* 1, 11–12.

39 See *Paliflex v Chief Commissioner of State Revenue (NSW)* 2002 ATC 4124.

40 Section 114 has been described as a "particular instance, covered by express prohibition, of federal taxation inconsistent with the federal nature of the Constitution": *Austin v Commonwealth of Australia* 2003 ATC 4042, 4053 (Gleeson CJ).

41 92 ATC 4079.

42 92 ATC 4066.

43 92 ATC 4079, 4083. See generally V Morabito, "The Constitutional Restriction on Taxes Imposed on Crown Property" (1998) 1 (1) *CCH Journal of Australian Taxation* 41.

> "organisations or institutions of government in accordance with the conceptions of ordinary life, [so that] . . . these references are wide enough to denote a corporation which is an agency or instrumentality of the Commonwealth or a State as the case may be."[44]

In *Queensland v The Commonwealth*,[45] the High Court denied the protection of s 114 to the state of Queensland in respect of FBT levied on the use by state employees of motor vehicles and dwelling houses owned by the state. The court held that the FBT was not a "tax on property" because:

> "in the case of car fringe benefits the tax . . . is not imposed on the ownership or holding of the car by the State as employer or on its possession or use of the car. Nor is it imposed on the disposition by the State of any interest in its property. The tax is imposed because the employer provides the employee with a benefit in connexion with his employment."

While it is usually state bodies that have sought shelter from the Commonwealth under the section, the Commonwealth or its bodies have sometimes sought protection under s 114 from state taxes, with mixed results.[46]

¶1-580 Wide effective reach of Commonwealth taxation power

The above discussion of the limitations on the s 51(ii) power might suggest that the Commonwealth Government's taxing power is relatively narrow. However, there are four factors whose combined operation significantly expands the effective scope of the Commonwealth's taxing power.

(a) The only legal limits on the Commonwealth's legislative power to impose taxation are those prescribed by the Constitution itself. Provided a tax observes the constitutional boundaries, the power given by s 51(ii) is in practice restricted more by political than by legal constraints: "[under s 51(ii)] the Parliament has, prima facie, power to tax whom it chooses . . . exempt whom it chooses . . . [and] impose such conditions as to liability or as to exemptions as it chooses".[47]

(b) The introductory phrase in s 51 gives the Commonwealth Parliament a wide power to make laws "with respect to" taxation. In *Bennett & Dix v Higgins*, Le Mere J noted that "the phrase 'in respect of' has a very wide connotation and has been said to have the widest possible meaning of any expression intended to convey some

44 This approach was followed in *SGH v FC of T* 2002 ATC 4366, 4366 (Gleeson CJ, Gaudron, McHugh and Hayne JJ).

45 (1987) 162 CLR 74, 98–99; 87 ATC 4029, 4041 (Mason, Brennan and Deane JJ).

46 In *Superannuation Fund Investment Trust v Commr of Stamps (SA)* (1979) 145 CLR 330; 79 ATC 4429, s 114 was held not to protect the Trust from stamp duty imposed by South Australian legislation, though it subsequently obtained protection when the Commonwealth amended its legislation: *Superannuation Fund Investment Trust v Commr of Stamps (SA) (No 2)* 80 ATC 4392; *Allders International v Commr of State Revenue (Vic)* (1996) 186 CLR 630; 96 ATC 5135.

47 *Fairfax v FC of T* (1965) 114 CLR 1, 16 (Taylor J), 12–13 (Kitto J); *Northern Suburbs General Cemetery Reserve Trust v The Commonwealth of Australia* (1993) 176 CLR 555; 93 ATC 4118; *Austin v Commonwealth of Australia* 2003 ATC 4042, 4046.

connection or relation between two subject-matters to which the words refer . . . but reflects the context in which it appears".[48]. Under this power, a s 51(ii) law may validly not only impose taxation directly, but may also deal with necessary ancillary matters, such as rules for returns and assessments, imposing penalties for the making of false returns,[49] collection and recovery of the tax,[50] the creation and staffing of an administrative tribunal to hear disputes,[1] requiring reporting of cash transactions to prevent tax evasion,[2] and a variety of other matters exhibiting only a "relevance to or connection with" taxation per se.[3]

(c) The incidental powers. The Commonwealth's legislative powers in s 51 are further expanded by two "incidental" powers, ie:

- an *implied incidental power* arising from the common law principle that the grant of a power inherently also gives power to do all things properly necessary to make that power effective,[4] and
- an *express incidental power* in s 51(xxxix) of the Commonwealth Constitution, which gives parliament power to make laws with respect to matters incidental to the execution of any of its legislative powers (though in practical terms the express incidental power seems to add little to the implied power).[5]

(d) In characterising laws for constitutional purposes, the High Court has traditionally focused upon a law's direct legal effect, rather than its indirect or economic consequences. The High Court has generally taken the view that a law must be characterised by reference to its *direct legal effect*, regardless of any indirect economic, social or political results it may have or be intended to have (¶1-560). Thus, in *South Australia v The Commonwealth* (the *First Uniform Tax* case), Latham CJ stated that:[6]

> "the validity of legislation is not to be determined by the motives or the 'ultimate end' of a statute . . .
>
> The true nature of a law is to be ascertained by examining its terms and, speaking generally, ascertaining what it does in relation to duties, rights or powers which it creates, abolishes or regulates . . . Even though an indirect consequence of an Act, which consequence could not be directly achieved by the legislature, is contemplated and desired by parliament, that fact is not relevant to the validity of the Act."

48 2006 ATC 4041, 4046–4047.

49 *R v Kidman* (1915) 20 CLR 425, 449–450; *DFC of T (WA) v Fontana* 88 ATC 4751.

50 *Bank of NSW v The Commonwealth* (1948) 76 CLR 1.

1 *Shell Co of Australia v FC of T* (1930) 44 CLR 530.

2 *Leask v Commonwealth of Australia* (1996) 187 CLR 579, 637–638; 96 ATC 5071, 5099–5100, Kirby J who expressly cautioned that he did not mean to suggest that "any law which might make the task of tax gathering easier would necessarily fall within . . . s 51(ii) . . . "

3 *Grannall v Marrickville Margarine* (1955) 93 CLR 55, 77 (Dixon CJ).

4 *D'Emden v Pedder* (1904) 1 CLR 91, 110; *The Australian Boot Trade Employees' Federation v The Commonwealth* (1954) 90 CLR 24, 43.

5 *The State of Victoria v The Commonwealth* (1957) 99 CLR 575, 614.

6 (1942) 65 CLR 373, 412, 424–425.

This approach has enabled the Commonwealth Government to use its taxation power to achieve a wide range of indirect social, political and economic objectives. For example, the High Court has upheld the validity of a scheme designed to encourage higher levels of investment in Commonwealth securities, by means of a law giving favoured taxation treatment to superannuation funds whose investment portfolio included a prescribed percentage of Commonwealth securities.[7]

It is true that the High Court has on occasion struck down a purported taxation law on the basis that it is in substance a law on some other topic "disguised" as a law with respect to taxation. However, this has been the exception rather than the rule.[8]

Overall effect: the Commonwealth has a broad effective taxation power

The four factors outlined above have significantly expanded the Commonwealth Government's law-making power in relation to taxation, and greatly strengthen the position of the Commonwealth Government by enabling it to extend its policies indirectly into a wide range of areas over which it is denied direct legislative control.

¶1-595 Section 109: Commonwealth law prevails over an inconsistent state law

In respect of all taxes other than excise, the state and Commonwealth Governments have concurrent law-making power, so that it is possible that the state and Commonwealth Parliaments may inadvertently or intentionally pass tax laws which are inconsistent and incompatible. Because taxpayers could not comply with both laws in such circumstances, s 109 of the Commonwealth Constitution provides that the Commonwealth law will override an inconsistent state law — but only to the extent of the inconsistency (ie the state law will not necessarily be wholly invalid).[9] The test most commonly applied for s 109 "inconsistency" was established in *Clyde Engineering v Cowburn*[10] and requires an assessment of whether the Commonwealth law is expressly or impliedly intended to "cover the field". Thus, in *Re Mazuran; Ex parte DFC of T*,[11] Jenkinson J held that a state Act which provided for payment of debts by instalments could not override the recovery provisions of ITAA36 (which empowered the Commissioner to recover the full amount as a lump sum). This aspect of the state Act was inconsistent with the Commonwealth law, and thus (to that extent) the state law was invalid.

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7 *Fairfax v FC of T* (1965) 114 CLR 1. So also a heavy progressive land tax arguably intended to prevent a person from amassing or retaining large landholdings was held valid in *Osborne v The Commonwealth* (1911) 12 CLR 321; *Northern Suburbs General Cemetery Reserve Trust v The Commonwealth* (1993) 116 CLR 555; 93 ATC 4118.

8 *R v Barger* (1908) 6 CLR 41.

9 *AMS v AIF* (1999) 24 Fam LR 756, 763, 766–767, 808. However, if the state law is inherently invalid (eg ultra vires), there is nothing on which s 109 needs to operate: *Allders International v Commr of State Revenue (Vic)* (1996) 186 CLR 630, 680; 96 ATC 5135, 5161.

10 (1926) 37 CLR 466.

11 90 ATC 4814; *DFC of T v Homewood* 91 ATC 4633. Other tests for inconsistency are whether simultaneous obedience to both state and Commonwealth laws is impossible; or whether one law removes a right or privilege conferred by the other: *Telstra Corp v Worthing* (1997) 197 CLR 61, 76–77.

¶1-600 Removal of states from the income tax field

Before 1942, the various states had levied their own income taxes (¶1-050–¶1-070). Nevertheless, the Commonwealth Government introduced its first income tax Act in 1915 and attempts were made to achieve uniformity in income tax laws throughout Australia. However, by 1942, uniformity had been eroded through local amendments to the various state Acts, and this factor, allied with the pressing need for revenue to enable the Commonwealth to sustain Australia's effort in World War II, prompted the federal government to seek to assume sole control over income tax.

The Commonwealth did not have the constitutional power to simply forbid the states from levying their own income taxes. A more indirect (or devious) approach was needed — an arrangement known as the "Uniform Tax Scheme".

Uniform Tax Scheme

In order to force the states out of the income tax field, the Commonwealth Government in 1942 passed four complementary Acts. Under these four Acts:

(a) a Commonwealth income tax was imposed Australia-wide at a substantial rate, calculated to yield the same amount of income as the state and Commonwealth Acts had together previously collected: the *Income Tax Act 1942*

(b) taxpayers were required to pay the Commonwealth income tax before paying any state income tax: the *Income Tax Assessment Act 1942*

(c) the Commonwealth effectively agreed to reimburse to each state the amount which they would have obtained from their own income taxes, but only if that state had not levied an income tax in the prior year: the *States Grants (Income Tax Reimbursement) Act 1942*, and

(d) state taxation officers were temporarily transferred to the Commonwealth's service (so that even if states had wished to levy an income tax, they would lack the personnel to do so effectively): the *Income Tax (War-Time Arrangements) Act 1942*.

The High Court in *South Australia v The Commonwealth*[12] upheld the validity of the scheme on the basis of the Commonwealth's powers under s 51(ii) (taxation), 51(iv) (the defence power) and 96 (tied grants) of the Constitution.

The crucial point, in the High Court's view, was that the Commonwealth did not attempt to prohibit the states *as a matter of law* from exercising their undoubted legislative power to levy an income tax. Each state was still free (in theory at least) to levy its own income tax if it so desired. However, as a matter of practical reality, the inevitable and intended result of the Commonwealth's scheme was to make it politically and economically impossible for any state to exercise its power to tax incomes.[13]

12 (1942) 65 CLR 373.

13 Ibid 416, 423–424.

The effect of the High Court's decision was to force the states out of the income tax field — as a matter not of legal necessity, but of practical political reality. Although the High Court subsequently held in the *Second Uniform Tax* case[14] that the provision of the *Income Tax Assessment Act 1942* which gave priority to the Commonwealth tax (s 221(1)(a)) was invalid, the High Court upheld the overall validity of the balance of the Uniform Tax Scheme, and the states have not since re-entered the income tax field.

¶1-610 Developments since 1942

In 1959, the provision in the *States Grants (Income Tax Reimbursement) Act 1942* making grants to a state conditional upon that state not levying its own income tax was repealed. Nevertheless, there was from 1959 until 1976 a political agreement that the states would not levy income taxes, and the Commonwealth Government's de facto monopoly of the income tax field continued largely unchallenged.

In 1968, attempts by Victoria and Western Australia to impose receipts duties on wages were frustrated by the Commonwealth's threat to reduce the grants to those states under the 1942 reimbursement legislation.

In 1976, the Commonwealth Government introduced a new system designed to share its (personal) income tax collection with the states. The Commonwealth Government thus tried to encourage the states to re-enter the income tax field, but the states declined to do so, and in 1989, the Commonwealth Government repealed the unused legislation.

The decision in *Allders International v Commr of State Revenue (Vic)* in 1996[15] suggested that state taxes such as pay-roll tax, financial institutions duty and bank account debits tax might be invalid in certain similar circumstances. This put considerable state revenues at risk, and to remove this risk the Commonwealth, at the request of the states, introduced a package of legislation in early 1998 to protect the states' tax base.

Revenue collected through this "mirror" legislation was returned to the states.

With the introduction of the GST in July 2000, the Commonwealth and state governments entered into arrangements (the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations) under which:

(1) the interim arrangements for recoupment of the former state taxes on petrol, liquor and tobacco terminated when the GST came into operation; the Commonwealth Government repealed its sales tax, and the states in return agreed to repeal nine taxes,[16] and not to reintroduce them

14 *State of Victoria v The Commonwealth* (1957) 99 CLR 575, 614, 625–626, 661–662.

15 (1996) 186 CLR 630; 96 ATC 5135.

16 Financial institutions duty; bank account debits tax; stamp duty (on marketable securities; business properties; certain credit arrangements, instalment purchase and hiring arrangements; leases; mortgages, bonds, debentures and other loan securities; cheques, bills of exchange and promissory notes); and bed taxes.

(2) the Commonwealth agreed to phase in transfer of the revenue from the GST to the states in accordance with horizontal fiscal equalisation principles[17]

(3) the Commonwealth undertook to maintain the GST base, and the GST rate at 10% — these elements can only be varied with the unanimous agreement of the states, and the Commonwealth Government's endorsement and enabling legislation, and

(4) a Ministerial Council was established to oversee the GST and the Commonwealth/State Intergovernmental Agreement.

The Commonwealth Government in March 2005 proposed the abolition of additional state indirect taxes from 1 July 2006, namely: stamp duty on non-quotable marketable securities, as well as on leases, mortgages bonds, debentures and other loan securities, credit arrangements, instalment purchase and rental arrangements, and on cheques, bills of exchange and promissory notes. The states indicated that they were prepared to abolish these taxes and stamp duty on business conveyances other than real property, over the period to 2010/11.

While transfer of the GST revenue to the states no doubt has helped to "level" the fiscal playing field somewhat, the Commonwealth's dominance of the Australian revenue base continues.

17 It was also agreed that the states would compensate the Commonwealth for the costs incurred by the ATO in administering the GST.

