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INTERNATIONAL
TAX LAW
VIENNA

Australian Tax Law

Chapter 1. Sources of taxation law

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Key points

[1.00]

- The main tax legislation consists of two income tax assessment Acts, a fringe benefits tax Act and a goods and services tax Act.
- Tax legislation is interpreted using the doctrine of precedent, a process not used in interpretation of financial accounting standards.
- There are five key differences between tax concepts and accounting principles.
- Tax law exam problems usually involve facts that might attract two alternative characterisations of a receipt or expense and a good answer will canvass both possibilities.
- The main sources of tax law are statutes and case precedents used to interpret the provisions

in tax law, but taxpayers can rely on Tax Office rulings to avoid penalties when interpreting the law.

Introduction

[1.10]

Time and again, surveys show many commerce and business students view taxation law as one of the most difficult subjects they encounter in their studies. This need not be so provided it is understood that the skills necessary for the successful study of taxation law are fundamentally different from other commerce subjects. If you understand the differences and learn the essential techniques of how to study taxation law, you should have no difficulty successfully completing the subject.

[1.20]

This chapter gives valuable guidance on the skills that you need to develop to get the most out of your study of tax law and explains how tax law differs from other commerce subjects. The key points covered are:

- The importance of the doctrine of precedent in interpreting tax law and its absence from the interpretation of financial accounting standards: see [1.30].
- Five technical differences between financial accounting and tax law: see [1.70].
- Detail on how the doctrine of precedent led to different definitions of "income" for financial accounting and tax law purposes: see [1.160].
- How to use the principal pieces of tax legislation in Australia and how the main Acts work together: see [1.190].
- The importance of case law in the interpretation of the legislation: see [1.270].

How you can most effectively access the hints set out in this chapter to maximise higher grades in this subject is described at [1.310].

Understanding tax law and the doctrine of precedent

[1.30]

Interpretation of the financial reporting standards is based on accounting principles. The words in the standards are interpreted with a single aim: to ensure amounts are recognised on a prudent and conservative basis that reflects actual increases or decreases in a firm's economic position.

The process of interpreting words in the tax legislation is fundamentally different from the principle-based interpretation of financial reporting standards. Terms in tax legislation are interpreted not by reference to any commercial or economic principles, but instead on the basis of a system of legal analysis known as the "doctrine of precedent". The doctrine of precedent is the foundation of the common law legal system used in English-speaking countries.

The doctrine of precedent requires judges (and, as a result, tax officials) to interpret words in laws in a manner that is consistent with the interpretation of those words in earlier judgments. If the facts of a later case are the same as those in a previously decided case, a similar result should follow in the later case. If the facts in the later case are slightly different from the earlier case, the precedent may be distinguished and another result might follow.

[1.40]

The first step in solving a tax law problem is to find the relevant rules in the tax legislation. Rarely, however, will only one rule be relevant. More likely, two or more provisions might potentially apply to the transaction described in the problem, with the borderline between competing rules unclear.

To determine on which side of the borderline a given transaction will fall, the tax accountant must proceed to the second step in solving a tax law problem, which is to interpret the words in the different rules. This, as mentioned at [1.30], is completed by looking at the judicial precedents in earlier tax cases.

The process is perhaps best explained with an illustration.

Example 1.1: Using precedents

A tax accountant is asked to advise a client who makes pottery whether there is any tax liability when she gives a piece of pottery to a friend.

First, the accountant will turn to the tax legislation to find the relevant tax rules. They are very clear. If the client's activities amount to a business, the item of pottery is trading stock and a tax liability is triggered when a taxpayer disposes of trading stock outside the ordinary course of business. If the client's activities are merely a hobby, the pottery is a personal asset, not trading stock, and there is no tax liability when a personal asset is given away.

The law is obvious – there is one legal consequence if the client's activities amount to a hobby

and another if they amount to a business. The tax legislation is silent, however, as to when activities cross the threshold from being a hobby to becoming a business. To answer the crucial question as to whether the client's activities constitute a hobby or business, the accountant will look outside the legislation to the precedents of previously decided court cases and try to find a case that closely resembles the client's situation. The outcomes in those precedents will provide a good indication as to whether the client's activities will amount to carrying on a business as a matter of tax law.

To the extent that the client's situation is *similar* to the situations of taxpayers described in the precedents, the same characterisation is likely to apply to the client's activities. To the extent that the client's situation *differs* from the situations of taxpayers described in the precedents, a different characterisation may apply. The tax accountant must decide whether the precedents will apply to the client and yield the same characterisation of the client's activities or whether the facts in the precedents are sufficiently different for them to be distinguished with a different characterisation applying to the client.

[1.50]

An important difference between tax law advice and accounting advice is the relative level of certainty. The accountant providing accounting advice can state with confidence that an outcome does or does not conform to accounting standards. In fact, on audit an accountant must be completely certain before signing off on the audit.

In contrast, the accountant dispensing tax law advice may only state a probability, based on the accountant's interpretation of the precedents and indications in public rulings issued by the Australian Taxation Office (ATO) of how the Commissioner of Taxation (Commissioner) interprets those precedents (the roles of the ATO and Commissioner are explained at [1.280]). This advice will be expressed as a view of how the law is *likely* to apply to the client, but will caution that, as with any advice on legislation, another interpretation is always possible.

The fact that there are two alternative arguments does not mean that there is no “answer” to a tax question. When the facts of a particular case are considered in light of the precedents, a probable answer will emerge and, while there is no guarantee that a court will not prefer the alternative argument, advice should set out the likely outcome with a summary of the alternative answer that could prevail if the expected outcome does not occur.

[1.60]

Example 1.1 illustrates two aspects of tax law that commerce students sometimes find troubling. The first is learning how to use the doctrine of precedent – relying on decisions in previous cases to advise on how the law will apply to a new set of facts. The second is coming to grips with the inherent uncertainty of any advice based on precedents.

By definition, there is always a correct answer to an accounting problem. Accounting students

are trained to discover the answer by way of coherent facts and unambiguous rules. But in tax law, students can only offer opinions of how precedents are *likely* to apply. To provide an opinion that first explains one possible outcome and then canvasses other possible competing views or interpretations of precedent is contrary to everything that an accounting student has previously been taught. No wonder then that commerce students find tax law difficult until they master the new skills required to succeed in the subject.

Technical differences between tax law and accounting

[1.70]

The commerce subject that at first glance seems most similar to taxation law is financial accounting. Both accounting and tax law scrutinise receipts and expenditures and measure net gains over an annual accounting period. However, these apparent similarities mask five key differences between the two subjects:

- Not all receipts are recognised for tax purposes: see [1.80].
- Accounting principles recognise all outgoings but may record an offsetting asset if an expenditure gives rise to an ongoing benefit or property. Income tax law distinguishes between capital and revenue expenses and recognises expenditures depending on their classification: see [1.110].
- Income tax law excludes some income and expenses for policy reasons: see [1.120].
- Income tax law ignores some transactions on the basis of anti-avoidance provisions: see [1.130].
- Timing rules differ in income tax law and accounting principles: see [1.140].

Not all receipts are recognised for tax purposes

[1.80]

To begin with, accounting rules and tax law take substantially different approaches to recognising receipts.

The object of accounting is to measure net gains or losses over a period and to measure net assets and liabilities at the end of the period. To do this accurately, accounting must recognise all receipts, whatever their character. When preparing a set of accounts, an accountant starts with *gross income*, meaning all amounts received by a business; profits from business activities, returns on investments, an unexpected windfall and even a gift will be included in the income

account. If a receipt is genuinely unexpected or unusual, the accountant will note that it is an unanticipated or one-off receipt so readers of the accounts are alerted to the fact that the receipt should not be regarded as typical and likely to be repeated each year. But the receipt itself will be fully recognised for accounting purposes to the same extent as repeated receipts such as ordinary and regularly received business income.

[1.90]

In contrast, some receipts are not recognised at all for tax law purposes while others are recognised but partially excluded from tax accounts. Many one-off or unusual receipts in particular are excluded or only partially recognised for tax purposes.

Receipts that are recognised for tax purposes are known as “assessable income”. Early Commonwealth income tax Acts defined assessable income using language almost identical to that used in financial accounting. Indeed, the early income tax laws looked very similar on paper to accounting principles. However, drawing on concepts from other areas of the law, courts concluded that gross income for tax purposes comprised only a subset of gross accounting income. See [1.160] for more detail on how the courts developed this narrow concept of income, now known as “ordinary income”. As a result of the restricted judicial interpretation of “income” for tax purposes, when income tax was first imposed in Australia, only a slice of accounting gross income was transferred to the income side of a tax return: see [1.150]–[1.170].

[1.100]

Soon after income tax was first adopted by the Commonwealth Government in 1915, the legislature began to broaden the tax base beyond “ordinary income”. Over the years, many sections were added to the income tax Acts to bring into assessable income various types of receipts which had been excluded from the judicial concept of “ordinary income”. Since 1997, the receipts that have been brought into assessable income by specific inclusion provisions have been known as “statutory income”.

As a result of these developments, the accountant's gross income for accounting purposes must be categorised into three boxes for tax purposes: ordinary income, statutory income (now included in assessable income, but often subject to concessional treatment or partial exclusion) and other receipts. The third category of receipts – amounts that are neither ordinary income nor statutory income – still fall completely outside the scope of income tax law, though of course they are recognised for financial accounting purposes.

Case study 1.1: Gifts

In *FCT v Slater Holdings Ltd* (1984) 156 CLR 447, the father of shareholders in a company gifted money to the company. As gifts are not characterised as ordinary income under the judicial concept of income and there is no statutory income measure that includes gifts, the amounts had not been included in the assessable income of the company. However, the Full High

Court agreed that the payments were nevertheless "profits" of the company within the accounting sense of that word.

Income tax law distinguishes between capital and revenue expenses

[1.110]

A second significant difference between financial accounting and tax law is the treatment of expenses in the two systems. Accounting principles recognise outgoings as expenses in the profit and loss statement unless the expenditure yields an asset. It that case it appears on the balance sheet as an asset (with a corresponding debit to cash if internal funds are used or an increase to debt if borrowed funds are used to purchase the asset). The cost of the asset is then recognised as deductions on the profit and loss statement as it is used or depreciates in value. In contrast, tax law distinguishes between two broad categories of expenditures: "revenue" expenses and "capital" expenses. Revenue expenses are deducted when they are incurred. Capital expenses are deducted over a period under a "capital allowance" or a "capital works" system. The distinction between capital and revenue expenses is based on judicial doctrines derived from case law. Whether an asset is acquired with the expenditure is not one of the factors considered directly in the judicial doctrines that distinguish between revenue and capital expenses, although how long a benefit acquired as the result of an expense will last is one factor used in the judicial doctrines. Others such as the frequency of similar expenses and the relationship between the expense and a business' income earning "process" and income earning "structure" are more important factors in the judicial tests. As a result, income tax law permits immediate deductions for some expenses that would be depreciated over a period of years for accounting purposes while it requires deductions over many years for some expenses that would be expensed immediately on a profit and loss statement in accounting practice.

Case study 1.2: Expenses to protect position

In *Broken Hill Theatres Pty Ltd v FCT* (1952) 85 CLR 423 the taxpayer incurred legal expenses opposing a licence application by a potential competitor. Licence applications were heard annually and, as a result of the expenditure, the taxpayer was protected from competition for at least 12 months. The taxpayer argued the expense should be deductible as a revenue expense as it did not alter or add to any asset of the taxpayer. However, the Full High Court viewed the expense as one related to the structure of the taxpayer's business, namely its ability to continue to operate without a competitor. Therefore, although the expense would be immediately deductible for accounting purposes, the court characterised the outgoing as a capital expense for tax purposes and denied the taxpayer an immediate deduction. The expense would now fall into one of the statutory provisions that allow taxpayers to deduct capital expenses over a period. Under s 40-880 of the *Income Tax Assessment Act 1997*, a taxpayer would be able to deduct a capital expense of this type in equal instalments over five years.

Income tax law excludes some income and expenses for policy reasons

[1.120]

A third major difference between financial accounting and tax law emanates from the inclusion of many "policy" provisions in the income tax laws. In terms of the profit and loss account, accountants pursue a single objective of measuring net gains in the accounting period. The tax law, in contrast, is used by politicians to achieve a wide variety of social and economic objectives. Thus, for example, while an accountant will record all income and receipts for financial accounting purposes, the tax law explicitly exempts some types of otherwise assessable receipts for policy reasons. On the expenditure side, the financial accountant does not distinguish between different types of expenses for policy reasons: if an expense was incurred in a business, it is recognised for accounting purposes.

The tax law, however, explicitly denies taxpayers deductions for some types of payments. For example, to discourage taxpayers from engaging in prohibited activity when carrying on a business, the tax law denies deductions for expenses such as fines, bribes and some expenses incurred in illegal businesses.

Income tax law ignores some transactions on the basis of anti-avoidance provisions

[1.130]

A fourth important difference between accounting and tax law derives from the effect of numerous anti-avoidance provisions in the tax law. Financial accounting measures net profits on an entity-by-entity basis. If one entity pays an excessive amount to another related entity, accounting will ignore the relationship between the two entities, and record an expenditure by the first entity and a receipt by the second. Tax law may ignore the transfer, however, if it falls afoul of an anti-avoidance rule that seeks to prevent taxpayers shifting profits from one entity subject to high tax rates to a related entity (a relative or another entity owned by the same person) subject to low tax rates.

In addition to a large number of specific anti-avoidance provisions in the tax legislation, there is a general anti-avoidance rule in the income tax law made up of several sections that operate together and which are collectively referred to as Part IVA (pronounced "four A", as the IV is the roman numeral for the number four) after the location of the rule in the *Income Tax Assessment Act 1936*. Like the specific anti-avoidance measures, the general anti-avoidance provisions can lead to divergences between financial accounting and tax law. Another general anti-avoidance rule is included in the goods and services (GST) tax law and a further general anti-avoidance rule is included in the fringe benefits tax law.

Timing rules differ in income tax law and accounting principles

[1.140]

Finally, a fifth major difference between accounting and tax law arises as a result of the different timing rules for when income receipts and expense payments are recognised. Financial accounting principles roughly align with a business' economic position. Receipts are recorded on an accrual basis and offset by provisions if the receipts relate to future obligations. Outgoings are similarly recorded on an accrual basis and offset by assets if assets are acquired as a result of the expenditures. These receipts and expenditures are not reflected immediately in the profit or loss accounts; receipts encumbered by future obligations are brought into profit or loss accounts only as the offsetting obligations are satisfied and expenditures for assets lasting beyond the end of the year are brought into profit or loss account only as the offsetting assets are consumed.

In contrast, income tax law measures receipts when they are "derived" and evaluates expenses when they are "incurred". As a result of judicial interpretation, the terms "derived" and "incurred" have unique judicial meanings. Only sometimes do the tax rules relating to when income is derived and when expenses are incurred coincide with accounting principles that determine when receipts and outgoings enter profit and loss accounts.

Origins of judicial tax law concepts

[1.150]

We have seen that there are five main areas of difference between accounting and tax law concepts: see [1.80]–[1.140]. Only two of these differences are the result of specific rules in the tax legislation: the adoption of special rules to achieve policy objectives other than the measurement of net gains and the adoption of specific anti-avoidance provisions and one general anti-avoidance rule. The remaining areas of divergence between financial accounts and tax accounts result from judicial concepts: the judicial distinction between ordinary income and other receipts, the judicial distinction between revenue expenses and capital expenses, and the judicial concepts of when amounts are derived and when expenses are incurred. Understanding the origins of those concepts is crucial to learning how to study tax law and write tax law exams.

[1.160]

Income tax is imposed on a taxpayer's "taxable income", which is defined as a person's assessable income minus deductions. Assessable income was defined in the original income tax laws as gross income while deductions were allowed for expenses other than *capital expenses*.

Australian courts were not encountering these terms – "income" and "capital expenses" – for the first time when they appeared in the original income tax laws. Both terms had been used much earlier in trust law. Trust law distinguished between two types of trust beneficiaries: income beneficiaries and capital beneficiaries. All receipts derived by the trustee had to be classified as either income gains or capital gains to determine which class of beneficiaries would be entitled

to the receipts. All expenses incurred by the trustee had to be classified as either revenue expenses or capital expenses to determine which class of beneficiaries would be charged for the outgoings.

When income taxation was first adopted in Australia, the courts concluded that the term “income” was intended to have the same meaning for tax law as it did for trust law. As a result, only receipts meeting the trust law concept of income were presumed to be income for tax purposes. Similarly, expenses labelled capital outgoings under trust law doctrines were treated as capital expenses for tax law purposes. As is pointed out at [5.20], while the original trust law notions of income may be much narrower than those used in accounting, they are probably similar to the understanding of income held by an “ordinary” person on the street. It is for this reason that gains fitting in the original judicial concept of income for tax purposes are usually labelled “ordinary income”.

[1.170]

Later chapters in this book explore in detail the nature of ordinary income and the tests used by the courts to determine whether a receipt will constitute ordinary income. As will be seen, one of the main features of ordinary income is its identification with a source that generates the income. If a receipt can be seen to be a product of labour or business activity or the use or exploitation of property, it will acquire an income character under the judicial tests. Thus, for example, salaries are considered ordinary income from employment, proceeds from the sale of trading stock are considered ordinary income from business and royalties or interest payments are considered ordinary income from property.

The basic tests used by the courts to identify when a receipt might constitute ordinary income from labour, business or the use of property are bolstered by two supplementary judicial tests. The first supplementary test treats a receipt as income if it has certain income-like characteristics, namely that it is periodic in nature, expected by the recipient and applied to the same uses as other types of income might be applied. The second test treats a receipt as income if it is received as compensation for lost income or in substitution for what would have been income receipts.

Sources of tax law

[1.180]

While tax law ultimately derives from the statutes that impose the tax, as we have noted, the coverage of the inclusion sections, exemption provisions and deduction measures is based on interpretation of the law based on judicial precedents. Thus, court cases have become a second source of law in Australia. A third source for tax rules in practice, if not strictly as a matter of

law, are the interpretations issued by the Commissioner in the form of "rulings". These three sources are explained at [1.190]–[1.300].

Legislation

[1.190]

As taxation law is a creation of statute, its primary source lies in legislation, and the income tax part of a taxation course is based on the operation of three pieces of legislation: *Income Tax Assessment Act 1936* (Cth) (usually referred as the ITAA 1936), *Income Tax Assessment Act 1997* (Cth) (usually referred to as the ITAA 1997) and *Fringe Benefits Tax Assessment Act 1986* (Cth) (usually referred to as the FBTAA).

This section of the chapter explains why there are two income tax laws and a separate fringe benefits tax law.

A fourth piece of legislation, *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (usually referred to as the GST Act) is also relevant to the study of Australian tax law although it does not tax income, but instead is a tax on final consumption. The background to the GST Act is described at [1.250]–[1.260] and the operation of the GST system is described in Chapter 25.

Four further laws are relevant: an "income tax act" contains the law which imposes the tax on the base set out in the two *Income Tax Assessment Acts*, a "rates" act sets out the actual rates of income tax, a "tax administration" act sets out the administrative rules for all tax laws, and an "international agreements" act modifies the income tax laws in the case of income derived overseas or by a non-resident taxpayer, as explained in [1.245].

Income tax legislation

[1.200]

Parallel Commonwealth and State laws. The first Commonwealth income tax in Australia was adopted in 1915. All six States had previously adopted State income taxes and, when the Federal Government adopted its income tax in 1915, the Commonwealth law operated in parallel to the State laws. As the States had already established income tax administrations, it was agreed that the States would collect the Commonwealth income tax on behalf of the Commonwealth.

The Commonwealth law differed in some respects from the State laws and these, in turn, differed between each State. As a result, State income tax administrators had to deal with two sets of laws and also had to divide revenues where businesses operated across State borders. An attempt to better harmonise the laws in the 1920s brought the different laws somewhat closer together for a brief period and in 1936 the States and Commonwealth agreed on a fully harmonised model that was enacted in each State and by the Commonwealth to replace the differing laws. The Commonwealth adopted as part of the harmonisation program the *Income Tax Assessment Act 1936*.

The parallel State and Commonwealth income taxes remained in effect only for a short time. In

1942, in the midst of the WWII, the Commonwealth effectively appropriated the exclusive power to levy income tax as a "temporary" war-time measure, instituting a system of transfer payments to the States to replace their lost revenue. The income tax has since remained a Commonwealth-only tax.

[1.210]

Tax law rewrite. The gaps in the Australian income tax laws caused by the somewhat narrow tax base (constrained by reliance on the judicial concept of ordinary income) provided numerous opportunities for avoidance. Rather than address the underlying problems that gave rise to resulting avoidance schemes, the legislature usually responded to costly avoidance arrangements with narrow and very ad hoc rules, including many piecemeal rules that brought different types of receipts into assessable income as statutory income.

A deluge of avoidance arrangements in the late 1970s and early 1980s led to an explosion of complicated tax provisions and by the mid-1980s the income tax law was, in the eyes of many, extraordinarily complex. Reforms in the mid-1980s led to further income tax complexity and in the early 1990s the Government announced a project to rewrite the income tax law using plain-English drafting style. The Government hoped the different drafting style might simplify the law.

The first parts of the rewritten law were released as the *Income Tax Assessment Act 1997*. Over the following three years, many measures were shifted from the 1936 Act to the 1997 Act, but the plans to move the entire income tax law across stalled by 2000, when a major Business Tax Review known as the Ralph Review (named after the chairman of the review) proposed a range of amendments to tax laws. Consequently, attention shifted from completing the shift of rules to enacting the business tax changes that eventuated from the Ralph Review. Continual amendments since then have used much of the available drafting resources and the process of shifting rules from the ITAA 1936 Act to the 1997 Act has proceeded more slowly than expected. As a result, both laws remain in effect.

[1.220]

Concurrent Income Tax Assessment Acts. Accordingly, there are two separate income tax Acts that tax students must consider when answering income tax law problems: the ITAA 1936 and the ITAA 1997. Students will mostly be concerned with the ITAA 1997 as the key statutory income measures have been moved from the ITAA 1936 to the ITAA 1997. As a general rule, it is easy to differentiate the provisions of the two principal Acts because each Act adopts a different numbering system. The sections of the ITAA 1936 are not hyphenated (eg s 24, s 51) while sections in the ITAA 1997 are hyphenated (eg s 6-5, s 8-1).

[1.230]

Capital gains tax. Almost as soon as the Commonwealth income tax was enacted and the courts read the law as applying only to the category of gross income that they labelled "ordinary income", the legislature started broadening the tax base. From 1915 until 1985, the broadening of the tax base was achieved through a continual stream of new inclusion amendments. Almost all amendments were narrow measures targeted at particular types of receipts or particular schemes aimed at taking taxpayers out of the tax net. The growth of statutory income sections was matched on the deduction side by the adoption of many provisions designed to recognise expenses that the courts had labelled capital expenses and which therefore fell outside the scope of the general deduction provision.

Despite a growing array of statutory income and capital expense provisions, many gains and outgoings remained outside the tax system. In 1985 the Government shifted its approach from the use of piecemeal inclusion and deduction provisions to a more comprehensive solution, with the adoption of broad-based capital gains measures designed to sweep up most gains and losses that remained outside the tax base. The provisions, which became known as the "capital gains" measures, were complex because they used many artificial deeming rules to capture gains that did not fall in the basic capital gains rules. The original capital gains rules were replaced in 1998 by a revised capital gains regime, labelled the "capital gains tax" or "CGT" provisions. A key feature of the new rules was the replacement of the artificial deeming rules found in the original provisions with a set of rules that described different CGT "events", each aimed at a different type of capital gain to be brought into the income tax.

The new CGT rules were placed in the ITAA 1997. The name of the new rules, the CGT or capital gains "tax" rules, is the source of some confusion as it suggests capital gains are subject to a separate tax. This is not the case. The CGT rules are discrete in the sense of matching gains and losses to determine a net capital gain included in assessable income. But despite its misleading name, the CGT is not a separate tax. It is fine to talk about a gain being subject to the CGT, but it is important to understand that any gain brought into the tax system via the CGT will actually be taxed as part of assessable income subject to income tax under the ITAA 1997.

Fringe benefits tax legislation

[1.240]

The judicial concept of "ordinary income" under the income tax legislation only included cash or non-cash benefits that could be converted to cash. A receipt that otherwise would be treated as income from labour, business or property would not be considered ordinary income if it did not take the form of cash or a benefit that the recipient could turn into cash. The effect of this restriction on the ordinary income concept was to exclude from the tax base many types of fringe benefits (non-cash benefits) provided by employers to employees.

The legislature initially responded to the problem by inserting a provision in the income tax law that included non-cash fringe benefits in assessable income. However, the original provision was not well drafted and, to the extent that it could function, it was poorly administered. As a consequence, many non-cash benefits continued to escape tax.

Rather than amend the income tax provision to repair its shortcomings, in the mid-1980s the

Government decided to copy a New Zealand precedent and move most employment fringe benefits into a separate assessment Act, the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA). Fringe benefits tax (FBT) is collected from employers providing the benefits, rather than the employees receiving them.

The income tax law explicitly excludes from an employee's income for income tax purposes the value of any benefits that are fringe benefits as defined by the FBTAA. Since fringe benefits are explicitly excluded from the income tax, the FBTAA is the starting point for any problem involving a benefit to an employee other than salary or wages and, if the benefit satisfies the definition of a fringe benefit under the FBTAA, it is not necessary to consider other tax laws. The income tax law must be considered only if the problem involves a cash benefit that does not fall within the broad understanding of salary or wages since salary and wages are not a fringe benefit according to the FBTAA.

Rates Act, Administration Act and International Agreements Act

[1.245]

Four supplementary laws play important roles in the income tax system. The first of these is the *Income Tax Act 1986* (Cth). It is thought that the Australian Constitution requires two separate laws to levy an income tax: an assessment Act that measures taxable income that will be subject to tax; and an imposition Act that then imposes tax on that base. The *Income Tax Act 1986* imposes a tax on taxable income at the rate of tax set out in a second supplementary Act, the *Income Tax Rates Act 1986* (Cth).

Thirdly, the *Tax Administration Act 1953* (Cth) contains the administration rules for collection of the tax and various penalties to ensure compliance with the tax laws.

The fourth law is the *International Tax Agreements Act 1953* (Cth). When Australian residents derive income overseas, they will be potentially subject to two tax systems. Australian residents are taxed on their worldwide income, including income derived abroad. The country in which the income was earned may also levy income tax as the “source” jurisdiction. Similarly, non-residents who derive income in Australia will be subject to Australian tax on income with a source in Australia and quite possibly to their own country’s income tax on their worldwide income. While both countries’ tax systems can solve the problem of double taxation through their own various credit or exemption rules, the normal practice that has emerged in the international arena is an agreed division of taxing rights through a bilateral (two country) tax treaty. Australia has signed more than 40 tax treaties. The taxing rules in these treaties are given effect by the *International Tax Agreements Act 1953*, which allows the treaties to override the normal income tax assessment laws.

GST legislation

[1.250]

To bolster tax revenues during the economic downturn that became the Great Depression, the Commonwealth Government adopted in 1930 a wholesale sales tax that applied to the sale of

goods. The tax was problematic in many respects, causing significant economic distortions by levying different rates on different types of goods and not applying to services at all. Over the following 70 years there were many calls for its replacement with a broad-based consumption tax that would apply to final consumption only. This was finally achieved in 1999, with effect from mid-2000, when the wholesale sales tax was replaced by the goods and services tax (known as GST).

While the GST is intended to be a tax on final consumption only, it is levied at every level of the supply chain and then reimbursed by way of credits or refunds to registered businesses in the chain, leaving the full burden to be borne by the final consumer.

[1.260]

The GST system operates independently of income tax and FBT systems. In other words, there is little reason to be concerned about GST when thinking of income tax or vice versa. However, for practical reasons, the two must be viewed in parallel as both GST liability (and entitlement to credits for GST included in the price of purchases) and certain income tax payments (in particular an employer's liability for income tax withheld from the wages of employees) are reported on the same tax interim return known as a Business Activity Statement (BAS). Fringe benefits tax liability is reported separately.

One point of intersection between the BAS and GST is the treatment of GST payments in the income tax. In most cases, a business paying GST on its purchases will be entitled to credit for the tax or a refund. Because the GST paid on acquisitions will be returned to the business, it is not considered a cost of doing business. Consequently, the income tax contains a provision denying a deduction for GST that will be credited or refunded back to the taxpayer. In some situations, a business is not entitled to credits or refunds of GST on purchases. In those cases, the tax is deductible as a cost of doing business for income tax purposes.

Case law

[1.270]

We have seen that the meaning of the words in tax laws derives from judicial precedents or decisions of courts interpreting the provisions in past cases. How binding the precedents will be depends on the level of the court. Decisions of the Australian High Court, the final court of appeal in Australia, are the strongest authority for interpretation of law. Decisions of the Federal Court or State courts are followed if there is no High Court decision on a point. In each case, the appeal levels (the “Full Federal Court” in the first case and State “Supreme Courts” in the second case) take precedence over decisions of lower courts. At the bottom of the precedent pole are decisions of the Administrative Appeals Tribunal or its predecessor in tax cases, the Board of Review. These are (or were, in the case of the Board) administrative bodies with less authority than a court.

In the early days of tax jurisprudence in Australia there was significant reliance on precedents of

United Kingdom courts. It is far less common today to look at United Kingdom decisions to interpret the provisions of the Australian tax law. However, many earlier UK cases continue to be influential and you will find a number of instances of reliance on decisions by UK courts in the chapters which follow.

Rulings

[1.280]

Australia's income tax administration is built upon a somewhat unusual foundation. The tax laws are administered by a government agency, the Australian Taxation Office (ATO). However, the tax law does not actually create the agency. Rather, it empowers a statutory officer (a government official whose appointment is protected by a statute or public law) to administer the tax laws. That person is known as the Commissioner of Taxation (Commissioner). The ATO is the agency that carries out the actual administration but in theory it is doing so on behalf of the Commissioner of Taxation. As a result, it is common to refer to actions of the ATO as acts of the Commissioner and to refer to advice from the ATO as coming from the Commissioner.

Australia's income tax law, fringe benefits tax law and GST law all operate on what is known as a “self-assessment” system. Under this system, taxpayers are responsible for interpreting the tax law and applying it to their transactions when they complete a tax return. The laws provide sometimes severe penalties for incorrect reporting of tax liability as an incentive for taxpayers (or, in reality, in most cases their professional advisers) to get it right.

Private rulings

[1.290]

Taxpayers who are genuinely unsure how the law will apply to a particular transaction can protect themselves from the risk of a penalty by asking the Commissioner for a “private ruling” on how the ATO would apply the law to that transaction. These rulings are “binding” on the Commissioner, meaning that the Commissioner must honour the ruling and shield a taxpayer from any penalties if the taxpayer follows the advice in the ruling, even if a court later decides the ruling was not a correct interpretation of the law. While private rulings are delivered directly to taxpayers who request them, the ATO often produces a “sanitised” version that describes the question asked and the Commissioner's answer without identifying the taxpayer who originally posed the question. These published versions of private rulings placed on the website are known as ATO IDs, an acronym for ATO interpretative decisions.

Public rulings

[1.300]

In addition to providing individual taxpayers with private rulings on request, the Commissioner often issues public rulings which set out more generally the ATO's views on the way in which a provision of an Act should be applied to determine the extent of tax liability. A public ruling may also be used to explain which factors will be taken into account by the Commissioner when

exercising a discretion provided in the tax law and how those factors will affect the decision the Commissioner is empowered to make. Like private rulings, public rulings are binding on the Commissioner, meaning that a taxpayer who relies on the view in a public ruling to complete a tax return cannot be penalised if that view is later found by a court to be an incorrect interpretation of the law.

Using this chapter

[1.310]

This chapter outlines some of the key differences between commerce and accounting units and the tax law subject. Understanding these differences is important to understanding how to study for a tax law exam and how to answer a tax exam question. Chapter 2 provides some details on how to study taxation law and prepare for exams.

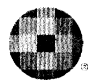
This chapter contains examples of issues that will be covered in more detail in your tax law course. It only touches upon these issues for the purpose of showing two things: how tax law contains many borderlines between competing rules and how precedents will be used in an exam answer to characterise a transaction and explain on which side of the border a particular set of facts is likely to fall. The other chapters in this book explain in much more detail the tax rules mentioned in the examples in this chapter and the tests established in case law precedents that are used to decide which tax rule will apply to a transaction straddling the border between competing provisions.

Return to this chapter periodically during the course. There is a risk that, as you learn about sections of the tax legislation and the case law tests used to interpret those sections, you will lose sight of how this information should be digested and used in an answer to a final exam question. Regular reviews of this chapter may help remind you of the bigger picture and provide guidance on translating what you learn about tax legislation and case law precedents into higher grades in the exam.

Legal Interpretation of Tax Law

Edited by

Robert F. van Brederode
Richard Krever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§2.01 Australia's Tax System: Constitutional Background

[A] Introduction

Under Australia's federal system of government, taxes are imposed at the national (Commonwealth), sub-national (State and Territory) and municipal levels. The Australian Constitution, which gave effect to Federation in Australia on 1 January 1901, provides for the taxation power of the Commonwealth government established at that time.[1] The Constitution also imposes a number of important restrictions on the tax powers of the State governments which, prior to Federation, were British colonies with parliamentary self-government and which continue to operate and impose taxes under their own Constitutions.[2] The mainland territory sub-national governments of the Northern Territory and Australian Capital Territory impose taxes which are comparable to those of the States,[3] while local municipal governments in Australia operate pursuant to State and Territory legislation.

Court systems operate at both Commonwealth and State levels in Australia, the ultimate appeal court in all matters being the High Court of Australia.[4] Appeals on State taxes are considered by State administrative bodies and State courts, with an appeal available to the High Court of Australia in some cases. Commonwealth legislation was once interpreted by a specialist tax administrative body known as the Board of Review and State courts or a single judge of the High Court. In 1986, the specialist Board of Review was folded into an Administrative Appeals Tribunal responsible for initial appeals of a broad range of Commonwealth administrative matters and since 1987, jurisdiction for appeals to a court has been shifted from the State Courts to a Federal Court. Appeal from the Federal Court is to the Full Court of the Federal Court and then, subject to a grant of special leave, to the High Court.

As Commonwealth statutes, interpretation of income tax and GST laws will be subject to the *Acts Interpretation Act 1901* (Cth.), which provides that an interpretation is to be preferred which 'would best achieve the purpose or object of the Act (whether or not that purpose or object is expressly stated in the Act)',[5] and that reference may be made to a variety of extrinsic materials in various

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[1] Constitution, s. 51(ii), which provides for power to make laws with respect to 'taxation; but so as not to discriminate between States or parts of States'.

[2] See Peter Hanks, 'Constitutional Issues of Australian Taxation', in Richard Krever (ed.), *Australian Taxation: Principles and Practice* (Melbourne: Longman, 1987), pp. 37, 50–51.

[3] These two territory governments are also parties to the Intergovernmental Agreement on Federal Financial Relations which provides for the distribution of GST revenue collected by the Commonwealth to the States, Northern Territory and Australian Capital Territory.

[4] Prior to 1968, federal tax cases could be appealed (with leave) to the Privy Council sitting in the UK. Appeals from State Supreme Courts direct to the Privy Council in State tax matters also were no longer possible after 1986.

[5] *Acts Interpretation Act 1901* (Cth.), s. 15AA.

circumstances.[6] Tax administrative legislation places the burden of proof on the taxpayer in tax disputes.[7]

One of the main features of Australia's taxation system, is the substantial 'vertical fiscal imbalance' in the revenue raising by the Commonwealth and State levels of government, which sees the two most important taxes, income tax (personal and corporate) and goods and services tax (GST), collected solely by the Commonwealth government and the States reliant upon substantial grants from the Commonwealth government (comprising all GST revenue collected and a portion of other Commonwealth revenue), in addition to the revenue collected under their taxes (payroll tax, land tax and various stamp duties). This imbalance, which existed in part from the outset at Federation and had led to the inclusion of constitutional provisions for revenue transfer to the States, has been greatly exacerbated by the course of interpretation of the broad financial provisions of the Constitution and the one-off event in 1942 when the Commonwealth, exercising war-time powers, effectively appropriated State income tax powers.

[B] Constitutional Restrictions on State Taxation

[1] Indirect Tax

At Federation, customs duties were one of the main sources of revenue to the States, and State income taxation was still in its infancy. To ensure there would be a single national customs law, the Constitution allocated to the Commonwealth the exclusive right to impose 'duties of customs and of excise'.[8] While the focus at the time was on the central government's assumption of all power to levy a customs tariff, the significant long-term impact came from the assignment to the central government of sole rights to impose excise duties. Subsequent interpretation of this measure that had the effect of denying States the power to levy most types of indirect taxes, along with the Commonwealth's de facto war-time appropriation of income tax rights, created the fiscal imbalance and need for extensive transfers from the central government.[9]

Over the course of nine decades, the Australian High Court interpreted the term 'duty of excise' widely to include any taxes imposed on goods at any stage in the process of production or distribution.[10] The

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[6] *Acts Interpretation Act 1901*, s. 15AB.

[7] *Taxation Administration Act 1953* (Cth.), ss 14ZZK and 14ZZO.

[8] Constitution, s. 90.

[9] See Cheryl Saunders, 'Vertical Fiscal Imbalance: Constitutional Origins', in David Collins (ed.), *Vertical Fiscal Imbalance and the Allocation of Taxing Powers* (Sydney: Australian Tax Research Foundation, 1993), pp. 55, 59–61; Cheryl Saunders, 'The High Court, Section 90 and the Australian Federation', in Neil Warren (ed.), *Reshaping Fiscal Federalism in Australia* (Sydney: Australian Tax Research Foundation, 1997), pp. 21, 22–27.

[10] Saunders, 'The High Court, Section 90 and the Australian Federation', *supra* note 9, p. 28, citing *Parton v. Milk Board (Vic.)* (1949) 80 CLR 229 and the earlier judgment of Dixon J. in *Matthews v. Chicory Marketing Board (Vic.)* (1938) 60 CLR 263; Hanks, *supra* note 2, pp. 53–56. The *Matthews* and *Parton* cases included references to Privy Council decisions on the distinction between direct and indirect taxation under the Canadian Constitution.

interpretation imposed the condition that there be a direct relationship between the tax and a transaction involving the goods. State governments attempted to bypass the constitutional prohibition on excises by imposing 'franchise fees' on the sale of products normally subject to excise taxes. These fees were presented as licence fees, with the fee charged based on the volume of sales in the previous assessment period. The legality of these fees was finally settled in a 1990s decision that found them unconstitutional.[11] That decision necessitated a financial rescue package for the States from the Commonwealth government with the imposition of corresponding increases in federal commodity taxes and a windfall profits tax equal to the tax that would be refunded if any taxpayers sought refunds of what had turned out to be unconstitutional taxes, together with a complementary increase in central government financial support for the States.[12]

Following a consideration of Australian[13] and US precedents,[14] as well as interpretations of the US Constitution[15] and historic English commentaries on law,[16] the court in the franchise fees case settled on a definition of excise tax as an inland tax on 'production, manufacture, sale or distribution of goods, whether of foreign or domestic origin'. The broad definition eliminated lingering uncertainty[17] about the possible constitutional validity of a State-based retail sales tax or VAT on the sale of new goods. A retail

[11] *Ha v. New South Wales* [1997] HCA 34; 189 CLR 465; 36 ATR 319. In *Eclipse Resources Pty. Ltd. v. WA (No. 4)* [2016] WASC 62, paras. [770]-[777], the Supreme Court of Western Australia concluded a levy imposed on waste disposed of to landfill was not an excise duty as there was no close connection between the levy and the waste including in circumstances where the recipient of the waste may later have used it after disposal to landfill in the production of valuable soil and structural fill products.

[12] See R. A. Dick, *A Loss of State Autonomy: Implications of the Ha and Hammond Decisions*, 27(1) Austl. Tax Rev. 30, 34 (1998), citing estimates that the revenue loss to the States for the 1997–1998 year would be greater than $5 billion; Michael Walpole, 'Sharing the "Magic Pudding" – An Australian Approach to Allocation of Taxing Rights', in Michael Lang and Peter Melz (eds), *Value Added Tax and Direct Taxation: Similarities and Differences* (Amsterdam: IBFD, 2009), pp. 1171, 1179–1180.

[13] In particular, *Matthews v. Chicory Marketing Board (Vic.)* (1938) 60 CLR 263, per Dixon J. and *Parton v. Milk Board (Vic.)* (1949) 80 CLR 229 at 260, per Dixon J., referred to in *Ha v. New South Wales* [1997] HCA 34; 189 CLR 465; 36 ATR 319 at 326–328.

[14] *Patton v. Brady, Executrix* 184 US 608, 617 (1902), cited in *Ha v. New South Wales* [1997] HCA 34; 189 CLR 465; 36 ATR 319 at 327, n. 37.

[15] J. Story, *Commentaries on the Constitution of the United States* (1833), vol. 2, sec. 940, cited in *Ha v. New South Wales* [1997] HCA 34; 189 CLR 465; 36 ATR 319 at 327, n. 37.

[16] W. Blackstone, *Commentaries on the Laws of England*, Bk. 1, Ch. 8, at 318, cited in *Ha v. New South Wales* [1997] HCA 34; 189 CLR 465; 36 ATR 319 at 327, n. 36.

[17] The uncertainty arose in part as a consequence of minority judgments such as that of Murphy J. of the High Court in *Hematite Petroleum Pty. Ltd. v. Victoria* (1983) 151 CLR 599 which led to the minority view that an excise duty was 'a selective tax on goods produced or manufactured locally': Saunders, 'The High Court, Section 90 and the Australian Federation', *supra* note 9, p. 30. A State retail *sales* tax would have been possible under this view.

sales tax or VAT on used goods[18] or on supplies of services remains possible in theory but for practical reasons is unlikely to ever see the light of day.

[2] Income Tax

The vertical fiscal imbalance has been exacerbated by the fact that the Australian States also have not levied income taxes since the imposition of uniform income taxation by the Commonwealth in 1942. Income taxes had been imposed on a source basis from the late nineteenth century by the Australian colonies (all of which had income taxes in some form in place by 1901 when they became States in the newly created Commonwealth of Australia).

The Commonwealth also entered the income tax field in 1915, however, and the administrative complexities of this system for taxpayers, and significant differences in the income tax rules in each jurisdiction, led to efforts to bring about greater harmonization over a long period.[19] One significant area of disagreement, for example, involved the allocation of income of multi-State businesses, which saw a variety of approaches taken by the States. Attempts were made to achieve a common basis for taxation in 1929 and again in 1936 when legislation was largely harmonized,[20] but differences had arisen again by 1942 when the Commonwealth government moved to monopolize the income tax field.

The Commonwealth's initiative, the 'uniform tax scheme', which was originally expressed to apply for the period of the war and a year thereafter,[21] had two elements: increasing national rates to the point where additional State tax could not be sustained; and the payment of a fixed amount of financial assistance to the States based on the average of their income tax collections in the two previous

[18] In *Commissioner for Australian Capital Territory Revenue v. Kithock Pty. Ltd.* (2000) FCA 1098, the court concluded that a tax imposed on the sale of used motor vehicles was not an excise tax because the items sold had ceased to be part of the commercial production, distribution and sales chain once they were in the hands of final consumers.

[19] See Cheryl Saunders, 'The Uniform Income Tax Cases', in H.P. Lee and George Winterton (eds), *Australian Constitutional Landmarks* (Cambridge: Cambridge University Press, 2003), pp. 62, 64–65; Rodney Maddock, *Unification of Income Taxes in Australia*, 28(3) Austl. J. Pol. & Hist. 354, 354–357 (1982).

[20] New South Wales at this point accepted the harmonized scheme proposed in 1929 in relation to inter-State sales of goods by a manufacturer (two-thirds of profit to State of manufacture and one-third to State of sale); Queensland, however, legislated to tax 50% of the profit on sales of goods manufactured in another State and sold in Queensland: *Income Tax (Management) Act 1936* (N.S.W.), ss 37–38 and *Income Tax Assessment Act 1936* (Qld.), s. 28(7) and (8). New South Wales and the Commonwealth also could not reach agreement in 1936 on the method to be used to calculate tax on sales of goods by overseas manufacturers. See Richard Krever and Peter Mellor, 'The Development of Centralised Income Taxation in Australia, 1901-1942', in Peter Harris and Dominic de Cogan (eds), *Studies in the History of Tax Law, Vol. 7* (Oxford: Hart Publishing, 2015), pp. 363, 381-383.

[21] See, for example, *States Grants (Income Tax Reimbursement) Act 1942* (Cth.), s. 8. See also the recommendation to this effect in Committee on Uniform Taxation, *Report* (28 March 1942), para. 1.

financial years, less certain cost savings and other deductions.[22] The scheme was challenged by four of the States and upheld by the High Court in the year that the legislation was enacted.[23]

Significantly, the key features of the uniform tax scheme, including the payment of grants of financial assistance to each State on the condition that the State had not imposed income tax in the prior year, were found to be valid by the High Court on grounds other than the war-time defence power of the Commonwealth.[24] This outcome opened the door to continuation of the Commonwealth's exclusive role in income taxation after the war.[25] (By contrast, the extensive national price and wage controls imposed during the war were wound down in the post-war period.[26])

In January 1946, the Commonwealth announced its intention to continue to monopolize the income tax field. The central government was successful in a subsequent attempt by States to challenge the constitutionality of its move,[27] leaving the States with the constitutional power to impose income tax but no practical way of doing so while the Commonwealth retained its combined tax and grant scheme.[28]

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[22] Saunders, 'The Uniform Income Tax Cases', *supra* note 19, p. 66, citing Treasurer Chifley, Debates, House of Representatives, vol. 170, p. 1290 (15 May 1942).

[23] *South Australia v. Commonwealth* (1942) 65 CLR 373 (*First Uniform Tax Case*).

[24] The Act providing for payment of grants to the States was upheld under s. 96, which relevantly provides that 'the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit'. However, the one-off transfer of State taxation office staff and equipment was upheld only under the war-time defence power of the Commonwealth. One judge would only have upheld the provision for priority in payment of Commonwealth income tax over State income tax under the defence power.

[25] Saunders, 'The Uniform Income Tax Cases', *supra* note 19, p. 69, citing K.H. Bailey, 'The Uniform Income Tax Plan (1942)', in W. Prest and R.L. Mathews (eds), *The Development of Australian Fiscal Federalism: Selected Readings* (Canberra: Australian National University Press, 1980), pp. 309, 323.

[26] See S.J. Butlin and C.B. Schedvin, *War Economy, 1942–1945* (Canberra: Australian War Memorial, 1977), Ch. 25. Efforts had been made by the Commonwealth on several occasions to secure constitutional power for such controls through referenda. More generally, in 1940 (prior to taking office) Australia's wartime Prime Minister John Curtin had set out a policy approach envisaging 'a greatly enlarged role for the Commonwealth in the management of the nation's affairs' both during and after the war: Chief Justice Robert French, 'If they could see us now – what would the founders say?', John Curtin Prime Ministerial Library Anniversary Lecture (18 July 2013), p. 4, available at: http://www.hcourt.gov.au/publications/speeches/current/speeches-by-chief-justice-french-ac (accessed on 6 September 2013).

[27] *Victoria v. Commonwealth* (1957) 99 CLR 575 (*Second Uniform Tax Case*).

[28] *First Uniform Tax Case* (1942) 65 CLR 373 at 416. Significantly, the Commonwealth had no power to outlaw State taxes where the revenue was to be used for State purposes but it could preclude the income tax at least through its own tax and grant powers. In this context, the 'New Federalism' policy of a conservative government in the late 1970s included legislation (since repealed) for the resumption of State income taxation, but for political reasons the option was not taken up by any of the States as the Commonwealth had not lowered its own rates to make room: Saunders, *supra* note 19, p. 77; Hanks, *supra* note 2, p. 53. Suggestions which have been made for limitation of the interpretation of the section 96 conditional grants power are also

[C] Limitations on Commonwealth Taxation Powers

Unlike the case with the States, which are specifically excluded from some taxing fields by the Constitution, the Commonwealth suffers no constitutional restrictions on the nature of taxes it can impose under its taxing power.[29]

The apparently 'plenary and absolute' power of the Commonwealth government to impose taxation[30] does not provide constitutional immunity for all supposed Commonwealth tax laws, however. The validity of tax legislation has been attacked on the basis of the interpretation of 'tax', with taxpayers arguing so-called tax laws are in fact disguised regulatory rules designed to enforce Commonwealth incursions into subject areas that constitutionally belong to the States. Tax laws have also been attacked on the basis of two constitutional limitations on the Commonwealth's tax powers, namely a prohibition against discrimination and preference by the Commonwealth as between the States,[31] and another preventing taxation of property of any kind belonging to the States.[32]

The courts have interpreted the word 'tax' generously in respect of the Commonwealth's attempts to use 'taxing' measures as a means of enforcing intervention in areas of State competence.[33] For example, it may be that the Commonwealth government has no power to mandate all employers to provide superannuation (retirement pension) contributions for employees. It does so however by levying a tax, labelled the 'superannuation guarantee charge' on employers who fail to do so,[34] an approach that has been upheld as a legitimate exercise of its taxing powers.[35]

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discussed in Peter Gerangelos, 'Tax Coordination between Regions in Australia – Role of the Courts', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Staringer (eds), *Horizontal Tax Coordination* (Amsterdam: IBFD, 2012), pp. 53, 68–71.

[29] *Roy Morgan Research Pty. Ltd. v. Federal Commissioner of Taxation* [2011] HCA 35; 244 CLR 97; 80 ATR 1 at 7, in which the High Court confirmed that a tax may be valid for constitutional purposes even though revenue raising is not the primary purpose of the impost. It had also been observed prior to this decision that the taxation power is '"plenary and absolute; unlimited as to amount, as to subjects, as to objects, as to conditions, as to machinery" so that "the Parliament has, prima facie, power to tax whom it chooses, power to impose such conditions as to liability or as to exemption as it chooses"': *Fairfax v. Federal Commissioner of Taxation* (1965) 114 CLR 1 at 12–13. See Hanks, *supra* note 2, pp. 38–39.

[30] *Fairfax v. Federal Commissioner of Taxation* (1965) 114 CLR 1 at 12–13.

[31] Constitution, ss 51(ii) and 99 respectively; see Hanks, *supra* note 2, pp. 40–44.

[32] Constitution, s. 114. A reciprocal prohibition applies against State taxation of property belonging to the Commonwealth.

[33] A leading precedent defines tax as 'a compulsory exaction of money by a public authority for public purposes, enforceable by law, and ... not a payment for services rendered': see *Matthews v. Chicory Marketing Board (Vic.)* (1938) 60 CLR 263 at 276.

[34] *Roy Morgan Research Pty. Ltd. v. Federal Commissioner of Taxation* [2011] HCA 35; 244 CLR 97; 80 ATR 1 at 13–14, in which the Full High Court unanimously upheld the validity of the superannuation guarantee charge in respect of shortfalls in employer superannuation contributions as a tax for constitutional purposes. See also the discussion of this case and of earlier comments on the scope of the taxation power by members of the High Court in Justice Michelle Gordon, *The Commonwealth's Taxing Power and Its Limits – Are We There Yet?*, 36(3) Melb. U. L. Rev. 1037, 1040–1044 (2013).

[35] The High Court has indicated that for a levy to be treated as a tax it cannot be a penalty, or be arbitrary, and an impost which is enacted in a way that makes it incontestable will also be invalid: see *MacCormick v. Federal Commissioner of Taxation* (1984)

The courts have in many cases taken a stricter view on whether various 'fees' imposed by the government or public authorities can be characterized as taxes for constitutional law purposes.[36] While a 'fee for immigration clearance' payable by airline operators in respect of arriving passengers has (at least where passengers are Australian citizens) been found to be a tax[37] as was a 'wool charge' imposed on farmers in respect of the sale of wool,[38] charges by a public authority to airlines for air services and facilities were considered outside the ambit of a tax,[39] as was a (State) commercial licence fee calculated by quantity for exploitation of natural resources.[40]

Courts have also been less sympathetic (to the Commonwealth) when interpreting the constitutional prohibition on the Commonwealth imposing tax on property of any kind belonging to a State.[41] They have, for example, invalidated a sales tax on goods created by a State instrumentality and then applied to own use[42] and income tax on gains realized on the sale of State assets, viewing the capital gain as an element of the underlying property which would make tax on the gain akin to tax on the underlying property.[43] By way of contrast, the Commonwealth has been allowed to impose income tax on interest payable to a State[44] and States are liable to pay a fringe benefits tax on non-cash benefits provided to

158 CLR 622 at 639–643. An impost payable if a particular behaviour is not carried out such as making superannuation contributions for employees appears to be neither a penalty nor arbitrary.

[36] In recent times, government imposts have also increasingly been described as 'levies', such as the Medicare levy, a state fuel levy in 1990 (to fund a partial bailout of depositors in a failed non-bank financial institution), a temporary increase in the Medicare levy in 1996-97 to fund the 'Gun Buy-Back Scheme', the Air Passenger Ticket Levy of 2001 (known as the 'Ansett levy', to fund staff entitlements on that airline's insolvency), the Temporary Flood and Cyclone Reconstruction Levy of 2011 (Queensland flood levy), and many others. That these are, however, regarded as taxes by the government is shown by the fact that the levies are generally imposed under separate assessment and imposition Acts so as to comply with s. 55 of the Constitution (see further below in this section).

[37] *Air Caledonie International v. Commonwealth* (1988) 165 CLR 462 at 467.

[38] *Moore v. Commonwealth* [1951] HCA 10; 82 CLR 547. The charge was fully creditable against the farmer's income tax liability for the year and refundable if it exceeded the income tax liability.

[39] *Airservices Australia v. Canadian Airlines International Ltd.* [1999] HCA 62; 202 CLR 133; 43 ATR 246.

[40] *Harper v. Minister for Sea Fisheries* [1989] HCA 47; 168 CLR 314 (provided that there is a relevant relationship between the amount of the impost and the value of the privilege conferred). As the licence fee was found not to be a tax, it could not be an excise duty prohibited to the State under s. 90 of the Constitution.

[41] One leading scholar nevertheless has argued that this restriction is generally applied under a 'fairly narrow definition' of the terms, 'focusing on the legal operation' of any legislation in question; see Vince Morabito, *The Constitutional Restriction on Taxes Imposed on Crown Property*, 1(1) J. Austl. Tax'n 41, 56 (1998).

[42] *Deputy Commissioner of Taxation v. State Bank of New South Wales* [1992] HCA 6; 174 CLR 219; 23 ATR 1.

[43] *South Australia v. Commonwealth* [1992] HCA 7; 174 CLR 235; 23 ATR 10.

[44] *South Australia v. Commonwealth* [1992] HCA 7; 174 CLR 235; 23 ATR 10.

State employees as remuneration in lieu of cash salaries.[45] The other limitation on the Commonwealth's taxing power, the prohibition on discrimination between States, featured prominently in unsuccessful challenges to a clean energy excise tax imposed by the Commonwealth in 2011[46] and a minerals resource rent tax imposed by the Commonwealth in 2012.[47]

Important procedural requirements are also laid down in relation to Commonwealth taxation. In particular, it is provided that '[l]aws imposing taxation shall deal only with the imposition of taxation, and any provision therein dealing with any other matter shall be of no effect'.[48] This has been interpreted as requiring the Commonwealth to set out all taxes in two distinct Acts, an 'assessment' Act that sets out all the rules for calculating the base (e.g., taxable income for the income tax, taxable fringe benefits for the fringe benefits tax, and so on) and a separate 'imposition' Act that actually imposes a tax liability in respect of the base set out in the assessment Act.[49]

Another requirement is also imposed that Commonwealth taxation laws (other than duties of customs and of excise) 'shall deal with one subject of taxation only', and that 'laws imposing duties of customs shall deal with duties of customs only, and laws imposing duties of excise shall deal with duties of excise only'.[50] This measure has been interpreted in a restrictive fashion to limit the means by which the Commonwealth can levy indirect tax. For example, a provision imposing sales tax in respect of swimming pools constructed *in situ* was invalidated on the basis that the provision imposed a tax on land (as a subject distinct from the other provisions of the relevant law imposing a duty of excise).[51] However, the measure has been read generously in the case of income tax, with the High Court interpreting the subject of that tax broadly to include statutory assessments of gains that the Court had concluded fall outside the judicial concept of income in Australia (this interpretation is discussed further in §2.02[A] below),[52] an undistributed profits tax imposed on retained earnings of private companies to prevent

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[45] *Queensland v. Commonwealth* [1987] HCA 2; 162 CLR 74; 18 ATR 158.

[46] *Queensland Nickel Pty. Ltd. v. Commonwealth* [2015] HCA 12; 255 CLR 252. (By the time of the judgment, the relevant tax had been repealed with effect from 1 July 2014.)

[47] *Fortescue Metals Group Ltd. v. Commonwealth* [2013] HCA 34; 250 CLR 548. The alleged discrimination was said to arise in respect of credits provided under the tax for the various mineral royalties paid by taxpayers to the States. (The minerals resource rent tax was also repealed in 2014.)

[48] Constitution, s. 55.

[49] See Hanks, *supra* note 2, pp. 46–49.

[50] Constitution, s. 55.

[51] *Mutual Pools & Staff Pty. Ltd. v. Federal Commissioner of Taxation* [1992] HCA 4; 173 CLR 450; 22 ATR 856. The statutory provision which added this tax in 1986 to the existing sales tax law was rendered void from the time of its introduction. The government implemented a scheme to refund an amount to the pool builder limited to the amount of the tax which had not been passed on or had been refunded to customers; the tax refund was otherwise payable to the customer directly. This scheme was upheld by the High Court in *Mutual Pools & Staff Pty. Ltd. v. Commonwealth* [1994] HCA 9; 179 CLR 155; 27 ATR 357.

[52] *Resch v. Federal Commissioner of Taxation* (1942) 66 CLR 198, which included reference to US authorities on the meaning of income for tax purposes. See also Geoffrey Lehmann and Cynthia Coleman, *Taxation Law in Australia* (5th edn, Sydney: Australian

shareholders from deferring indefinitely their income tax liability on dividends,[53] and imputed benefits enjoyed by taxpayers who owned their principal residences.[54]

§2.02 Income Tax Interpretation

Australia has a common law system and many fundamental elements of the legal system such as contract law and tort law are based on principles developed by the courts through application of the doctrine of precedent. The tax law, in contrast, derives entirely from statute. The application of that statute, however, is guided to a significant extent by judicial interpretation of the words in the law and judicial characterization of transactions in light of the interpretation of the terms of tax provisions.

Three aspects of interpretation by the courts of the income tax law have proved central to its application and development. The first two are the judicial interpretation of the fundamental building blocks of income and allowable deductions. The most basic terms in the law are undefined, leaving enormous scope for the courts to sculpt the shape of the Australian income tax system. On the receipt side, it was the courts interpreting the word 'income' that established the boundaries for the original income tax law and set the stage for all subsequent amendments to alter the base. On the outgoing side, the courts decided what types of expenses were 'capital' in nature and in consequence created both a boundary to the tax base and a guidepost to the later statutory rules to recognize expenses incurred to derive gross income.

The third aspect of interpretation of income tax law by the courts that has played a major role in the application of the law and, importantly, in the design of the income tax system as the legislature endorsed or reacted against court decisions, derives from the courts' alternating preference for a narrow or expansive interpretation of tax measures, sometimes described as 'literal' or 'purposive' interpretations.

[A] The Key Concept of 'Ordinary Income'

Australia's income tax legislation imposes tax on 'taxable income', which is calculated as gross income minus deductions.[55] From the introduction of income tax legislation in the late nineteenth century in

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Tax Practice, 1998), pp. 17–18, discussing the *Resch* case and arguments concerning the validity of the capital gains tax provisions in the context of the High Court decisions in *Mutual Pools & Staff Pty. Ltd. v. Federal Commissioner of Taxation* [1992] HCA 4; 173 CLR 450; 22 ATR 856 and *South Australia v. Commonwealth* [1992] HCA 7; 174 CLR 235; 23 ATR 10.

[53] *Cornell v. Deputy Federal Commissioner of Taxation (South Australia)* (1920) 29 CLR 39.

[54] *Harding v. Federal Commissioner of Taxation* (1917) 23 CLR 119.

[55] The earliest income tax laws tended to speak directly of gross income – see, for example, *Taxation Act 1884* (South Australia), s. 12(V); *Income Tax Act 1895* (Victoria), s. 9(1), and *Income Tax Assessment Act 1915* (Commonwealth), s. 18(a) ('the gross income'). The Commonwealth legislation subsequently defined taxable income as assessable income less allowable deductions, with 'assessable income' in turn defined as meaning 'gross income' – see, for example, *Income Tax Assessment Act 1922* (Cth.), s. 4; *Income Tax Assessment Act 1936* (Cth.), s. 25(1).

Australia,[56] the term income was not defined in the law and it was left to the courts to interpret the word and, in the course of doing so, decide what receipts should be included in gross income.[57] Not surprisingly given the use of precedent in Australian law and the influence of UK precedents in particular through much of Australia's legal history, the Australian judicial interpretation of the term was based on UK concepts.

The UK income tax at that time was a schedular tax applicable to 'profits' and 'gains' of various kinds, and the interpretation of the legislation in this form came to be based on a limited concept of income imported from the meaning of income for trust law purposes.[58] Importantly, the transplanted judicial meaning of income excluded amounts that would be considered 'capital' receipts or gains for trust law purposes. Capital gains, in this context, encompassed not only gains realized in respect of the sale of property other than inventory, but also capitalized receipts such as payments for the sale of investment income or employment income streams.

In contrast to the UK tax law, the early Australian income tax statutes taxed 'income' under a global statutory structure, on a model very similar to the US federal income taxes to that time.[59] In this context, some early Australian judicial decisions interpreted the terms of income tax law differently from their meaning in trust law, adopting a broad view of assessable amounts, in one case even including accruing gains in the concept of income. The separate interpretation track for income in tax law lasted only briefly, however, and by the opening years of the twentieth century Australian courts had largely settled on an interpretation that for the most part aligned the meaning of income for tax and trust law purposes, excluding the range of gains and receipts that would be considered capital gains for

[56] See Peter Harris, *Metamorphosis of the Australasian Income Tax, 1866–1922* (Sydney: Australian Tax Research Foundation, 2002); Julie Smith, *Taxing Popularity* (Sydney: Australian Tax Research Foundation, rev. ed., 2004), pp. 36–44.

[57] See Peter Mellor, *Origins of the Judicial Concept of Income in Australia*, 25(3) Austl. Tax F. 339 (2010).

[58] Ross Parsons, *Income Taxation: An Institution in Decay*, 13(3) Sydney L. Rev. 435, 436–443 (1991); John Avery Jones, Luc De Broe, Maarten Ellis, Kees van Raad, Jean-Pierre Le Gall, Henri Torrione, Toshio Miyatake, Sidney Roberts, Sanford Goldberg, Jürgen Killius, Guglielmo Maisto, Federico Giuliani, Richard Vann, David Ward and Bertil Wiman, *Treaty Conflicts in Categorizing Income as Business Profits Caused by Differences in Approach between Common Law and Civil Law*, 57(6) Bull. Int'l Tax'n 237, n. 3 (2003); Richard Vann, 'Income as a Tax Base', in Richard Krever (ed.), *supra* note 2, p. 62; Richard Krever, 'Interpreting Income Tax Laws in the Common Law World', in Markus Achatz, Tina Ehrke-Rabel, Johannes Heinrich, Roman Leitner and Otto Taucher (eds), *Steuerrecht Verfassungsrecht Europarecht: Festschrift für Hans Georg Ruppe* (Vienna: Facultas Verlags- und Buchhandels AG, 2007), pp. 354, 357 (as noted in that chapter, the process of interpreting tax law provisions by reference to transplanted categories has been described as logically fallacious in Neil Brooks, 'The Responsibility of Judges in Interpreting Tax Legislation', in Graeme Cooper (ed.), *Tax Avoidance and the Rule of Law* (1997), pp. 93, 122–123); but see also John Prebble, *Income Taxation: A Structure Built on Sand*, 24(3) Sydney L. Rev. 301 (2002), contesting the view that the UK concept of income was drawn from limited trust concepts as opposed to the ordinary meaning of the term.

[59] Mellor, *supra* note 57 at 341.

trust law purposes.[60] An early decision by the High Court[61] that appeared to distinguish a key UK authority aligning income for tax and trust law purposes[62] was subsequently interpreted as an opinion based on the narrow facts of the case and ultimately had no impact on the judicial concept.[63] As noted in §2.01[C] above, the narrow judicial concept of income for tax purposes in Australia is in contrast to the broader view of the 'subject' of income taken by the High Court for the purposes of the constitutional requirement that laws imposing taxation must deal only with the one subject of taxation.[64]

The judicial concept of income that had been applied for tax law purposes clearly differed from the economic concept and the accounting concept of income. Following a 1935 decision that described the judicial concept of income for tax purposes as amounts 'determined in accordance with the ordinary concepts and usages of mankind', a new term came into use by the courts and from that time courts and commentators commonly described amounts that would be characterized by a court as income for tax purposes as 'ordinary income'.[65]

The relatively narrow judicial concept of income excluded from the tax base a wide range of receipts – gains on the sale of most assets other than inventory or assets actively traded in a business, employment income paid by way of non-convertible in kind benefits, capitalized employment benefits paid on termination of employment or as lump sum benefits from pension (superannuation, in Australian terminology) plans, compensation for the loss of income-generating property, discounts or premiums in lieu of interest or rent, and other 'capital' amounts.[66] There was little evidence to support the assertion made by some[67] that courts considered both legal and economic concepts in their decision making, at least in terms of the meaning of income.

The equity implications of and opportunities for avoidance from the narrow judicial concept of income were obvious and soon after the enactment of the first Commonwealth income tax Act the legislature

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[60] *In re the Income Tax Acts (No 2)* (1901) 27 VLR 39 at 41–42.

[61] *Commissioner of Income Tax (Queensland) v. The Brisbane Gas Company* (1907) 5 CLR 96. The case involved a provision of the *Income Tax Act 1902* (Qld.) for taxation of dividend payments relating to undistributed profits not previously taxed under the *Dividend Duty Act 1890*.

[62] *Bouch v. Sproule* (1887) 12 App. Cas. 385 (H.L.).

[63] The High Court applied the income tax provision of the 1902 Queensland Act to payments described by the company as dividends, and an analysis of the nature of those payments was unnecessary. In *Orr v. Wendt* [2005] WASCA 199, the *Brisbane Gas* case was put forward (unsuccessfully) to support the converse argument that the trust law meaning of income is always narrower than its tax law meaning in Australia.

[64] *Resch v. Federal Commissioner of Taxation* (1942) 66 CLR 198.

[65] *Scott v. Commissioner of Taxation* (1935) 35 SR (NSW) 215 at 219.

[66] See Julie Cassidy, *Concise Income Tax* (5th ed., Sydney: Federation Press, 2010), pp. 174–175.

[67] Lehmann and Coleman, *supra* note 52, pp. 79 and 82.

embarked on a programme of base broadening by including specific types of gain into the calculation of income for tax purposes. Following seventy years of piecemeal inclusion measures, the legislature finally inserted into the income tax law a comprehensive inclusion regime subsequently renamed as the 'capital gains tax' rules that swept in many gains that had escaped the specific gain inclusion measures.

In 1997, the income tax legislation was largely replaced with a 'plain English' version of the tax law. In the new law the legislature formally recognized the judicial concept of income by setting out a new definition of taxable income with two elements to the inclusion side: 'ordinary income' and 'statutory income'. The former was not defined but was understood to mean income according to judicial concepts and the latter as all amounts included in the income tax base as a result of a specific inclusion provision in the income tax law. To avoid any overlap, when the inclusion measures were redrafted in plain English, a proviso was generally added stating that the provisions applied to amounts described in the sections to the extent they would not already be included in the tax base as ordinary income.

[B] The Concept of 'Capital' Expenses

From its inception, Australian income tax law established timing rules for the deduction of expenses by placing a restriction in the general deduction provision that allowed a deduction for expenses incurred in the derivation of gross income apart from 'capital' expenses. Separate depreciation rules then provided for the depreciation of capital expenses. There was no definition in the law of a capital expense and once again the courts settled on a definition by importing tests from trust law, in this case the tests used to identify expenses of a trust that were charged against the interest of remainder or capital beneficiaries.

For accounting purposes or the measurement of economic income, a capital expense is one with a life longer than the current accounting year. These expenses are recognized over their effective lives through a depreciation or amortization process. For tax law purposes, applying trust law tests the courts looked at a range of factors, including the longevity of any benefit acquired as a consequence of an expenditure. The life of the benefit is not determinative, however. More important is the form of the expense – one-off expenditures are likely to be considered capital outgoings while repetitive ones are most often treated as 'revenue' expenses, the judicial term for expenditures not characterized as capital in nature and thus deductible under the general deduction provision.

The frequency of payment test was supplemented in the 1940s by what remains the most important test, a distinction between expenses incurred in respect of an income-earning structure (treated as capital expenses) and those incurred in respect of an income-earning process (treated as revenue expenses). Ironically, when the test was first proposed by a single judge of the High Court, it was dismissed by the remainder of the bench[68] but it was adopted as the predominant test following that judge's elevation to the position of Chief Justice.[69] Not surprisingly, the question of when an expense relates to a 'structure' or 'process' is at best problematic and it is not uncommon for commentators

[68] Dixon, J. in *Sun Newspapers Ltd. and Associated Newspapers Ltd. v. Federal Commissioner of Taxation* (1938) 61 CLR 337.

[69] *Broken Hill Theatres Pty. Ltd. v. Federal Commissioner of Taxation* (1952) 85 CLR 423.

describing outcomes to cite the often quoted observation from a UK decision that 'in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as would an attempt to find reasons'.[70]

The income-earning structure/process test did achieve appropriate results (from a tax policy perspective) in most cases where an expenditure resulted in the taxpayer acquiring tangible or legally recognized intangible property. Depreciation rules were then needed for the recognition of wasting assets with a limited life but the legislature moved slowly and in a very piecemeal fashion to address this issue. The original depreciation section only covered what was termed 'plant and equipment', meaning machinery or equipment other than buildings. Depreciation rules for buildings were added in several tranches over seven decades with separate depreciation regimes for mining buildings, forestry buildings, hotels and motels and finally other buildings used in the generation of income. Separate depreciation regimes applied to various types of intellectual property and further discrete rules applied to a range of services such as the cost for rural property owners of paying for connection to telephone or electricity lines. The legislature finally consolidated the depreciation and amortization rules into a simplified set of capital allowances in 2001.

The interaction of the judicial tests and the limited range of depreciation or capital allowance measures meant many expenses commonly incurred in the course of a business could never be recognized for tax purposes. Some relief was provided in the course of tax reforms in 1985. For example, taxpayers were allowed to add the expense of defending title to property to the cost of the property, thus recognizing the outgoing on the eventual disposal of the property. Indirect recognition of expenses incurred to acquire wasting intangible property such as contract rights not covered by the capital allowance rules was provided at the same time by allowing the taxpayers to recognize the expense as a capital loss (quarantined so it could only be deducted from a capital gain) when the rights expired. There remained a large number of expenses that could not be recognized, including outgoings that were characterized as capital because they were associated with an income-producing structure but generated no ongoing benefit or asset recognized in law. These were known colloquially as 'black hole' expenses, that is, expenses incurred for commercial purposes which disappeared into a black hole for tax purposes.

Decades of pressure from tax advisors and business taxpayers finally led in 2001 to the adoption of a residual expense capital allowance measure that permitted taxpayers to depreciate on a straight-line basis over five years the cost of capital expenses not recognized elsewhere as part of the cost base of an asset or depreciated under another specific capital allowance provision. The original version failed to catch a number black hole expenses but since its amendment in 2005, the provision appears to achieve its goal.

[70] *Inland Revenue Commissioners v. British Salmson Aero Engines, Ltd.* [1938] 3 All ER 283. The case concerned a UK company that made payments to use a patent. The question to be determined was whether the taxpayer was required to withhold tax on the payments and the answer turned on the character of the royalty-like payments once received by the patent holder. It appears to have been assumed, however, that the character of the payments would be similar in respect of the payer and recipient if they were found to be capital amounts.

While the multi-element system now in place for recognizing expenses characterized as capital outlays under the judicial tests is an improvement over the original situation where none were recognized for tax purposes, none of the recognition rules are as generous as the immediate deduction allowed if the taxpayer can arrange a transaction in a way that presents the outgoing as a revenue expense. For example, expenses to secure multi-year contracts would be recognized only on the expiry of the contracts and then as capital losses only deductible against capital gains under the statutory recognition provisions. If the expenses are characterized as revenue outgoings regularly incurred in the ordinary course of business, they are immediately deductible.[71] Similarly, as noted, expenses incurred to protect title to an asset must be capitalized into the price of the asset if treated as capital in nature. If this happens, they will be recognized only when there is a disposal of the asset. If the expense is incurred to protect rights that are regarded as separate assets, the expense can only be recognized over five years through the residual capital allowance rule. But if the taxpayer can show defence of title expenses are regularly incurred as an incident of the income-earning process in the taxpayer's business, it will be characterized as an immediately deductible revenue outgoing.[72]

Most commonly, businesses incur expenses in response to commercial needs and only after the fact seek to attribute a particular character to the outlay. Well advised enterprises able to plan before expenses can establish an evidentiary trail or pattern of behaviour that may assist in reinforcing a tax advantageous revenue characterization of expenses.

[C] Literal and Purposive Interpretation of Substantive Provisions and the General Anti-avoidance Provision

In principle, the interpretation of a tax law should follow the same processes and doctrines as that of any other statute.[73] It is clear, however, that in practice interpretation of tax statutes may be subject to ideological and social perspectives that are unlikely to arise in other contexts.

Analysis of interpretation of tax law in Australia often seeks to place case law along a spectrum that has at one end a 'literal' interpretation approach and at the other a 'purposive' interpretation approach. Both approaches purport to give effect to the intent of the legislature in enacting a measure subject to interpretation and both rely on the meaning of the words used in the law. As the meanings of words are based primarily on the context in which they are used, the difference between the two approaches is

[71] An example of a taxpayer achieving this characterization is found in *BP Australia Ltd. v. Federal Commissioner of Taxation* (1965) 112 CLR 386 where the taxpayer regularly paid gas station owners consideration to enter into multi-year 'tied house' agreements under which the operators agreed to sell the taxpayer's product exclusively for the life of the agreements.

[72] A taxpayer who was able to do this is found in *Federal Commissioner of Taxation v. Consolidated Fertilizers Ltd.* (1991) 22 ATR 281. The taxpayer's right to use a technology under licence was challenged and the taxpayer incurred legal expenses to defend its right. It argued, successfully, that there was a continual risk of attack of this sort in its line of business and the expense was consequently a revenue outgoing.

[73] '[The fact that an Act] is a taxing statute does not make it immune to the general principles governing the interpretation of statutes': *Cooper Brookes (Wollongong) Pty. Ltd. v. Federal Commissioner of Taxation* (1981) 147 CLR 297 at 323 (per Mason and Wilson JJ.).

fundamentally one of the extent to which judges look at words in isolation to attribute meaning to them or look at them in broader contexts and adopt the meaning most suitable for that broader context. Most often, the literal approach is argued by taxpayers seeking to avoid a liability on the basis that the words in the statute do not apply to their situation. Literal interpretation is thus often associated with successful tax avoidance arrangements.

For the first six decades of the twentieth century, Australian tax jurisprudence followed a middle path between extremes of so-called strict literalism or limited context interpretation and purposive interpretation looking at terms in the broader context of the legislation and the aim behind the provisions in which words were placed. A shift in the 1970s to the literalism extreme of the spectrum and a debate within the High Court over the relationship between statutory interpretation techniques and the role of a responsible judiciary led to a radical overhaul of the entire Australian income tax system and a significant shift in interpretation approaches back towards the central position taken by courts prior to the extreme literalism period.

The apex of strict literalism in Australia came in the late 1970s and early 1980s following the approach of the then Chief Justice of the High Court, Sir Garfield Barwick, who aligned a strict interpretation of tax law that considered the meaning of words in the law only in terms of the sentences in which they were found, without regard to the broader object of the sentences, with the maintenance of a free society.[74] This literal approach led to a string of judgments in favour of taxpayers who had engaged in clearly artificial schemes entered into for the purpose of tax avoidance, prompting some commentators to conclude that the High Court under Sir Garfield was encouraging tax avoidance.[75]

The approach taken by the Chief Justice was strongly criticized in the dissenting High Court judgments of Lionel Murphy, who described the Court's 'absolutely literalistic' approach as an 'open invitation to artificial and contrived tax avoidance' that, rather than protecting the legal rights of citizens as asserted by the Chief Justice, could lead to great oppression as the Parliament responded by vesting tax officials with more and more discretion.[76] Justice Murphy's warning that the legislature would intervene if the

[74] 'It is for the Parliament to specify, and to do so, in my opinion, as far as language will permit, with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax. The function of the court is to interpret and apply the language in which the Parliament has specified those circumstances. The court is to do so by determining the meaning of the words employed by the Parliament according to the intention of the Parliament which is discoverable from the language used by the Parliament. It is not for the court to mould or to attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed': *Federal Commissioner of Taxation v. Westraders Pty. Ltd.* (1980) 144 CLR 55; 11 ATR 24 at 26 (per Barwick C.J.).

[75] See, for example, Geoffrey Lehmann, *The Income Tax Judgments of Sir Garfield Barwick: A Study in the Failure of the New Legalism*, 9(3) Monash U. L. Rev. 115 (1983).

[76] 'It has been suggested, in the present case, that insistence on a strictly literal interpretation is basic to the maintenance of a free society. In tax cases, the prevailing trend in Australia is now so absolutely literalistic that it has become a disquieting phenomenon. Because of it, scorn for tax decisions is being expressed constantly, not only by legislators who consider that their Acts are being mocked, but even by those who benefit. In my opinion, strictly literal interpretation of a tax Act is an open invitation to artificial and contrived tax avoidance. Progress towards a free society will not be advanced by attributing to Parliament meanings which no one believes it intended so that income tax becomes optional for the rich while remaining compulsory for

literalist approach were to continue proved to be correct, though it did so not strictly in the manner he predicted.

The tax avoidance era of the late 1970s and early 1980s[77] and the vigorous debate over the relative merits of literalism and purposive interpretation that accompanied it led directly to three legislative developments.

The first was the amendment of the *Acts Interpretation Act*, the law setting out rules for the interpretation of Commonwealth statutes generally, so that it explicitly required courts to adopt a purposive interpretation when reading statutes.[78]

The second was the replacement of the previous anti-avoidance measure that had proved wholly ineffective in the face of complex and, in the words of the Chief Justice, 'ingenious' tax avoidance schemes.[79] A new and sweeping general anti-avoidance rule[80] was adopted. It can be invoked by the tax authority whenever a taxpayer's predominant reason for any arrangement affecting tax is the reduction of a tax liability.

The third, and most important legislative response was a sweeping overhaul of the Australian income tax system. A common feature of the tax avoidance cases at the heyday of the so-called strict literalism era was the structuring or restructuring of transactions with the aim of achieving a reduced tax burden. This was possible only because the tax law provided dramatically different outcomes for economically similar but legally different forms of transactions. For example, a gain on the sale of an asset was tax-

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most income earners. If strict literalism continues to prevail, the legislature may have no practical alternative but to vest tax officials with more and more discretion. This may well lead to tax laws capable, if unchecked, of great oppression': *Federal Commissioner of Taxation v. Westraders Pty. Ltd.* (1980) 11 ATR 24 at 40 (per Murphy J.).

[77] Detailed in the comprehensive account of the era produced by a former Commissioner of Taxation, Trevor Boucher: *Blatant, Artificial and Contrived: Tax Schemes of the 70s and 80s* (Canberra: Australian Taxation Office, 2010), available at: http://www.ato.gov.au/super/content.aspx?menuid=39504&doc=/content/00244226.htm&page=3#P63_15145 (accessed on 8 March 2013). The second half of the 1970s saw a proliferation of evasion building upon successful avoidance schemes, the most famous of which were the 'bottom of the harbour' schemes that built upon dividend stripping schemes to avoid both primary company tax and tax on shareholder's gains; see further Richard Krever, *Tax Reform in Australia: Base-Broadening Down Under*, 34(2) Can. Tax J. 346, 369–375 (1986); see also Arie Freiberg, *Enforcement Discretion and Taxation Offences*, 3(1) Austl. Tax F. 55, 89 (1986), suggesting that the Australian Taxation Office to that time had 'sought the speedy and cost-effective resolution of problems at the cost of legitimating tax deviance'.

[78] Section 15AA of that Act now says: 'In interpreting a provision of an Act, the interpretation that would best achieve the purpose or object of the Act (whether or not that purpose or object is expressly stated in the Act) is to be preferred to each other interpretation.'

[79] See *Federal Commissioner of Taxation v. Westraders Pty. Ltd.* (1980) 11 ATR 24 at 25 (per Barwick C.J.).

[80] Commonly called Part IVA (four A), based on its location in the *Income Tax Assessment Act 1936*. See discussion of Australia's general anti-avoidance rule (GAAR) in Richard Krever and Peter Mellor, 'Australia', in Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch and Claus Staringer (eds), *GAARs: A Key Element of Tax Systems in the Post-BEPS World* (Amsterdam: IBFD Publications, 2016), p. 45.

free if characterized as a capital gain and fully taxed at marginal rates if characterized as business profits from a one-off business-like transaction. Arrangements could be made to achieve either characterization and taxpayers found judges sympathetic to their de facto elections. The same was true of taxpayers extracting company profits by way of dividend stripping schemes that recharacterized fully taxable dividends as tax-free capital gains and taxpayers entering into a host of other arrangements designed to move arrangements across undefined borders or sharp divides with no economic substance.

Reforms adopted in the 1980s including adoption of a full company and shareholder imputation system that removed the double taxation of company profits distributed as dividends, inclusion of capital gains in the income tax base (albeit on an indexed cost base until 1999 and then on a half-inclusion basis), adoption of a comprehensive fringe benefits tax regime, replacement of the exemption for most foreign-source income with a comprehensive foreign tax credit system, the later adoption of attribution rules for income from investments in controlled foreign companies, trusts and investment funds in low tax jurisdictions, and implementation of a partial accruals regime for interest and interest substitutes, have greatly reduced the opportunities for game-playing by rearranging the legal form or character of a transaction to attract lower or nil tax rates. Some of the reform measures are remarkably complex, however, and the complexity has opened new avoidance opportunities that taxpayers, particularly large corporate taxpayers, have been able to exploit with some success.

The amendment of the *Acts Interpretation Act* to mandate 'purposive' interpretation of legislation and adoption of the replacement general anti-avoidance provision in 1981 helped shift the pendulum from the zenith of strict literalism it had reached, prompting the courts to read legislation generously where the purpose was clear, even if the language of the law was not.[81] It remained the case, however, that where the legislature knowingly left gaps in the tax law and declined to delineate the borders of those gaps, the judges very often adopted interpretation techniques endorsing taxpayers' choices, throwing responsibility back to the legislature to tackle the politically sensitive issues it had sought to avoid.[82]

In recent years, as a general rule, where a transaction has no economic basis other than to generate tax benefits that will yield an after-tax profit from a pre-tax loss, courts recognize an abuse of the law and interpret substantive provisions or the general anti-avoidance sections to deny the tax benefits (deductions, exemptions, rollovers, deferrals, etc.) sought. At the same time, the courts have continued to respect the legitimacy of taxpayer choice where the law provides alternative tax treatments for

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[81] For example, in *Cooper Brookes (Wollongong) Pty. Ltd. v. Federal Commissioner of Taxation* (1981) 147 CLR 297 the High Court departed from apparently defective wording in a statute to achieve a legislative intent and policy otherwise clear from the law. The case was decided when the 'purposive interpretation' amendments to the *Acts Interpretation Act* were before the Parliament.

[82] For example, in *ANZ Savings Bank Ltd. v. Federal Commissioner of Taxation* (1993) 25 ATR 369, the taxpayer bank redrafted a standard blended loan agreement (a loan with equal payments comprising a diminishing interest component and increasing principal repayment component over the life of the loan) as a fixed term 'annuity' to take advantage of a rule that allowed banks to defer recognition of interest if the loan took the form of an annuity. The Full Federal Court allowed the taxpayer to structure the loan as an annuity and take advantage of the generous recognition rules for annuities. The decision forced the legislature to withdraw the concessional treatment of fixed term annuities.

legally different and economically similar transactions. Accordingly, the courts tend to deny the tax authority the ability to argue either substantive grounds or to invoke the general anti-avoidance measure if a taxpayer can show that valid economic objectives lay behind an impugned transaction that was carried out in a manner that sought to achieve the most favourable tax outcome.[83] Amending legislation adopted in June 2013 was intended to extend the reach of the general anti-avoidance provisions to any transactions implemented in a particular way with the aim of avoiding tax even if there is a sound commercial goal to the transaction. It remains to be seen, however, whether the amending legislation will achieve its intended goal if the taxpayer can show that the primary purpose of the transaction was to achieve a legitimate commercial outcome, with the tax benefits from a particular form of the arrangement arising only because the tax law provides alternative rules for legally different but economically similar undertakings.

[D] 'Plain English' and Principle-based Drafting of the Income Tax Legislation

While technical changes to the tax law in the 1980s largely stemmed the extremes of tax avoidance Australia had experienced in the second half of the 1970s and changing judicial approaches in the 1980s showed a clear retreat from excessive literalism, concern remained over the difficulties judges faced in finding the 'purpose' of sections from the words in the provisions. At the same time, the many changes to the law in the 1980s had expanded the legislation to several volumes of printed text and both taxpayers and tax administrators found the growing complexity daunting. The government, through the Australian Taxation Office, initially resisted the notion of simplified drafting, claiming plain English lacked the precision needed for the technicality of the tax law. Outside the Taxation Office, support for simplified language grew and a project undertaken by the Law Reform Commission in the State of Victoria to redraft a division of the income tax law in 'plain English' showed how much simpler the law could be while retaining technical accuracy.[84]

Finally, in late 1993, the government announced a project to 'simplify' the tax legislation by re-drafting the principal law in plain English. The project was funded to last three years from 1994 but the first tranche of redrafted law did not appear until 1997, when the project was originally scheduled to wind up. The tax and drafting experts seconded to the Taxation Law Improvement Project, as it became known, spent more than a year researching best drafting practice before sitting down to prepare the initial drafts using plain English and 'principle-based drafting' techniques. The process was a long one and sixteen years and many tranches later, there remain parts of the old law yet to be redrafted into the 1997 version.

While the structure of the 1997 law was very different from that of the predecessor legislation, most of the key terms in the earlier law with meanings based on judicial interpretations were used again in the

[83] See, for example, *Mills v. Federal Commissioner of Taxation* [2012] HCA 51; 250 CLR 171; 83 ATR 514. See also A.H. Slater, *Part IVA: An International Perspective*, 42(3) Austl. Tax Rev. 149 (2013).

[84] The Division redrafted in plain English by the Law Reform Commission Victoria in 1992 provided accruals recognition of deep discounts and the imputed interest component on zero coupon debt: see Law Reform Commission of Victoria, *Redraft of Division 16E of Part III of the Income Tax Assessment Act 1936* (Melbourne, 1992).

new law to ensure continuity of the meaning given by the courts. To reinforce this intended outcome, a general statutory interpretation rule was also introduced in 1987 to provide that an idea expressed in an Act shall not be taken to have been changed as a result of the use of a 'different form of words for the purpose of using a clearer style' in a later Act.[85]

The new law, in the initial tranches at least, but no longer, used simpler construction and ordinary words and was generally accessible to non-tax experts, a group that would include the vast majority of judges sitting on the benches deciding tax cases. Some confusion, enduring to the present, resulted from the assertion by proponents of the new law that it was an example of what was labelled 'principle-based drafting',[86] a claim that obscured the extent to which the new law was in fact the antithesis of actual principle-based law. Each part of the law was prefaced with a 'purpose' section that apparently explained the objective of the part but in practice these sections did nothing more than explain briefly the operation of technical rules set out in more detail in following provisions. The provisions themselves set out technical rules but rigorously avoided explaining any principles underlying the rules and the structure derailed any attempt a reader might have made to ascertain a purpose to the organization.

The problem was best illustrated with the 'capital gains' provisions in the new law. As discussed in §2.02[A] above, the Australian courts had interpreted the term 'income', the foundation concept in the main charging provision, narrowly, excluding from the judicial definition of income a wide range of gains. The original capital gains measures included in the old legislation sought to overcome this with a single charging rule that, along with a small handful of deeming measures, effectively captured all the gains that had been excluded from the judicial concept of income. The replacement 'plain English' version reverted to the drafting style that had been used (and failed) for seven decades prior to the adoption of a capital gains regime, namely piecemeal identification of transactions intended to be covered by the capital gains inclusion rules, albeit this time in plain English. Gains to be brought into the tax base were identified as capital gains tax 'events' and new ones added every time a transaction revealed a type of gain that had been missed in the previous events. The thirty-six recognition events included in the capital gains measures inserted in the new law in 1998 had been expanded to fifty-three recognition events by 2013.

Ironically, in 1986 Australia had adopted a tax law that could have served as a model for principle-based tax law design. In the course of the mid-1980s tax reform, the decision was made to tax employee benefits by way of a separate excise tax imposed on employers rather than include the value of the benefits in the employees' assessable employment income. The 'fringe benefits tax' law, as it was known, was drafted in plain English and while the structure was awkward (the charging provision was inserted at section 66 of the *Fringe Benefits Tax Assessment Act 1986*, rather than up front!), structurally the law was a model for principle-based drafting. The charging provision and associated definitions set out a clear default position imposing tax on all benefits of every kind other than salary that were

[85] *Acts Interpretation Act 1901*, s. 15AC and, similarly, *Income Tax Assessment Act 1997*, s. 1–3; see also I.M.L. Turnbull QC, *Clear Legislative Drafting: New Approaches in Australia*, 11(3) Statute L. Rev. 161, 165–166 (1990).

[86] Greg Pinder, *The Coherent Principles Approach to Tax Law Design*, Econ. Roundup 75 (Autumn, 2005).

received directly or indirectly by a past, present or future employee. The onus was thus on the taxpayer to show amounts fell into one of the explicit exemptions which were drafted to clearly delineate the limits for each concession. In contrast to the income tax law and the later GST law, the fringe benefits tax generated almost no requests for rulings or litigation, suggesting the principle-based drafting greatly simplified the task of interpreting the tax law. The income tax experience showed that the traditional Australian approach to defining a tax base using multiple separate narrow and specific rules for different transactions and different versions of transactions inevitably led to difficult to interpret borders that resulted in overlaps or lacunae in the law.

§2.03 Interpretation of GST/VAT

[A] Introduction

The goods and services tax (GST) in Australia is imposed on taxable supplies and taxable importations of goods and services[87] at the rate of 10%.[88] The GST was introduced with effect from 1 July 2000 and falls into the group of 'modern' value added tax (VAT) laws influenced by the example of the landmark New Zealand tax which was characterized by a single lower standard rate and limited exemptions, in contrast to the earlier traditional VAT laws imposed in European countries.[89]

While the Australian GST is considered to fall into the 'modern' VAT/GST camp because of its single rate and limited list of exempt supplies (called 'input taxed supplies' in the Australian legislation), in many respects it is more concessional than the dual-rate, multiple exemption European VAT laws. The Australian legislation contains a wide range of zero-rated supplies (known as 'GST-free supplies' in the Australian law) that includes food, health and education.[90] However, in line with the New Zealand

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[87] *A New Tax System (Goods and Services Tax) Act 1999* (Cth.) (GST Act), ss. 9–5 and 13–5.

[88] The GST is imposed under six separate imposition Acts so as to meet the constitutional requirements relating to imposition of different subject matters of taxation discussed in §2.01[C] above: see *A New Tax System (Goods and Services Tax Imposition – Customs) Act 1999* (Cth.), s. 4; *A New Tax System (Goods and Services Tax Imposition – Excise) Act 1999* (Cth.), s. 4; *A New Tax System (Goods and Services Tax Imposition – General) Act 1999* (Cth.), s. 4; *A New Tax System (Goods and Services Tax Imposition (Recipients) – Customs) Act 2005* (Cth.), s. 4; *A New Tax System (Goods and Services Tax Imposition (Recipients) – Excise) Act 2005* (Cth.), s. 4; *A New Tax System (Goods and Services Tax Imposition (Recipients) – General) Act 2005* (Cth.), s. 4. For further discussion of the introduction of GST in Australia, see Kathryn James, *The Rise of the Value-Added Tax* (New York: Cambridge University Press, 2015), ch. 6.

[89] See Rita de la Feria and Richard Krever, 'Ending VAT Exemptions: Towards a *Post*-Modern VAT', in Rita de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (Alphen aan den Rijn: Kluwer Law International, 2013), pp. 3, 4, citing L. Ebrill, M. Keen, J.-P. Bodin and V. Summers, *The Modern VAT* (Washington, DC: International Monetary Fund, 2001).

[90] Of the taxes in the modern group, 'few have adhered as closely as New Zealand' to the principle of allowing no concessional exemptions from the tax base; in Australia's case in particular, there are 'many important gaps in the base as a result of what is quite probably the widest scope of GST-free (zero-rated) supplies of any VAT/GST system': Richard Krever, Book Review: *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems Around the World* (T. Ecker, M. Lang and I. Lejeune, eds, Wolters Kluwer, 2012), 12(4) Austl. GST J. 186 (2012). As a result of '[c]onsumer caution and changes in spending patterns', the

precedent, it is comprehensive in its reach to all commercial and public entities so that government departments, charities and other bodies can register and claim potentially refundable input tax credits in the same manner as commercial enterprises.

[B] Approaches to Interpretation

A key issue which arose at an early stage in the application of the GST legislation[91] was the extent to which the legislation should be interpreted according to the broad economic principles of a value added tax, to ensure that the GST is viewed as a tax on consumption and, as a corollary, that the tax is borne by consumers rather than the businesses involved in the supply chain under a principle of 'fiscal neutrality'.[92]

An important consideration in this regard was that the government's Explanatory Memorandum which accompanied the original Bill for the GST prefaced its discussion of the tax with the broad statements that GST 'is effectively a tax on final private consumption in Australia' and is 'effectively borne by consumers when they acquire anything to consume'.[93] The GST legislation itself, by contrast, did not contain an express statement of purpose to this effect along the lines of the introductory provision of the European Union's Directive governing the value added tax system in its Member States, which (although not restricted to 'final' consumption) states that VAT is 'a general tax on consumption'.[94]

Before the courts had an opportunity to hear any appeals of GST assessments, a large number of cases concerning the application of the law were decided in the civil courts in the context of tort and contract cases – litigants arguing over whether GST was payable on supplies and should be or should not be included in amounts due under contracts or damages for tortious wrongs or breaches of contracts, and so forth. As these disputes did not involve assessments of tax liability, the Commissioner of Taxation was not party to the litigation and as a result, the initial interpretation of the GST legislation by the civil courts took place with no input from tax authorities.

GST revenue pool has declined to the extent it has been described by the New South Wales government as a 'structural and significant collapse': New South Wales Treasury, *Budget Paper No. 2, Budget Statement 2012-13* (2012), p. 1-1.

[91] See in particular the discussion by Justice Graham Hill in *Some Thoughts on the Principles Applicable to the Interpretation of the GST*, 6(1) J. Austl. Tax'n 1, 25–31 (2003).

[92] Peter Hill, 'Taxation of Goods and Services in Australia: Past, Present, and Future', in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Sydney: Thomson, 2009), pp. 547, 557–561; Michael Evans, 'Commentary: Taxation of Goods and Services in Australia', in Chris Evans and Richard Krever (eds), *ibid.*, pp. 563, 568–571, referring for example to the comments of the European Court of Justice in *Abbey National plc v. Customs and Excise Commissioners* (Case C-408/98) [2001] ECR I-1361. See also Rebecca Millar, *What's VAT Got to Do With It?*, 12(3) Austl. GST J. 99, 104–106 (2012), discussing the observations of Justice Hill in *HP Mercantile Pty. Ltd. v. Federal Commissioner of Taxation* [2005] FCAFC 126; 60 ATR 106.

[93] Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1998, p. 6.

[94] Currently Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, Article 1(2). See discussion in Chapter 5 of this volume.

The early cases had the effect of seriously narrowing the GST base by reading into the legislation a requirement that the supplier must take an active role in making the supply for it to satisfy the definition of a taxable supply.[95] Thus, if the supply were the consequence of an expropriation by a government authority (when the supplier was a passive supplier)[96] or a consequence of a court order,[97] the supply would not be viewed as a taxable supply by the court. Among other things, this meant the supplier, even if it was registered and had been paid a tax-inclusive value for the supply, would not have to remit any GST, yielding a windfall for the supplier and a detriment to the buyer who would not be able to claim input tax credits despite having paid the tax-inclusive value for the supply.

These non-tax cases interpreting GST law had a dramatic effect on the interpretation of the GST when the reasoning set out in the cases was accepted by the Australian Taxation Office (ATO) and incorporated into its private rulings for taxpayers.[98] The ATO subsequently decided, for example, that there would be no taxable supply if a former employer made a payment to a new employer to cover the costs that the new employer would automatically (and involuntarily) incur as a result of state employment law.[99] The tax authority became so enamoured with the logic of these 'no active supply' decisions that it even extended the reasoning to cases where taxpayers deliberately put themselves into a position that would require them to make a 'passive' supply. The ATO ruled, for example, that there was no taxable supply in the case of a supply that followed automatically in respect of an expired commodities future contact even though the arrangement followed an agreement by the supplier and was not a consequence of government or court compulsion.[100]

Two appeal decisions from mid-2005 were to prove of significant importance in guiding subsequent approaches to judicial reasoning in GST cases. The lead judgment by Hill J. in the first of these, the *HP Mercantile* case,[101] explained in detail the theory behind the GST – a multi-stage tax that was ultimately borne by final consumers only as a result of input tax credits that ensured there would be no cascading of tax prior to the supply to a final consumer. The approach reflected the principles set out in the Explanatory Memorandum prepared by the government to explain the purpose of the GST law when it was first submitted to Parliament. The Explanatory Memorandum introduced the GST as a tax on final

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[95] See further Peter Edmundson, *GST and Involuntary Supplies*, 6(2) J. Austl. Tax'n 224 (2003); Christopher Sievers, *GST and Compulsory Acquisitions of Land: Can You Have an 'Involuntary Supply'?*, 12(4) Austl. GST J. 165 (2012); Richard Krever, *Involuntary and Statutory Supplies – The Australian GST Base Narrows*, 16(1) Int'l VAT Monitor 19 (2005).

[96] *CSR Ltd. v. Hornsby Shire Council* [2004] NSWSC 946; 57 ATR 201.

[97] See, for example, *Shaw v. Director of Housing and State of Tasmania (No. 2)* [2001] TASSC 2; 46 ATR 242; *Walter Construction Group Ltd. v. Walker Corporation Ltd. & Ors.* [2001] NSWSC 283; 47 ATR 48; and *Interchase Corporation Limited v. ACN 010 087 573 Pty. Ltd. & Ors.* [2000] QSC 13; 45 ATR 445.

[98] ATO ID 2003/1172, ATO ID 2003/1173.

[99] ATO ID 2002/1078.

[100] ATO ID 2004/359.

[101] *HP Mercantile Pty. Ltd. v. Federal Commissioner of Taxation* [2005] FCAFC 126; 60 ATR 106.

consumption, collected via business. The second decision, the *Sterling Guardian* case, took a different approach. At first instance, the single judge hearing the case described the GST as a 'practical business tax', imposed on commercial transactions,[102] a conclusion endorsed by a higher court on appeal from the decision of the single judge,[103] with the appeal judgment explicitly rejecting the notion of the GST being a tax on consumption, ironically citing the *HP Mercantile* decision as authority for that conclusion.

Ultimately, with only a few exceptions, the second view prevailed in first instance and lower level appeal courts (but not in the High Court, as detailed further below),[104] with a narrow interpretation that read the GST legislation as a tax on business rather than consumption.[105] A court concluded, for example, that a supply of foreign currency to a customer exiting the country was a taxable supply while the policy intent of the GST law was arguably to treat the transaction as a GST-free (zero-rated) export.[106] In another case, the court found the tax office had no authority to delay a refund of GST where input tax credits exceeded output tax even when the tax authority was investigating the legitimacy of the transactions.[107] In a third case, the court allowed the full recovery of input tax by an agency paying part of the cost of taxi fares for a group of subsidized consumers, effectively eliminating the GST on the final consumption acquired with the payments.[108] In another case, the court found a business made no taxable supply when it provided a contract for sale of property and retained the deposit when the buyer failed to proceed with the transaction[109] and in a further and not dissimilar case an appeal court found an airline had made no taxable supply when it retained payments for non-refundable discount airfares if the customer failed to board the flight even though the customers clearly acquired the rights they had sought with the discount fares.[110] In a case concerning a series of rebates provided by a manufacturer to

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[102] *Sterling Guardian Pty. Ltd. v. Federal Commissioner of Taxation* [2005] FCA 1166; 60 ATR 502.

[103] [2006] FCAFC 12; 60 ATR 119.

[104] One exception was *Saga Holidays Ltd. v. Federal Commissioner of Taxation* [2006] FCAFC 191; 64 ATR 602 (Federal Court of Appeal). The appeal court in that case rejected the taxpayer's argument that the supply of hotel accommodation in Australia was a tax-free export if sold through foreign travel agency packages when it was clear the consumption of the hotel services takes place in Australia.

[105] In *Sterling Guardian Pty. Ltd. v. Federal Commissioner of Taxation* [2006] FCAFC 12; 62 ATR 119 (Federal Court of Appeal) at [10]–[15], the Court said, 'In economic terms it may be correct to call the GST a consumption tax, because the effective burden falls on the ultimate consumer. But as a matter of legal analysis what is taxed, that is to say what generates the tax liability (and the obligations of recording and reporting), is not consumption but a particular form of transaction, namely supply; see generally *HP Mercantile Pty. Ltd. v. Commissioner of Taxation*.'

[106] *Travelex Ltd. v. Federal Commissioner of Taxation* [2009] FCAFC 133; 73 ATR 463 (Federal Court of Appeal).

[107] *Federal Commissioner of Taxation v. Multiflex Pty. Ltd.* [2011] FCAFC 142; 82 ATR 153 (Federal Court of Appeal).

[108] *Federal Commissioner of Taxation v. Secretary to the Department of Transport (Victoria)* [2010] FCAFC 84; 76 ATR 306 (Federal Court of Appeal).

[109] *Reliance Carpet Co. Pty. Ltd. v. Federal Commissioner of Taxation* [2007] FCAFC 99; 66 ATR 117 (Federal Court of Appeal).

[110] *Qantas Airways Limited v. Federal Commissioner of Taxation* [2011] FCAFC 113; 81 ATR 816 (Federal Court of Appeal).

an unrelated retailer based on sales of the manufacturers' products, the court concluded the payments were gifts and not consideration for supplies where the rebates were not expressly included in the dealership agreement.[111]

The narrow approach adopted by first instance and lower appeal courts has not been endorsed by the High Court, Australia's final court of appeal. The High Court has accepted the *Sterling Guardian* view that the GST may be a consumption tax in an economic sense but falls on supplies, not consumption in a legal sense, but nevertheless has interpreted the law in a manner consistent with the broader policy goal of the GST as a consumption tax. For example, the Court reversed the lower decision on currency conversion services to find no GST was payable on currency conversion services where the benefit of the service was enjoyed outside Australia.[112] Similarly, it reversed lower appeal court decisions on non-refundable deposits, concluding GST was payable where suppliers had received and kept deposits for the cancelled purchase of land and airline flights.[113]

It remains to be seen whether the broader purposive path apparently taken by High Court will permeate through to the lower level appeal and first instance tribunals. The assertion that the GST is a 'practical business tax' has been repeated time and again in GST cases but the impact of the business tax analogy on judicial analysis may yet prove to be limited. The outcomes in High Court decisions suggest there is room for interpretation that yields outcomes consistent with the GST being a tax on consumption despite the language suggesting it is a tax on business.[114]

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[111] *KAP Motors Pty. Ltd. v. Federal Commissioner of Taxation* [2008] FCA 159; 68 ATR 927 (Federal Court).

[112] *Travelex Ltd. v. Commissioner of Taxation* was reversed by the High Court at [2010] HCA 33; 241 CLR 510; 76 ATR 329.

[113] *Reliance Carpet Co. Pty. Ltd. v. Commissioner of Taxation* was reversed by the High Court at [2008] HCA 22; 236 CLR 342; 68 ATR 158; *Commissioner of Taxation v. Qantas Airways Ltd.* was reversed at [2012] HCA 41; 247 CLR 286; 83 ATR 1. The logic of the decision in *Reliance Carpet* was explored further by the High Court in *Commissioner of Taxation v. MBI Properties Pty. Ltd.* [2014] HCA 49, 254 CLR 376. For further discussion of the *Reliance Carpet*, *Travelex* and *Qantas Airways* cases, see Richard Krever and Jonathan Teoh, *Justice Edmonds and interpretation of Australia's GST legislation*, 45(2) Austl. Tax Rev. 121 (2016).

[114] On the discussion of the 'practical business tax' arguments by the High Court in reaching its decision in *Travelex*, see also M. Wigney SC, *Text, Context and the Interpretation of a 'Practical Business Tax'*, 40(2) Austl. Tax Rev. 94, 102–105 (2011) and Justice Richard Edmonds, *Interpretation of s 11–15: Significance of the Text, Context and History*, 12(3) Austl. GST J. 79, 81–83 (2012). A senior tax official, perhaps hopeful that the High Court unwinding the narrow 'practical business tax' outcomes of lower courts will become the norm, has described the approach as one that is consistent with general principles of statutory interpretation. See Robert Olding, 'Interpretation of the GST Act – Towards a Principled Basis?', in Christine Peacock (ed.), *GST in Australia: Looking Forward from the First Decade* (Sydney: Thomson, 2011), pp. 77, 88–91. The Explanatory Memorandum prepared by the government to accompany a recent amendment Act, the *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Act 2016*, stated: 'The GST is a multistage tax with input tax credits (ITCs) generally available to businesses to prevent cascading of GST through each stage of production and to ensure that the incidence of the GST falls upon private consumption ...' (p. 67).

[C] Interpretation: Some Specific Instances

[1] The Transitional Provisions and Long-term Contracts

The application of the GST law to long-term contracts that had commenced prior to the introduction of the tax was controlled by a separate transitional law which deemed supplies made under pre-GST contracts to be zero-rated (GST-free in Australian terminology) until the earlier of five years after the introduction of the GST and the first review opportunity allowed under the contract.[115] The legislation did not define what constituted a review opportunity and the issue generated litigation between taxpayers and the tax office and between suppliers and customers when suppliers interpreted contracts as allowing price adjustments to include the new tax.[116]

Ultimately the results in the cases turned on the specific language in each contract, making it difficult to apply decided cases as precedents. While the confusing case law had been described as 'a minefield' for practitioners in this area[117] and the analysis often appears to be based on legalistic interpretation of private law features in contracts,[118] as well as precise quantification of the various components of consideration payable under the contracts,[119] there is considerable evidence that behind the legalism courts are very much aware of a guiding principle, namely the 'fundamental premise of the GST Act that a supplier is entitled, and indeed expected, to pass on to the recipient of the supply the burden of the GST'.[120] As a general rule, where the contract provides leeway for an alteration of consideration payable at a particular time or upon a particular event, the occasion will not be treated as a review opportunity if the terms of the contract would prevent the supplier from adding the full value of GST to the

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[115] *A New Tax System (Goods and Services Tax Transition) Act 1999* (Cth.), s. 13. The rule was based on the earlier New Zealand transition rule: *Goods and Services Tax Act 1985* (N.Z.), s. 85. In contrast to the New Zealand legislation, however, a provision for recovery of GST after the five year period under long-term contracts was not included in the original legislation, and a rule for payment of GST by recipients under such contracts was only added after commencement of the tax, under amendments made shortly before the end of the period of transitional relief in 2005.

[116] A case typical of long lease disputes between private parties is *Westley Nominees Pty. Ltd. v. Coles Supermarkets Australia Pty. Ltd.* [2006] FCAFC 115; 62 ATR 682.

[117] Chris Bevan, *GST on Long-Term Non-reviewable Contracts: Unresolved Transitional Problems*, 9(1) The Tax Specialist 28, 30 (2005).

[118] An example is *Federal Commissioner of Taxation v. DB Rreef Funds Management Ltd.* [2006] FCAFC 89; 62 ATR 699, which characterizes supplies and payments under a lease.

[119] A payment which could not be reviewed amounting to 17% of the total consideration prevented a finding that there had been an opportunity for a general review, but a payment amounting to 3% of the total did not: *Federal Commissioner of Taxation v. DB Rreef Funds Management Ltd.* [2006] FCAFC 89; 62 ATR 699 at 715 and *MTAA Superannuation Fund (R. G. Casey Building) Property Pty. Ltd. v. Federal Commissioner of Taxation* [2012] FCAFC 89.

[120] *Federal Commissioner of Taxation v. DB Rreef Funds Management Ltd.* [2006] FCAFC 89; 62 ATR 699, referring also to *ACP Publishing Ltd. v. Federal Commissioner of Taxation* [2005] FCAFC 57; 59 ATR 98; see also *Westley Nominees Pty. Ltd. v. Coles Supermarkets Australia Pty. Ltd.* [2006] FCAFC 115; 62 ATR 682.

consideration otherwise payable at that time. It seems contractual terms are being interpreted to achieve outcomes consistent with the policy objectives of the GST law.

[2] Exemptions and Classifications

In the GST, as in all tax laws, many disputes arise in respect of transactions that fall near the statutory borderlines describing taxable and non-taxable events. For example, the GST law generally imposes a 10% rate of tax but food is zero-rated. A number of cases consider whether particular supplies do or do not constitute food. Similarly, the ordinary rate applies to most supplies of immovable property but supplies of some types of residential premises are specified as exempt (input taxed) supplies and there are many cases on the character of premises.

While it may be possible to speculate on the broad objectives underlying concessional treatment of particular types of supplies, arguments about the merits of legalistic or literal interpretation, on one hand, and purposive interpretation, on the other, have no meaning where there are no signposts as to where particular supplies might fit within the general policy goals. Faced with borderlines that have not been clearly delineated by the legislature, courts must turn to other doctrines to classify transactions or supplies.

One approach is to adopt classifications or interpretation doctrines used in older laws on the assumption that by repeating distinctions used in past laws, the legislature was implicitly accepting the borders that had been drawn by courts when those predecessor laws had been applied. Reliance on this approach has been particularly noticeable in cases involving the definition of zero-rated (GST-free) food. For example, courts have referred to sales tax case law in the course of reaching decisions under the GST that a blackcurrant syrup product was not a beverage or ingredient 'of a kind marketed principally as food for infants',[121] that carbonated fruit juice drinks with 1% to 2% additives were not GST-free as 'non-alcoholic carbonated beverages [consisting] wholly of juices of fruits',[122] and that a product labelled by the manufacturer as Italian 'Mini Ciabatte' product was to be classified as a cracker, one of a list of items carved out of the general concession for food for human consumption.[123]

Another approach is for courts to recognize explicitly the political motivation for concessions and interpret cases on the basis of the political aims behind the law. For example, acknowledgement that the GST concession for food was the result of a 'political deal that gave partial exemption to food' paved the way for courts to interpret terms in the law using 'ordinary' or lay usage rather than consider the technical or industry meaning of terms.[124] In Australian law, an individual less than 18 is an 'infant' in terms of legal capacity for many purposes but clearly the layperson considering whether drinks are

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[121] *Cascade Brewery Company Pty. Ltd. v. Federal Commissioner of Taxation* [2006] FCA 821; 64 ATR 28.

[122] *P. & N. Beverages Australia Pty. Ltd. v. Federal Commissioner of Taxation* [2007] NSWSC 338; 65 ATR 391.

[123] *Lansell House Pty. Ltd. v. Federal Commissioner of Taxation* [2011] FCAFC 6; 79 ATR 22.

[124] *Cascade Brewery Company Pty. Ltd. v. Federal Commissioner of Taxation* (2006) 64 ATR 28. See also the finding of a policy that 'basic fare should be GST-free', in *JMB Beverages Pty. Ltd. v. Federal Commissioner of Taxation* [2009] FCA 668; 73 ATR 191.

marketed principally as food for infants would have a very different view of an infant and on this basis would no doubt have reached the same conclusion as the court that blackcurrant syrup product that might be popular with younger persons was not a beverage or ingredient of a kind marketed principally as food for infants, or similarly that de-alcoholized wine is not fruit juice.[125] And while the manufacturer of Mini Ciabatte may label the product 'Italian flat bread', the fact that supermarkets stock the product on the shelves with crackers can be a more powerful and independent indicator of whether the consumers regard the product as being of the same kind as taxable crackers rather than non-taxable bread.[126] Put simply, the interpretation of items in terms of tax classifications adopted with lay usage in mind should not involve 'over-elaborate, almost mind-numbing, legal analysis'.[127]

A third approach adopted by courts when interpreting terms denoting a taxable or exempt borderline is to consider the practical administrative impact of the alternatives rather than focus on the effect of characterization on the final price of supplies. This approach is evidenced in cases requiring the interpretation of the provision that treats the supply of residential premises that are 'to be used predominantly for residential accommodation ...' as exempt (input taxed) supplies.[128] Read literally, the reference to the use to which property is to be put implies a responsibility for the supplier to know the intention of the customer to determine whether GST is payable on the supply and in an early case involving a residential house and land marketed as a development site, a State court hearing a civil dispute relating to the sale of the property concluded that 'it does not accord with the natural meaning' of the provisions to determine the issue solely by reference to the physical characteristics of the property without also taking the purchaser's intention into account.[129] From an administrative perspective, however, this approach would have been unworkable in most cases. One of the principal advantages of the GST is the simplicity for the supplier who can calculate the tax liability by looking at the supply, without the need to know anything about the customer's status as a registered or not registered person or whether the supply will be used for taxable or private purposes. No doubt cognizant of these considerations, courts considering the question in the context of tax appeals have adopted a more pragmatic approach, interpreting the provision so the supplier can determine whether property is to be used for residential accommodation from its physical characteristics.[130]

§2.04 Treaties

[125] *JMB Beverages Pty. Ltd. v. Federal Commissioner of Taxation* [2010] FCAFC 68; 76 ATR 76.

[126] *Lansell House Pty. Ltd. v. Federal Commissioner of Taxation* [2011] FCAFC 6; 79 ATR 22.

[127] *Lansell House Pty. Ltd. v. Federal Commissioner of Taxation* [2011] FCAFC 6; 79 ATR 22 at 28–29, citing *Procter & Gamble U.K. v. Revenue and Customs Commissioners* [2009] STC 1990 at [14].

[128] GST Act, s. 40–65.

[129] *Toyama Pty. Ltd. v. Landmark Building Developments Pty. Ltd.* (2006) 62 ATR 73 at 90–91.

[130] See, for example, *Sunchen Pty. Ltd. v. Federal Commissioner of Taxation* [2010] FCAFC 138; 78 ATR 197.

[A] Background

Australia maintains an extensive network of taxation treaties,[131] developed since the conclusion of its first such agreement with the UK, in 1946. The executive government of the Commonwealth has power to enter into treaties, and an approach of 'strict dualism' generally requires a legislative enactment by the Parliament for treaties to take effect in domestic law.[132] Proposed treaty actions are subject to review by the Joint Standing Committee on Treaties of the Parliament before action is taken to bind Australia to the treaty at international law, and consultation in relation to treaty matters also takes place through a further standing committee comprising Commonwealth and State officials.[133]

[B] Interpretation of Australia's Taxation Treaties

Australia's income tax law and tax treaties are reconciled by the incorporation of the income tax law[134] and all tax treaties into a single International Tax Agreements Act[135] that provides in the event of inconsistency between the tax law and the treaties, apart from the application of the general anti-avoidance rule in the income tax law, the terms of the treaties prevail.[136]

Australia is a signatory to the Vienna Convention on the Law of Treaties and the Convention governs the interpretation of tax treaties in the same manner as all other international agreements. Australian courts regard the Vienna Convention as reflecting customary interpretation rules and therefore the interpretation rules in the Convention also apply to the interpretation in Australia of a taxation treaty with a country that is not party to that Convention.[137] Reference can be made to the OECD Commentaries as 'supplementary means of interpretation' for the purposes of Article 32 of the Vienna Convention.[138] Significantly, Australian courts have explicitly endorsed a 'purposive' approach to the interpretation of treaties, looking beyond the words (which of course remain the primary consideration)

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[131] For an analysis of the provisions of Australia's treaties, see Kathrin Bain, Richard Krever and Anthony van der Westhuysen, *The Influence of Alternative Model Tax Treaties on Australian Treaties*, 26(1) Austl. Tax F. 31 (2011).

[132] See Alice de Jonge, 'Australia', in Dinah Shelton (ed.), *International Law and Domestic Legal Systems: Incorporation, Transformation, and Persuasion* (Oxford: Oxford University Press, 2011), pp. 23, 26–28, discussing also (pp. 42–50) the role of customary rules and principles of international law in relation to Australian law.

[133] De Jonge, *supra* note 132, pp. 29–31.

[134] *Income Tax Assessment Act 1936* and Income *Tax Assessment Act 1997*.

[135] *International Tax Agreements Act 1953* (Cth.), s. 4(1).

[136] *International Tax Agreements Act 1953*, s. 4(2).

[137] *Thiel v. Federal Commissioner of Taxation* [1990] HCA 37; 171 CLR 338. This approach was applied recently by the Federal Court, for example, in a case involving the taxation treaty of 1991 between Australia and India (the latter country not a party to the Vienna Convention): see *Tech Mahindra Ltd. v. Federal Commissioner of Taxation* [2016] FCAFC 130 at [22].

[138] *Thiel v. Federal Commissioner of Taxation* [1990] HCA 37; 171 CLR 338.

to the broader object and purpose of the treaties.[139] They recognize this may mean that questions of interpretation arising under tax treaties may follow a more liberal approach to interpretation than would be adopted where all that was involved was a question of construction of domestic law.[140] A court will not, however, read a treaty in a manner that is wider than the clear words in the treaty. For example, a definition of real property that includes shares in a company with assets that consist wholly or principally of direct interests in land would not be read as catching interests in a company with indirect interests in land by virtue of ownership of another land-rich company.[141]

A primary purpose of tax treaties is to eliminate double taxation by requiring residence countries to provide credits for any tax levied on the income by the source country or to exempt the income from residence country taxation where it has first been taxed in the source jurisdiction. The relief only applies to prevent double 'juridical taxation', where both jurisdictions seek to tax the same person on the same income, one on the basis of the person's residence in the jurisdiction and the other because it claims the income had a source in the jurisdiction. Australian judicial interpretation follows the commonly accepted view that the treaties do not require residence countries to provide relief for double 'economic taxation' where each jurisdiction taxes a different entity on the same income. For example, if a foreign jurisdiction taxes a company resident in that jurisdiction on Australian source income while Australian law treats the individual resident in Australia who provided the actual services to the customer as the person deriving the income, an Australian court will not support the individual's bid to use a tax treaty to prevent the double taxation.[142]

The judicial process of interpreting treaties is similar to that employed when considering domestic legislation, starting with the words in the treaty and considering precedents and judicial authority for the meaning of terms used. While authority is drawn primarily from precedents considering treaties, there may also be regard to cases interpreting similar concepts in domestic law and authorities may be used in the same creative way, including drawing upon *obiter* in a precedent (conclusions or

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[139] *Applicant A v. Minister for Immigration & Ethnic Affairs* [1997] HCA 4; 190 CLR 225, endorsed in *Federal Commissioner of Taxation v. Lamesa Holdings B.V.* [1997] FCA 785; 36 ATR 589 at 595–596 and *McDermott Industries (Aust.) Pty. Ltd. v. Federal Commissioner of Taxation* [2005] FCAFC 67; 59 ATR 358.

[140] Justice Graham Hill, *The Interpretation of Double Taxation Agreements – The Australian Experience*, 57(8) Bull. Int'l Tax'n 320, 323 (2003).

[141] See, for example, *Federal Commissioner of Taxation v. Lamesa Holdings B.V.* (1997) 36 ATR 589. Some Australian treaties provided explicitly for direct and indirect ownership of land through interposed entities. The legislature's response to the *Lamesa* decision was a treaty override measure that deemed all references in Australia's treaties to interests in companies with direct interests in land to mean interests in companies with direct and indirect interests in land! See *International Tax Agreements Act 1953*, s. 3A.

[142] *Russell v. Federal Commissioner of Taxation* [2011] FCAFC 10; 79 ATR 31.

assumptions by the court not central to the decision) as authority for a proposition that is at the core of a later decision.[143]

Interestingly, a different approach has been taken to interpreting domestic law where interpretations of the treaty counterparts are available. For example, interpretation of transfer pricing adjustments allowed under tax treaties may take into account the transfer pricing guidelines prepared by the OECD to explain the operation of the adjustment rule in the model treaty.[144] In a recent case involving the application of the domestic transfer pricing rule, the court ruled that no regard could be had to the guidelines manual when interpreting the domestic law,[145] prompting a legislative amendment to specify that the guidelines are to be consulted when applying domestic law.[146]

The ongoing international law debate over 'ambulatory' or 'static' interpretations of treaties has not been decided definitively in respect of Australian tax treaties, though the courts appear to take a broadly 'ambulatory' approach to interpreting fundamental provisions in treaties. This is illustrated in the key decision on the tax authority's assertion that income tax treaties enacted prior to the inclusion of capital gains in the tax base have no application to later assessments of capital gains by non-residents. The assertion rests on an argument that the capital gains measures in the income tax law amount to a completely different tax from the income tax, and treaties that applied to income tax law therefore did not cover future capital gains tax measures. The foundation of the argument is the exclusion of all capital gains from the judicial concept of income for tax purposes. The penultimate court of appeal has rejected this argument, concluding that, for treaty purposes, the income tax extended to amounts that were outside the strict meaning of the term 'income' for tax law purposes.[147] The decision parallels the approach taken by the court for constitutional law purposes where courts have decided

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[143] An example is the decision in *McDermott Industries (Aust.) Pty. Ltd. v. Federal Commissioner of Taxation* (2005) 59 ATR 358 considering the meaning of permanent establishment under the Australia–Singapore tax treaty, where the court looked at a precedent that considered the meaning of permanent establishment under domestic law (the starting point for the definition of permanent establishment in both the domestic law and treaties is the definition in the OECD model). The precedent relied upon, *Unisys Corporation Inc. v. Federal Commissioner of Taxation* [2002] NSWSC 1115; 51 ATR 386, concerned the question whether the storage of records in a location amounted to carrying on a business at the place. In the course of this judgment it was noted that the premises were rented on a temporary basis and the later case drew upon this *obiter* when considering the question of what constituted ongoing presence in the jurisdiction.

[144] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

[145] *Federal Commissioner of Taxation v. SNF (Australia) Pty. Ltd.* [2011] FCAFC 74; 82 ATR 680 at 715.

[146] *Income Tax Assessment Act 1997*, ss. 815-20, 815-135 and 815-235. The amended law at present allows reference to the guidelines as last amended on 22 July 2010; further legislation is proposed which would also allow reference to the OECD's recommended revisions to the guidelines set out in OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, October 2015).

[147] *Virgin Holdings S.A. v. Federal Commissioner of Taxation* [2008] FCA 1503; 70 ATR 478. An 'ambulatory' approach to interpretation of a tax treaty provision was also recently endorsed by the Federal Court in *Federal Commissioner of Taxation v. Seven Network Ltd.* [2016] FCAFC 70 at [83], a case involving the scope of the term 'other like property or right' for the purposes of the royalties withholding tax article of the treaty between Australia and Switzerland of 1981.

that income for constitutional law purposes will include capital gains outside the judicial concept of income as the term in the income tax law is interpreted.[148]

This is likely to be one of many treaty interpretation issues that will be developed further by the courts in the future. However, the ongoing commentary on this issue[149] remains cautious about any greater reliance on an ambulatory approach to extend the existing avenues of treaty interpretation.

§2.05 Summary

Judicial interpretation of tax legislation has had a profound effect on the development of tax law in Australia. The income tax base was determined originally by the transplanted judicial concept of 'income' on the revenue side (euphemistically called 'income according to ordinary concepts') and 'capital' on the expense side, with subsequent legislative changes respecting and building on the judicial concepts.

The many borderlines in the income tax law created opportunities for taxpayers to minimize tax by rearranging transactions and a period of narrow literal interpretation of provisions encouraged the growth of a tax avoidance industry. The resulting revenue losses and public disapproval led to dramatic legislative changes to the income tax system and the law governing statutory interpretation. The pendulum of interpretation subsequently swung back to a more moderate approach in which taxpayers' choices are respected where the law provides alternative treatments for economically similar and legally different versions of transactions, but courts invoke interpretations or allow the Commissioner to apply a general anti-avoidance provision where transactions would not be economically viable but for the tax benefits generated by the steps pursued.

The GST base was narrowed significantly by early judicial decisions interpreting key concepts in the context of civil cases at which tax authorities were not represented. Lower courts have continued to apply legalistic interpretations while ignoring the objective of taxing final consumption. The final court of appeal, the High Court, however has adopted an interpretative approach much more in alignment with the characterization of the GST as a consumption tax and this approach may gradually shift the approach of lower courts.

The judicial approach to the interpretation of treaties has been generous, looking at the underlying objectives of the law, similar to the approach adopted for the interpretation of income tax for constitutional purposes.

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[148] See, for example, *Resch v. Federal Commissioner of Taxation* (1942) 66 CLR 198; see text at *supra* notes 52 and 64.

[149] See, for example, Peter Wattel and Otto Marres, *The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties*, 43(7/8) Eur. Tax'n 222 (2003); Michael Lang and Florian Brugger, *The Role of the OECD Commentary in Tax Treaty Interpretation*, 23(2) Austl. Tax F. 95 (2008); Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge: Cambridge University Press, 2011), pp. 167–178.

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The Ironic Australian Legacy of Eisner v. Macomber

Rick Krever*

The Horticultural Horizons of Australian Income Tax Law

No metaphor is dearer to the hearts of Australian tax scholars and practitioners than the fruit and tree depiction of income and capital.[1] An important characterisation in early economic theory, the agricultural allegory was imported into Australian income tax law not long after the adoption of the first federal legislation in 1915. The metaphor derives from a 1920 decision of the U.S. Supreme Court, *Eisner v. Macomber*,[2] a case that has probably become the most cited U.S. decision in Australian tax jurisprudence.[3] The Australian progeny it has spawned includes some of the most colourful descriptions in the law reports.

As was the case in Australia, the fruit and tree metaphor was incorporated into many leading tax judgments in the U.S. delivered after *Eisner v. Macomber*, so much so that it gradually lost its ties with its source in that jurisdiction.[4] The nexus between the metaphor and its source was not lost in Australia, however, as tax practitioners and academics generally ignored the following U.S. cases, while continuing to cite the original decision (most often inaccurately, as we shall see) in support of their arguments on the distinction between income and capital gains.

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* Rick Krever is a Reader in Law at Monash University.

1 It was described by the Asprey Committee as one of the 'basic notions' underlying the legal meaning of income - see Aust., *Taxation Review Committee Full Report (Asprey Report)* (Canberra: AGPS, 1975) 1, at 59.

2 1920) 252 U.S. 189.

3 In addition to the fruit and tree depiction of income and capital, the decision is also cited in Australia for the important two-source theory of income, which holds that income is derived from labour or property or some combination of the two.

4 Even tax scholars in the U.S. show confusion over its genesis. Molloy appears to attribute the metaphor to *Helvering v. Horst* (1940) 311 U.S. 112, which he suggested gave rise to 'a truly lamentable host of horticultural metaphors' - see R. Molloy, 'Some Tax Aspects of Corporate Distributions in Kind' (1950) 6 *Tax L. Rev.* 57, at 61. Bittker criticised Molloy's inaccuracy and perpetrated his own, identifying as the 'culprit' *Lucas v. Earl* (1930) 281 U.S. 111 - see B. Bittker, 'Charitable Gifts of Income and the Internal Revenue Code: Another View' (1952) 65 *Harvard L. Rev.* 1375, n. 5.

Australian tax lawyers cite *Eisner v. Macomber* and its fruit and tree analogy as judicial endorsement of the distinction between income and capital and the immunity from income taxation of gains associated with the latter. The case establishes nothing of the kind; in fact, it states quite explicitly that both income and capital gains constitute 'income' for 'income tax' purposes. To find support in the judgment for a contrary proposition is possible only if the Supreme Court's ruling is carefully dissected and the extracted parts quoted out of context.

It is exactly this course that Australian tax lawyers, judges and scholars followed. Their acts were deeds of misuse and not abuse, resulting from ignorance and inaccuracy rather than malevolence or deceit. The resulting peculiar Australian legacy of *Eisner v. Macomber* serves as a useful reminder of the narrow and parochial origins of Australian tax jurisprudence and the slowness of its evolution.

Taxes and Trusts

As was the case with Australia's first federal income tax, the primary objective of the earliest U.S. income tax was to raise revenue to sustain the nation's war efforts. Income taxation was first adopted in the U.S. during the Civil War. Its initial application was short-lived, however, as the impost was considered an inappropriate public finance tool for peace and reconstruction. Although it later appeared as a state tax in some instances, income taxation remained off the federal agenda until 1894, when it was adopted for a second time by the central government. This time, however, a conservative Supreme Court, considering the tax outside the context of a national emergency and in the setting of considerable political turmoil over the distribution of economic wealth and power, concluded it was unconstitutional. Constitutional amendment and income taxation became the cry of the populists, whose presidential candidate, Teddy Roosevelt, successfully oversaw the adoption of a constitutional amendment and third, constitutionally sanctioned, income tax in 1913. Although greatly modified (and complicated), this tax has shown no signs of impending demise since that time.

Australia's first federal income tax was adopted in 1915. State precedents for the tax pre-dated federation and although the Australian federal legislation was not greatly dissimilar from its U.S. counterpart, it drew upon a variety of sources for inspiration, including the State legislation.[5] One precedent that played no

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5 See I. vanden Driesen and R. Fayle, 'History of Income Tax in Australia' in R. Krever, ed., *Australian Taxation Principles and Practice* (Melbourne: Longman Professional, 1987) 27, at 32.

apparent role in the drafting of Australia's first tax legislation was that of the U.K.[6]

Originally adopted in 1799 as a war-time finance measure in the struggle against Napoleon, U.K. income taxation was similar to that of the U.S. in its rapid demise following the end of the war and later revival as a permanent instrument of public finance, in the U.K. case in 1842. Apart from this slight historical similarity, U.K. income tax law bore little resemblance to its U.S. peer, however. The U.K. law was an income tax in name only. Organised on schedular system, the U.K. legislation listed various categories of gains that were subject to taxation. Although residual provisions were gradually added to the schedules to pick up limited types of gains that happened to fall within the broad genus of a schedule but outside its specific enumeration, little attempt was made to consolidate the different types of gains for tax purposes or to assess gains falling outside the categories specified.

One other structural feature that greatly influenced the evolution of the U.K. income tax jurisprudence was the fact that tax on most types of income was collected at source.[7] Attention on income measurement was thus focused on payers rather than recipients, an emphasis reinforced by the fact that tax was levied at a flat rate until Lloyd George's Liberal government adopted a progressive rate structure in 1909. Only then did the accurate computation of total income in the hands of the recipient become essential.

U.K. and U.S. courts were thus being asked different questions in income tax cases. The U.S. judges were asked whether a receipt was 'income' without any restrictions or qualifications imposed on the term apart from those the judges might wish to adopt themselves. Their U.K. counterparts, by way of contrast, were asked whether a receipt was a specific type of gain (rent, dividends, interest, etc.) or 'income' of a particular genre falling within a designated category.

Taxpayers disputing assessments adopted similar arguments employing similar terminology in both jurisdictions. The basis for most disputes was an assertion that income for tax purposes was similar to income for trust law purposes. The argument was made that only gains to which the life or income beneficiary would have been entitled, had the amounts been derived by a trust, were income for tax

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6 But see the comment by Mr Glynn in Aust., *H. of R. Debates* 1 September 1915, at 6541.

7 See the Table in W. Strachan, 'Capital and Income Under the Income Tax Acts' (1913) 114 *Law Quarterly Review* 163, at 172. The article provides a useful general discussion of the capital/income dichotomy as it stood in the U.K. at the time of *Eisner v. Macomber*.

purposes. Gains to which a remainder or capital beneficiary would have been able to lay claim fell outside the reach of the income tax, it was claimed.

Starting with laws based on unlike structural foundations, the U.K. and U.S. courts adopted fundamentally different approaches to statutory interpretation when resolving those disputes. The U.K. judges turned to the precedents that, on their face, appeared to be on point, the trust law concepts which they had encountered and dealt with for hundreds of years. They accepted taxpayers' submissions that 'income' in the income tax meant the same as it did in trust law. Gains which would have vested to a capital beneficiary had they been derived by a trust were thus held to be outside the ambit of the income tax.

U.S. judges dismissed similar arguments put to them by taxpayers. The income tax, they asserted, was intended to measure gain and trust law precedents were of no relevance to this end. This was not to say that all receipts were taxable - income for tax law purposes had identifiable attributes, but the overlap, if any, of those characteristics and the qualities enjoyed by trust income was at best coincidental. Income for tax purposes, they concluded, was to be determined by tax criteria.[8]

Notwithstanding the similarity between the U.S. and Australian income tax acts and the dissimilarity between the U.K. and Australian Acts, it was the U.K. approach that prevailed in Australian courts.[9] Like their U.K. counterparts,

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[8] Early U.S. cases in which taxpayers attempted unsuccessfully to persuade the U.S. Supreme Court to follow British precedents and exclude from assessable income gains realised on the sale of capital assets include *Merchants' Loan & T. Co. v. Smietanka* (1921) 255 U.S. 509 (sale of appreciated shares); *Eldorado Coal & Mining Co. v. Mager* (1921) 255 U.S. 525 (sale of a coal mine and mining plant by company winding up); and *Walsh v. Brewster* (1921) 255 U.S. 537 (sale of appreciated bonds by investor who was not a trader or dealer in securities). The broad income concept adopted in these cases was, admittedly, not used in the interpretation of the original income tax adopted during the Civil War - in *Gray v. Darlington* (1872) 15 Wall. (U.S.) 63, the Supreme Court concluded that the gain realised by a taxpayer selling appreciated bonds should 'be treated merely as [an] increase of capital.' (at 66). The decision appeared to have been approved in a case under the 1913 Act, *Lynch v. Turrish* (1918) 247 U.S. 221, at 230. Later cases distinguished *Gray v. Darlington* or treated it as a case of construction of the Act - see, for example, *Hays v. Gauley Mt. Coal Co.* (1918) 247 U.S. 189, at 191. See further C. Clark, 'Eisner v. Macomber and Some Income Tax Problems' (1920) 29 *Yale L. J. 735*, at 739.

[9] The assertion in G. Cooper, R. Krever and R. Vann, *Income Taxation Commentary and Materials* (Sydney, Law Book Company, 1989), at 79 that Australian is not a 'colony' of the U.K. in the income tax area is true insofar as decisions turn on the details of particular provisions; where they rely on general principles or concepts, however, the tendency has

Australian judges distinguished between capital and income, but failed to dissect (at least for tax purposes) the capital concept into original capital and gain realised as a result of the increase in value of the original capital.

Prima facie, in Australian (and U.K.) tax jurisprudence a realisation upon sale of appreciated property was considered a 'mere enlargement of capital', even if the realisation produced a profit, and the profit would only be separated and treated as 'income' if it otherwise displayed characteristics the courts commonly attributed to income from business or income from property.[10] As one commentator summed it up, 'Australia's income taxing law is founded on the artificial notion that, in law, there is a distinction between capital and income gains'.[11]

Eisner v. Macomber - The Facts and the Holding

Although *Eisner v. Macomber* became a leading U.S. tax decision, it was argued before the U.S. Supreme Court as a constitutional law matter. The dispute turned on the application of the *Revenue Act of 1916*, which included stock dividends in the definition of income to which it applied. The taxpayer, Macomber, argued the inclusion was unconstitutional. The 16th Amendment to the U.S. Constitution empowered Congress to levy a tax 'incomes, from whatever source derived'. Stock dividends, she claimed, were not income in the constitutional law sense.[12] The U.S. Supreme Court agreed with her.

There was no denying the taxpayer had enjoyed a gain in the value of her property (the shares had appreciated in value from the time at which she had acquired

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been, particularly in the early years of Australian income taxation, to rely slavishly on U.K. precedents and judicial pronouncements.

[10] See, for example, the judgments of the High Court members in *Blockey v. F.C.T.* (1923) 31 CLR 503.

[11] R. Fayle, 'A Commentary on the Section 25 Income/Capital Distinction' in Queensland Division of the Taxation Institute of Australia, State Convention Papers (Sydney: TIA, 1983) 18, at 22.p

[12] Section 2(a) of the *Revenue Act of 1916* stated: 'That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived...also from interest, rent dividends...gains or profits and income derived from any source whatever: Provided, That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation...of its earnings or profits... whether in cash or in stock of the corporation, ...which stock dividend shall be considered income, to the amount of its cash value.'

them) but, she argued, there was no income derived upon distribution of the stock dividend since it amounted to no more than a restatement in a new legal form of her existing wealth. Following the stock dividend, the taxpayer held more shares, but the total value of the shareholding remained approximately the same with each share worth less individually than the original shares were worth before the declaration of the dividend;[13] the capitalisation of retained earnings and unrealised gains from revaluation of assets did not change the total value of her shareholding, only its constitution.[14] As the U.S. Supreme Court explained, in an economic sense, the stock dividend did not represent a separate gain, realised as something of exchangeable value proceeding from the property but severed from the capital.[15]

There was never any question that the gain would eventually be taxed; the only issue in the Court's mind was one of timing - when would it be taxed? The conclusion reached by the court was that the issuance of a stock dividend was not the time to assess the gain.[16] The appropriate time was when the gain was

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13 In the words of Pitney J., the issue of the new shares 'does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.' (*Eisner v. Macomber*, *supra* note 2, at 211). Rich, Dixon and McTiernan JJ of the Australian High Court explained the economic and legal effect of a stock dividend in these terms: 'in the end the shareholder obtains nothing but a different paper title to a share in the same assets' - see *FCT v. Stevenson*, (1937) 59 C.L.R. 80, at 98.

14 In fact, as noted later by Scrutton L.J. in the Court of Appeal in *I.R.C. v. Blott* (1920) 2 K.B. 657 at 676, and Evatt J. in the High Court in *Dickson v. FCT* (1940) A.I.T.R. 515, at 534, the value of shares in a public company following a stock dividend will not be an exact mathematical reflection of the dilution resulting from the dividend, since the dividend itself will cause speculators to enter or leave the market. As it turned out, the market value of the shares in *Eisner v. Macomber* accurately reflected the effect of the stock dividend (see E. Warren, 'Taxability of Stock Dividends as Income' (1920) 33 *Harvard L. Rev.* 885, at 887). The case reveals the potential effect of external circumstances on the value of shares when a newspaper reporter's incorrect report of the holding caused a 'considerable and unfortunate stock market flurry' - see 'Comment' (1920) 29 *Yale L. Rev.* 678, at 679.

15 *Supra* note 2, at 208.

16 At the time, commentators generally supported the Supreme Court's decision on the non-assessability of stock dividends (albeit qualified in some cases) - see, for example, Clark, supra note 8; 'Editorial' (1919) 13 *Maine L. Rev.* 171. There were some, however, who criticised the holding as wrong as a matter of law, and perhaps of policy as well - see, for example, Warren, supra note 13 and, less explicitly, T. Powell, 'Income from Corporate Dividends' (1922) 35 *Harvard L. Rev.* 363, resiling somewhat from his earlier note in the *Columbia L. Rev.* Prior to the Eisner v. Macomber decision, one commentator argued on

realised by a disposal of the shares.[17] Commentators have since suggested that the strict realisation basis of income established by the case may no longer be an essential element of income for constitutional purposes in the U.S.[18]

Australia, too, had constitutional restrictions on the income tax powers of the federal government. Section 55 of the Constitution prevents Parliament from enacting taxing legislation dealing with 'more than one subject of taxation'. To the extent that an *Income Tax Assessment Act* is used to assess anything other than 'income', the assessment would be unconstitutional in the same manner as was the assessment in *Eisner v. Macomber*. In Australia, however, the constitutional restrictions provided little support for taxpayers. The High Court made a sharp distinction between the phrase 'income' as employed in the taxing legislation and 'income' as it appeared in the constitution. The latter was as wide in its scope as the former was narrow in its application. Indeed, the definition of income for Australian constitutional law purposes was arguably much broader than the widest interpretation accorded that word for tax purposes by the U.S. courts. Provided it does so by explicit and unambiguous statutory provisions, the Australian Parliament has been allowed to include in the 'income' tax virtually any gain realised by or accruing to the benefit of a taxpayer.[19]

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the basis of existing precedents that the inclusion of stock dividends in the definition of income was almost certainly constitutional - indeed, he suggested Congress could assess shareholders on an appropriate proportion of undivided, undistributed corporate profits at any time it chose, whether or not it had been capitalised into a stock dividend - see R. More, 'Stock Dividends as Income' (1918) 16 *Michigan L. Rev.* 521, at 526-27.

17 See the discussion by Pitney J., *supra* note 2, at 212.

18 See, for example, the comments of Bittker in B. Bittker, *Federal Taxation of Income, Estates and Gifts* (Boston: Warren, Gorham & Lamont, 1981), at 5-20. A similar observation of the U.S. constitutional position was made by an Australian observer in R. Vann, 'Income as a Tax Base' in R. Krever, ed., *Australian Taxation Principles and Practice* (Melbourne: Longman Professional, 1987) 62 at 70.

19 Thus, for example, as explained below, the Australian Parliament could constitutionally assess receipts such as stock dividends of the sort that were held not to constitute income in *Eisner v. Macomber* (see *James v. FCT* (1924) 34 C.L.R. 404). It also could include in taxable income undissected amounts distributed to shareholders on liquidation, to the extent the payment included retained profits (see *Resch v. FCT* (1942) 66 C.L.R. 198), undistributed company income not distributed to shareholders to the extent it escaped higher personal rates of taxation by virtue of its retention in the company (see *Cornell v. DFCT* (S.A.) (1920) 29 C.L.R. 39), and imputed rental income enjoyed by taxpayers who owned their principal residences (see *Harding v. FCT* (1917) 23 C.L.R. 119). No taxpayers have sought to challenge the capital gains provisions of the Act, introduced in 1986 with effect from September of the previous year, on the basis of unconstitutionality.

The Australian Legacy

As a result of the broad interpretation accorded income for constitutional law purposes in Australia, *Eisner v. Macomber* has played only a minor role in this country in the development of judicial doctrines applicable to taxable and tax-free company distributions. When the issue directly addressed in *Eisner v. Macomber* first came before the Australian High Court, it concluded the equivalent Australian provisions were constitutionally valid and effective so long as the company had carried out the accounting procedures necessary to effect a stock dividend.[20] So, while *Eisner v. Macomber* was cited as authority for the non-income nature of stock dividends in some jurisdictions such as the U.K.,[21] in Australia it was merely cited as authority for what the position would have been at common law, but for the specific wording of the Australian legislation subjecting them to tax[22] or as an example of differing U.S. treatment.[23] On a few occasions U.K. jurisprudence which relied on *Eisner v. Macomber* has been cited in Australia to support arguments that other company distributions were not income.[24]

The real impact of *Eisner v. Macomber* in this jurisdiction follows from its role in developing and refining the Australian judicial concept of income. Both the fruit and tree metaphor developed by Pitney J. and selected passages from his judgment are continually cited in support of the proposition that capital gains are conceptually inseverable from the underlying capital assets from which they arise

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[20] See *James v. FCT*, supra note 19.

[21] See, for example, *I.R.C. v. Blott* [1921] 2 A.C. 171 where Viscount Cave referred to the 'luminous reasoning' of Pitney J. (at 202). The taxpayer in *Blott* had been successful in the lower courts but the *Eisner v. Macomber* judgment, coming in the time between the Court of Appeal and the House of Lords decisions, proved to be a respected authority directly on point.

[22] See, for example, the reference to *Eisner v. Macomber* by Dixon C.J. in *FCT v. W.E. Fuller Pty. Ltd.* (1959) 101 C.L.R. 403, at 405, where the issue was whether bonus shares would have been 'income' if not for the specific charging provision.

[23] See, for example, the judgment of Dixon J. in *Resch v. FCT* (1942) 66 C.L.R. 198, at 225.

[24] See, for example, *Webb v. FCT* (1922) 30 C.L.R. 450, where the High Court concluded the charging provision successfully relied upon by the Commissioner in *James* (*supra* note 19) did not apply to new shares in a completely different company distributed to former shareholders in satisfaction for their interests in a liquidated company that had sold its assets to the company issuing the new shares. For a review of the *James* and *Webb* decisions, see H. Buckley, 'Federal Income Tax - Bonus Shares' (1928) 1 *Australian Law Journal* 365. These U.K. cases were also used by the High Court to support a conclusion that shareholders could realise the value of retained profits as tax free distributions upon winding up of the company - see *FCT v. Stevenson*, supra note 12.

and therefore cannot constitute income, leaving them outside the scope of the ordinary charging provisions in the Australian income tax legislation.

The passage of the judgment of Pitney J. which proved to be of such great import to Australian tax jurisprudence reads:

> The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop ...'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of assets ... Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth* or *increment* of value in the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital ...[25]

The ironic nature of the legacy stems from the principal proposition in support of which the case was, and continues to be, cited, namely that capital gains are inherently incapable of characterisation as 'income' for tax purposes. The premise can only be derived from the case if the passage reproduced above is selectively edited to excise the crucial phrase 'provided it [income] be understood to include profit gained through a sale or conversion of assets'. Without that qualification, the extract establishes the fruit and tree analogy for income and capital and ignores the conclusion that gains realised on the sale of trees are income of the same type as regular returns from the exploitation of the tree.

Although Hannan is usually credited with the introduction of the U.S. case into Australian doctrinal writing,[26] the Australian practice of selectively quoting *Eisner v. Macomber* and omitting the crucial phrase characterising realised capital gains as income was actually initiated by Ratcliffe and McGrath.[27] The precedent established by these writers was followed by other early leading authors such as

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25 Supra note 2, at 207; all italics in the original. The quote contained in the passage ('Income may be defined as the gain derived from capital, from labor, or from both combined') was taken from the Supreme Court's decisions in *Stratton's Independence v. Howbert* (1913) 231 U.S. 399, at 415 and *Doyle v. Mitchell Bros. Co.* (1918) 247 U.S. 179, at 185.

26 J.P. Hannan, *Principles of Income Taxation* (Sydney: Law Book Company, 1946), at 5. See *Case P16* (1963) 14 T.B.R.D. 66, at 71 and *Case L86* (1960) 11 T.B.R.D. 512, at 516.

27 J. Ratcliffe and J. McGrath, with J. Hughes, *The Law of Income Tax* (Sydney: Law Book Company, 1938), at 30.

Challoner and Collins[28] and more contemporary both authors such as Ryan (and the authors or co-authors of six successor editions of his work),[29] Parsons[30], and Woellner, Vella and Chippendale,[31] as well as by the editors of tax services,[32] contributors to books,[33] and authors of journal articles.[34] Other writers such as Barrett have cited only the fruit and tree portion of the passage to explain the income/capital dichotomy, which avoids the clearer misrepresentation of these volumes, but still fails to reveal the actual legal doctrine espoused in the case.[35]

These approaches were by no means universal. *Eisner v. Macomber* has been more accurately used by some authors for completely different purposes - for example, Lehmann and Coleman use the case as an illustration of a court deciding on the basis of economic substance.[36] To cite another example, Gunn employed the decision in an explicit acknowledgment of the different approaches of the U.S. and Australian authorities to the definition of income.[37] Also, all Australian

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28 N. Challoner and C. Collins, *Income Tax Law and Practice* (Sydney: Law Book Company, 1953) 107. Although the case was presented in a different manner in the second edition of this book, the same procedure - omitting the crucial phrases - was followed in the later edition: N. Challoner and J. Greenwood, *Income Tax Law and Practice* (2nd ed) (Sydney: Law Book Company, 1962), at 138.

29 K. Ryan, *Manual of the Law of Income Taxation* (Sydney: Law Book Company, 1965), at 19 through to G. O'Grady and K. O'Rourke, *Ryan's Manual of the Law of Income Tax In Australia* (7th ed) (Sydney: Law Book Company, 1989), at 21.

30 R. Parsons, *Income Taxation in Australia* (Sydney: Law Book Company, 1985), at 88. Parsons also cites the *Eisner v. Macomber* metaphor (at 90) as authority for the proposition that a receipt in satisfaction of rights that make up the taxpayer's property in a share is not income, unlike a receipt that is derived from that property.

31 R. Woellner, T. Vella and R. Chippendale, *Australian Taxation Law* (Sydney: CCH, 1987), at 175.

32 See CCH's Federal Tax Reporter, at 11-760 and Butterworths service, infra note 37.

33 See, for example, B. Colditz, 'Tax Accounting' in R. Krever, ed., *Australian Taxation Principles and Practice* (Melbourne: Longman Professional, 1987) 176, at 178.

34 See, for example, D. Bloom, 'An Examination of Some Aspects of Section 23(q) of the *Income Tax Assessment Act*, 1936, as Amended' (1979) 13 *Taxation in Australia* 599, at 638.

35 R. Barrett, *Principles of Income Taxation* (Sydney: Butterworths, 1975), at 27. The practice continued in Barrett's 2nd edition (1981, at 25) and the third edition, co-authored with P. Green (1986, at 31). Another example of this practice may be found in CCH, *Looking Ahead to a Possible Capital Gains Tax In Australia*; Vol. 1: What is a Capital Gains Tax (Sydney, 1984) 6.

36 G. Lehmann and C. Coleman, *Taxation Law in Australia* (Sydney: Butterworths, 1989), at 40. Lehmann and Coleman used the 'fruit and tree' metaphor effectively to illustrate the judicial concept of income, as it has evolved - see 36-37.

37 Gunn, for example, in his 1943 text used *Eisner v. Macomber* to show that stock dividends were not income at common law, but was careful not to cite the decision or its

casebooks extracting the decision contain accurate citations of the critical passage.[38] Still, when the case is cited in legal argument, it is usually used to support the very proposition it rejects, namely that a gain accruing on a capital asset will remain part of a capital realisation even when the 'gain in value is converted to money by sale'.[39]

Much more significant than any direct impact on Australian tax jurisprudence that *Eisner v. Macomber* itself may have had is the key role in developing and reinforcing the Australian judicial concept of income played by its fruit and tree metaphor. Although the decision itself is rarely cited any longer by Australian adjudicators, the metaphor has become an integral part of the judicial mythology of capital. Leading tax judgments which adopt the fruit and tree characterisation include *Shepherd v. FCT*[40] (validity of assignment of royalties), *FCT v. Smith*[41] (assessability of disability insurance payments), *FCT v. Everett*[42] (validity of

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famous metaphor as support for the Australian income concept; indeed, he deliberately reproduced the observation of Douglas J. in *U.S. v. Stewart* (1940) 311 U.S. 60, at 62 (by way of an extract of the judgment of Dixon J. in *Resch v. FCT* - see supra note 23) that '"income" is a generic term amply broad to include capital gains for purposes of income tax'. His successors maintained this practice through ten editions of the book, until it was converted into a service in 1975, when the collective editors removed the relevant reference to the correct U.S. position and reproduced the selectively edited version of the important passage to bolster their description of the Australian dichotomy between capital and income. See Butterworths, *Australian Income Tax Law and Practice* (Sydney: Butterworths) (service), para 25/01. The most recent redraft of the materials which formerly contained the correct statement of U.S. law now cites *Eisner v. Macomber* for the proposition that, to use the terms of the metaphor, a growth in the size of the tree would not represent income, though it might represent a profit - D. Harris, Commentary on Section 44 in *Australian Income Tax Law and Practice*, para. 44/90.

38 The only casebooks containing extracts from the decision reproduce in full the often omitted proviso - see R. Baxt et al., *Cases and Materials on Taxation* (Sydney: Butterworths, 1978), at 38 and (2nd ed) (1984), at 47 and G. Cooper, R. Krever and R. Vann, *Income Taxation Commentary and Materials* (Sydney: Law Book Company, 1989), at 80.

39 See, for example, *Case R68* (1965) 16 T.B.R.D. 313, at 337, from where the quotation in the text is derived. The Board of Review in this case concluded the gains realised by the taxpayer on the sale of land were not assessable but gains realised on building ventures were.

40 (1965) 113 C.L.R. 385, at 397. *Eisner v. Macomber* and the fruit and tree metaphor were also used in an AAT decision on the validity of an assignment of book debts decided similarly to *Shepherd* - see *Case V141* (1988) 88 A.T.C. 891, at 898.

41 (1981) 147 C.L.R. 578, at 583.

42 (1980) 143 C.L.R. 440, at 446.

interest in partnership income) and, more recently, *FCT v. Myer Emporium Ltd.*[43] (assessability of lump sum proceeds from an assignment of an income stream).

Eisner v. Macomber and its fruit and tree metaphor has played an equally significant role in developing the capital and revenue distinction with regard to outgoings. The decision is often cited in deduction cases, particularly by Boards of Review, whose literary skills have produced wonderfully colourful variations on the theme. Cases in which *Eisner v. Macomber* has been cited as authority for the capital characterisation of outgoings include disputes over the deductibility of outlays incurred by:

- a mining company to acquire a mining lease from the taxpayer to which it was paying royalties -

  > In short, to avoid the recurring expense of purchasing successive crops of fruit, the company chose the alternative of buying the tree itself, the 'profit-yielding subject', outright.;[44]

- a company engaged in legal proceedings to resist an attempt by dissident shareholders to force a dividend -

  > [T]he expenditure was incurred for fear that the fruit-bearing tree might become ringbarked and thus lose so much sapflow that it would not so much die as wither - and thus its fruit-bearing potentialities, even though they might not cease altogether, would be much curtailed.[45];

- a taxpayer in exploring prospects for a new business -

  > [T]he taxpayer was expending money in planting a tree, which he hoped would bear future crops - an entirely different procedure from pruning, tending or plucking the crop from a tree or an orchard already in being.[46];

- a taxpayer to preserve his professional reputation and good-will -

  > [It] seems to me that what was to be feared in [a case cited by the taxpayer] was loss of part of the crop of the tree - perhaps even a large part of it - but there was no real or present danger that the tree itself might be destroyed (as in the present reference).[47];

- a public accountant to study courses in public administration, economics and history -

  > [I]t is more like the initial expense of buying the fruit-tree rather than the recurring cost of fertilizing it.[48]; and

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[43] (1987) 163 C.L.R. 199, at 215 and 219.
[44] *Case F47* (1955) 6 T.B.R.D. 285, at 288.
[45] *Case P55* (1963) 14 T.B.R.D. 255, at 256.
[46] *Case M56* (1961) 12 T.B.R.D. 282, at 283.
[47] *Case L86* (1960) 11 T.B.R.D. 512, at 517.
[48] *Case P15* (1963) 14 T.B.R.D. 63, at 65.

- a city engineer to obtain a university diploma in public administration and a degree in economics -

  > The present taxpayer, in my view, is enjoying the fruits of one tree that he has already purchased: and ... is in the process of buying another tree of a very different kind, with a potential, when the purchase is complete, of producing its own distinctive fruit.[49];

Metaphysical Derivations of Fruits and Trees

The failure of the judiciary in both the U.S. and Australia to recognise unrealised appreciation gains as income for tax purposes is understandable. Although such gains now form an integral part of the economist's benchmark income tax system, the so-called Schanz-Haig-Simons tax base, the broad economic definition of income was only just being clearly articulated at the time cases such as *Eisner v. Macomber* first came before the courts.[50]

The refusal of Australian (and U.K.) judges and U.S. judges to recognise accruing but unrealised gains as income established common ground between the two judicial concepts of income. There was a sharp departure between the two on the issue of realised gains, however. As the U.S. Supreme Court states so explicitly in *Eisner v. Macomber*, gains on capital assets, once realised, comprise part of the U.S. judicial concept of income. By way of contrast, Australian jurisprudence considers such gains to be income only when they exhibit certain 'income' characteristics - features such as periodicity, recurrence and regularity that were originally used to identify income for trust law purposes.

From a tax policy perspective, the non-recognition of accrued gains as income raises an interesting question of when gains can be characterised as income. *In Eisner v. Macomber* the U.S. Supreme Court concluded that a change in the form of paper ownership of accruing gains was not an appropriate time. Instead, the Court asserted, the gains should be recognised when they were realised in the

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[49] *Case P16* (1963) 14 T.B.R.D. 66, at 71.

[50] The pioneering work of Schanz had appeared in 1896 but was not widely read in the English-speaking world. Haig's leading work was published in 1921 and Simons' treatise did not appear until 1938. See: G. Schanz, 'Der Einkommensbegriff und die Eindommensteurergesetze' 13 *Finanz-Archiv* (No. 1) 1; R. Haig, *The Federal Income Tax* (New York: Columbia University), reproduced in R. Musgrave and C. Shoup (eds), *Readings in the Economics of Taxation* (Homewood, Ill.: Richard Irwin, 1959) at 54; H. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938).

sense of being severed from the underlying property and changed in actual form, not merely in form of ownership.

Australian (and U.K.) judges came to a fundamentally different decision about the nature of realised gains, concluding that the gain on a capital asset remained capital even after it was realised, severed from the asset and converted into another form. The decision was not obviously illogical from a tax policy perspective. If the change of legal form is not to be used as a point of taxation, why should a change of economic form? The taxpayer who disposes of an appreciated asset for full consideration is no richer immediately after the transaction than he or she was immediately before - all that has changed is the form of the wealth. One could argue with some force that in absence of an accrual-basis income tax, any taxation point short of actual consumption is artificial and contrived.

The Australian characterisation of capital gains as non-income receipts was not, of course, premised on such tax policy arguments. Rather, it was reliance on U.K. tax precedents and trust law analogies that led to the compression of the entire proceeds from the disposition of a capital asset into a single, undissected realisation of capital. Given the doctrine of precedent underlying the common law system, the evolution of the Australian judicial concept of income is neither surprising nor illogical. Indeed, although there is no documentation to support or deny the assertion, it is almost certainly the case that the judicial concept faithfully gave effect to the original legislative intent with regards to the scope of the first Australian federal 'income' tax.

As it turned out, the U.S. judicial approach to the definition of income was better suited to a modern effective, efficient and fair income tax. In Australia, legislative intervention was required to undo the consequences of the judicial characterisation and bring capital gains into the income tax base. With the legislative change, Australian income tax law has, in a sense, travelled a full circle. For over five decades Australian jurists relied on *Eisner v. Macomber* as authority for the very proposition the case was incapable of supporting. With the legislative expansion of the income tax in 1985 to embrace capital gains, the Australian income tax system has finally moved towards the tax base envisaged by the U.S. Supreme Court in *Eisner v. Macomber* not long after the Australian federal income tax was first adopted.

Markus Achatz, Tina Ehrke-Rabel, Johannes Heinrich,
Roman Leitner, Otto Taucher (Hg.)

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Interpreting income tax laws in the common law world

Richard Krever

I Origins of the Anglo-American tax jurisprudence split

A common theme in comparative legal scholarship is the contrast between doctrinal analysis and judicial decision making in civil code and common law legal systems, the two law making systems used in most jurisdictions. Far less common, in tax law at least, is the comparison of the two principal schools of common law, the American variation, followed in the world's largest economy, and the Anglo approach, used in almost all other English-speaking countries.[1] And yet, the contrasts in interpretation approaches taken by American and Anglo courts, especially in taxation law, in many ways exceed those separating the civil code and common law worlds.

This note surveys some of the key differences between the two common law approaches in the interpretation of income tax law.[2] That these differences might exceed those between the civil code and common law systems seems counter-intuitive. After all, the common law and civil code systems

1 Interestingly, one of the few examples of such a comparison focusing directly on taxation law was prepared by an Israeli – see Assaf Likhovski, "The Duke and the Lady: *Helvering v. Gregory* and the History of Tax Avoidance Adjudication" (2003) 25(3) *Cardozo Law Rev.* 953. The dichotomy is also explored in Hugh Ault, *Comparative income taxation: a structural analysis* (2nd ed) (The Hague: Kluwer, 2004) and Victor Thuronyi, *Comparative Tax Law* (The Hague: Kluwer, 2003), who describes these two branches as the "Commonwealth Family" and the "American Family" (see ch. 2).

2 While there are many parallels between the U.S. retail sales tax and the value added tax (often called the goods and services tax) used in much of the rest of the English-speaking world, the fundamentally different structures of the two systems, the relatively smaller pool of case law precedents to draw on, and the relative newness of VAT and GST compared to income tax suggests that a restriction of the comparison to income tax is logical.

have long and very separate heritages. Modern post-Napoleonic civil codes trace their heritage to Roman law, which in turn has roots in much earlier codes, while the common law developed entirely separately in the second millennium. Ultimately, the very recent and slight convergence of the two systems, the result of Anglo and continental judges sitting together on the European Court of Justice and the increased availability and distribution of civil law judicial decisions in the digital publication world, may impact on judicial approaches in both types of jurisdictions. However, to date these recent developments in interpretation of European Union law have had little impact on judicial approaches at the national level.

In contrast to the long historical differences between civil code and common law systems, the split in the common law world is relatively recent. While U.S. courts were no longer bound by U.K. precedents following independence in 1776, constant communication between the jurisdictions facilitated common paths in both legal systems. The doctrine of precedent, including the distinction between binding precedents from superior courts and persuasive precedents from equal or inferior courts, remained the same in both American and Anglo courts. The Americans even retained the English distinction, derived originally from the split between the King's courts and the parallel ecclesiastic courts, between civil jurisdiction and equity jurisdiction. Similarly, the convergence between the civil jurisdiction courts and equity courts in the late 19th century for the most part occurred in parallel fashion in both the American and Anglo jurisdictions.

Taxation law is something of a special creature in both civil code and common law jurisdictions. It is not the product of either general codes or judicial doctrines (in civil code and common law jurisdictions, respectively) such as those governing, say, contract law or torts law. Rather, tax law derives from very specific statutes that set out a process for the state to collect a portion of private citizens' income, wealth or consumption. Although its historical roots stretch back some way (the first U.K. income tax dates back to the Napoleonic wars at the end of the 18th century and the first national income tax in the U.S. to the civil war in the middle of the 19th century, with some earlier state laws), the income tax is a relatively young creature with most income tax laws based on statutes adopted in the first decades of the 20th century.[3]

3 There are, however, a number of English language income tax laws or tax laws that included imposts on income which were enacted much earlier. A comprehensive history of early English language income taxes may be found in Peter Harris, *Income Tax in Common Law Jurisdictions: Part I to 1820* (Cambridge: Cambridge University Press, 2006).

In the English speaking world two fundamentally different approaches were taken to the design of income tax laws. The U.K. adopted a schedular system of income taxation, measuring different types of net taxable income separately under different schedules of the legislation. When the U.K. shifted to a progressive income tax in 1911, it retained the separate schedules for different types of income but provided for an additional surcharge to be imposed on the combined incomes calculated under different schedules.

In contrast, the approach taken in almost all other English-speaking countries including the U.S., Canada, Australia, and New Zealand, was to adopt a "global" income tax under which all income and all expenses incurred to derive that income were considered together to compute a single taxable income. Over time, the global systems took on some schedular-like features such as quarantining rules that grouped capital losses with capital gains or passive losses against investment income, but the fundamental base remained the global gross income scheme.[4] The U.K. itself recommended a single global income tax for the colonies it retained in the 20th century.[5]

Although Anglo income tax laws outside the U.K. closely resembled the U.S. global model and not the much older U.K. schedular system, courts in Anglo jurisdictions outside the U.S. turned to U.K. precedents and tax concepts interpreting provisions of the schedular income tax to interpret the global income tax laws in their jurisdictions. From a policy perspective, the outcome was often inconsistent with the objectives of the legislation. The process started many of the Anglo jurisdictions down an accelerating slide towards greater complexity, administrative costs, and compliance costs as legislatures responded to the resulting avoidance opportunities with an array of piecemeal and ad hoc counter-measures.

II Manifestations of the U.S. and Anglo Split

Four phenomena in particular led to or derived from the split between U.S. tax jurisprudence and that followed in other English-speaking jurisdictions: the initial use of "transplanted categories" to interpret fundamental income tax concepts in the Anglo world and the explicit rejection of this approach in the U.S., the rise of tax law mysticism in Anglo jurisdictions, a "colonial cringe" reliance on English precedents in Anglo jurisdictions, and the triumph of form over substance in those countries. One consequence of these

4 See L. Burns and R. Krever, 'Individual Income Tax' in V. Thuronyi (ed), *Tax Law Design and Drafting* (Washington, D.C.: International Monetary Fund, 1997) 495–563; republished (The Hague: Kluwer Law International, 2000) 495–563.

5 United Kingdom Colonial Model Income Tax of 1923.

phenomena has been the adoption of and increasing reliance on a general anti-avoidance rule in many of these jurisdictions.

II.1 The application of "transplanted categories"

The concept of "taxable income" in the tax law of the U.S. and almost all Anglo jurisdictions other than the U.K. commences with a measurement of gross income from which various types of deductions are allowed to arrive at the net amount – taxable income – on which tax is levied. No deduction is allowed for a "capital" expense which merely amounts to a conversion by the taxpayer of cash to another asset, although deductions are allowed for depreciation if the asset wastes over time.

The two key concepts in U.S. and Anglo income tax law, therefore, are the meaning of "income" on the receipts side of the taxable income equation and the notion of "capital" expenses on the outgoing side. Neither term is defined in the laws – their meanings derive entirely from judicial common law interpretation principles.

Central to the common law system is the doctrine of precedent – the use of past judgments to craft new ones consistent with those that preceded the new ones. Where a law is set down in a statute, the initial judicial interpretation of the law will establish the precedents used by later courts interpreting those provisions. Should the terms used in a statute be found in other older laws or in non-statutory doctrines, the judicial interpretation of the terms in the other areas may be "transplanted" to the new law if similar meanings are appropriate for the new law.

While both U.S. and Anglo courts apply the doctrine of precedent to the interpretation of the income tax statutes, they headed in fundamentally different directions when their respective legislatures enacted income tax legislation and the scope of the terms used in the laws were first subject to judicial scrutiny. At an early stage, U.S. courts concluded that the principles of income tax law were fundamentally different from those of other areas of law and as a result declined to apply to income tax terms the meanings ascribed to those terms when they were used in other bodies of law. U.S. judges set about developing new tax law meanings for familiar terms. Anglo courts, by way of contrast, engaged in what has become known as the "logical fallacy of the transplanted category",[6] turning to trust law and property law in particular to

6 The term appears to originate in a critical analysis of judicial decision-making by Neil Brooks, 'The Role of Judges' in: Cooper GS, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD, 1997) 93.

add meaning to the words of income tax statutes. This transplantation was done without regard to whether the meanings given to terms in the context of other areas of law could support the objectives of the income tax. The different approaches of U.S. and Anglo courts to the use of transplanted categories led to radically different common law understandings in the U.S. and Anglo jurisdictions of the fundamental terms and concepts in an income tax law including what amounts constitute gross income, what a capital expense is, and who derives income in multi-party transactions.

In some areas, particularly in respect of the meaning of "income" for tax purposes, similar and on occasion the same precedents were cited originally by taxpayers in both U.S. and Anglo courts. In both sets of jurisdictions, taxpayers sought to limit the scope of tax law income by reference to the meaning of the term in trust law, a body of law whose origins preceded that of modern income tax by several centuries. Trusts, or "uses" as they were first known, were created by the medieval English ecclesiastic courts as a means of enforcing equitable rights over assets. Ownership of property was separated into legal title and beneficial rights to enjoy the fruits of the property so legal owners could be forced by the ecclesiastic courts (or equity courts, as they were known) to apply income derived from the property to the benefit of other persons with an equitable claim to the property.

Trusts became useful vehicles for the intergenerational transfer of wealth[7] as the entitlement to trust property could be divided between life or income beneficiaries, entitled to income derived by the legal owner of trust property, the "trustee", during the income beneficiaries' lifetimes, and capital or remainder beneficiaries, entitled to a distribution of the underlying assets of the trust on the death of the life beneficiaries. All gains derived by the trustee were characterised as either income receipts, payable to the life beneficiary, or capital gains, realised when trust assets were sold or exchanged for replacement assets and payable to the remainder beneficiary. The distinction was relatively clear in the early days of trusts when trust assets comprised landed estates but the line between income and capital gains began to blur with the industrial revolution and the shift of wealth from land to other assets which might be turned over more often. At some point, the turnover of trust assets might be considered a business activity of the trustee and the gains from the sale of underlying trust assets characterised as ordinary business income to which the income beneficiary, and not the capital beneficiary, should be entitled.

7 And the avoidance of estate duty – the most famous tax anti-avoidance law in Anglo history is King Henry VIII's "Statute of Uses", designed to prevent taxpayers from avoiding estate duties through uses. It proved somewhat ineffective as taxpayers developed the concept of a "use upon a use", now known as a sub-trust, to circumvent the rule.

Long before the adoption of modern income tax laws, the equity courts developed a comprehensive set of doctrines to resolve disputes between life and remainder beneficiaries over the nature of gains realised by the trustee. Early in the 20th century, taxpayers assessed under new income tax laws adopted in North America and other Anglo jurisdictions sought to apply these tests to the income tax, arguing that by definition an "income" tax could not extend to "capital" gains. Anglo courts responded sympathetically to these arguments, transplanting almost directly to income tax law the meaning of income in trust law and excluding from the tax base all amounts that would be "capital gains" for trust law purposes.[8]

In stark contrast to this approach adopted by Anglo courts, the U.S. courts, looking at the purpose of the income tax law – to appropriate a portion of economic gains from private ownership to the state for public application – explicitly rejected the transplantation of the trust law distinction between income gains and capital gains into tax law. In one early famous case *Eisner v. Macomber*,[9] the U.S. Supreme Court acknowledged the distinction used in trust law analysis between a tree (a capital amount) and fruit from the tree (its income) but indicated the distinction had no application to tax law if a taxpayer sold the tree for a profit – the gain was "income" for tax purposes whatever its status in other types of law. Subsequent cases consistently asserted that income for tax purposes comprised any and all gains realised by a taxpayer, whether anticipated or the result of windfall and whatever their character for the purposes of other bodies of law.[10]

As it turned out, *Eisner v Macomber*, a U.S. precedent supporting a broad judicial concept of income, became one of the most cited U.S. tax cases in the Anglo world. Ironically, however, it is cited as support not for broad U.S. in-

8 See further John F. Avery Jones *et al*, Treaty Conflicts in Categorizing Income as Business Profits Caused by Differences in Approach between Common Law and Civil Law (2003) 57(6) *Bulletin for International Fiscal Documentation* 237, esp. note 3; R. Parsons, "Income Taxation – An Institution in Decay" (1986) *Australian Tax Forum* 233, reproduced in (1986) 12 *Monash Law Rev* 77 and later in a slightly revised version in (1991) 13 *Sydney Law Rev* 435.

9 252 U.S. 189 at 207 (1920).

10 The case most often cited for the broad concept of income is *Commissioner v. Glenshaw Glass Co.* 348 U.S. 426 (1955) in which the U.S. Supreme Court described income in terms of "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion". The case involved the receipt of punitive damages in an anti-trust dispute. Very recently, the Court of Appeals for the District of Columbia held that compensatory damages for emotional distress and loss of reputation were not income: see *Marrita Murphy and Daniel J. Leveille v. IRS* 2006 U.S. App. LEXIS 21401

come concept, but rather for the far narrower Anglo notion of income for tax purposes. This apparent contradiction comes about as a result of the very selective quotation by Anglo courts of the "tree and fruit" passage in *Eisner v Macomber*. Anglo courts extract the first part of the passage as authority for a distinction between capital and income produced by the capital and then deliberately omit the latter half in which the U.S. Supreme Court indicates that gains from the sale of capital assets should also be regarded as income for tax purposes. As a result, outside the U.S. the case stands for exactly the opposite of the conclusion to which it leads in U.S. tax jurisprudence.[11]

In the latter half of the 20th century, many Anglo jurisdictions in which courts had excluded capital gains from the judicial concept of income for tax purposes broadened their income tax bases by way of a separate tax on capital gains (the U.K.) or statutory inclusion of some or all capital gains in taxable income (for example, Canada, Australia, and South Africa), in most cases providing concessional treatment for the gains by way of lower tax rates. The U.S. moved in the other direction, carving capital gains out of the ordinary tax base to provide a partial exclusion for this type of income. As the U.S. judicial concept of income made no distinction between income gains and capital gains, a statutory definition of capital gains was needed in that country. Anglo jurisdictions that brought capital gains into the tax base uniformly did so without any definition of the gains; in most cases, the laws simply referred to gains to the extent they were not included in the tax base as judicial concept ("ordinary") income. As capital gains were most often included on a preferential basis, taxpayers regularly probe the unclear boundary between ordinary income and capital gains in Anglo jurisdictions. The uncertainty inherent in the ambiguous border as well as the array of specific statutory responses enacted in response to continually evolving gain characterisation schemes remains a major source of complexity in Anglo tax systems.

The transplanted distinction between income gains and capital gains was mirrored on the outgoing side by a distinction between revenue expenses, charged to the income or life beneficiaries of a trust, and capital expenses, paid from the capital of an estate. The judicial tests developed by the courts to distinguish the two types of outgoings paralleled those used on the receipt

11 See further, R. Krever, 'The Ironic Australian Legacy of *Eisner* v. *Macomber*' (1990) 7 *Australian Tax Forum* 191. The narrow Anglo judicial concept of income is sometimes euphemistically labelled "ordinary concept income" by Anglo courts, implying the narrower meaning derived from judicial doctrines has some sort of inherent independent legitimacy. Subsequent to the early U.S. cases on income gains and capital gains, the U.S. Congress intervened to carve a statutory notion of capital gains out of the broad U.S. judicial concept of income for the purpose of lowering the tax imposed on these defined gains.

side. These look in particular at the form of the payment (periodic vs. one-off) and whether the outgoing relates to the taxpayer's income earning "process" (in which case they are ascribed a revenue character) or the income-generating "structure" (in which case they are treated as capital outgoings). The borderline between the process and structure concepts proved particularly elusive and has led to a problem perhaps unique to Anglo jurisdictions – the phenomenon of "nothings" (as they were called in the U.K., Canada, and some other jurisdictions) or "black hole expenses" (as they were labelled in Australia).

As the general deduction provisions in Anglo income tax law only apply to revenue expenses, capital outgoings could only be recognised if they fell within a specific statutory recognition measure. "Nothings" arose in Anglo jurisdictions because the statutory rules for recognition of capital expenses applied only to expenditures that resulted in the acquisition of identifiable assets. Depreciation rules applied to outgoings for wasting assets and cost base rules applied to expenses for other capital assets. But if the outgoing was labelled a "capital" expense under the judicial tests and did not lead to the acquisition of an identifiable asset, no recognition was possible – the expense was simply lost for tax purposes.[12]

Transplanted doctrines were also used in Anglo jurisdictions to determine who derived income from property. The contrasting decisions of the highest courts in the U.S. and Australia respectively in *Lucas v. Earl*[13] and *Shepherd v Federal Commissioner of Taxation*[14] illustrate the legal issue giving rise to the phenomenon and the contrasting approaches to resolving the tax question the issue raises.

The cases involve a consequence of the common law legal concept of property. In the common law system, the legal concept of property is quite distinct from the underlying asset from which property derives. While the asset may be a tangible moveable or immovable object, the property in law comprises rights with respect to the asset, not the asset itself. Thus, ownership of a piece of land in the common law is actually ownership of a bundle of rights in relation to the land, not ownership of the earth itself. A person who

12 See, for example, *Broken Hill Theatres Pty. Ltd. v Federal Commissioner of Taxation* (1952) 85 C.L.R. 423, where a taxpayer incurred expenses to oppose a licence application by a potential competitor. The expense was found to be "capital" as it related to the structure of the taxpayer's business and as it yielded no asset was never recognised for tax purposes. Some jurisdictions including Australia and Canada have adopted special amortisation rules for "nothings"; many remain nothings in jurisdictions such as the U.K. and South Africa.

13 281 U.S. 111 (1930).

14 (1965) 113 C.L.R. 385.

owns the entire bundle of rights related to an asset is said to have a "fee simple" interest in the asset but the bundle can be separated into an infinite number of separate rights and those in turn can be transferred to an infinite number of separate owners. For example, the owner of immovable "property" may sell forever to one person an easement or right of access across the property and lease possession rights for a fixed period to another person. The "owner's" property then consists only of the right at some point in the future to reversionary possession of the property that remains subject to the easement.

One of the rights that can be severed from the entire bundle that comprises a fee simple in an asset is the right to income from the property. Only a crystallised right is capable of transfer – that is, a right which exists at the time of transfer (known as a "presently existing" right). Thus, it is possible to transfer, say, a right to rental income from property where there is an executed lease in place but there is no right to transfer a right to rental income where a property owner has yet to sign a lease on the property – in that case, the owner has no more than a "mere expectancy" that has yet to crystallise into a presently existing property right.[15]

The taxpayers in the *Earl* and *Shepherd* entered into contracts that validly transferred rights to income – in the *Earl* case through an agreement allowed under Californian law to share all income rights between spouses and in the Australian *Shepherd* case through a valid assignment (the Anglo property law term for the transfer of intangible rights) of a right to royalties under a licence agreement. In both cases, the validity of the transfers was a question of state property law (property transfers are a subject of state jurisdiction under both the U.S. and Australian federal systems). In both cases, courts agreed the transfers were effective as a matter of (state) property law. The U.S. Supreme Court found that the assignment was ineffective for (federal) tax purposes, however – for tax purposes, the Court held, the gratuitous assignor of an income stream was the person who derived the income, not the recipient of the payments. In other words, while property law might recognise transferred income as accruing to the assignee, the transaction had no effect for tax law where the purpose of the law was best fulfilled if the property law results were ignored.

The Australian High Court adopted a starkly different approach, accepting state property law outcomes as the basis for determining federal tax liabil-

15 It is sometimes said that an uncrystallised right to future income can be transferred in equity where consideration has been paid for the transfer. As a matter of equity law, however, no property rights are transferred in this case, however. Rather, in these circumstances equity will create an obligation on the transferor to assign the right to income when the right crystallises.

ity, an approach consistent with that generally followed by Anglo courts. As the assignment of the right to royalties in *Shepherd* was valid as a matter of state property law, the outcome was accepted for federal income purposes. No consideration was given to the policy implications of transferring property law outcomes to income tax law – that is, whether recognition of an income assignment would defeat the objective of a progressive income tax imposed on the basis of economic capacity and ability to pay. A similar approach was followed in most Anglo jurisdictions.[16] Subsequent intervention by legislatures to overturn the effectiveness for tax purposes of income assignments showed the legislatures viewed recognition of the transfers as inconsistent with tax principles.[17]

II.2 The triumph of English tax law mysticism

The U.S. judicial concept of income for tax purposes – any gain from any source or, in the case of a windfall, no source – largely coincides with an economic understanding of income as a net accretion of economic capacity[18] and the commercial notion of profit. The tests applied by U.S. courts to characterise receipts have no independent power – they do not define income *per se*; rather, they look to see if the external objective economic criteria that define income are present.

The Anglo judicial concept of income has an independent basis, however – income in the Anglo world derives its substance solely from judicial tests and characteristics set out in those tests. A receipt is income if it exhibits an income characteristic set out in the judicial tests and it is not income if it

16 In one extreme case that led to a flood of tax minimisation transfers, the Australian High Court held that it was possible for a partner in a professional partnership to transfer by way of assignment what was effective personal services income by transferring the right to income from a share of the partnership, a right the court concluded was a valid property right capable of assignment: see *FCT v Everett* (1980) 143 C.L.R. 440. The New Zealand Court of Appeal rejected a similar argument by the taxpayer in *Hadlee & Sydney Bridge Nominees v Commr of Inland Revenue*, a decision affirmed by the Privy Council (1993) 25 ATR 206 not on the basis of any policy arguments but rather because those courts concluded there was no presently existing right to income from the partnership capable of transfer as a matter of property law.

17 In some cases income assignments were attacked explicitly (e.g., Canada) while in other jurisdictions assignments were indirectly by, for example, assessing transferors of property rights under capital gains legislation (e.g., Australia).

18 Originally, in decisions such as *Eisner v Macomber*, above note 9, the U.S. income concept was limited to realised gains but accruing gains such as a discount on a zero-coupon bond would now also fall into the concept.

lacks any income characteristic under those tests, period. It is the tests themselves that bestow an income nature on a receipt, an almost mystical process that has no regard to external criteria such as notions of gain or loss. The resulting income concept is assumed by Anglo courts to be a universal norm. With no hint of irony, these courts view their judicial concept of income to be synonymous with the "ordinary concepts and usages of mankind".[19]

The primary Anglo judicial test used to identify income is the nexus of a receipt with a source – income derives from one of three possible sources: the provision of labour services, business activities, or the use of property. An additional proviso is that the gain must be in the form of cash or convertible to cash. Thus, a benefit that must be enjoyed in kind will not constitute income at common law unless the recipient is allowed to sell the benefit and convert its value to cash.[20] The gain realised on the sale of an asset, even a business asset other than inventory (or trading stock, as it is called in some Anglo jurisdictions) normally sold in the course of a business, will not *prima facie* constitute income as it is not a product of labour services, business activities, or from the use of property. Instead, it is considered a "realisation of capital" by Anglo courts.

The primary nexus-with-a-source test used to identify Anglo judicial concept income is supplemented by two further tests. The first is the substitution or compensation test. An amount received in substitution for what would have been an income receipt or as compensation for non-receipt of an income amount itself assumes an income character. The second is the income form and nature test. A payment that satisfies no other test may be income if it has an income "feel" because of the form it takes, usually a periodic payment.

The crux of most disputes generated by the mystical distinction between income gains and capital gains is the question of when an activity constitutes

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19 One of the most cited quotations in Australian income tax law, for example, comes from the judgment of Jordan CJ in *Scott v Comr of Taxation* (1935) 35 SR (NSW) 215; 3 ATD 142 where he said at SR 219, "what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income".

20 The proviso derives from the U.K. case of *Tennant v Smith (Surveyor of Taxes)* [1892] AC 150 where the U.K. House of Lords concluded the provision of accommodation by an employer did not fall within the relevant schedule of the U.K. schedular tax. Its transference to the general notion of income in other Anglo jurisdictions is an example of the "colonial cringe" phenomenon described below.

a business and when it is a mere enterprising realisation of capital. A sale of inventory clearly generates income. The sale of an investment asset generates a capital gain. The sale of a business asset such as depreciable property used to produce income generates a capital gain unless the taxpayer is also in the business of selling its depreciated property.

The most important factor moulding the character of a gain and distinguishing business from investment activities is the taxpayer's subjective intent – was the property sold acquired with the purpose of resale at a profit or in the course of a profit-making scheme or was it acquired without these business like objectives in mind. An illustration of the importance of subjective intent in characterising a gain in the mystical judicial concept of income is to be found in the case of a taxpayer acquiring an asset for one purpose (say, investment or personal use) and then changing his or her intention (or its intention, in the case of a company – in the judicial doctrines used to identify income, even companies can have intention with respect to assets they acquire) to one of profit-making. The gain from the cost of acquisition until the time the taxpayer's intention changes is a capital gain; the gain from the asset value at time the taxpayer's intention changes until the time of disposal is an income gain.[21]

On its face, a distinction between income and capital gains based on a taxpayer's subjective intent appears unsustainable but decades of application have not softened the doctrines at all; to the contrary, they have cemented the place of ethereal concepts in Anglo income tax. Perhaps the most cynical explanation of the basis for distinguishing what look to be indistinguishable cases is that offered by one of the great experts on the Anglo judicial concept of income, Ross Parsons. Professor Parsons proposed the "gentlemen's club" test as an easy way to identify the cases in which courts find an asset sale generates an income gain and those in which they will find it generates a capital gain.[22] If the asset sold were of the sort that a gentleman member of the club to which the judges likely belonged might sell such as land or interests in a company, it was highly improbable that the vendor had the requisite "income" purpose. On the other hand, a one-off sale of, say, a shipload of toilet paper could on its own constitute a business that generates ordinary income – clearly no gentlemen would be in engaged in such activities.[23]

21 *Federal Commissioner of Taxation v Whitfords Beach Pty. Ltd.* (1982) 150 C.L.R. 355.

22 R. Parsons, "Capital Gains Taxation – A Lawyer's Perspective" (1984) 1 *Australian Tax Forum* 122, at 125.

23 See, for example, the decision of the Court of Session (Scotland) in *Rutledge v. Commissioners of Inland Revenue* (1929) 14 TC 490.

The absence or presence of an identifiable source generating income – labour, property or business – is usually decisive in determining whether a gain is a capital or income receipt, as the often-cited *Federal Coke* case showed.[24] The taxpayer in that case, Federal Coke, was an operating subsidiary of a mining company, Belambi. Federal Coke processed minerals for its parent which in turn sold the processed minerals to a French corporation, Le Nickle. When Le Nickle sought to extricate itself from its contract with Belambi, it agreed to pay compensation for the cancellation of the contract. Belambi subsequently sought to change the settlement between the companies and returned the cheque it had received from Le Nickle, asking the French company to instead pay the money to Belambi's processing subsidiary, Federal Coke.

Had the tax office sought to assess Belambi on the money paid by Le Nickle to Federal Coke, it almost certainly would have been successful. The funds were clearly a substitute for income Belambi would have received had the contract not been terminated and, as noted, one alternative test used by Anglo courts to identify judicial concept income is a substitution test – an amount substituted for or in compensation for lost income acquires its own income character. Belambi would have been treated as having constructively received the funds it directed to be paid elsewhere and they would have been assessable as income it its hands.

The tax office, however, unwisely sought to assess Federal Coke on the funds it received. On the taxpayer's appeal of the assessment, the court held the amount received was a capital receipt to the company as there was no connection between the receipt and any services provided by the company to Le Nickle. Without a nexus with source, the payment was simply a windfall in the hands of the recipient company.

Importantly, the nexus with source is viewed from the perspective of the recipient of a payment, not the payer. Thus, for example, a person making a payment may see the payment as a reward for services provided by the recipient. However, if the recipient does not perceive it as a reward for services, it will not acquire an income character and instead will be characterised as a gift or windfall in the hands of the recipient.[25]

The second supplementary test used to identify judicial concept income – the inherent "income" nature of a payment possessing an income-like feel – is based on truly ethereal factors: the form of payment, the extent to which the taxpayer anticipated the payment, and even the use of the payment – did

24 *Federal Coke Co. Pty. Ltd. v Federal Commissioner of Taxation* 77 ATC 4255.

25 See, for example, *Hayes v FCT* (1956) 96 CLR 47 and *Scott v FCT* (1966) 117 CLR 514.

the taxpayer apply it to pay for the sort of things for which he might normally be expected to apply his income? The application of these factors is illustrated in the *Dixon* case,[26] where an employer, faced with labour shortages during the Second World War and anxious to encourage employees to return to the firm after voluntary enlistments in the armed forces, made regular payments to employees who enlisted equal to the difference between their (lower) army pay and the (higher) pay they had previously received when in employment. While there was no contractual requirement that recipients of the payments would return to the firm when their tour of duty expired, it was anticipated by the employer and employees that they would.

The court in this case found the payments were not income as a reward for services as the payments were neither in reward for past services for the employer nor present services in the army. Nevertheless, the court upheld the assessment on the basis of the inherent income character of the payments – periodic, anticipated by the recipients, and applied towards the same sort of expenses formerly paid from salaries.

The power of mysticism – payments taking on a legal character by virtue of their form or legal label – is paramount in Anglo tax law. Nowhere is this better illustrated, perhaps, than in the characterisation of annuity payments. Annuities were originally developed as charges on property, the most common being an obligation imposed on executors of a deceased person's estate through a testamentary will which required the executors to make regular support payments to a surviving beneficiary (commonly a spouse) for the remainder of her or his life. The will would direct the executors to pay the "annuity" out of income of the estate but empowered – in fact, required – them to impinge on capital if the income generated was insufficient to meet the annuity payments. As these amounts were no longer available for distribution to the capital beneficiaries of the estate, they were characterised as income payments for trust law purposes, even where paid out of the estate's capital.

Because they were payable for the unknown lifetime of a designated beneficiary, annuities were originally for uncertain periods and from an accounting or finance perspective it would have been difficult or impossible to determine an appropriate amortisation schedule to recognise the capital component in each annuity payment. This was not true of fixed term annuities later sold by financiers, investments that in all respects apart from the label were identical to blended payment or amortising loans. But judicial characterisation prevailed and for tax purposes, the courts said the purchaser of an annuity had "surrendered" a capital payment in return for an income stream[27]

26 *FCT v Dixon* (1952) 86 C.L.R. 540.

27 *Southern-Smith v Clancy* (1941) 1 KB 276.

and as a consequence there is miraculous transformation of capital into income for tax purposes.[28] Statutory intervention was necessary to allow investors to recover their capital free of taxation in the case of purchased and gifted annuities.

II.3 The influence of "colonial cringe"

The use of transplanted categories helps explain the origins of many of the fundamental tax concepts in the Anglo world such as the income and capital distinction. In many cases, however, following the doctrine of precedent, common law judicial decisions are based not on the general concepts but rather rely on particular precedents that appear to address the same fact situation (a fact situation said to be "on all fours" with the current dispute).

The doctrine of precedent rests on a presumption that justice requires similar cases to be treated similarly and requires courts to follow judgments of higher courts while giving due consideration to judgments of equal or inferior courts and allowing consideration of judgments of foreign courts. As foreign judgments need not be considered, let alone have any binding effect on local common law judges, it might be expected that extra-territorial precedents would have little if any impact on local interpretations of law. However, in most Anglo jurisdictions two factors have elevated "foreign" U.K. decisions to a status on the par with or even above that of local precedents.

The first factor elevating the importance of U.K. precedents derives directly from colonial law. Although each British colony had its own judiciary and appeals system, the final court of appeal for jurisdictions in the British Empire was the U.K. based Judicial Committee of the Privy Council (commonly referred to as the Privy Council). Most former U.K. colonies retained a right of appeal to the Privy Council for years and sometimes many decades following independence.[29] Membership of the Privy Council mostly comprised U.K. law lords from Britain's final court of appeal, although the Council was sometimes augmented with higher court judges drawn from countries retaining appeals to that body. Inevitably, Privy Council decisions on tax laws of former colonies were coloured by perceptions held by the U.K. judges based on their interpretation of the U.K. tax law.

28 *Scoble v Secretary of State in Council for India* (1903) 1 KB 494.

29 Canada ended appeals to the Privy Council in 1949, Australia not until 1975 from all federal courts, Hong Kong in 1997 upon the handover to China, and New Zealand as recently as 2003. Several ex-colonies, including a number in the Caribbean, retain a right of appeal to the Privy Council.

The role of the Privy Council faded in the second half of the 20th century as most former colonies shifted to local higher courts as their final courts of appeal, leaving only older Privy Council decisions binding in those jurisdictions. The cessation of technical reliance on judgments of a U.K.-based court did not mark an end to consideration of U.K. decisions, however. A second, and ultimately far more persuasive, factor guided Anglo courts to reliance on U.K. decisions: a legacy of colonialism that judicial critics sometimes refer to as "colonial cringe". Colonial cringe refers to the almost reflexive assumption by Anglo-speaking judges holding strong and continued respect for British institutions and systems that U.K. precedents can provide better guidance on interpretation of statutes than independent consideration of those laws undertaken by local courts looking at the law in the context of the local environment.

In a sense, continued regard by Anglo courts to U.K. common law cases as persuasive, if not binding authority, following independence reinforced the principle underlying the doctrine of precedent – consistent outcomes for similar situations. Arguably, the logic could also have extended to interpretation of terms in statutes where the local legislation was based directly on a U.K. statute.[30] The logic stops, however, where local statute is different from the U.K. legislation being considered by U.K. judges.

Such is the power of colonial cringe, however, that many Anglo jurisdiction judges outside the U.K. still look to U.K. precedents based on the U.K. income tax statute when determining the scope of their own legislation even when the local legislators explicitly rejected the U.K. model in favour of a completely different structure. For example, a U.K. precedent deciding whether a particular type of payment fell into the specific inclusion measures of one particular schedule of the U.K. tax legislation should be of little relevance to a court in a global tax law jurisdiction required to decide if a similar receipt constituted gross "income" in the global tax law. But illogical or not, Anglo courts often turn to English cases interpreting specific words in the schedular U.K. tax law to interpret broad concepts in their own global tax laws.

Mention has already been made of one important Anglo income concept attributable to colonial cringe – the assumption that "gross income" in the Anglo global income tax laws catches only remuneration that comes in the

30 For example, the Partnership Acts across much of the English-speaking world are based directly on the original U.K. legislation drafted by in 1879 by Sir Frederick Pollock which in turn was based on his *Digest of the Law of Partnership*, published two years earlier and which was, essentially, a codification of common law precedents.

form of cash or something that is convertible to cash.[31] A more recent and often cited example of colonial cringe is the continued respect shown by courts in many jurisdictions outside the U.K. for the England & Wales Court of Appeal decision in *Higgs (Inspector of Taxes) v Olivier.*[32] The taxpayer in the case was a popular English actor who entered into a contract to direct and act in a film production. After the film had been completed, the taxpayer entered into a second negative covenant agreement with the company that produced the film under which the taxpayer agreed not to act in, or produce or direct any film anywhere for a period of 18 months, except for films produced by that company. The taxpayer was assessed on the amount paid for the negative covenant agreement under a provision in the income tax schedule applicable to profits or gains arising or accruing from the taxpayer's profession or vocation. The Court of Appeal concluded the amount received by the taxpayer was not "profits or gains accruing or arising from his trade or profession" as required to fall within the schedular charging provision.

The question of whether an amount received for entering into a negative covenant agreement fell within the scope of profits or gains accruing or arising from a trade or profession looks to be very different from the question as to whether the gain to the taxpayer should be considered gross "income" of the person enjoying the gain in the context of a global income tax. The *prima facie* illogic of applying a finding in a case based on the statutory language of the U.K. schedular legislation to interpret the words used in another country's very different statute enacting a global tax is compounded by the fact that the U.K. precedent in this case is found in a judgment of a relatively low level court that should hold relatively little persuasive weight. And yet, many Anglo courts outside the U.K. applied the decision in *Higgs v. Olivier* to decide that negative covenant payments would usually fall outside the scope of gross income subject to tax in a global income tax.[33] It fell to the legislatures in these jurisdictions to adopt specific inclusion measures to bring these payments into the tax base.

The legacy of the colonial cringe phenomenon will long outlast the direct manifestation of the phenomenon. Of former U.K. colonies, Canada has

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31 The cash or convertible doctrine is the legacy of the U.K. case of *Tennant v Smith (Surveyor of Taxes)*, above note 20.

32 (1952) Ch 311.

33 It was suggested by one Australian High Court judge Kitto J in *Dickenson v. FCT* (1958) 98 C.L.R. 460 that the holding in *Higgs v Olivier* might not be applicable in Australia given the different structure of the Australian law but Australian courts have ignored this difference and rely on *Higgs v. Olivier* as support for the proposition that payments for negative covenants will generally be capital receipts.

probably moved the farthest in terms of shifting away from direct citation of U.K. precedents. But colonial cringe played a central role in the development of Canadian precedents for the first five or six decades of Canadian income taxation. As a result, while a Canadian judge might today look only at Canadian precedents when interpreting Canadian income tax law, the precedents she or he is using could well be based directly on a misapplication of U.K. judgments. Canadian tax concepts thus continue to resemble closely those used in Anglo jurisdictions less shy of continued direct citation of U.K. precedents.

In contrast to judgments from courts in Anglo jurisdictions, decisions of U.S. courts have never been affected by a colonial cringe factor. The striking difference between the U.S. and other jurisdictions in this respect lies, of course, in the origins of the U.S. – by a Declaration of Independence from U.K. law and a revolution to achieve that independence. Although the independent American states inherited the colonial laws in effect at the time of independence and both the state and national courts followed U.K. common law system, the fundamentally different foundation for U.S. law, deriving authority from a written constitution rather than a hereditary monarch ensured that U.K. precedents would have minimal influence on U.S. jurisprudence.[34] In one of the few early tax cases in which one of the parties (the tax authority in this case) sought to rely on a U.K. precedent, the U.S. Supreme Court declared that a U.K. decision interpreting the construction of a U.K. statute was "manifestly" not a precedent for U.S. courts testing "an act of Congress by the limitations of a written Constitution having superior force".[35]

II.4 The triumph of form over substance

The dichotomy between so-called "purposive" and "literal" or "black-letter" interpretation of tax laws is as old as the income tax itself and debate over the most appropriate path for courts to follow is heard across common law and civil code jurisdictions. The focus on interpretation can be restated as a more fundamental legal question, whether tax consequences should follow the form or the substance of a transaction. This, in turn, is sometimes restated by some observers in policy terms: should the words of a tax law be interpreted

34 Some state legislatures went so far as to ban reliance on U.K. precedents. See further O. Benvenuto, "Reevaluating the Debate Surrounding the Supreme Court's Use of Foreign Precedent" (2006) 74 *Fordham Law Rev.* 2695, text at note 61 and following.

35 *Eisner (Internal Revenue Collector) v. Macomber* 252 U.S. 189 (1920), at 216.

to give effect to the policy objectives of the law or should they be read without regard to policy goals.

American tax jurisprudence from its outset had regard to economic substance when applying tax provisions to arrangements that could trigger a tax liability or benefit. In a sense, the approach superseded the literal or purposive question by accepting the terms in the law at face value but looking to the elements of transactions in their entirety – that is their actual substance – to determine if they fell within the words set out in the statute. By way of contrast, U.K. courts have tended to look at the superficial form of a transaction without regard to the actual commercial or economic outcome to see how the law should apply.

The causes of the dichotomy between Anglo and U.S. approaches to tax law interpretation are not immediately clear. One important factor could be the fact that a policy basis of Anglo tax law is often obscure, if one can be discerned at all. As noted earlier, initial judicial consideration of Anglo tax laws often used transplanted concepts and poorly fitting U.K. precedents to fragment the tax bases and these early interpretations helped mask any structural policy the laws may have had. The initial decisions could have been swiftly overcome by Anglo legislatures to restore the base and signal the policy objectives of the laws. They failed to do so, however, instead tacitly or even overtly and deferentially accepting judicial characterisations to guide policy and concealing any policy basis to the tax law.[36]

All else being equal, a court looking through the fog of complex and unprincipled legislative responses to earlier judicial decisions for underlying principles to guide the interpretation of tax law would face a challenging task. The undertaking assumes Herculean proportions after the proliferation of tax expenditures beloved by Anglo legislatures has effectively obscured any tax policy objectives that may have been distilled from the law. Tax expenditures are, of course, used by governments of all types to hide spending programs from the transparent review accorded ordinary expenditure initiatives, but

36 An example of this approach is the Australian legislative response to the judicial characterisation of negative covenant payments described earlier (above, note 33). Relying on an imported U.K. precedent based on an entirely different statutory construction, Australian courts concluded negative covenant payments fell outside the judicial concept of income. Instead of moving quickly to reverse the doctrine and providing the courts with a clear message regarding the policy intent of the law, the legislature accepted the judicial characterisation of the gains as non-assessable capital receipts. The payments were left outside the income base for a long time and eventually brought in by way of the capital gains tax, effectively endorsing the original judicial depiction of the receipts.

Anglo jurisdictions seem particularly enamoured with the subterfuge of these indirect expenditures.[37]

To be sure, there are critics that call on Anglo judges to adopt a more principled approach to interpretation of tax legislation,[38] and it is evident that Anglo judges can adopt this approach where the principles of a tax law are clear.[39] The task may not be that easy where the law on its face is not guided by principles. It should not be surprising that in this case a court might conclude the preferable course of action is too look no further than the literal text of the law.

The classic illustration of the Anglo approach, a precedent that came to epitomise literalism or black-letter interpretation by regard to the form of a transaction, is the (U.K.) House of Lords decision in *Inland Revenue Commissioners v. Duke of Westminster*.[40] Lord Tomlin's assertion in that case that "Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be" is perhaps the most cited extract in tax avoidance litigation in the Anglo world.

The taxpayer in the case had entered into an arrangement in an attempt to deduct wages paid to his gardener, an expense that would normally have been a non-deductible personal outgoing. U.K. tax law at the time allowed taxpayers to shift income from one taxpayer to another by entering into covenants to make payments for a minimum of seven years and the taxpayer substituted a covenant for his employee's wages. While the gardener was not obligated to continue his work to be entitled to ongoing payments under the terms of the covenant, after his employment contract was replaced by the covenant, the gardener continued to carry out his duties exactly as he had formerly.

The arrangement had the legal form of covenant payments. But where the payments directly substituted for wages and all parties continued to act after the change in legal form in exactly the same manner as they did prior to the

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37 Few Anglo jurisdictions admit to the extent to which they spend by way of tax concessions. Australia is one of the few that does. Its annual disclosure of tax expenditures (almost 5 % of GDP) reveals the extent of the problem. See (Australia) Treasury, *Tax Expenditures Statement 2006* (Canberra: Treasury, 2006).

38 See, for example, N. Brooks, "The Appropriate Role of Courts in Interpreting GST Legislation: Reflections on the Canadian Experience" (2006) 6(1) *Australian GST Journal* 1.

39 See, for example, the judgment of Hill J. in *H P Mercantile Pty Ltd v Commissioner of Taxation* (2005) FCAFC 126. Hill J. was notable for his black letter approach to interpretation of many income tax cases; in *H P Mercantile* he shifted to a clear policy analysis when interpreting a goods and services tax statute written in a clear and principled fashion.

40 (1936) AC 1.

change, it would not be difficult to say the payments had the substance – the economic outcome – of wages. The House of Lords respected the notional form of the transaction, however, without looking to see what character might be ascribed to them when the entirety of the arrangement was considered.

American courts, by way of contrast, tend to look at the totality of a multi-element arrangement – the actual substance of the arrangement – to characterise transactions for tax cases. Thus, for example, where parties enter into a series of connected transactions that they intend to follow in *seriatim*, a U.S. court would characterise the separate events as steps in a larger transaction and apply the tax law to the larger transaction, not the individual elements. For example, while an Anglo court would view a standard "repo" transaction[41] as a separate sale of an asset, put option for the repurchase, and further sale back to the original vendor, a U.S. court would simply collapse the arrangements for tax purposes into a secured loan and apply the tax provisions relevant to debt to the transaction.[42]

The U.S. Supreme Court decision in *Gregory v. Helvering (Commissioner of Internal Revenue)*[43] is often cited by commentators as an example of a court collapsing a multi-element transaction to ascertain the legal character of the arrangement once its true substance has been identified. The taxpayer in the case wished to sell assets held in a wholly-owned company. To avoid an overt distribution that would have triggered recognition of taxable dividends in her hands, she created two interposed transactions, a tax-free inter-corporate rollover of the assets to a newly created group company (labelled a "reorganisation" in the U.S. tax code), followed by a tax-free distribution upon liquidation of the newly-created company. The U.S. Supreme Court collapsed the intermediate transactions and treated the arrangement as the distribution of a taxable dividend. Once the transaction in its entirety was considered and the interposed steps ignored, there was no basis for applying the tax relief available only through those intermediate steps.

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41 The trade term for a guaranteed reciprocal repurchase transaction.

42 *Nebraska Dept. of Revenue v. Loewenstein* 513 U.S. 123, 128 n. 3 (1994). See also *First American Nat'l Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972); *Union Planters Nat'l Bank of Memphis v. United States* , 426 F.2d 115 (6th Cir.), cert. denied, 400 U.S. 827 (1970); *American Nat'l Bank of Austin v. United States*, 421 F.2d 442 (5th Cir.), cert. denied, 400 U.S. 819 (1970). The Anglo judicial approach to repo transactions has been overcome by legislation in some cases. In the U.K., for example, section 730A of the *Income and Corporation Taxes Act* 1988 treats the transaction as a debt for income tax purposes and s. 263A of the *Taxation of Chargeable Gains Act 1992* complements this treatment by ensuring there is no disposal for capital gains tax purposes of the asset used in the repo transaction.

43 293 U.S. 465 (1935).

Interestingly, a similar approach was adopted in the 1980s by superior courts in the U.K. through what became known as the "fiscal nullity" doctrine, used to collapse multi-step transactions that had no economic explanation apart from the tax benefits they generated.[44] There appears to have been a significant retreat from the approach in the U.K. in more recent times, however,[45] and even at its apex, the fiscal nullity doctrine only applied to a small set of multi-step transactions with no inherent economic substance. It did not extend to arrangements designed to provide a tax benefit by way of legal recharacterisation of a substantive transaction and it was not followed in other Anglo jurisdictions.

Yet another technique used in the U.S. to defeat transactions that rely on legal form to generate tax benefits is application of what is known as the "sham" doctrine. A leading example is the *Knetsch* case[46] in which the taxpayer sought deductions for interest on a "loan" from an insurance company. The taxpayer used the funds he received to purchase an annuity from the insurer and secured his debt obligation against the annuity contract. While in legal form the payments purported to be interest for the use of money, they were not interest payments in substance – the round-robin of transactions meant in essence there was no economic debt incurred by the taxpayer. On this basis, U.S. Supreme Court labelled the arrangements a "sham", a label that has stuck with transactions not intended to yield more than a token net economic result apart from tax savings.

The term "sham" is also used in Anglo tax law and on one level the meaning is the same – a sham transaction is one where the rights and obligations apparently created by a transaction do not exist in reality. But while a U.S. court will look to the substance of a transaction to see if it is a sham in the sense of creating rights or obligations of no real effect or value, the Anglo court will look no further than the transaction's legal form to see if it creates legal rights and obligations. Thus, in an Anglo jurisdiction, a sham transaction is one in which "acts are done or documents executed which are intended to give third parties or a court the appearance of creating between parties legal rights and obligations, which differ from the actual legal rights and obligations (if any) which the parties intended to create".[47] Since a court will not give effect to an apparent legal status that is not based on actual legal arrangements, an Anglo "sham" transaction is automatically nullified without need

44 *WT Ramsay Ltd. v. Inland Revenue Commissioners* (1982) AC 300; *Furniss v. Dawson* (1984) 1 AC 474, (1984) 1 ALL ER 530; (1984) STC 153.

45 *MacNiven (HM Inspector of Taxes) v. Westmoreland Investments Ltd.* [2003] 1 AC 311.

46 364 US 361 (1960).

47 M. Kobetsky, M. Dirkis and A. O'Connell, *Income Tax: Text, Materials and Essential Cases* (4th ed) (Sydney: Federation, 2003), p. 591.

for any statutory intervention.[48] But if the parties intend the transactions to create actual legal rights and obligations, an Anglo court will apply the tax rules to those legal forms, even if they exist only in a legal sense.

II.5 The rise of the GAAR

The uncertain boundaries inherent in Anglo tax systems reliant on common law judicial tests to define key concepts invite exploitation by taxpayers and the development of both simple and complex avoidance schemes to alter the legal character of both receipts and outgoings. The initial reaction of authorities in virtually all Anglo jurisdictions was the adoption of piecemeal and ad hoc anti-avoidance measures on a scheme-by-scheme basis. The responses failed to address any of the underlying causes of or opportunities for avoidance and often actually facilitated subsequent avoidance by establishing boundaries to charging measures. In the absence of any clear structure or purpose to legislation constructed on the foundation of judicial concepts, courts were content to endorse arrangements devised to slip taxpayers just over the edge of the limits of specific anti-avoidance provisions.

The legislatures in most Anglo jurisdictions, the exception being the U.K., responded to the problem not by addressing the underlying problem – the perverse tax base constructed on judicial concepts – but by adopting "general" anti-avoidance rules, or GAARs as they are commonly called. GAAR provisions allow tax administrators to disregard or reconstruct any transaction entered into mostly for the purpose of tax avoidance. While the tests differ in superficial form, they are all remarkably similar in substance. Common to almost all is a subjective trigger threshold – the GAAR applies where the taxpayer's main purpose for entering into a transaction or for structuring it the way it was structured was to obtain a tax benefit.[49]

48 *Jaques v FCT* (1924) 34 CLR 328 at 358. See further S. Karlinsky and R. Krever, "Characterising Derivative-based Loan Arrangements" (2004) 19 *Australian Tax Forum* 454.

49 At one end of the spectrum is the New Zealand law – a transaction can be caught by the anti-avoidance provision where the purpose of obtaining a tax benefit is "not merely incidental" to the arrangement. Further along the scale is the Australian rule, catching arrangements entered into for the "dominant" purpose of saving tax and the Canadian rule, which only excludes arrangements entered into "primarily" for bona fide purposes other than obtaining a tax benefit. The proposed new South African rule will apply to transactions with the "sole or main purpose" of obtaining a tax benefit.

Judicial reaction to the GAARs tends to vary over time in line with prevailing social mores and the society-wide pendulum swings toward and against tolerance of aggressive tax minimisation. When courts consider a taxpayer has crossed the line of acceptable tax planning, they can use the GAAR to stymie arrangements. In those cases in which the courts conclude taxpayers have legitimately arranged their affairs to take advantage of the ambiguities and inconsistencies in the legislation, they commonly find the GAAR does not apply because the tax authority has failed to prove the taxpayers' primary subjective intention of minimising tax. Far from clarifying the law, GAARs often enhance uncertainty by legitimising continued reliance on ill-defined judicial concepts and reinforcing the judicial distinctions used as the basis for determining tax liability. More often than not, the outcome is further complexity in the tax law.[50]

III Future prospects

Globalisation and the swift transference of legal forms and constructs across national boundaries has in one sense led to a convergence of tax laws in broad concept if not fine detail. There have been, for example, relatively similar responses to cross-border investments including widespread adoption of CFC regimes, exemption or foreign tax credit systems, rules to deal with new financial instruments and arrangements, responses to income splitting and transfer pricing, measures to address the proliferation of fringe benefits, and various rules aimed at arrangements to exploit any gap between the corporate and individual marginal tax rates. At the same time, statutory expansion of the tax base with the adoption of "capital gains" tax measures in many Anglo jurisdictions has brought the tax base in those jurisdictions closer to their U.S. counterpart.

In contrast to the legislative developments, fundamental judicial concepts in Anglo jurisdictions remain for the most part frozen in time. True, the concept of business income has been relaxed and one-off transactions or transactions outside a taxpayer's core activities are more likely to attract an income characterisation than might have been the case in the past, but the underlying tests – the need for a nexus with a source or a display of "income" attributes remains largely unchanged. Nor are there any signs that this might change. For the foreseeable future, the divide between U.S. and Anglo tax

50 R. Krever, 'Taming Complexity in Australian Income Tax' (2003) 25 (4) *Sydney Law Review* 467.

concepts looks set to remain in place. In the tax field at least, the gap between approaches taken by different schools within the common law world are likely to exceed that between the civil code and common law worlds.

CHAPTER 6

The Troubling Role of Tax Treaties

Kim Brooks & Richard Krever

§6.01 INTRODUCTION

Most low-income countries stare down a yawning gap between their current capacity and the achievement of the Millennium Development Goals endorsed by the General Assembly of the United Nations in 2000. While the first of the original eight millennium development goals, halving extreme poverty between 1990 and 2015, has been met, many of the other goals have not.[1] Global development assistance to the forty-nine least developed countries has fallen as a consequence of austerity measures associated with the global financial crisis.[2] Inadequate literacy rates and schooling, insufficient transportation and communications infrastructure, food insecurity, flagging health outcomes and other indicators of social and economic security plague low-income countries and the people who live within them. Given the disparities in living standards between high- and low-income countries, every high-income country in the world has recognized the moral and pragmatic case for providing aid to low-income countries.[3] Nevertheless, most high-income countries have at the same time entered into tax treaties with low-income countries that have restricted low-income countries' abilities to collect urgently needed revenue from income earned in their jurisdictions, even

1. Millennium Development Goals, *Eradicating Extreme Poverty and Hunger*, Online: Millennium Development Goals and Beyond 2015 http://www.un.org/millenniumgoals/poverty.shtml.
2. MDG Gap Task Force Report 2013, *The Global Partnership for Economic Development: The Challenge We Face* (19 Sep. 2013), Online: United Nations Department of Economic and Social Affairs http://www.un.org/en/development/desa/publications/mdg-gap-task-force-report-2013.html.
3. G20, *G20 Leaders Declaration* at paras 81-89, September 2013 (Saint Petersburg Summit); See also *Report of the Special Rapporteur on extreme poverty and human rights,* UNGAOR, 26th sess., UN Doc A/HRC/26/28 (2014).

though normative principles of international tax support low-income countries' right to collect that tax.

The staggering proliferation of tax treaties (there are now over 3,000 bilateral income tax treaties between countries around the world) has sometimes been celebrated as indicative of their success.[4] The tragedy for low-income countries is that the success of the high-income states in negotiating ever more treaties has come at the expense of the tax revenue bases of low-income countries. These treaties may be a true 'poisoned chalice' for developing countries,[5] perversely transferring tax revenue from low-income countries to high-income countries (and from low-income countries to multinationals) while yielding limited or no offsetting benefits such as increased foreign direct investment. Surprisingly, however, sceptical questioning by scholars of the need for tax treaties as a way of dividing taxing rights between nations is a relatively recent phenomenon.[6]

In 2009, Sebastien Drevet and Victor Thuronyi took stock of the tax treaties entered into by OECD and non-OECD members.[7] At the time, the 30 members of the OECD had an average of 72 treaties each, while the 162 non-OECD members had an average of 17 treaties. The countries with the fewest tax treaties were those with extremely low-income levels. In the five years since that study, the number of treaties entered into by lower-income, non-OECD countries has continued to grow. In 2014, there were 34 OECD member countries, with an average of 75 tax treaties each and 158 non-OECD members with an average of 20 tax treaties. The increase in treaties is troubling given the growing scepticism about their advisability for low-income countries.

There are, however, modest signs that lower-income countries may be recognizing that tax treaties have distinct disadvantages. In late 2012, Mongolia cancelled its tax treaties with the Netherlands, Luxembourg, Kuwait, and the United Arab Emirates on the grounds that those treaties were facilitating the tax free expatriation of profits from Mongolia's extractive industries.[8] In 2013, Argentina, which had also agreed to tax

4. See John Avery Jones, *Are Tax Treaties Necessary?*, 53(1) Tax L. Rev. 1, 2 (1999) ('The success of tax treaties can be measured by their number.')
5. The description of tax treaties as a 'poisoned chalice' for developing countries has been borrowed from Martin Hearson of the London School of Economics in his presentation of 11 Sep. 2013 to the Strathmore Business School, Nairobi – see http://www.slideshare.net/martinhearson/double-tax-treaties-a-poisoned-chalice.
6. See, e.g., Allison Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71(2) Brook. L. Rev. 639 (2005); John Avery Jones, *supra* n. 4; Richard Vann, 'International Aspects of Income Taxation' in Victor Thuronyi (ed.), *Tax law design and drafting*, 725 (Washington, DC: International Monetary Fund, 1996); Alex Easson, *Do we still need Tax Treaties?*, 54 Bull. Int'l Tax'n 619 (2000); Tsilly Dagan, *The Tax Treaties Myth*, 32(4) N.Y.U. J. Int'l L. & Pol. 939 (2000); Lee Sheppard, *How Can Vulnerable Countries Cope With Tax Avoidance?*, 69 Tax Notes Int'l 410 (2013).
7. Sebastien Drevet & Victor Thuronyi, *The Tax Treaty Network of the U.N. Member States*, 54 Tax Notes Int'l 783 (2009).
8. The IMF had advised Mongolia to renegotiate its treaty with the Netherlands, given the use of that bilateral agreement to strip profits without withholding tax from Mongolia. See Geerten M.M. Michielse, *Safeguarding Domestic Revenue – a Mongolian DTA Model*, (Washington, DC: IMF Publication Services, 2012) Online: IMF http://www.imf.org/external/pubs/ft/scr/2012/cr12306.pdf.

treaties with other countries that demanded low source-based taxation, cancelled treaties with Austria, Chile, Spain, and Switzerland. On 5 June 2013, Malawi cancelled its tax treaty with the Netherlands.[9] Also in 2013, Rwanda renegotiated its unfavourable tax treaty with Mauritius. In 2014, Uganda suspended new treaty negotiations and announced its intention to renegotiate its existing tax treaties to better protect its interests.[10]

In his work at the IMF, Victor Thuronyi strove to design tax systems for low-income countries that would be effective in raising revenue, that would support the revitalization of their economies, and that would assist in achieving an acceptable distribution of income. In his scholarly work, he frequently wrote about the need to protect the integrity of the taxation systems of low-income countries from international tax policy pressures. He well recognized that there was little point in designing optimal tax systems for low-income countries if pressures from high-income countries and multinationals made their tax systems vulnerable. In the course of pursuing this theme across a number of areas of tax law, one issue that he frequently returned to was the pernicious effect and even the lack of necessity of tax treaties.[11]

In view of the considerable amount that has been written questioning the legitimacy of tax treaties, the object of this chapter is modest. Picking up on Thuronyi's misgiving about tax treaties, it simply restates in summary form the case against tax treaties. Again, reflecting a concern that permeated all of Thuronyi's work, it suggests that low-income countries should fiercely guard their jurisdiction to tax. Finally, it notes that if there are any circumstances in which low-income countries might consider ceding tax rights, there are no advantages to ceding that tax jurisdiction through tax treaties as opposed to unilaterally in domestic legislation.

To provide some context for these conclusions, Part §6.02 briefly reviews the development of the tax treaty network. Even from the earliest days of model treaty design, participants in the process understood that the standard treaty provisions would favour capital exporting over capital importing countries.[12] Indeed, many South

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9. Development in Dutch Tax Treaties, *Cancellation of tax treaty with Malawi*, Online: Deloitte https://testregfollower.wordpress.com/2014/02/17/malawi-netherlands-dta-terminated/. An Australian business report has suggested that Australia should terminate its tax treaty with low tax jurisdictions such as Ireland: see Georgia Wilkins, 'Call to tear up treaties with tax havens', *Sydney Morning Herald* (22 Jan. 2014), http://www.smh.com.au/business/call-to-tear-up-treaties-with-tax-havens-20140121-316wq.html.
10. See generally Amanda Athanasiou, *Developing Countries Rethinking Tax Treaties* 76(5) Tax Notes Int'l 395 (2014).
11. Victor Thuronyi, 'Tax Treaties and Developing Countries' in Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer, Alfred Storck & Martin Zagler (eds.), *Tax Treaties: Building Bridges between Law and Economics*, 441, 455 (Amsterdam: IBFD Publications, 2010). ('These countries probably do not need a lot of treaties and can accomplish unilaterally virtually all things that can get done via treaties. In doing so they would avoid the cost of treaty negotiations and possible negative aspects of treaties.')
12. Throughout this chapter we refer to capital importing countries as low-income countries rather than as developing or emerging economies because it focuses on the relevant factor in considerations of the distributive possibilities of taxation: income. The language masks the enormous heterogeneity between low- and middle- income countries, of course. See the plea by Michael Keen, *Taxation and Development, Again*, 4 (Washington, DC: IMF, 2012) ('[T]he

American countries have refused to enter into tax treaties because of the obvious bias in the proposed treaties.[13] Nevertheless, as the data above reveal, treaties have proliferated. Part §6.03, headed 'Are Tax Treaties Necessary' reviews the traditional purposes assigned to tax treaties and suggests none are compelling. Part §6.04 focuses on the key outcome of tax treaties, shifting taxing rights from a source jurisdiction to the country in which a foreign investor is resident and considers the alleged benefits a source country might enjoy from reducing its tax base. It suggests none of the arguments suggesting benefits flow from reductions of taxing rights are persuasive. Part §6.05 assumes that despite the strong case for maintaining the scope of source-based taxation, some countries may nevertheless decide to sacrifice some of their source-based taxing rights. It considers whether this sacrifice is best undertaken through the use of tax treaties or through unilateral measures. The study concludes that there is no real advantage to the tax treaty mechanism and there are some notable reasons why tax treaties create new challenges for tax administrations.

§6.02 THE SHIFTING OF TAXING RIGHTS AWAY FROM CAPITAL IMPORTING COUNTRIES

From the early days of modern tax systems, business interests pressured governments to coordinate their taxing legislation to avoid taxing the same income in two jurisdictions.[14] Colloquially referred to as 'double tax', the taxation of the same income in two jurisdictions might be avoided in any number of ways. To broadly characterize the approaches available for states that wish to act unilaterally, double taxation can be avoided by the residence state (the state where the taxpayer has significant economic or political ties) exempting the tax owing on all or some income earned abroad (an exemption system or a tax credit system), or by the source state (the state that supports the production of the income, regardless of the residence of the taxpayer) deciding not to tax the income at source.

Tax treaties provide the legal framework through which countries might bilaterally bargain a different allocation of taxing rights than the allocation that they could achieve through unilateral legislation. However, since the source state always has the initial potential taxing jurisdiction, these arrangements can only ever result in the sacrifice of taxing rights by the source state. Put another way, tax treaties are not used as a way of increasing the taxing rights or revenue of a source state. In contrast, tax

recurrent title [Tax and Development] does reflect a search for generalization that, after decades of work in the area one might have hoped to move beyond. By comparison, public finance specialists rarely set out to provide similarly generic treatments of taxation in advanced economies.')

13. See Lee Sheppard, *supra* n. 4 ('Smaller, capital-importing, mineral-exporting, or market countries should never sign OECD model bilateral double tax treaties. South American countries do not sign them.')
14. The International Chamber of Commerce motivated much of the early work by the League of Nations on the eradication or reduction of double taxation. Kim Brooks, 'The Potential of Multilateral Tax Treaties' in Michael Lang et al. (eds), *supra* n. 11, at 211, 219.

treaties can increase the tax revenue of a residence state, if the residence state can exact a commitment by the source state to limit its taxing jurisdiction.

Acceptance of the right of source countries to tax income derived in the jurisdiction by non-residents is as old as income taxation. In the 1920s, the League of Nations published a report authored by four economists that articulated an appropriate basis for delimiting the tax jurisdiction of nations. That report concluded, and it has been widely accepted since that time, that nations are justified in taxing income where the taxpayer owes some economic allegiance to the country.[15] Therefore, even where the taxpayer itself was not resident in a jurisdiction, it was accepted that income with an economic attachment to that jurisdiction is justifiably taxed by that state.

After reviewing different methods of allocating the tax base between a source and a residence state, the authors of the League of Nations report ultimately leaned in favour of residence state taxation for income from personal property while recognizing the logic of greater source country taxing rights over income related to land and business property in the source country. The preference for residence-based taxation in some cases was largely pragmatic. The four economists worried that it would be harder to determine in which countries income was sourced than to determine in which country the taxpayer was resident. However, even in the 1920s, they recognized that a division of taxing rights, which shifted rights from the source country to the residence country was only appropriate where countries had similar economies.[16]

Latin American countries especially resisted the preference for residence-based taxation in tax treaties in the early formulations of the model. In 1943, they took advantage of the absence of rich countries from the League of Nations meetings at which a model treaty was being crafted and produced the so-called ‘Mexico’ model tax treaty, which had a source country bias.[17] Unfortunately, when the rich countries returned to the meetings after the war, meeting in London in 1946, the ‘Mexico’ model was swiftly replaced with a ‘London’ model that reverted to residence state bias.[18]

Lacking organizational endorsement, the ‘London’ model had relatively little impact until 1956 when the Organisation for European Economic Cooperation (OEEC), the post-war organization that emerged in 1948 from the Marshall Plan, started work

15. Bruins, Einaudi, Seligman, Stamp, *Report on Double Taxation submitted to the Financial Committee, Economic and Financial Commission Report by the Experts on Double Taxation* (League of Nations report), League of Nations Doc. E.F.S. 73. F. 19, 5 Apr. 1923. One of the most important surveys of the policy arguments concerning source and residence based taxation is Richard Musgrave & Peggy Musgrave, ‘Inter-nation equity’ in Richard Bird & John Head (eds), *Modern Fiscal Issues: Essays in Honor of Carl Shoup*, 63 (Toronto: University of Toronto Press, 1972).
16. See the League of Nations report, *ibid.* at 48.
17. League of Nations, *Fiscal Committee Model Tax Conventions: Commentary and Text*, 64 (1946); Michael Kobetsky, *International Taxation of Permanent Establishments*, Ch. 4 (‘History of tax treaties and the permanent establishment concept’), 106 (Cambridge: Cambridge University Press, 2011).
18. See League of Nations *ibid.* at 65. See also Richard Vann, ‘Writing Tax Treaty History’ in Michael Lang & Ekkehart Reimer (eds), *History of Tax Treaties* (Berlin: Nomos, forthcoming), Online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1788603. The Andean states developed an alternative to the OECD model in the early 1970s, but it did not receive the international attention of the OECD model. See Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4(1) Berkeley J. Int’l L. 1, 10 (1986).

on a model tax treaty for use by its members. In 1963, two years after the OEEC had evolved into the OECD, the successor institution released a model tax treaty that mirrored the residence country bias of the 'London' model. Updated a number of times since, the OECD model has served as a starting point for almost all of the over 3,000 bilateral income tax treaties between countries in the world.[19]

At the time it released its first model treaty shifting taxing rights from source countries to residence countries, the Council of the OECD indicated the model was for use by member countries when negotiating treaties with each other.[20] Despite the clear intention of the designers to craft a model for treaties between higher income, outward investing countries, in the absence of a widely supported alternative model, the OECD model became the starting point for treaties by OECD members with countries outside the OECD camp.

As the influence of the OECD model spread, scholars began to articulate the risks tax treaties posed to the revenue resources of low-income countries and the impact they had on the taxing rights of lower-income, capital importing countries.[21] Concerns about the consequences of divisions of taxing rights in treaties based on the OECD model triggered a response by the United Nations,[22] which led to the release in 1980 of a UN model tax treaty. Like its OECD counterpart, the UN model has been updated from time to time.[23] It is designed to be more favourable to low-income countries by

19. OECD, *OECD Draft Double Taxation Convention on Income and Capital (1963)*, (OECD, 1963).
20. OECD, *Model Tax Convention on Income and on Capital (2010)*, 8 (OECD, 2010).
21. See, e.g., Charles Irish, *International Double Taxation Agreements and Income Taxation at Source*, 23(2) Int'l & Comp. L.Q. 292, 303 (1974). ('As between the two countries, the potential residence country thus has the stronger economic position and the evidence indicates that it has used its superior position to "persuade" the source country to forgo tax revenues'), ('However significant the loss of revenues would be to developed countries as a result of greater taxation at source, the present system of tax agreement causes a much more significant loss of badly needed revenues for developing countries'); Yitzhak (Isaac) Hadari, *Tax Treaties and Their Role in the Financial Planning of the Multinational Enterprise*, 20(1) Am. J. Comp. L. 111, 125 (1972). ('Very commonly today developing countries offer tax concessions to encourage investments. Yet, as representatives from these countries have been at pains to point out, such concessions are often frustrated in their purpose of attracting foreign capital, and only serve to increase the tax revenue of the investor's home country').
22. UN Financing for Development, *Committee of Experts on International Cooperation in Tax Matters*, Online: United Nations http://www.un.org/esa/ffd/tax/overview.htm. (The UN established an Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries in 1967. The group had ten developed and ten developing country representatives). Harvard Professor Stanley Surrey was a key advisor. In a speech delivered in 1964, US Treasury Assistant Secretary Stanley Surrey explained that the US would not require developing countries to reduce their tax rights to the level required by a model if the countries did not believe it was in their interest to do so. See Stanley Surrey, *The United States Tax System and International Tax Relationships*, 17(2) Tax Executive 104 (1965). For an early comprehensive survey of the work of the UN experts, see Stanley Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries*, 19(1) Harv. L. Rev. 1 (1978). Surrey later compared the UN and OECD approaches in Stanley Surrey, *Reflections on the Allocation of Income and Expenses among National Tax Jurisdictions*, 10 Law & Pol'y Int'l Bus. 409 (1978) and prepared a full analysis of the UN model in Stanley Surrey, *United Nations Model Convention for Tax Treaties between Developed and Developing Countries: A Description and Analysis* (IBFD, 1980).
23. Department of Economic & Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

removing fewer taxing rights from source countries, but it is essentially a variation of the OECD model.[24]

Since the early days of treaty design spearheaded by the League of Nations, times have changed dramatically. Globalization, financial innovation, and increased reliance on services and intangibles as the key generators of business profit have undermined or largely eliminated the potential for simpler administration of residence-based taxation. Trade and investment among nations, not just between high-income nations, have proliferated. Policy makers and scholars recognize that robust tax systems will require coordination and assistance in tracking income and collecting tax, especially on the profit of multinational enterprises. A growing body of scholarship has worked to redefine the normative foundation from which high-income countries could justify allocating a greater share of the taxing rights to low-income states.[25] However, this chapter does not depend on that scholarship. Instead, it requires only the acceptance of the source state's right to tax, and a recognition that relying solely or primarily on residence-based taxation will exacerbate the enforcement challenges for tax administrators in this changing economic environment.

§6.03 ARE TAX TREATIES NECESSARY?

The notional purpose of tax treaties, reflected in the original long title of the League of Nations and then the OECD model tax treaty, is to reduce double taxation and prevent international tax evasion and avoidance. Only a small part of tax treaties is directly aimed at these two objectives, however. An article that provides for an exchange of information assists in combating tax evasion while the prevention of double taxation follows from an article that requires the residence country to provide relief from double taxation by way of credit for source country tax or exemption from residence country taxation of income derived in the partner source country. Other articles facilitate international trade and investment by preventing tax discrimination against non-residents, providing a dispute resolution mechanism, and establishing a tie-breaker rule to determine residence where a taxpayer satisfies the residence definition of both jurisdictions.

24. See Sergio Rocha, *International Fiscal Imperialism and the 'Principle' of the Permanent Establishment*, 64 Bull. Int'l Tax'n 83, 84 (2014) ('As the position of the developed countries prevailed [on the development of the UN Model], the UN Model ended up very similar to the OECD Model and failed to achieve its objective of fairly distributing taxing rights between developed and developing countries.')

25. See, e.g., Allison Christians, *supra* n. 6; Gillian Brock, *Reforming Our Taxation Arrangements to Promote Global Gender Justice*, 37 Philosophical Topics 141 (2009); Ilan Benshalom, *The New Poor at our Gates: Global Justice Implications for International Trade and Tax Law*, 85(1) N.Y.U. L. Rev. 1 (2010); Karen Brown, *Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?*, 23(1) U. Pa. J. Int'l Econ. L. 45 (2002); Tsilly Dagan, *Just Harmonization*, 42(2) U.B.C. L. Rev. 331 (2010); Yariv Brauner, *Brain Drain Taxation as Development Policy*, 55(1) St. Louis U. L.J. 221 (2010); Reuven Avi-Yonah & Yoram Margalioth, *Taxation in Developing Countries: Some Recent Support and Challenges to the Conventional View*, 27(1) Va. Tax Rev. 1 (2007).

The bulk of the measures in tax treaties achieves an outcome that does not fit clearly into any of these objectives, the reallocation of taxing rights between the source jurisdiction and residence jurisdiction. In the absence of a treaty, the source jurisdiction, by virtue of its command over the sources of income, would enjoy first taxing rights over income, leaving the residence jurisdiction to double tax the income or provide relief for source country tax. In the latter case, the residence country would enjoy only a residual taxing right over income derived from abroad. Tax treaties shift the balance significantly in favour of residence countries, however. They limit the source country's right to tax income such as dividends, interest, and royalties paid to investors from the residence country by setting caps to source country taxes on these types of income. They remove entirely the right to tax business income derived from the source country other than income derived through a permanent establishment in the source country. In treaties based on the OECD model, they also remove entirely the source country's right to tax any other type of income not specifically enumerated in the treaty. The transfer of taxing rights from source country to residence country reduces double taxation only to the extent the residence country relieves double taxation by providing a credit for source country tax and the credit rules do not provide full recognition of source country taxation.

To be sure, many outcomes of tax treaties apart from the reallocation of taxing rights require agreements of some sort. To the extent country-to-country agreements are desirable or necessary, however, there is no need for the agreements to also reallocate taxing rights. Country-to-country agreements provide a simple path to exchange of information, for example, although unilateral action such as the US Foreign Account Tax Compliance Act or centrally imposed edicts such as the European Union Savings Directive can also generate information sought by tax authorities. While there is some question whether information exchange mechanisms in bilateral treaties or any of these alternatives yield data of genuine value to tax collectors in a macro sense (no doubt information in some particular cases can be important),[26] to the extent information exchange by agreement is desirable, the means to achieve it are wholly unrelated to the division of taxing rights.

The same is true of dispute resolution mechanisms. Tax treaties nominate 'competent authorities' in the respective tax administration as negotiators in the case of disputes arising from the intersection of each country's domestic tax laws as well as application of the treaties and may also provide for arbitration, including binding arbitration to resolve cross-border tax disputes. International agreements other than comprehensive tax treaties can serve as vehicles for establishing dispute resolution

26. Michael McIntyre, *How to End the Charade of Information Exchange*, 56 Tax Notes Int'l 255, 260 (2009) ('The view is widely held that the OECD tax information exchange act is ineffective – not nothing, but not much.'), ('The OECD efforts at getting countries to sign information exchange agreements based on its model TIEA is a sideshow, even a charade.'); Lee Sheppard, *Don't Ask, Don't Tell, Part 4: Ineffectual Information Sharing*, 63 Tax Notes Int'l 1139 (2009) ('The standard OECD information exchange agreement is nearly worthless. Information exchange under the standard agreement is sporadic, difficult, and unwieldy for tax administrators even under the best of circumstances.')

mechanisms.[27] There is no need to forgo taxing rights to establish a dispute resolution system.

A third function of tax treaties, facilitating international investment, by requiring the parties to treat domestic and foreign investors similarly, is achieved through a non-discrimination clause.[28] While the aim may be admirable in terms of encouraging cross-border investment by levelling the playing field, there are limits to what bilateral agreements can achieve in terms of preventing discrimination against non-residents. For example, countries with multiple treaties that include non-discrimination clauses manage to retain an array of tax expenditures available only to residents of the jurisdiction and those with imputation systems are similarly able to restrict access to imputation benefits to residents. To the extent non-discrimination is important to growing cross-border investment, the surest way of achieving it is unilateral domestic legislation. If international agreement is seen as a desirable or necessary assurance against shifts in domestic policy, agreement can be set out in investment treaties that do not mandate overarching source country losses of taxing rights.

A related investment facilitation benefit sometimes attributed to tax treaties is the supposed signalling effect they might have, assuring foreign investors that a capital importing source country follows international norms in cross-border tax practice.[29] There is, however, little empirical evidence that entering into comprehensive tax treaties is a meaningful signal.[30] To the extent entering into treaties might be viewed as a signal of adherence to norms expected by foreign investors, it would be regarded as truly trivial compared to the more important signal that a country follows international

27. See, e.g., the European Union approach in EC, *90/436/EEC: Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises - Final Act - Joint Declarations - Unilateral Declarations*, [1990] O.J., L. 225/10; EC, *Protocol amending the Convention of 23 July 1999 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises*, [1999] O.J. C. 202/1.
28. See, e.g., Ruth Mason & Michael Knoll, *What is Tax Discrimination?*, 121(5) Yale L.J. 1014 (2012).
29. See Allison Christians, *supra* n. 6, at 706-707 ('It has been suggested that tax treaties may signal a stable investment and business climate in which treaty partners express their dedication to protecting and fostering foreign investment'), ('Thus bilateral tax treaties may serve largely to "signal that a country is willing to adopt the international norms" regarding trade and investment, and hence, that the country is a safe place to invest'); Horst Raff & Krishna Srinivasan, *Tax Incentives for Import-Substituting Foreign Investment: Does Signaling Play a Role?*, 67(2) J. Pub. Econ. 167, 168 (1998) ('To attract FDI, governments may therefore have to signal a positive investment environment to foreign firms. Tax incentives can serve this signaling role better than tariff walls').
30. The possible impact of treaties on levels of foreign direct investment has been subject to numerous studies. The conclusion of the IMF in a review of the studies is that they show 'mixed results', noting treaties contain measures that might encourage investment (e.g., lower tax rates) or discourage investment (e.g., information exchange articles). See IMF, *Spillovers in International Corporate Taxation*, 26 (Washington, DC: IMF, 2014). See also, Paul Baker, *An Analysis of Double Taxation Treaties and their Effect on Foreign Direct Investment*, University of Cambridge (2012), Online: http://www2.warwick.ac.uk/fac/soc/economics/news_events/conferences/peuk12/paul_l__baker_dtts_on_fdi_23_may_2012.pdf. ('As to the other potential benefits of a DTT - fiscal certainty, stability and the signalling of a favourable Host investment climate - these are incidental and do not appear to be enough to influence the MNE's FDI locational decisions.')

tax norms by staffing an effective (and non-corrupt) tax administration and by enforcing robust legislation in a consistent way in line with the rule of law.

The most widely heralded purpose of tax treaties is their supposed role in preventing double taxation where income derived in one country by a resident of a second country is subject to tax imposed by the first country on local source income and again by the second country imposing tax on the worldwide income of its residents. Tax treaties use two mechanisms to resolve the problem of double taxation. The draconian method, used for some business income and sometimes for 'other' income not otherwise enumerated in the treaties, is simply to strip the source country of all taxing rights over this income. The second method shifts the onus for relieving double taxation to the residence jurisdiction, requiring that country to either exempt from tax income derived from the other country or provide a tax credit for taxes paid in the source country. In a sense, these latter rules are largely redundant, effectively replicating exemption and credit measures already found in the domestic tax laws of most countries.

Somewhat ironically, notwithstanding their alleged purpose, tax treaties are remarkably ineffective at addressing the most important causes of double taxation, inconsistent characterization of income, and inconsistent source rules. If two countries attribute different characters and consequently different sources to the same income flow, neither country's rules for preventing double taxation will be triggered as neither will recognize the income as having a source in the other country. This can happen, for example, if a first country characterizes income as income from personal services sources from that country and a second country characterizes the same income as royalty income from the exploitation of property rights with a source in the second country.[31] Because they contain almost no characterization rules, treaties are unable to address a root cause of double taxation.

The principal purpose of tax treaties is to reallocate taxing rights between the source and residence countries that are parties to the treaty by removing entirely or capping the source country's taxing rights. The inherent policy objective of tax treaties to reduce the taxing rights of source countries raises two policy issues. The first is whether it is in the interest of developing countries to forgo taxing rights in favour of capital exporting nations and the second, which arises only if it is concluded that the benefit of forgoing taxing rights outweighs the cost of lost tax revenue, is whether this should be done by way of treaty or through unilateral action by a capital importing source country.

§6.04 RATIONALES FOR REDUCING SOURCE TAXATION

Different rationales have been offered in respect of different types of income to support a case for capital importing countries to reduce taxing rights by way of treaty or unilaterally. Viewed objectively, the rationales are weak, making it difficult to see how

31. The dilemma faced by Pierre Boulez, a famous conductor who was subject to double taxation for this reason, is often cited by tax professionals as an example of the Achilles' heel of tax treaties.

the supposed benefits can offset the fiscal costs of sacrificing badly needed revenue in low-income countries, creating tax avoidance opportunities, and reducing the effectiveness of tax enforcement efforts. To the extent a rationale might be plausible, the case for using treaties to achieve the intended objectives in all cases bar one is weak.

[A] Recognizing Administrative Limitations: Forgoing Tax on Business Income Not Derived through a Permanent Establishment

When a multinational sells goods or services in a country, that country has a strong claim to tax some of the multinational's profits due to the sale of those goods and services. While manufacturing and distribution are essential precursors to a final sale, it is the sale itself that yields profits from the entire business chain. The link between profits and the benefit of public goods and services provided by the government in the country of sale is clear. Thus far, however, jurisdictions have not generally sought to tax the profits of a multinational attributable to sales alone in the country,[32] with domestic laws only seeking to tax profits attributable to actual business activities, a threshold that includes sales in conjunction with a modest presence or additional activities such as solicitation.

Tax treaties remove entirely the taxing rights of a source country over business income derived in the country by a non-resident unless the profits are attributable to a permanent establishment in the jurisdiction. This threshold requires a substantial economic presence in the source country by a non-resident business and on its face could lead to a considerable revenue sacrifice for source jurisdictions.

The case for abandoning taxing rights over business income derived by non-residents where the income is sourced in the country but not attributable to a permanent establishment in the jurisdiction has been made on policy and pragmatic rationales. The policy argument suggests that revenue sacrifice would encourage more international trade and investment since multinationals would be freed of the administrative burden of filing tax returns in every country in which they did business. The trade-off would be sensible if subsidiary benefits of increased competition and business activity were greater than the cost of lost revenue.

The pragmatic reason stems from the obvious difficulty of identifying and tracking business income of a non-resident with little physical presence or activity in the jurisdiction. In some cases, a business person's high profile as, say, a sportsperson or a performer, can alert authorities to the activities that generate business income without an enduring presence in the jurisdiction but in other cases identifying and taxing that income presents a significant challenge to local authorities. It has thus been argued that the residence jurisdiction, having access to all financial data of its residents, is in the best position to track and tax this income. As the model was originally intended to apply to a small group of advanced economies enjoying mutual

32. Within economic unions that divide tax revenues using a formula apportionment approach, sales may be a key factor in dividing taxing rights. This is true in Canada and the United States, for example, and has been proposed for the EU.

cross-border trade and business activities, it was assumed the treaty rule would not have a significant impact on overall tax revenues from business income.

The challenge of taxing enterprises deriving business income without a permanent establishment in the jurisdiction has been exacerbated in recent years by the advent of electronic commerce and electronic payment systems.[33] Recent initiatives by the OECD to revisit the concept of permanent establishment in the context of a programme to address problems of 'base erosion and profit shifting' may alter taxing rights at the margin but will have no impact on the practical difficulty of taxing business profits derived by a non-resident with no enduring presence or high profile in the jurisdiction. At best, it is uncertain from a practical perspective if a source country actually loses significant tax revenue by agreeing to forgo taxing rights on business income derived by a non-resident other than through a permanent establishment or high profile activity. The risk, however, is that adoption of a conventional treaty definition of permanent establishment may eliminate taxing rights over some sorts of business activities that can be tracked and taxed in the source jurisdiction. As explained further below, this is thus a concession that if it is to be adopted is best adopted through unilateral measures that set boundaries based on the source country's actual tax administration capacity, not a standard treaty definition of a permanent establishment.[34]

[B] Reducing Costs for Domestic Businesses: Limiting Tax on Interest Income

A source country's claim for taxing interest income derived in the country is not based on activity by or presence of the lender in the source country. Rather, it is based on the fact that the borrowed funds are used by the borrower in the source country to generate the returns paid to the lender for the use of the funds. Since the expenses the investor incurred in earning the income are difficult to verify, and since it is difficult to collect the tax from the non-resident investor, interest income is normally taxed by means of a flat rate withholding tax imposed on the payor. The rate of tax is usually set lower than the country's company tax rate or its highest individual tax rate to reflect the fact that the tax is imposed on the gross interest income. A source country's right to impose withholding tax at the rates prescribed in national laws is reduced, often substantially, where a treaty is in place as treaties almost invariably prescribe maximum interest

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33. See D. A. Albregtse, *The Server as a Permanent Establishment and the Revised Commentary on Article 5 of the OECD Model Tax Treaty: Are the E-Commerce Corporate Income Tax Problems Solved?*, 30(10) Intertax 356 (2002); Dale Pinto, *The Need to Reconceptualise the Permanent Establishment Threshold*, 60(7) Bull. Int'l Tax'n 266 (2006); Craig Elliffe, *Meaning of 'Permanent Establishment' in Article 5 of Double Tax Conventions*, 16 N.Z. J. Tax'n L. & Pol'y 11 (2010); Craig Elliffe, *Canadian Tax Court on the Meaning of 'Permanent Establishment' Treaties*, 22 J. Int'l Tax'n 26 (2011).
34. See, e.g., OECD, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)*, (2013); OECD, *Action Plan on Base Erosion and Profit Shifting*, ACTION 7, (2013).

withholding tax rates well below those found in the national laws of capital importing nations.

The rationale most often made for reducing withholding tax rates on interest paid from a source country by way of treaties is that the reduction is necessary to reduce financing costs of domestic borrowers. It is assumed that in many if not all instances, particularly where lenders are able to route loans through low or no-tax jurisdictions, foreign lenders seek particular after-tax rates of return on loans. Interest rates are accordingly grossed-up to include the effect of any withholding tax that might be imposed on the income.[35] In effect, it is domestic borrowers who pay the tax of foreign lenders, not the lenders. If this is the case, reduction of the withholding tax on interest could lower the borrowing costs of domestic borrowers relying on offshore-sourced debt.

The overall revenue effect of reducing interest withholding tax rates will depend on whether resident companies or subsidiaries of multinational firms are conducting the borrowing. In the case of a resident company, borrowing may be a genuine cost of doing business and any reduction in interest costs due to a drop in withholding tax rates would reduce deductible expenses and thus increase domestic taxes payable on net corporate profits. To the extent interest rates are grossed-up to include withholding taxes, there may, therefore, be an increase in domestic tax revenues from a drop in interest withholding tax rates. The increase cannot be as great as the lost withholding tax revenue since domestic tax will be a percentage (the local tax rate) of the reduced deduction, which is smaller than the gross withholding tax amount that was incorporated into the lending rate. Nevertheless, there is an offset and the costs are not as great as may first seem.

If the international tax system were designed to enable jurisdictions to effectively tax cross-border investment, the potential for increased financing costs for resident borrowers would not be a significant issue. In the general case, a non-resident investor might be presumed to pay tax on worldwide income in the residence state and receive a tax credit for tax paid to the source state. Where that system operates effectively, the interest withholding tax should not change the cost of borrowing. Where, however, the non-resident investor is able to route interest payments through a country where no domestic tax is imposed on the interest, then the tax imposed by the source state would affect the total cost of borrowing.

This phenomenon may not be true with non-arm's length loans between related enterprises. An important tax minimization strategy for multinational firms is to shift profits from the source country to a lower tax jurisdiction by way of 'thin capitalization' techniques. Company groups using thin capitalization to minimize taxes in a source country will finance a subsidiary in that country largely through debt, so that much or even most of the gross profit is used to pay interest on the excessive debt. The interest payments are deductible when calculating taxable income in the source country, thus

35. See Tim Edgar, *Interest Deductibility Restrictions and Inbound Direct Investment: Research Report Prepared for the Advisory Panel on Canada's System of International Taxation* (Government of Canada Publications, 2008) Online: Government of Canada Publications http://publications.gc.ca/collections/collection_2010/fin/F34-3-3-2009-eng.pdf.

reducing tax payable by the local company, leaving the company instead to bear only interest withholding tax. The tax on distributed profits – the dividend withholding tax – is also avoided through this technique.

The primary anti-avoidance tool used to prevent tax minimization in this way is a thin capitalization rule that denies taxpayers a deduction for interest expenses above a specified ratio of capital. Commonly, the ratio is generous, anticipating a higher level of debt funding than would be used by a resident company with similar capital needs so the rule, in effect, acts as a cap on tax minimization but does not prevent it. To the extent thin capitalization is allowed, a reduction in the interest withholding tax rate gives rise to a further loss in tax revenue. Since lending in these circumstances is based on tax minimization goals rather than commercial considerations, there is no grossing up of interest rates to offset the effect of the withholding tax and thus no offsetting increase in taxes paid by the borrower on source country profits. In these cases, therefore, reductions in withholding tax rates represent real uncompensated losses of tax revenue.

[C] Reducing the Cost of Accessing Intangible Property Rights: Limiting Taxation of Royalties

Royalty payments are returns to the owner of intangible property for the use or exploitation of that property. Following the direct nexus between the payments and the use of property, it is an accepted international norm that the source of the income is the jurisdiction in which the property is used and from which payments are made. Remuneration for the use of the property is only possible because the source state provides infrastructure to support that use and, more importantly, the intellectual property protection that gives value to the property and the ability to command rents for its use.

The primary rationale argued for a source country forgoing taxing rights on interest income – because the tax may be passed on to borrowers, increasing the cost of borrowing by business – does not apply to royalties. Lenders may be able to seek an after-tax rate of return and shift lending from any jurisdiction not offering that rate. The same is not true of the owners of intangible property. Licenses to use intangible property usually include commitments by both parties to limit the distribution of property rights associated with the property, limiting the potential pool of customers.[36] It simply is not possible to shift a licence to another jurisdiction as it is with debt if the after-tax rate of return is reduced. Put simply, if the owner of intangible property wants to derive income from a particular jurisdiction, the owner has no option but to bear a tax burden in the jurisdiction if tax is imposed on royalties. The policy rationale for reducing tax on royalties as means of reducing costs for domestic users of intangible property is very weak at best.

36. See, e.g., Peter C. Dawson, *Royalty Rate Determination*, 8 J. Bus. Valuation & Econ. Loss Analysis 133 (2013).

Again, as was the case with interest, a serious concern is that any royalty tax concession aimed at reducing the cost of accessing intangible property rights for domestic business will be exploited by multinational firms to avoid source jurisdiction taxation. Through the use of thin capitalization rules and arm's length pricing rules, it is possible to control to some extent the syphoning of local profits to overseas low-tax jurisdictions by way of excessive interest charges. It is much more difficult to prevent erosion of the domestic tax base by way of payments to related parties for the use of intangible property. There are no agreed precedents for anti-avoidance rules for royalty payments comparable to the thin capitalization rules used to limit the diversion of profits as interest and because of the unique nature of each type of intellectual property, it is difficult to establish any arm's length price to control deductions. The problem of profit diversion may be severely compounded if royalty withholding tax rates are unilaterally reduced. In this case, they would then be available for payments to tax havens in addition to treaty partners, encouraging tax avoidance through royalty payments. Given the absence of any evidence that domestic businesses pay higher royalty rates if withholding tax is imposed on royalties and the significant risk of profit base erosion as taxes reduce on royalties outside of treaties, reduction of source-based taxation of royalty payments appears not to be a sensible move.

[D] Attracting More Foreign Direct Investment: Limiting Withholding Tax Imposed on Dividends

Most tax systems impose tax on resident companies, including local subsidiaries of non-resident companies, and tax on dividends paid to shareholders. Dividends to non-residents are commonly collected by means of withholding taxes, often set at a rate below the ordinary company tax rate to reflect the fact that it is imposed on a gross basis, without recognition of costs incurred to derive the dividends.

In tax treaty negotiations, source countries are typically urged to reduce their tax on dividend income to very low rates or withdraw it altogether. The only plausible argument for reducing withholding tax is that it would result in additional foreign direct investment in the country. If that were true and a country realized additional foreign direct investment as a result of withholding tax reductions, spin-off benefits could include increased employment, opening of new markets, the transfer of expertise and generally a higher level and faster rate of economic growth. If this growth in investment eventuated, the corporate income tax take would increase, potentially offsetting or even exceeding the loss in the revenue from the reduction or withdrawal of the withholding tax.

These arguments given in support of source countries surrendering their right to tax business income earned in their jurisdiction are not persuasive. The hypothetical benefits are unlikely to eventuate in practice. To begin with, the withholding tax is not a tax on current profits. It can be deferred indefinitely by firms willing to reinvest in the jurisdiction to build greater current profits; if anything, higher withholding tax rates might encourage more investment, not less, by companies that make the initial foray into the country.

Separately, it has long been accepted that of the matrix of factors that affect investment decisions, and in particular direct foreign investment, tax rates, and especially withholding tax rates, will play a marginal role at best in tipping a decision to or not to invest in a particular jurisdiction. Labour costs, infrastructure facilities, labour force skills, political stability, proximity to market, transportation costs, environmental costs, and a host of other factors commonly are cited as more important than tax considerations in terms of driving foreign direct investment locations.[37] Tax is a particularly subsidiary consideration in driving the investments of firms seeking location specific rents such as profits from mineral exploitation possible only in the jurisdiction.

It has been argued that tax may play a greater role in investments based on firm-specific rents or profits attributable to attributes of the firm, not the location where business activities take place. Thus, the iron ore miner seeking location specific rents will locate where the ore bodies are found with tax being a secondary concern. In contrast, the international running shoe manufacturer deriving profits from the production of shoes embodying its design and intellectual property features can make the shoes in any number of countries. In the unlikely case that all other costs were equal in two jurisdictions, tax may well play a role in determining in which jurisdiction the firm locates its production.

To the extent tax levels could impact on investment location decisions by multinational firms seeking firm-specific rents, their importance is receding as economies develop and shift from primary reliance on manufacturing and related heavy industry to service and consumer societies based on business that must be located in the region to service a local market. Ironically, the growth of modern internet commerce has actually increased the need for local service providers and support as well as local outlets, accelerating the shift from firm-specific rents to location specific rents. The trend further weakens any case that might be made for reducing dividend withholding taxes to attract foreign direct investment.

[E] Achieving Non-tax Strategic Benefits

The final reason a country might forgo taxing rights under a tax treaty is the perception that voluntarily shifting taxing rights to a capital exporting treaty partner can yield strategic benefits that outweigh the cost of lost tax revenue. A country might, for example, conclude that better relations with the treaty partner will enhance a security or trade relationship, or result in other economic benefits, such as the provision of aid. These types of strategic reasons for entering into tax treaties might seem particularly compelling if a source country observes its competitor countries making similar concessions. A complementary explanation for why countries cede taxing rights is that

37. For an excellent review of the empirical case against incentives to increase foreign direct investment into low-income countries see Yariv Brauner, 'The Future of Tax Incentives for Developing Countries' in Yariv Brauner & Miranda Stewart (eds), *Tax Law and Development*, 25 (Cheltenham: Edward Elgar Publishing, 2013). For a recent IMF review see Tidiane Kinda, *The Quest for Non-Resource-Based FDI: Do Taxes Matter?*, IMF working paper WP14/15 (2014).

poorer countries are caught in a prisoner's dilemma, which inspires them to provide harmful tax incentives to investors in wealthy countries. These low-income countries cede taxing rights because they believe they need to do so before other competitor countries do so.[38]

Other non-tax objectives behind a decision to reduce source country taxing rights may include strategic political benefits such creating an impression of a government playing a proactive role in internationalizing the economy[39] or simply using the tax treaty as an indirect means of signalling recognition of independence or legitimacy by a treaty partner.

An irony of using tax treaties as a means of achieving non-tax strategic benefits is that comparable high-income countries are likely to be in much stronger negotiating positions to achieve these ancillary outcomes than their low-income counterparts. There is, thus, more likelihood of quid pro quo outcomes in treaty negotiations between two higher income capital exporting jurisdictions than in negotiations between a high-income capital exporting country and a low-income capital importing jurisdiction.

§6.05 THE CASE FOR DEFINING A COUNTRY'S TAXING JURISDICTION IN DOMESTIC LEGISLATION AS OPPOSED TO TAX TREATIES

Few of the five rationales for a capital importing country to forgo taxing rights on income derived by non-residents withstand critical scrutiny. Despite the apparent weaknesses with the rationales for reducing taxation, there will be jurisdictions that nevertheless accept the arguments for forgoing taxing rights. With one exception, to the extent sacrificing taxing rights might actually yield ancillary benefits, the beneficial outcomes would be maximized if the jurisdiction acted unilaterally rather than selectively traded off taxing rights for perceived non-tax advantages by means of treaties.[40]

If, for example, the administrative and compliance cost of taxing business income other than that associated with a permanent establishment or derived by a high profile sportsperson or performing artist outweighs any possible revenue gains from comprehensive taxation of this income, it would be most logical to define the domestic tax base

38. Eduardo A. Baistrocchi, *The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications*, Brit. Tax Rev. 352 (2008); OECD, *Harmful Tax Competition: An Emerging Global Issue*, 34 (Paris, OECD, 1998), Online: OECD www.oecd.org.
39. See, e.g., WikiLeaks, *Bulgaria: Next Step on Negotiating a Double Taxation Treaty* (4 Apr. 2005), Online: WikiLeaks www.wikileaks.org (despite the low level of trade between Bulgaria and the US, the Bulgarian government pushed strongly for a DTT in 2005 'in return for [their] support in Iraq and Afghanistan.' The Bulgarian government was 'eager to publically announce [the recent movement toward a negotiation of a DTT] ahead of the June general elections.')
40. While raised in the context of treaties by developing countries, the argument advanced by Dauer that unilateral action will yield a revenue loss without any guarantee of offsetting gains resulting from reciprocal action by a treaty partner is arguably only relevant to cross-border investment between two capital exporting nations. If a convincing reason could be found for revenue sacrifices by a developing country, offsetting sacrifices by a treaty partner are unimportant; *cf.* Veronika Dauer, *Tax Treaties and Developing Countries*, 12 (Alphen aan den Rijn: Kluwer Law International, 2014).

to exclude this income generally. This way, the base can be broadened in the future as administrative capacity improves. Similarly, if a country believes reductions in interest withholding tax reduced borrowing costs for domestic businesses generally and can be partly recovered through lower interest expense deductions, the presumed benefits could be amplified by adoption of a general reduction of interest withholding tax rates rather than limited reductions by means of selective tax treaties. The same is true in respect of the theory that reductions in withholding tax on royalties could reduce the cost for domestic enterprises to access intangible property rights. As noted, this appears to be the weakest of all the possible rationales for forgoing domestic taxing rights. Nevertheless, if it were accepted as a legitimate reason to give up taxing rights, the rationale would extend to all royalty payments, not just payments to treaty partners.

The exception to the general rule that unilateral action is preferable to reducing taxing rights through bilateral agreements is where taxing rights are sacrificed not in recognition of administrative limitations or to affect taxpayers' costs or investment returns but rather to obtain a non-tax strategic benefit from a specific treaty partner. This goal for obvious reasons cannot be achieved by way of unilateral action, though countries may want to consider carefully whether sacrificing revenue needed for government functions is an appropriate or necessary trade-off for non-tax goals.

Apart from the question of obtaining maximum benefit from concessional treatment of non-resident investors or businesses operating in the jurisdiction, if it is assumed there are benefits from concessional treatment, there are seven additional reasons why source countries would be ill advised to forgo taxing rights by means of bilateral tax treaties rather than unilateral action.

To begin with, even if a country has treaties with all of its major trading partners, it may not have treaties with investment partners – many investment flows from capital exporting nations are routed through tax havens with no or few treaties. If source country tax rates matter in these cases, they must be adjusted through unilateral domestic law.

Second, defining a country's tax jurisdiction in domestic legislation as opposed to bilateral tax treaties is more consistent with principles of good democratic governance. The tax concessions made in bilateral treaties are often negotiated by bureaucrats reporting to the executive. Although ultimately most countries require their tax treaties be approved by the legislative branch, this approval process, with a few country exceptions, is not generally as rigorous as the process for drafting and approving domestic tax legislation. Unilateral concessions, by contrast, must be debated by the legislature and may additionally face exposure through tax expenditure reporting.

Third, concessions granted in tax treaties are not as accessible or as transparent for source country citizens or legislators as domestic tax legislation. Tax treaties are individually negotiated and inevitably each one varies slightly from the others. To determine the specific rules for a particular country, an interested source country citizen or legislator needs to look at each of the tax treaties the country has entered. Additionally, treaties are amended periodically by protocol or mutual agreement. Finding those amendments can be difficult and time consuming.

Fourth, tax treaties are expensive to negotiate and difficult to change. Renegotiations take time, political will, and agreement by both parties. In contrast, taxing

rights provided in domestic legislation can be amended by the legislative body of the source country alone, without approval or negotiation with the residence state. Unilateral action avoids the risk of being locked into tax rules no longer appropriate as the economy evolves to deal with loopholes as they are uncovered.

Fifth, experience has shown that if a country cedes its taxing jurisdiction in individual bilateral tax treaties, tax avoidance will be difficult to prevent.[41] The inherent lack of coordination between states to minimize taxes in a world of bilateral treaties generates new opportunities for enterprises to reduce their tax burdens through avoidance arrangements.[42]

Sixth, lower-income countries are particularly likely to be prejudiced by the relative bargaining disparities enhanced in bilateral relations. Thuronyi suggested multilateral treaties could redress the problems posed by bilateral treaties,[43] but in the absence of such arrangements it is far from clear that bilateral negotiations are desirable.

Seventh, the basic design of tax treaties is highly stylized and in particular relies upon a detailed breakdown of income into different schedules. For example, passive income must be classified as interest, royalties, dividends, management fees, technical services income, or other income. The withholding tax rate on each of these sources of income often varies in each treaty and from treaty to treaty. Yet it is often easy to transform one source into another. Countries have much greater freedom in dealing with the tax avoidance opportunities presented by passive income in their domestic legislation.

§6.06 RETURNING TO THURONYI: RENEGOTIATING INTERNATIONAL TAX NORMS

The tax norms underlying the over 3,000 bilateral tax treaties that countries throughout the world have signed with one another, and which govern around 85% of world trade, form the basis of the international tax regime.[44] Apart from their pernicious effect in transferring taxing rights from capital importing nations to capital exporting countries, treaties reinforce a tax policy principle advocated by the OECD – the 'arm's length' principle – that allows multinational corporations to allocate the total income derived by the entire group among each member of the group, including subsidiaries located in tax havens, on the basis of transactions arranged between the related parts of the single group. Multinational corporations have found the system offers a simple path to avoid

41. Victor Thuronyi, *In Defense of International Tax Cooperation and a Multilateral Tax Treaty*, 22 Tax Notes Int'l 1291 (2001).
42. *Ibid.* at 1293.
43. Victor Thuronyi, *International Tax Cooperation and a Multilateral Tax Treaty*, 26(4) Brook. J. Int'l 1641 (2001); Victor Thuronyi, *Coordination Rules as a Solution to Tax Arbitrage*, 57 Tax Notes Int'l 1053 (2010); Victor Thuronyi, 'Tax Treaties and Developing Countries', *supra* n. 11.
44. Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime*, 3 (New York: Cambridge University Press, 2007) ('I would argue that the network of two thousand or more bilateral tax treaties that are largely similar in policy, and even language, constitutes an international tax regime, which has definable principles that underlie it and are common to the treaties.')

taxation.[45] An alternative approach – the formula apportionment system, which attributes the source of income to objective factors based on inputs (tangible capital and payroll costs) and outputs (place of sales) – is used within economic unions such as Canada and the United States but has gained little traction internationally.

Revelations of the extent of tax avoidance by multinationals based on exploitation of the arm's length system prompted a rear-guard action by the OECD described as the base erosion and profit shifting (BEPS) programme but the programme deliberately avoids any principled re-examination of norms underlying the international tax regime or any consideration of a shift from residence to source-based taxation.[46] Genuine reform of the international tax system requires multinational action as opposed to dissected bilateral agreements. Thuronyi, in the context of a discussion of multilateral tax treaties, suggested establishing a World Tax Organization.[47] That organization could be charged with developing a multilateral treaty to allocate income from cross-border business and investment in a fairer manner that reflects the actual source of income, not the source nominated by multinational companies through intra-group transactions intended to shift profits and minimize taxes. The first stage towards a more equitable global tax system is a halt by capital importing countries to new bilateral treaties and support through the international organizations to which they belong for a multilateral body along the lines advocated by Thuronyi.

45. See, e.g., Allison Christians, *How Starbucks Lost Its Social License -- and Paid £20 Million to Get It Back*, 71 Tax Notes Int'l 637 (2013); Conrad Mapp, *Apple Funnels Italian Subsidiaries' Profits to Ireland*, 74 Tax Notes Int'l 711 (2014); Stephanie Scong Johnston, *EU to Investigate Apple, Starbucks, and Fiat Tax Rulings*, 74 Tax Notes Int'l 991 (2014); Thomas Jaworski, *SEC Exam of Google Leads to More Disclosure of Foreign Earnings*, 74 Tax Notes Int'l 727 (2014).
46. For an excellent review of the BEPS proposals, see Yariv Brauner, *What the BEPS?* 16 Fla. Tax Rev. 55 (2014).
47. Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, *supra* n. 43. Dale Pinto and Adrian Sawyer have similarly argued for a world tax organization; see Dale Pinto & Adrian Sawyer, *Building Bridges between Revenue Authorities: Would a World Tax Organisation be a Key Facilitator?*, J. Applied L. & Pol'y 25 (2011). Nolan Sharkey has suggested a South East Asian Tax Organization would be useful; see Nolan Sharkey, *A South East Asian tax organisation*, Brit. Tax Rev. 175 (2013).

ANALYSING IMPLICIT TAX EXPENDITURES

RICHARD KREVER[*]

[For almost three decades, the Australian Treasury has issued an annual 'tax expenditure statement' detailing concessions in Australia's tax laws. It was originally argued that tax expenditure budgets (the international term for these statements) would lead to simpler laws with fewer and better targeted concessions. This clearly has not happened in Australia, as tax laws have become more complex and tax concessions less efficient since the tax expenditure budget concept was accepted in Australia. The problem is not with the concept itself but rather with its execution. In particular, Australia has copied a United States model — a model that may be very inappropriate in the context of Australian tax jurisprudence. In Australia, many tax concessions that give rise to uncertainty and complexity have not been introduced explicitly by the legislature but rather result from judicial doctrines that have been implicitly endorsed in the design of the tax law. Tax expenditure analysis will not yield better outcomes until it is extended to these implicit tax expenditures.]

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I THE FAILURE OF TAX EXPENDITURE BUDGETS

More than 40 years after the Assistant Secretary of the United States Treasury, Stanley Surrey, first coined the phrase and articulated the concept[1] and almost

[*] LLB (Osgoode), LLM (Harv); Professor of Taxation, Monash University; Director, Monash University Taxation Law and Policy Research Institute.

[1] The expression 'tax expenditure budget' is commonly attributed to Surrey's first academic paper on the topic (see Stanley S Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures' (1970) 83 *Harvard Law Review* 705), although its origins are sometimes attributed to earlier German work. The phrase was used two years prior to Surrey's *Harvard Law Review* paper by the United States Treasury in Treasury Department, United States, *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968* (Document No 3245, 1969) 326–40. See also Stanley S Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Harvard University Press, 1973), which played an important role in extending the understanding of the concept. The concept has been the subject of an enormous volume of literature in the past four decades.

three decades since the first Australian tax expenditure statement was prepared, tax expenditure budgets have become a key tool for analysing government revenue collection and spending policy.

Tax expenditure budgets record the fiscal cost of deliberate deviations from a neutral tax system, particularly measures providing concessional treatment for particular taxpayers or activities, and, in some cases, analyse as well their economic effect and their impact on the fairness of the tax system. The budgets measure the cost of concessions by calculating the tax that would have been collected under a neutral 'benchmark' tax law without any concessions and then treating the value of taxes actually forgone as a result of legislated concessions as substitutes for equal value cash grants.[2] It is the equivalence of taxes forgone as a consequence of tax concessions and the direct expenditure that could have been made to provide similar fiscal benefits that has led to the term 'tax expenditure' for these deviations from a neutral tax base.[3] In Australia, the term (and some might claim the concept) has been extended to the opposite situation, where additional tax is imposed on taxpayers relative to the neutral benchmark because they are denied deductions for non-personal expenses incurred to derive assessable income[4] or are required to defer recognition of those expenses. Measures leading to overtaxation of this sort are sometimes labelled 'tax disincentives'.[5]

In a sense, the tax expenditure concept is merely a restatement of a fundamental premise of tax policy: taxes should raise revenues needed for public goods and services and to achieve the redistribution goals of social equity in a way that leaves the smallest economic footprint and causes the least interference possible in the operation of the market.[6] This is not to say that governments should not use tax legislation to achieve social or economic goals. Often policymakers deliberately intervene in the market to promote transactions that yield positive

Much of this is covered in J Clifton Fleming Jr and Robert J Peroni, 'Reinvigorating Tax Expenditure Analysis and Its International Dimension' (2008) 27 *Virginia Tax Review* 437.

2 See Surrey, 'Tax Incentives', above n 1, 706; Mark Burton, 'Making the Australian Tax Expenditures Statement an Effective Policy Instrument — From Fiscal Record to Transparent Report' (2005) 8 *Journal of Australian Taxation* 1, 1–3.

3 The Australian experience is set out in Burton, above n 2; Kerrie Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime: A Review of Australia's Tax Expenditures Program' (2008) 23 *Australian Tax Forum* 339. There is, to be sure, a vibrant debate in academic literature about the definition of a 'benchmark' tax base. An early piece by Victor Thuronyi summarised much of this debate nicely: see Victor Thuronyi, 'Tax Expenditures: A Reassessment' [1988] *Duke Law Journal* 1155. A key component in the debate is whether capital gains should be measured on an accrual or a realisation basis. In practical terms, however, the debate concerns issues that are truly at the margin — there is little or no debate about the classification of the vast majority of tax expenditures identified in national tax expenditure accounts.

4 Examples include several measures seeking to impose moral limitations on the way taxpayers conduct business by denying deductions for business expenses in the nature of fines or bribes: see *Income Tax Assessment Act 1997* (Cth) ss 26-5 (fines), 26-52 (bribes to foreign public officials), 26-53 (bribes to public officials).

5 See Surrey, *Pathways to Tax Reform*, above n 1, 336 n 61.

6 Richard and Peggy Musgrave, in their seminal work on public finance, describe this principle as follows: 'Taxes should be chosen so as to minimize interference with economic decisions in otherwise efficient markets' (Richard A Musgrave and Peggy B Musgrave, *Public Finance in Theory and Practice* (McGraw-Hill, 2nd ed, 1976) 210).

externalities, to discourage those that generate negative externalities, or to overcome market failures. While many vehicles apart from tax rules can be used to address these issues, embedding needed subsidies or disincentives in a tax law rather than another law is as legitimate an option as all others for policymakers. Tax expenditure analysis simply states that spending programs and disincentives inserted into tax laws should be subject to the same level of rigorous scrutiny as parallel programs outside the tax legislation to determine whether the intervention mechanisms achieve their goals in an efficient and equitable manner, with the least collateral distortion possible.[7]

Badly designed tax expenditures have been criticised in their own right as inefficient subsidy programs and separately for the complexity they bring to the tax law and the compliance costs they impose on taxpayers and tax administrators.[8] The process of subjecting tax expenditures to scrutiny through exposure in tax expenditure budgets has, to some extent, led to reductions in the inefficiencies or inequities of some concessions.[9] Some upside down concessional deductions or exemptions[10] have been replaced by disappearing and refundable credits and others have been replaced by more efficient and better targeted direct spending programs.[11] Exposure and critical review of tax expenditures has, however, had no apparent impact on the overall complexity of the law or consequent compliance costs. To the contrary, in the decades since tax expenditure analysis was incorporated into Australian budget processes, tax laws have become increasingly complex and unmanageable, and consequential compliance costs continue to escalate.[12] In short, as a tool of reform, tax expenditure identification, exposure and analysis appears to have been pretty much a failure.

The inability of the tax expenditure concept to translate into better tax laws is not a consequence of inherent weaknesses with the model but rather results from the way in which it has been used or, more significantly, not used. Tax expenditure analysis has failed to lead to simpler or more efficient tax legislation because the concept has been used at the wrong time and in the wrong way, and

7 See Sadiq, above n 3, 340–1; Surrey, *Pathways to Tax Reform*, above n 1, 6.

8 The relationship between tax concessions and tax law complexity was explored in Tracy Oliver and Scott Bartley, 'Tax System Complexity and Compliance Costs — Some Theoretical Considerations' [2005] (Winter) *Economic Roundup* 53.

9 For discussion in the context of Australia, see Sadiq, above n 3.

10 Deductions and exemptions are inherently more valuable to high income persons than to low income persons.

11 For example, personal deductions for primary earners supporting spouses or child housekeepers have been replaced with a disappearing rebate that shades out as the claimant's income rises: see *Income Tax Assessment Act 1936* (Cth) s 159J. The rebate is slowly being phased out altogether. Concessional deductions to support the production of Australian films have been replaced with refundable tax credits (called 'offsets') in *Income Tax Assessment Act 1997* (Cth) div 376 and a direct grant program administered by a dedicated Commonwealth agency, Screen Australia, with further funding provided by State Screen agencies.

12 A recent review of complexity in Australia's tax system may be found in Chris Evans and Binh Tran-Nam, 'Controlling Tax Complexity: Rhetoric or Reality?' in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects after Henry* (Thomson Reuters, 2010) 439, 443–4. A leading conceptual study of complexity in tax law remains Graeme S Cooper, 'Themes and Issues in Tax Simplification' (1993) 10 *Australian Tax Forum* 417. An analysis of causes of complexity may be found in Richard Krever, 'Taming Complexity in Australian Income Tax' (2003) 25 *Sydney Law Review* 467, 469–90.

applied to the wrong target. It has usually been applied retrospectively, after law is made; it has been used to evaluate the operation of laws rather than guide their design; and, most significantly, it has been limited to explicit legislative measures that affect the calculation of taxable income, ignoring the implicit tax expenditures that shape much of the tax system and generate many of its most significant distortions. Until these failings are addressed, tax expenditure analysis will remain an impotent tool for tax reform.

II Explicit and Implicit Tax Expenditures

A *Transplanted Categories in Australian Tax Jurisprudence*

The starting point for Surrey's tax expenditure analysis was the tax legislation. In the case of income concessions, identification of tax expenditures was merely a matter of scanning the legislation for full or partial exemptions or exclusions.[13] In the case of deduction concessions, it was a matter of running through the allowable deductions and identifying instances when taxpayers were allowed deductions for personal consumption expenses rather than inputs to derive gross income.[14] A third set of timing tax expenditures could be identified by noting statutory measures that allowed taxpayers to defer recognition of income until later years or accelerate recognition of expenses before they were fully incurred in an economic sense.[15] A fourth set of tax expenditures was included in the law as tax credits (now known in Australia as 'offsets') that reduced and in some cases refunded taxes otherwise due to subsidise a range of transactions.[16]

The Australian Treasury's wholesale importation of the United States ('US') approach of looking only at the tax legislation for tax expenditures is not surprising. At first glance, the legislation in the US and in Australia look similar. The income tax laws in the US and in Australia impose tax on a measurement of net gains known as taxable income and in both cases the calculation of this net amount starts with the inclusion of 'income' followed by deductions for expenses incurred to derive the income.[17] In both cases expenses are categorised as capital or non-capital outlays[18] and in both cases there are rules that allow the immediate deduction of non-capital expenses and the deduction over time of capital expenses through a depreciation or capital allowances regime.[19] On paper, at least, the laws look pretty much the same, and starting with a proven operational

[13] Surrey, 'Tax Incentives', above n 1, 706; Surrey, *Pathways to Tax Reform*, above n 1, 3–5, 35–9.

[14] Surrey, 'Tax Incentives', above n 1, 706; Surrey, *Pathways to Tax Reform*, above n 1, 36.

[15] Surrey, 'Tax Incentives', above n 1, 706; Surrey, *Pathways to Tax Reform*, above n 1, 100–2.

[16] Surrey, 'Tax Incentives', above n 1, 706; Surrey, *Pathways to Tax Reform*, above n 1, 6. Surrey also included preferential tax rates in his classification: Surrey, 'Tax Incentives', above n 1, 706.

[17] *Internal Revenue Code of 1986*, 26 USC § 63(a) (taxable income means gross income minus deductions); *Income Tax Assessment Act 1997* (Cth) s 4-15 (subtract your deductions from your assessable income and the result is your taxable income).

[18] *Internal Revenue Code of 1986*, 26 USC § 263(a); *Income Tax Assessment Act 1997* (Cth) s 8-1(2)(a).

[19] *Internal Revenue Code of 1986*, 26 USC §§ 161 (immediate deduction), 167(a) (recognition over time); *Income Tax Assessment Act 1997* (Cth) s 8-1(1) (immediate deduction), pt 2-10 (recognition over time).

model added legitimacy to the arguments of those advocating adoption in Australia of tax expenditure budgets in the face of reluctant or even hostile politicians.[20]

A closer examination reveals, however, that the superficial language and structural similarities between US tax law and its Australian counterpart mask significant differences in the conceptual foundations of the two laws. Both laws may start with income, for example, but there is no shared understanding of what constitutes income. In the US judicial concept of income, a buck is truly a buck. The calculation of taxable income commences with 'gross income'[21] and US courts have interpreted the term to include virtually all receipts, whatever their form or character for other purposes.[22] Payments in respect of labour, business and property are income but so, too, are complete windfalls — money found purely by chance[23] or unexpected gifts.[24] Receipts and gains are removed from the tax base only by explicit legislative intervention,[25] and concessional treatment of particular types of receipts can be identified simply by looking in the legislation for full or partial exclusion rules or deferred inclusion measures.[26]

The Australian legislation starts with the same term, 'income', but the judiciary in this jurisdiction, using the 'transplanted categories' and 'transplanted outcomes' doctrines, has read down the income concept so it captures only a small slice of receipts that would be considered income by US courts. The transplanted categories doctrine refers to the practice of importing into tax law concepts from other areas of law,[27] such as the use by Australian judges of trust law tests to define income for tax purposes.[28] Trust law dissects gains derived by a trustee

[20] The adoption of a tax expenditure budget in Australia followed the report of the House of Representatives Standing Committee on Expenditure, Parliament of Australia, *Taxation Expenditures* (1982), tabled in Commonwealth Parliament on 16 September 1982. Treasury trod carefully, first adding an appendix to the budget papers describing tax expenditures and finally after two years issuing a separate tax expenditure statement.

[21] *Internal Revenue Code of 1986*, 26 USC §63(a).

[22] *Commissioner of Internal Revenue v Glenshaw Glass Co*, 348 US 426, 429–30 (Warren CJ for Warren CJ, Black, Reed, Frankfurter, Douglas, Burton, Clark, Minton and Harlan JJ) (1955).

[23] See, eg, *Cesarini v United States*, 428 F 2d 812 (Phillips CJ, McCree and O'Sullivan JJ) (6th Cir, 1970).

[24] Gifts fall within the US judicial concept of income but are explicitly taken back out by the US *Internal Revenue Code of 1986*, 26 USC § 102(a) to avoid double taxation, as the payments are potentially subject to the gift tax.

[25] See ibid sub-tit A ch 1 sub-ch B pt III.

[26] In the case of the capital gains concession, the tax expenditure is identified by the lower tax rate applied to capital gains: ibid §1(h) provides a 15 per cent rate for most capital gains for most individuals, while the highest marginal rate on other income under § 1 is 35 per cent.

[27] The term derives from and the concept is best articulated in the leading article by Neil Brooks, 'The Responsibility of Judges in Interpreting Tax Legislation' in Graeme S Cooper (ed), *Tax Avoidance and the Rule of Law* (IBFD, 1997) 93, 122–4.

[28] John F Avery Jones et al, 'Treaty Conflicts in Categorizing Income as Business Profits Caused by Differences in Approach between Common Law and Civil Law' (2003) 57 *Bulletin for International Fiscal Documentation* 237, 237 n 3; Ross W Parsons, 'Income Taxation — An Institution in Decay?' (1986) 3 *Australian Tax Forum* 233, reproduced in 'Income Taxation — An Institution in Decay?' (1986) 12 *Monash University Law Review* 77 and later in a slightly revised version in 'Income Taxation: An Institution in Decay' (1991) 13 *Sydney Law Review* 435. A New Zealand scholar, John Prebble, has argued Parsons was incorrect in attributing the judicial concept of income to trust law notions, asserting instead that the judicial notion is simply the 'ordinary' meaning of income, although he concedes the income concept accepted for tax purposes is

into two categories: income gains, to which life or income trust beneficiaries are entitled, and capital gains, to which remainder or capital beneficiaries are entitled.[29] Applying trust law tests to income tax, the judiciary narrowed the concept of income for tax purposes so it included only amounts that would have an income character for trust law purposes — receipts that are periodic in nature, anticipated by the recipient, in the form of cash or something convertible to cash, realised and severed from the source, and paid in respect of the provision of services, the use of property, or a business transaction.[30]

The transplanted outcomes phenomenon reflects what is sometimes referred to as the 'colonial cringe' mentality of Australian judges in the first decades (or longer) of independence — an assumption that precedents of United Kingdom ('UK') judges interpreting UK law should govern the interpretation in Australia of Australian law, with little regard to differences in the legislative regimes.[31] The UK schedular income tax was fundamentally different in structure from the income tax laws enacted in the Australian colonies prior to Federation and the income tax Act adopted by the Commonwealth during the First World War.[32] Australian legislators deliberately eschewed the UK system of classifying receipts and outgoings into 'schedules' and then 'cases' within schedules in favour of global income taxes,[33] but when it came to interpret the scope of the global income tax, Australian judges looked to English precedents — even first instance decisions — as guides to the meaning of terms in Australian law. As a result, a receipt that was found by a UK court to be outside the scope of a narrow case within a narrow schedule in the UK statute would be assumed to be a capital gain that fell outside the 'income' concept in Australia.[34] In the post-Second

the same as that used for trust purposes: see John Prebble, 'Income Taxation: A Structure Built on Sand' (2002) 24 *Sydney Law Review* 301, 302–4.

[29] See generally J D Heydon and P L Loughlan, *Equity and Trusts: Cases and Materials* (LexisNexis Butterworths, 7th ed, 2007) ch 33.

[30] This process is described in Richard Krever, 'Interpreting Income Tax Laws in the Common Law World' in Markus Achatz et al (eds), *Steuerrecht Verfassungsrecht Europarecht* (Facultas Verlags- und Buchhandels, 2007) 354, 357–63.

[31] See ibid 369; Rick Krever, 'The Ironic Australian Legacy of *Eisner v Macomber*' (1990) 7 *Australian Tax Forum* 191, 195.

[32] Krever, 'The Ironic Australian Legacy of *Eisner v Macomber*', above n 31, 193.

[33] See, eg, the first general income tax statute in the Australasian colonies, South Australia's *Taxation Act 1884* (SA), with a global structure that was carried to the income tax when it was enacted at the federal level in Australia in the *Income Tax Assessment Act 1915* (Cth): Cynthia Coleman and Margaret McKerchar, 'The Chicken or the Egg? A Historical Review of the Influence of Tax Administration on the Development of Income Tax Law in Australia' in John Tiley (ed), *Studies in the History of Tax Law* (Hart Publishing, 2004) 285, 287–8. The rejection of the UK model is reviewed in Peter Mellor, 'Origins of the Judicial Concept of Income in Australia' (2010) 25 *Australian Tax Forum* 339, 341–2. One motivation for rejection of the UK schedular model may have been commitment of Australian politicians to the goal of progressivity based on progressive rates applying to a taxpayer's total income. See J A L Gunn, *Commonwealth Income Tax Law and Practice* (Butterworth & Co, 1943) 2–3.

[34] A classic example is the assumption in Australia that the non-competition payment received by the taxpayer in *Higgs (Inspector of Taxes) v Olivier* [1952] 1 Ch 311, which was found to be outside the scope of *Income Tax Act 1918*, 8 & 9 Geo 5, c 40, sch D case II, would fall outside the Australian judicial concept of income. The presumption that Australian judicial concepts automatically followed decisions of UK judges considering the very different UK statute was once questioned by Kitto J in *Dickenson v Federal Commissioner of Taxation* (1958) 98 CLR 460, 492, but the capital gains character of non-competition payments has been accepted by the

World War period, judges in Australia gradually shifted from blind adherence to English precedents, but by then the consequences of colonial cringe had been embedded in local cases that would become the precedents for the next generation of cases.[35]

Australian judicial concepts also diverged from their US counterparts significantly on the deduction side. Like the US law, the Australian tax legislation denied an immediate deduction for capital expenses and contained separate rules for the later recognition of these expenses.[36] Australian courts took a very different approach to determining what constituted a capital outlay, however. The US judicial concept by and large characterises expenses as capital outgoings when they yield benefits that last well past the end of the tax year.[37] In Australia, a transplanted distinction between revenue and capital expenses gave only passing consideration to the longevity of an acquired benefit relative to the tax year in which it was acquired. Instead, it looked at the factors originally used to allocate the expenses of a trust to the account of a remainderperson (the capital beneficiary) as opposed to those allocated to the account of a life beneficiary (the income beneficiary).[38] As a result, under Australian tax law the character of an outgoing as a revenue or capital expense depends on factors such as the form of the payment or payments (lump sum or periodic), how often the taxpayer acquires similar benefits or assets, whether the expenditure yields an 'enduring benefit' (the judicial test closest in effect to accounting principles) and, most importantly under current judicial tests, whether the expense is said to relate to the 'process' of the taxpayer's enterprise or to its 'structure'.[39] These Australian judicial doctrines sometimes have the effect of classifying what would be considered revenue expenses in tax policy terms as capital outgoings and vice versa.[40]

Australian Treasury, which deliberately excluded these payments from the definition of assessable eligible termination payments and assessable fringe benefits, leaving them to be taxed in the capital gains provisions of the *Income Tax Assessment Act 1997* (Cth): see *Income Tax Assessment Act 1997* (Cth) s 82-135(j); *Fringe Benefits Tax Assessment Act 1986* (Cth) s 136(1) (definition of 'fringe benefit', para (m)).

35 See Krever, 'Interpreting Income Tax Laws', above n 30, 369–70.

36 *Income Tax Assessment Act 1997* (Cth) ss 8-1(2)(a), pt 2-10; *Internal Revenue Code of 1986*, 26 USC §§ 263, 167(a).

37 The decision of the Seventh Circuit Court of Appeals in *Encyclopaedia Britannica Inc v Commissioner of Internal Revenue*, 685 F 2d 212 (7th Cir, 1982) explains the logic behind this approach clearly. The Court found the taxpayer's expenses to acquire a book manuscript a capital expense because the acquisition 'was intended to yield *Encyclopaedia Britannica* income over a period of years. … Where the income is generated over a period of years the expenditures should be classified as capital': at 214 (Posner J).

38 The most cited articulation of the principles of characterisation of expenses is that of Dixon J in *Sun Newspapers Ltd v Federal Commissioner of Taxation* (1938) 61 CLR 337. Surveying the precedents, Dixon J found three matters were important to the revenue or capital nature of expenses: the character of the advantage sought as a consequence of an outlay, the manner in which the benefit would be used, and whether it was acquired by way of a lump sum payment or periodic payments: at 363. The longevity of the benefit acquired was merely a factor that might be relevant to the first of the three relevant matters.

39 The development of Australian tests is reviewed in Philip Burgess et al, *Income Taxation — Commentary and Materials* (Lawbook, 6th ed, 2009) 493–500.

40 In tax policy terms, there is no deduction for the cost of acquiring an asset with a life past the end of the tax year, because there has been no actual decrease in economic wealth; the taxpayer has

Although the US and Australia started with not dissimilar legislative regimes, the remarkably different directions taken by the judiciaries in the two jurisdictions has significant implications for the efficacy of a tax expenditure budget based only on deliberate statutory concessions. The restricted tax expenditure analysis may work well in the US, where judicial doctrines reinforce the underlying tax law and deviations from the benchmark tax base are for the most part limited to explicit concessions inserted in the law. It is woefully inadequate in a country in which judicial interpretations initially emasculated the law and subsequent incorporation into administrative practices and acceptance by the legislature of judicial characterisation then camouflaged a wide range of deviations from the benchmark in practice.

B *Legislative Endorsement of Transplanted Categories*

The phenomenon of legislative endorsement of a judicial characterisation can be illustrated with three examples: the treatment of expenses incurred to protect a taxpayer's legal title to an asset, the characterisation of payments received by individuals in return for non-competition covenants, and the treatment of payments to acquire wasting contractual rights such as a tied-house agreement.

The subject of the first example, an expense to resist a challenge to legal title, is assumed by accounting standards and tax systems abroad to have no ongoing value to a taxpayer (the benefit expires when the challenge is met, whatever the outcome) and is thus normally a deductible expense.[41] Australian courts originally followed this approach. However, following his appointment to the most senior position on the High Court, Dixon CJ was able to elevate his preferred test for distinguishing revenue and capital expenses (the 'process' or 'structure' test noted earlier) from its initial presentation in a non-majority judgment[42] to

merely substituted one asset (cash) for another (the tangible or intangible benefit with a value past the end of the year). A neutral income tax measures expenditures as economic capacity is actually consumed: a machine would be depreciated as it lost value over its effective life; an intangible asset would be amortised as it lost value due to the passing of time as it nears the end of its legal life; and the cost of a non-wasting asset such as land would be recognised when there is a disposal of the asset.

[41] A challenge to title will reduce the value of the taxpayer's asset. If the taxpayer loses the challenge, the value is permanently lost and there clearly is no ongoing benefit from the expenditure. If the taxpayer wins, the asset's value is restored to the value it had prior to the challenge. Accounting principles assume there is no ongoing value, however, as meeting the challenge of one attack on legal title brings no new asset or benefit into existence. For a review of the common position in jurisdictions outside Australia and the shift in Australia from this view to the current view that these expenses have a 'capital' nature, see Richard Krever, 'Capital or Current: The Tax Treatment of Expenditures to Preserve a Taxpayer's Title or Interest in Assets' (1986) 12 *Monash University Law Review* 49.

[42] While the test advocated by Dixon CJ, attributing a capital or revenue character to an expense depending on whether it seemed to be associated with the taxpayer's business 'process' or its business 'structure', was not new, his clear articulation paved the way for its eventual triumph. Dixon J first argued for this approach to trump all other considerations in a concurring decision in *Sun Newspapers Ltd v Federal Commissioner of Taxation* (1938) 61 CLR 337, 359–63. It was not accepted by a majority of the High Court in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634, 641 (Latham CJ), 643–4 (Starke J), 655 (Williams J) (the majority finding defence of title expenses to be revenue outgoings).

become the law of the land[43] and as a consequence, these expenses, formerly treated as revenue outgoings, acquired a capital character in Australian jurisprudence.

A quarter century after expenses incurred to defend legal title were characterised as capital outlays, the legislature finally conceded taxpayers should be allowed to recognise these costs for tax purposes.[44] However, rather than restore the deductibility of these expenses, the drafters of the amending legislation accepted the judicial characterisation of the expenses as capital outlays and provided for recognition of the expense through the capital gains regime.[45] Taxpayers are allowed to add defence of title expenses to the cost base of assets to which they relate,[46] so the outgoings can only be recognised when there is a disposal of the asset. From a benchmark tax base perspective, this treatment amounts to a significant tax penalty. Because the tax expenditure statement does not recognise instances where judicial characterisation deviates from the benchmark tax system, the rules are not included in the tax expenditure accounts.

The subject of the second example, the characterisation of payments received by individuals for negative covenants or non-competition agreements, is a useful example of the transplanted outcome or colonial cringe phenomenon. UK courts, working with the narrow UK tax legislation catching particular types of income that fell within specific cases under defined schedules, had concluded that paying an employee or contractor an amount for not working for a competitor as well as an amount for working for the employer or principal was not taxable, as it fell out of the case that assessed a profit or gain 'arising or accruing from the taxpayer's profession or vocation'.[47] While there were no Australian cases directly on point, the Australian Taxation Office ('ATO') and Australian Treasury assumed that the payments would be capital payments in Australia following the UK decision based on fundamentally different legislation.[48]

Subsequently, legislative drafters, adopting the assumption of the ATO and Treasury, went out of their way to ensure the receipts were not taxed under Australia's income tax regimes for fringe benefits[49] or the rules for payments related to retirement or termination of office.[50] They were only brought into the

43 *Broken Hill Theatres Pty Ltd v Federal Commissioner of Taxation* (1952) 85 CLR 423, 433–4 (Dixon CJ, McTiernan, Fullagar and Kitto JJ). The expenditure incurred by the taxpayer in *Broken Hill Theatres* continues to be characterised as capital outgoings, though today it can be amortised over five years under *Income Tax Assessment Act 1997* (Cth) s 40-880.

44 *Tax Law Improvement Act (No 1) 1998* (Cth) sch 1 item 1, inserting *Income Tax Assessment Act 1997* (Cth) s 110-25(6).

45 *Income Tax Assessment Act 1997* (Cth) s 110-25(6).

46 Ibid.

47 *Higgs (Inspector of Taxes) v Olivier* [1952] 1 Ch 311, 320 (Evershed MR).

48 Kitto J of the High Court of Australia did suggest in obiter that the UK precedent might not be relevant in the face of the Australian legislation: *Dickenson v Federal Commissioner of Taxation* (1958) 98 CLR 460, 492; however, this comment had no lasting impact in Australia.

49 See *Fringe Benefits Tax Assessment Act 1986* (Cth) s 136(1) (definition of 'fringe benefit', para (m)).

50 *Income Tax Assessment Act 1936* (Cth) s 27A(1) (definition of 'eligible termination payment', sub-para (m)), as repealed by *Superannuation Legislation Amendment (Simplification) Act 2007*

tax net through the capital gains tax regime adopted in 1986, with effect from 1985.[51] In this case, while the legislators retained the judicial characterisation of the receipt in their statutory response, the tax inclusion mechanism removes any preference for this type of remuneration. The payments are treated as realised capital gains,[52] but are excluded from the generous 50 per cent exemption concession provided for most other types of capital gain.[53] They are, as a result, effectively taxed in the same manner as they would be if they were considered ordinary income subject to the general assessment formula. Once again, the tax expenditure statement does not mention the judicial characterisation of these payments, although in this case, since the statutory treatment yields the same outcome as would a benchmark income tax characterisation, there is no deviation from the benchmark and consequently no tax expenditure.

A tied-house agreement, the basis for the third example of tax expenditure analysis failing to capture measures based on judicial characterisations, is a contractual obligation by a retailer to stock exclusively the wares of a manufacturer or to give prominence to that manufacturer's products. Under a neutral benchmark income tax (and accounting principles), expenses incurred to secure long-term contractual rights such as a tied-house agreement are amortised over the life of the contracts. But at the time when Australian courts were first asked to characterise these expenses, the amortisation rules in the Australian income tax law only applied to expenses for tangible plant and articles.[54] No depreciation was allowed for intellectual property assets such as copyrights or patents or for intangible assets such as multi-year contracts.[55]

The only options open to the courts were to characterise the expenses incurred to acquire multi-year contracts as revenue expenses, allowing an immediate deduction, or as capital outgoings, denying the taxpayers any recognition for their expense. Both options were wrong from a tax policy perspective, with a revenue characterisation amounting to a tax concession and a capital characterisation being a tax penalty. The courts recognised that both options were flawed,[56] but having no other options made the best of a bad situation by characterising expenses for some relatively shorter-term contracts as revenue expenses[57] while

(Cth) sch 1 item 3. See also the corresponding exclusion in *Income Tax Assessment Act 1997* (Cth) s 82-135(j).

51 *Income Tax Assessment Act 1936* (Cth) s 160M(7), replaced by *Income Tax Assessment Act 1997* (Cth) s 104-155, was originally intended to apply to situations involving the creation of rights in favour of other persons (treated as the disposal of an asset); *Income Tax Assessment Act 1936* (Cth) s 160M(6) also applied more generally to disposals of assets that did not exist prior to the disposal.

52 *Income Tax Assessment Act 1997* (Cth) s 104-35.

53 Ibid s 115-25(3)(a).

54 *Income Tax Assessment Act 1936* (Cth) s 54, repealed by *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* sch 1.

55 Gunn, above n 33, 407.

56 See especially the comments of Reid LJ in *Regent Oil Co Ltd v Strick (Inspector of Taxes)* [1966] AC 295, 324.

57 See, eg, *BP Australia Ltd v Federal Commissioner of Taxation* (1965) 112 CLR 386 (Privy Council) (expenses incurred by petrol company to secure three to five year exclusive supplier contracts with retailers characterised as revenue outgoings).

treating the costs of acquiring some relatively longer-term contracts as non-deductible capital outgoings.[58]

In the mid 1980s, the legislature finally intervened. It accepted the judicial characterisation of expenditures to secure short-term contracts as revenue outgoings and the characterisation of expenditures to obtain long-term contractual benefits as capital expenses, but adopted rules to modify the tax treatment of both types of expenses. Acquisition costs enjoying a revenue character were made subject to an amortisation regime that requires taxpayers to spread recognition of the cost over the life of the contracts.[59] The amortisation rules were limited to revenue expenses,[60] which automatically excluded the cost of acquiring long-term contractual arrangements that were (correctly) regarded as capital outgoings under judicial tests. These outgoings were incorporated in the capital gains regime which allows taxpayers to recognise the expenses — but only when the contracts expire and then only as capital losses, meaning they cannot be utilised unless the taxpayer has capital gains against which the losses can be offset.[61] As with the previous two examples, the deviation from the benchmark based on judicial characterisation is ignored under the current tax expenditure accounting system.

III Technical Arguments for Excluding Implicit Tax Expenditures from the Tax Expenditure Budget

Implicit tax expenditures and flawed responses to these unanticipated concessions and disincentives have generated much of the complexity, inefficiency and inequity in Australian tax laws. The case for extending tax expenditure analysis to implicit tax expenditures, and particularly to legislative responses that effectively endorse judicial characterisations at odds with benchmark principles, seems compelling. There are, however, a number of technical issues sometimes raised as pragmatic barriers to the application of the tax expenditure concept to implicit expenditures and disincentives. However, these four technical issues — difficulty with costing these deviations, the risk of perceived criticism, the unclear boundaries of the benchmark, and the difficulty in identifying possible objectives for the implicit expenditures — may also apply to explicit tax expenditures.

[58] See, eg, *Regent Oil Co Ltd v Strick (Inspector of Taxes)* [1966] AC 295 (expenses incurred by petrol company to secure 5, 10 and 21 year tied-house agreements by way of lease and lease-back contracts requiring only nominal rent from the retailer so long as the company's petrol was sold on an exclusive basis characterised as capital outgoings).

[59] *Income Tax Assessment Act 1936* (Cth) s 82KZMD.

[60] Ibid s 82KZL (definition of 'excluded expenditure', para (d)) excludes capital outgoings from the operation of the amortisation regime.

[61] If the cost of acquiring the asset (the multi-year contract) is characterised as a capital outgoing, the expense is treated as the reduced cost base of the asset: *Income Tax Assessment Act 1997* (Cth) ss 110-25(2), 110-55(2). The expiry of the contract gives rise to a 'CGT event' (s 104-25(1)(c)), yielding a capital loss equal to the reduced cost base (s 104-25(3)).

A *Inability to Provide Full Costing*

The principal technical objection to expansion of the tax expenditure budget to include implicit tax expenditures is the difficulty or even impossibility of costing most implicit spending programs or tax disincentives. Many tax expenditures are difficult to cost because the tax administration process does not generate data specific to particular measures. For example, if judicial doctrines allow an immediate deduction for an expense that would be capitalised and amortised over its life in the benchmark income tax, the taxpayer simply includes the expenditure in gross deductions, without flagging that it results from an implicit tax expenditure. A similar problem can arise with a statutory provision, however. If a concessional statutory provision allows the immediate deduction of an expense that could be considered a capital outgoing in a benchmark income tax, taxpayers will include the outgoing in their calculation of deductions and there will be no means of collecting data on the impact of the measure.

Completely accurate costing data is only possible where tax expenditures or disincentives are identified explicitly and corresponding deductions, inclusions, exclusions and so forth are entered separately on tax returns. Accurate measurement gives way to some, and often considerable, guesswork as soon as the effect of the expenditure or disincentive is consolidated with other data or achieved through non-inclusion of information on the return. Even when data is available, the actual impact of tax expenditures and disincentives in terms of distributional burden across different categories of taxpayers, different income levels, etc, is not revealed in most jurisdictions' tax expenditure budgets; only the estimated total cost is shown.[62] To the extent that some extrapolation is necessary to estimate the overall fiscal cost of tax outcomes, the processes of costing both implicit and explicit tax expenditures poses difficulty.

As is the case with explicit statutory tax expenditures, the difficulty of costing the impact of a deviation from the benchmark in no way undermines the importance of the process of considering the possible rationales for deviation and asking whether the tax incentive or disincentive is the most cost-effective, economically efficient and fair method of achieving the possible objectives of the shift from a neutral tax. Identification of the implicit tax expenditure is a necessary first step to that analysis.

B *Risk of Perceived Implicit Criticism*

While implicit tax expenditures derive initially from judicial interpretations of terms in the tax law, some may be traced to subsequent assumptions by the tax administration as to how judicial doctrines will apply to transactions that have not been directly considered by the courts. The ATO explains its interpretation of the legislation by way of binding (on the Commissioner) rulings that have the force of law if they are more generous than the law intended. There may be a concern that inclusion in the tax expenditure statement produced by the Treasury

62 See The Treasury (Cth), *Tax Expenditures Statement 2009* (2010) 4.

of operational expenditures and disincentives resulting from ATO rulings will be perceived as implicit criticism by Treasury of the ATO for its failure to support the government's tax policy.[63] If the effect of an expanded tax expenditure analysis were to drive a wedge between the ATO and Treasury, the cost may outweigh any benefits from a shift in policy.

A perception that including the impact of ATO rulings in the tax expenditure account amounts to criticism of the ATO for undermining the policy of the tax law would be misconceived. In most cases, identification of operational shifts from the benchmark will not expose a failure by the tax administration to apply the law as it was intended to operate but rather a failure by the Treasury to take account of the likely judicial interpretation of the words it approved for inclusion in the law. The ATO is not responsible for writing the law, merely for applying it. It has no option but to adopt an understanding of the law most consistent with judicial precedents and approaches — the interpretation that would be expected from an appellate court. Once the ATO's interpretation of the law is communicated through its public documents such as rulings and decisions, inaction by the government can and should be regarded as implicit endorsement of the deviation from the benchmark that has been identified by the ATO. At this point, it is the government that takes responsibility for the policy implications of the interpretation, not the ATO.

In a mass assessment tax regime subject to constant legislative change and judicial developments, there will, of course, inevitably be some instances when a decision by the tax administration is just plain wrong — the drafters of a ruling have simply misinterpreted the holding of a decision or the language of a statute. Tax expenditure analysis of these cases will show the administrative interpretations as errors, not revelations of implicit tax expenditures. In these instances, the concern that one agency is publicly criticising another would have merit. On the other hand, the prospect of inclusion of these things in the tax expenditure statement may be sufficient to minimise the problem. The risk of tax expenditure analysis of administrative decisions may prompt the ATO to revise its drafting and review processes and in the process reduce or even eliminate instances where the positions taken are difficult to justify.

C *Unclear Boundaries of the Neutral Benchmark*

Some implicit tax expenditures and disincentives will arise in areas in which the delineation of the neutral benchmark income tax is the subject of some debate.[64] Where the benchmark has uncertain borders, the process of identifying and analysing expenditures and disincentives is inherently complicated. While similar difficulties can be observed with many explicit statutory tax expenditures, implicit tax expenditures may be more likely to touch upon issues sitting

[63] See the discussion of tax administration in Burton, above n 2, 56–61.

[64] See Neil Brooks, 'The Under-Appreciated Implications of the Tax Expenditure Concept' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 233, 234–7. Contributions to debate over this issue are surveyed in Fleming and Peroni, above n 1.

on the boundaries of the generally accepted benchmark principles. In both cases, however, the fact that questions may arise on the outer boundaries of a concept does not invalidate the use of the concept. Virtually every law on the books involves concepts that have uncertain boundaries at the extremes. The fact that the outer boundaries of concepts used to evaluate laws are uncertain does not prevent analysis of the vast majority of cases that fall within accepted benchmarks. The same is true of implicit tax expenditures that in most cases give rise to clear departures from generally accepted tax benchmark principles.

D *Difficulty in Identifying Objectives for Implicit Tax Expenditures*

The introduction of explicit tax expenditures is inevitably accompanied by supplementary materials — parliamentary debates, second reading speeches, explanatory memoranda, etc — that provide plausible, if sometimes disingenuous, explanations for the measures. No similar guidance is available to assist analysis of implicit tax expenditures and if understanding the purpose of a tax expenditure is a central feature of tax expenditure analysis, the case for extending analysis to implicit tax expenditures would be weak.[65]

The absence of official rationales for implicit tax expenditures and disincentives does not necessarily make the challenge of attributing an aim to the expenditures or disincentives any more difficult than is the case for many explicit tax expenditures, however. Quite often there is a muddle of alternative rationales offered for explicit tax concessions, reflecting the different views and ideologies of the range of players who collectively sponsor particular measures. The final rationale offered in an explanatory memorandum or second reading speech may bear little relation to the rationale offered by the proponent of a measure when the proposal is first raised. Currently tax expenditure budgets often deal with this issue by simply noting tax expenditures, with little, or more often no, credible rationale for the concessions.

The adoption of the current statutory capital gains concession for individuals provides a useful illustration of how difficult it may be to discover the purpose of an explicit tax expenditure. No rationale was offered for this concession when it was first proposed by the Australian government[66] and none was included in the announcement establishing a business tax review to consider the concession[67] or in the terms of reference for the Review of Business and Taxation.[68] The Review

[65] While courts sometimes refer to explicit policy criteria in their decisions interpreting tax statutes, interpretation based on transplanted categories or outcomes are explained by reference to precedents, not published policy objectives.

[66] See Peter Costello, Treasurer (Cth), *Tax Reform: Not a New Tax, A New Tax System — The Howard Government's Plan for a New Tax System* (1998), with a section entitled 'Gains for Businesses' proposing '[c]onsultations with the business sector on … the prospect of further CGT relief' without any explanation for the proposal: at 25.

[67] Peter Costello, 'Business Income Tax Consultation' (Media Release, No 081, 14 August 1998), establishing a business tax review to, inter alia, examine the scope for 'capping the rate of tax applying to capital gains for individuals at 30 per cent', again, without any rationale for the proposed concession.

[68] See Review of Business Taxation, *Report — A Tax System Redesigned: More Certain, Equitable and Durable* (1999) vii.

recommended a 50 per cent exemption for realised capital gains and finally offered a possible rationale for the concession: 'to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources.'[69] The second reading speech introducing a legislative amendment to achieve the concession offered a completely different rationale, the reduction of complexity with the end of cost base inflation adjustment.[70] The Explanatory Memorandum accompanying the amendment Bill introducing the concession suggests the change was made to achieve 'a simpler and more transparent system; how capital gains are worked out becomes easier to understand and apply'.[71] The concession, one of the most significant recorded concessions,[72] is presented without a rationale in the government's annual tax expenditure budget.

In the first instance, it is sufficient for the purpose of the tax expenditure budget that the concession be identified as a deviation from the benchmark income tax that will affect taxpayer behaviour. To be sure, consideration of the possible objectives of a concession is an important second step. However, anticipated difficulties in understanding a rationale for the deviation should inhibit identification for neither implicit nor explicit tax expenditures. Indeed, consideration of possible rationales for tax expenditures can be fruitfully incorporated into subsequent stages of evaluating the operation of the concessions.

IV DEALING WITH OPERATIONAL BASES THAT DEVIATE FROM THE NEUTRAL BENCHMARK

The neutral benchmark tax bases include features that could be difficult to apply in practice and as a result the tax legislation in most jurisdictions has adopted pragmatic operational benchmarks that accommodate perceived practical constraints on administering the neutral benchmark bases. Tax expenditure budgets may adopt the operational benchmark as the most practicable tax base from an administrative perspective while conceding it deviates from the truly neutral benchmark. Some judicial or administrative decisions may move the operation of the tax law away from the compromise operational base in favour of the conceptually preferable neutral benchmark base. These cases raise the question of whether deviations from the compromise base are themselves tax expenditures or instead should be viewed as corrective measures from a base that is in fact a tax expenditure.

[69] Ibid 598. See also at 599, noting that the 50 per cent exclusion would 'reduce the effective top marginal rate on capital gains income to 24.25 per cent.'

[70] Commonwealth, *Parliamentary Debates*, House of Representatives, 21 October 1999, 12181 (Peter Costello, Treasurer).

[71] Explanatory Memorandum, New Business Tax System (Integrity and Other Measures) Bill 1999 (Cth) 148 [12.5].

[72] In the most recent financial year, the capital gains discount was estimated to be the equivalent of an indirect expenditure of $4.7 billion for investments in assets other than principal residences and a further $20 billion for investments in family homes. See The Treasury (Cth), *Tax Expenditures Statement 2011* (2012) 7.

The most significant operational departure from a benchmark tax system in Australia is the realisation basis used to recognise gains and losses on some investment assets.[73] The neutral benchmark tax base is indifferent to portfolio choice and would treat the person who chooses to retain an appreciated or depreciated asset at the end of the tax period similarly to one who disposes of the asset during the year. That is, in the benchmark tax, accrued gains and losses enjoyed or suffered by the person who decides to retain assets are taxed in the same manner as realised gains and losses enjoyed or suffered by the person who changes investments. In practice, however, it is thought that valuation challenges would make it difficult or impossible to apply full accruals taxation to all assets. Accordingly, the operational base substitutes alternatives to the benchmark treatment.

For some types of appreciating and depreciating assets, the tax law prescribes surrogate measurements of annual gains and losses in lieu of actual annual valuation. The end of year value of wasting business assets, for example, is calculated using presumed depreciation formulas,[74] while the annual change in value of debt instruments and various substitutes for debt is calculated by prorating the anticipated gain or loss on a compound basis over the life of the instrument.[75] Gains and losses on trading stock and most investment assets apart from debt are most commonly taxed only on a realisation basis.[76]

There are, as a result, two parallel bases used in the income tax law, a realisation base for some assets and an accrual base for others, with the accrual base using estimated values in some cases. This raises the question whether judicial or administrative decisions that recharacterise assets so they shift from one camp to another should be evaluated in terms of the operational base or the neutral benchmark base — a decision undermining the integrity of the operational base could reinforce the benchmark base, for example.

A variation of this question arises in cases where judicial doctrines have been codified into the legislation and later decisions move outcomes back towards the neutral benchmark. An example is the treatment in some cases of defence of title expenses. As noted earlier, these expenses were once treated as deductible revenue outgoings but a shift in judicial reasoning led to their characterisation as capital expenses and this outcome was codified with measures that require taxpayers to add these expenses to the cost base of assets if they can be tied to

[73] The realisation basis for capital gains follows from the structure of the legislation which measures gains and losses on the transfer of an asset. The most important manifestation of the realisation basis is found in *Income Tax Assessment Act 1997* (Cth) s 104-10, the primary capital gains recognition measure, which records gains and losses on the disposal of capital assets. There is a limited exception to this rule for some debt assets, for which gains are recognised on an accrual basis under *Income Tax Assessment Act 1936* (Cth) pt III div 16E and *Income Tax Assessment Act 1997* (Cth) div 230.

[74] *Income Tax Assessment Act 1997* (Cth) div 40.

[75] *Income Tax Assessment Act 1936* (Cth) pt III div 16E; ibid div 230.

[76] Taxpayers do have the option of recognising gains on trading stock on an accrual basis: see *Income Tax Assessment Act 1997* (Cth) s 70-45. However, the option is rarely exercised unless the taxpayer anticipates a rise in the tax in a future year.

particular assets.[77] A judicial decision characterising these costs as ordinary deductible business outgoings likely to arise as part of day-to-day business operations (even if they only arise once)[78] would appear to undermine the operational benchmark but be in complete conformity with the benchmark base.

The problem also arises in the indirect tax base, most commonly in respect of financial supplies. While the goods and services tax ('GST') is intended to be a tax levied on final consumption, it is imposed at the point of supply on the supplier, not on the consumer.[79] For most types of goods and services, there is a connection between the consideration received by the supplier and the value of the goods or services acquired by the consumer, so calculating GST on the basis of consideration paid captures the value of consumption.

The service provided by a financial institution is an exception to this rule. Financial institutions provide intermediary services, connecting individuals with funds to lend with borrowers who want to use those funds. The fee for the intermediary services provided by financial institutions is the spread between the interest rates they charge borrowers and the rates they pay to lenders. This type of service does not fit easily into the normal GST system of taxing supplies and providing input tax credits for business customers, mostly because the value of the service provided by the financial intermediary is different from the value of the payments to and from the service provider, the usual base for calculating a GST liability.[80] Also, one group of persons involved in the transactions — private households with deposits in financial institutions — are not registered for GST purposes[81] and there is no simple way to relieve them of tax on the services they enjoy even though those services relate to savings, not consumption. The pragmatic compromise developed first by the European Union and subsequently copied by almost all countries levying a GST, including Australia, is to adopt a system of 'input taxation' for financial intermediation services — that is, impose no GST on financial services but deny financial service providers full input tax credits for the tax borne on their acquisitions.[82] The effect is that all persons acquiring financial services — depositors and borrowers, businesses and private individuals — pay some, but not full, GST on the services they use.

The normal GST system of taxing supplies and providing business tax customers with refundable credits achieves the benchmark goals of removing the tax from businesses along the production and sales chain and imposing it on final consumers. The operational benchmark used for financial intermediary services — subjecting the services to input taxation — overtaxes business consumers of the services and undertaxes final consumers. The distortion caused by the overtaxation of businesses can be serious as it reduces the competitiveness of

77 See above nn 41–46 and accompanying text.

78 See, eg, *Federal Commissioner of Taxation v Consolidated Fertilizers Ltd* (1991) 101 ALR 385.

79 *A New Tax System (Goods and Services Tax) Act 1999* (Cth) div 9.

80 GST is payable on the value of a taxable supply (see ibid s 9-70) and the value is defined by reference to the gross consideration paid (see ibid s 9-75).

81 See ibid pt 2-5.

82 Ibid s 40-5; for discussion of the European approach, see Adrian Ogley, *Principles of Value Added Tax: A European Perspective* (Interfisc Publishing, 1998) 55–9.

enterprises relying on debt finance vis-a-vis those able to draw on equity and penalises those sectors that have more reliance on debt along the supply chain than do other sectors with different financing arrangements.

To address these issues, some countries, such as New Zealand and Singapore, have rules in place to effectively eliminate any taxation of business-to-business financial supplies, thus restoring the full intended neutrality of the GST.[83] Australia has moved partly in this direction with limited credits for financial institutions,[84] and the recent Henry Review recommended adoption of a system that would effectively provide full credits for GST borne by business customers of banks.[85]

The norm in most countries and the basic default rule in Australia, however, is to input tax financial supplies, which raises the question of how decisions or measures that remove business-to-business transactions from the GST net should be characterised. An example is the Australian treatment of 'reciprocal repurchase' arrangements. A reciprocal repurchase arrangement, commonly called a 'repo' transaction in commercial terms, is a form of secured loan. Under a standard repo transaction, a borrower 'sells' an asset to the lender and at the same time provides a put option that will result in the borrower 'repurchasing' the asset after a specified period. The repurchase price includes a notional interest charge based on an appropriate commercial interest rate.[86] While in form the repo transaction involves the sale of an asset to a lender and its repurchase at a higher price, in substance it is identical to a secured loan. GST legislation would thus normally treat these transactions as exempt financial supplies, and the Australian regulation setting out examples of exempt financial supplies specifically includes a reciprocal repurchase transaction as a type of financial supply.[87]

Despite this, the ATO in an administrative decision has indicated it will allow a taxpayer entering into a repo arrangement that was not labelled as such in the ruling request to treat the transaction as a taxable sale and taxable repurchase.[88]

[83] Details of the New Zealand rules are set out in Marie Pallot, 'GST and Financial Services — Rating Zero-Rating' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers, 2007) 163 and Marie Pallot, 'GST and Financial Services in New Zealand' in Christine Peacock (ed), *GST In Australia: Looking Forward from the First Decade* (Thomson Reuters, 2011) 161. The Singapore regime is described briefly in Satya Poddar, 'VAT on Financial Services — Searching for a Workable Compromise' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers, 2007) 179, 187–8.

[84] *A New Tax System (Goods and Services Tax) Act 1999* (Cth) div 70.

[85] See Review Panel, *Australia's Future Tax System: Report to the Treasurer — Part Two: Detailed Analysis* (2009) 303–13 ('D4: Taxing Financial Services').

[86] Stewart Karlinsky and Richard Krever, 'Characterising Derivative-Based Loan Arrangements' (2004) 19 *Australian Tax Forum* 435, 436–7.

[87] *A New Tax System (Goods and Services Tax) Regulations 1999* (Cth) sch 1 pt 8 item 3.

[88] ATO, *Goods and Services Tax: GST and Agreement for the Supply and Repurchase of a Commodity*, ATO ID 2004/76, 12 August 2002 distinguishes a sale and repurchase of commodities from a sale and repurchase of securities on the basis of a definition of a reciprocal repurchase agreement in an earlier ATO ruling (ATO, *Goods and Services Tax: GST Treatment of Financial Supplies and Related Supplies and Acquisitions*, GSTR 2002/2, 26 June 2002, sch 1 (definition of 'Repurchase Agreement (Repos)') rather than the commercial meaning consistent with the intent of the legislation. There is no indication in the ATO ruling that the definition relied upon

Quite likely the ATO officers responsible for the decision did not realise that the transaction in question fell within the scope of the regulation. On its face, the ATO interpretation looks to be a mistake — the law is explicit on the point and the decision is wrong in terms of the law, which establishes input taxation (that is, partial taxation) of financial supplies as the operational benchmark. As the parties to the transaction considered by the ATO were all registered businesses entitled to input tax credits for any tax imposed on their acquisitions, the effect of the ATO decision was to eliminate any tax burden for the de facto borrower.

But for what was probably an inadvertent error, the ATO would have sought to enforce the law and this decision could therefore be analysed as an implicit tax expenditure, extending a concession where none was intended under the operational benchmark or under ordinary ATO practice. However, the transaction in question is only likely to be undertaken where there are GST-registered businesses on both sides of the transaction and the outcome — allowing both the borrower and lender to recover fully all input taxes related to the transaction, thus making it a tax-free business-to-business transaction — is entirely consistent with the benchmark principles of a GST, namely that the tax should only stick to supplies to final consumers. In other words, failure to implement the law as set out achieves the policy objectives of the model GST rather than the operational benchmark. In this case, the apparent mistake could be seen as a preferable outcome. In effect, it allows business taxpayers a route to opt out of the ordinary GST rules and achieve a desirable tax-free outcome.

It is unclear whether overall the outcome is positive or negative. This is not, however, a reason for concluding there is no merit to tax expenditure analysis of the decision. To the contrary, the very fact that the uncertainty in analysis exists is itself of great value. Tax expenditure analysis will expose for critical scrutiny the difference between the operational benchmark and the neutral benchmark and show that taxpayers have, with the inadvertent assistance of the tax authority, found a simple way to remove the GST from business-to-business financial supplies. In this case, the analysis may trigger a rethink of the operational benchmark and prompt the government to explore alternative structures that can shift the tax towards the neutral benchmark, as has occurred in some other jurisdictions.[89] More generally, the example shows that there are inherent benefits of exposure when the operational benchmark deviates from the model benchmark. The fact that a decision shifts outcomes from an operational benchmark to a model benchmark renders the decision a prime candidate for critical examination.

by the author of the ATO ID was intended to be an exclusive definition; rather, the authors of the ATO ruling based their definition on the transactions in effect at that time.

[89] See above n 83.

V EXTENDING TAX EXPENDITURE ANALYSIS TO IMPLICIT TAX EXPENDITURES

Outsiders sometimes wonder if tax law in practice is little more than a jumble of apparently inconsistent rules featuring innumerable overlaps and lacunae. Insiders know this to be the case. In the case of explicit deviations from a benchmark tax, the legislature devotes much time inserting non-revenue measures into tax laws and then following up with continuous amendment to slow the haemorrhage as well-advised taxpayers aggressively test the ill-defined borders of concessions. In the case of implicit deviations resulting from judicial decisions, the legislature's response is only reactive, patching the loopholes as taxpayers restructure arrangements to take advantage of the judiciary's generosity.

Identification and critical analysis of implicit tax concessions in the government's annual tax expenditure statement could set the stage for meaningful reform of much of the law. The benefits would be limited, however, if this analysis was treated as an end in itself or merely triggered another round of limited responses to address the most egregious problems identified. One of the prime causes of complexity and uncertainty in Australian taxation is the proliferation of piecemeal responses that bypass a serious examination of the underlying structural issues. Tax expenditure analysis of implicit tax expenditures could end up reinforcing the problem if it led to measures that address the symptoms rather than prompt reform of the structural shortcomings.

The risk of doing more harm than good with an extension of tax expenditure analysis can be illustrated by considering its potential application to one area of tax law described earlier, the treatment of capital expenses. The basic statutory rule prevents taxpayers from immediately deducting capital expenses,[90] with other provisions providing for the later recognition of these outlays.[91] Spotting the concessions among the statutory amortisation rules for capital expenses is not difficult. In the benchmark income tax, expenses to acquire wasting assets are recognised over the life of the benefits acquired. A number of Australian statutory measures are consistent with the benchmark: borrowing expenses are amortised over the life of the loan to which they relate;[92] the acquisition cost of intellectual property is deductible over the legal life of the property;[93] and generally the cost of acquiring tangible equipment is deductible over the estimated usable life of the equipment.[94] Fixed amortisation periods far shorter than actual life are specified for assets such as tractors (6 years and 8 months)[95] and

90 *Income Tax Assessment Act 1997* (Cth) s 8-1(2)(a).
91 Ibid pt 2-10.
92 Ibid s 25-25.
93 Ibid s 40-75(6).
94 Ibid s 40-25.
95 Ibid s 40-102.

telephone lines or powerlines connected to a farm (10 years),[96] while lease expenses are fully deductible at the start of the lease.[97]

The short amortisation times for tractors and utility connections and the immediate write-off for lease expenses are unambiguously concessional rules. Tax expenditure analysis of rules that provide accelerated recognition of capital expenses is relatively straightforward. Amortisation of the cost of installing powerlines over 10 years when the known life of the benefit is much longer can be treated as a concession to foster rural development,[98] as can the rapid write-off for tractors. Up-front deduction for lease expenses[99] can be analysed as a somewhat perverse subsidy for persons shifting lease costs to the commencement of the lease, and so on.

The benchmark income tax is also the starting point for identifying implicit expenditures and disincentives. For example, in the benchmark income tax, a lump sum payment to acquire a multi-year tied-house agreement would be recognised over the life of the contract. Under judicial doctrines, the cost of a relatively short-term agreement is characterised as an immediately deductible revenue expense while prepayment for a longer multi-year agreement is characterised as a capital expense.[100] The statutory response to the first characterisation is a rule denying up-front deductions for the acquisition costs and instead mandating amortisation over the life of the contract.[101] The statutory response to the second characterisation allows a taxpayer incurring an expense of this sort to recognise the cost of acquiring a longer-life agreement at the expiry of the agreement by way of a capital loss equal to the cost of the acquisition.[102] The first response is consistent with the benchmark treatment and gives rise to no tax expenditure or tax disincentive. A tax expenditure analysis would cast the second rule as a tax disincentive for persons paying lump sums to obtain commercially appropriate wasting benefits.

Similarly, in the benchmark income tax the cost of litigation to defend an attack on title to an asset is a currently deductible expense as it yields no asset or benefit lasting into the future.[103] Tax expenditure analysis would regard a rule forcing taxpayers to capitalise into the price of assets expenses incurred to protect legal title as a (highly irrational) tax disincentive to penalise enterprises that respond to threats to their title to assets.

Relatively simple proposals for reform would follow if tax expenditure analysis were applied to implicit tax expenditures in the same manner as it is used for explicit tax expenditures. One recommendation would be to abolish the rule requiring taxpayers to capitalise the cost of defending title and restore the

[96] Ibid s 40-645.
[97] Ibid s 25-20.
[98] The most recent tax expenditure statement records the equivalent of a $17 million annual subsidy for this concession: see The Treasury (Cth), *Tax Expenditure Statement 2010* (2011) 102.
[99] *Income Tax Assessment Act 1997* (Cth) s 25-20.
[100] See above nn 57–58 and accompanying text.
[101] See above n 59.
[102] See above n 61.
[103] See above n 41.

deductibility of these outgoings. Another would be to replace the rule requiring capitalisation of the cost of longer-term contracts with a measure extending the amortisation rule for prepayments of shorter-term contracts to include prepayments enjoying a capital characterisation under judicial tests.

Reforms of this type would disregard a fundamental difference between explicit and implicit tax expenditures and disincentives, however. Explicit tax expenditures derive from deliberate decisions to deviate from a benchmark income tax to favour particular taxpayers or particular transactions. These are akin to distinct expenditure or disincentive programs and their effectiveness or fairness can be improved directly through better targeted rules. In contrast, modifying statutory rules enacted in response to incorporation of judicial concepts into the tax system ignores completely the underlying issue that prompted the questionable rules in the first place — the judicial doctrines, developed in the context of an inadequate statutory framework, that characterise receipts and outgoings using considerations unrelated to benchmark tax design principles. Instead of tax expenditure analysis being used to develop piecemeal modifications to inappropriate rules, it can be used as a tool to unearth and address the underlying problems.

An examination of the judicial doctrines that gave rise to statutory responses and the ad hoc responses reveals two underlying problems in this area of tax law. First, the analysis shows that the judicial tests to distinguish capital and revenue expenses yield inappropriate results in many cases. Second, the analysis reveals an incomplete amortisation regime with significant gaps and no overriding principle, establishing separate rules for different types of wasting assets. The solution to the first problem is not to enact specific rules to address every type of mischaracterised expense separately but instead to replace the judicial test with a statutory definition of capital expenses based on the longevity of the benefits acquired. The solution to the second problem is to replace multiple amortisation rules with a single principle: the cost of a wasting asset or benefit acquired to derive assessable income is recognised over the life of the asset.[104]

A tax law built upon these foundations can accommodate any explicit or implicit tax expenditures or disincentives desired. If the legislature wants to subsidise farmers hooking up to mains electricity, a 10 year write-off can be set out as an explicit deviation from the rule. If it wanted to penalise those who take the initiative to protect their title to their assets, it can similarly deny an immediate write-off for the expense. But in each case, the legislature would have to explicitly carve out the concession or penalty from the general rule and, hopefully, provide a rationale that can help target the exception. Most importantly, the

[104] This principle-based approach to statutory design is used in the US tax law: see *Internal Revenue Code of 1986*, 26 USC §167. Greg Pinder has advocated its use in Australia in his analysis for Australian Treasury on principle-based law design: see Greg Pinder, 'The Coherent Principles Approach to Tax Law Design' [2005] (Autumn) *Economic Roundup* 75. The report of the Ralph Review of business taxation released in 1999 was accompanied by a proposal for a principle-based assessment Act: see Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable — Draft Legislation* (1999).

general rule will be transparent and known to all who do not fall into one of the deliberate carve-outs.

VI THE PATH FORWARD

Proposals to extend the scope of tax expenditure analysis and to use this analysis to support a shift towards principle-based design of tax law will almost certainly encounter considerable resistance from a wide coalition of groups with complementary interests. Politicians would have to confront directly issues they prefer to sweep aside to be dealt with by administrators. Courts handing down decisions and administrators issuing rulings that give rise to implicit tax expenditures will be confronted with timely critical analysis of their judgments and rulings respectively, an outcome to which the former group may be indifferent and that the latter group could find distressing. To the extent that problems may be traced to bad drafting instructions, the department responsible for poor advice would be the same one documenting the consequences of the design shortcomings and use of sub-optimal language. Finally, the extension of expenditure analysis to include implicit tax expenditures deriving from administrative and judicial decisions and legislative measures that adopt judicial characterisations will have significant resource implications for Treasury.

As difficult as it may be to extend the current system of tax expenditure analysis to include implicit tax expenditure, the long-term benefits could greatly outweigh the costs if exposure of implicit concessions prompts reform to remove or better target the reliefs. The initial revenue costs of inadvertent and untargeted subsidy programs may pale into insignificance when put beside the deadweight costs of planning and restructuring transactions and investments into preferentially taxed regimes. These costs are in turn quite probably overshadowed by the costs to society of tax-driven distortions as human and financial capital are inefficiently reallocated to exploit the implicit concessions. A program that catalogues and analyses the distortions will not in itself fix the problems but it is a necessary first step to genuine reform.

The most important gain from establishing a process to analyse implicit tax expenditures may not be the direct benefits realised through reform of the concessions and disincentives but rather may arise from the impact this process could have on tax law drafting, administration and adjudication. Preparation of an expanded tax expenditure budget will prompt changes to the interpretation of current law by all parties and help facilitate a shift to principle-based tax law design. The sooner a shift is made to full tax expenditure analysis, the sooner tax law, administration and adjudication will improve.