

# CHAPTER 1

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## Taxation Principles and Theory

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Introduction	¶1.1
Kinds of taxes	¶1.2
Functions of taxation	¶1.3
Tax expenditures	¶1.4
Structural features of taxes	¶1.5
Tax system design	¶1.6
Features of a good tax system	¶1.7
The tax unit	¶1.8
Tax evasion, tax avoidance and tax planning	¶1.9
Sovereign right to tax	¶1.10
Jurisdiction to tax	¶1.11
International taxation agreements	¶1.12
Level of taxation	¶1.13
Study questions	¶1.14
References and further reading	¶1.15

### [¶1.1] Introduction

Taxation is an ancient and ubiquitous concept that forms one of the central pillars around which civilisation has been built. In his 1925 treatise, *Taxation in Australia*, Stephen Mills noted that one of the certainties of history is that ‘no structural society has ever arisen without taxation’. Taxation plays a critical role in society and has the capacity to affect the lives of everyone within it. As Benjamin Franklin once stated: ‘In this world nothing is certain but death and taxes.’

#### What is taxation?

The *Oxford English Dictionary* defines a ‘tax’ as: ‘A compulsory contribution to the support of government, levied on persons, property, income, commodities, transactions, etc’. One of the earliest Australian judicial pronouncements on the notion of taxation is found in *R v Barger* (1908) 6 CLR 41, where Griffith CJ, Barton and O’Connor JJ said (at 68): ‘The

primary meaning of “taxation” is raising money for the purposes of government by means of contributions from individual persons.’

Taxes come in a variety of forms and are also known by different names, such as duties, levies, tariffs and charges. The etymology of the word ‘tax’ can be traced to the Latin word *taxare*, meaning evaluate, estimate, or assess.

Taxation is the principal means by which governments raise revenue. Without taxation, governments would be unable to finance their operations or deliver the many public goods and services they provide to the community. Other ways that governments can raise revenue include:

- charging fees for rendering services or granting licences
- imposing fines for breaches of the law, and
- generating returns from their assets and investments.

Taxes are a special kind of impost that can be distinguished from fees and fines on the basis that they are imposed on the community at large and are not specifically connected with the receipt of any particular services, the granting of any special rights or privileges, or the breach of any law by the payer. Taxpayers are compelled by law to pay taxes and are obliged to do so even though they may not necessarily receive any direct benefits in return. In *Architecture of Australia’s Tax and Transfer System*, the Australian Treasury recognised (at 11):

A core characteristic of a tax is that there is no clear and direct link between the payment of the tax and the provision of goods and services to the taxpayer. The funds that the government raises from taxes may be used to provide goods or services to the community as a whole, and this may provide a benefit to the taxpayer, but the payment will still be considered a tax if there is no direct relationship between the amount of the payment and the benefit to the taxpayer.

Similar observations were made by the Australian Bureau of Statistics in *Australian System of Government Finance Statistics: Concepts, Sources and Methods*, where it is noted that although ‘taxpayers expect provision of government services in return for the taxes they pay’, there is ‘usually no direct link between taxes paid by an individual taxpayer and the government services consumed by that taxpayer’.

### What is taxation law?

Taxation law is the body of law that governs a person’s liability to pay tax to the government. It covers the rules that establish the incidence of tax and the tax base (ie who and what is subject to tax). It also extends to the rules relating to the administration and enforcement of the tax system, including the rules dealing with the collection and recovery of tax.

Australia, like other developed countries, has a vast body of taxation law. The primary source of this law is found in the many thousands of pages of tax legislation enacted by the Commonwealth, state and territory parliaments and the many hundreds of cases handed down by the courts and tribunals that have interpreted the statutory provisions over the years. Australia’s extensive body of statute and common law is complemented by a broad array of administrative rulings, guidelines and practice statements issued by the relevant revenue authorities.

Australia's taxation laws operate subject to the Commonwealth Constitution and the terms of its international treaties, including many Double Taxation Agreements (DTAs) entered into with foreign countries.

### Why study taxation law?

Taxation law is an extremely important and useful area of law to study, but is also incredibly challenging because of its voluminous nature, technical complexity and constant reform. Taxation law is particularly worth studying because of its wide social and economic impact and its practical relevance to all sorts of commercial transactions. It also raises interesting theoretical, ethical and philosophical issues, making it a discipline worth examining for purely academic purposes.

Taxation law does not operate in a vacuum. It intersects with many other areas of law, including aspects of commercial law, property law, corporate law and administrative law. Taxation is the major source of finance for most governments, and it affects all sorts of employment, business and investment dealings. In the commercial world, taxation is of great importance as it heavily influences the ways that entities are structured, investments are held and arrangements are financed. It is, frankly, impossible to properly appreciate how the government and the economy function without understanding basic notions of taxation. Each day, many millions of transactions are entered into that have taxation consequences.

Taxation is also a topical current affairs issue that features prominently in the media—stories relating to taxation appear frequently in daily newspapers and news broadcasts. The financial press, in particular, is peppered with articles on taxation. The pervasive nature of taxation means that it intrudes on many aspects of everyday life. It is therefore not surprising that people have strong and passionate views about taxation and that it is a perennial political issue that has the capacity to polarise public opinion. History vividly illustrates that taxation policies have the capacity to make or break governments and that good tax policies can lead to economic prosperity, while bad tax policies can result in social and political unrest.

On a personal level, having knowledge and skills in taxation law can be beneficial as it opens up many employment opportunities in the tax profession (in both the public and private sectors) as well as in related fields of law, accounting, business and finance. Understanding how the tax system works helps people run their businesses, plan their personal finances and comply with their reporting and other obligations under the law. Taxation awareness also provides people with a better appreciation of political and economic issues and enables them to engage more effectively in public debate in these areas.

### What is the aim of this book?

This book provides an introduction to the policy, principles and practices that underpin the Australian tax system. It is designed to be used by students studying taxation law and as a general reference guide for taxation academics, researchers and practitioners. My principal objective is to explain the foundations of Australian taxation law in a clear, concise, straightforward and structured manner without oversimplifying the law or avoiding discussion of complex concepts that have important practical ramifications.

More than 100 different taxes are levied in Australia. This book focuses on three of the most widely encountered Commonwealth taxes: income tax, goods and services tax (GST) and fringe benefits tax (FBT). In addition, it examines a number of other Commonwealth taxes, including a range of superannuation taxes and various levies and charges. It also briefly touches on some of the main state, territory and local government taxes.

Although the book is designed as a legal text, it does not just present the reader with a bunch of technical rules. The objective is to place taxation law in its proper commercial context and to synthesise the legal analysis with discussion of related social, political, economic and policy issues. By weaving in these broader perspectives, taxation law can be better understood and its practical relevance better appreciated.

### How is this book structured?

This book is divided into 15 parts, consisting of 46 chapters. The discussion progresses gradually from basic principles to more advanced and specialised concepts, as outlined below:

- **Part A—Introduction to Taxation and Australia's Tax System.** Chapter 1 introduces the concept of taxation and discusses a number of issues relating to taxation theory. Chapter 2 outlines the primary sources of taxation law (statute and common law) and the broad range of secondary material that can be used in researching tax problems. It also examines some basic principles of statutory interpretation. Chapter 3 provides a historical background to Australia's system of government and examines the constitutional foundations that underpin Australia's tax laws. Chapter 4 introduces the main Commonwealth, state, territory and local government taxes. Chapter 5 discusses the ways in which tax policy is formed in Australia and the politics of tax reform. Chapter 6 examines the roles of the Australian Tax Office and tax professionals.
- **Part B—Goods and Services Tax.** Chapter 7 focuses on the GST system. It examines core concepts such as taxable supplies, input taxed supplies, GST-free supplies and creditable acquisitions. GST accounting, reporting and invoicing issues are also discussed as well as a number of special topics.
- **Part C—Income Tax.** Chapter 8 examines the way income tax liability is calculated. It explains the concepts of taxable income, tax rates and tax offsets and discusses the Medicare levy (ML), Medicare levy surcharge (MLS) and the Higher Education Loans Program (HELP).
- **Part D—General Jurisdictional Rules.** Chapter 9 outlines the general jurisdictional rules around which Australia's income tax laws are framed. These rules determine the territorial scope of Australia's income tax laws and are based on two key concepts, 'residence' and 'source'.
- **Part E—Income.** Chapter 10 examines the concept of ordinary income. Chapter 11 examines some commonly encountered statutory income provisions. Chapter 12 deals with exempt income and non-assessable non-exempt income.

- **Part F—Deductions.** Chapter 13 examines the general deduction provision. Chapter 14 focuses on a number of specific deduction provisions. Chapter 15 deals with various provisions that deny or restrict deductions.
- **Part G—Asset Taxation Rules.** Chapter 16 examines the capital write-off and allowance rules. Chapter 17 discusses the trading stock rules. Chapter 18 explores the capital gains tax (CGT) regime.
- **Part H—Fringe Benefits, Superannuation and Employment.** Chapter 19 focuses on the FBT regime. It examines the nature of a fringe benefit and explains how FBT is calculated. Chapter 20 focuses on Australia's superannuation regime and outlines the way superannuation funds are regulated and superannuation contributions, investments and benefits are taxed. Chapter 21 examines the taxation of employment termination and related payments. Chapter 22 deals with the taxation of benefits under employee share schemes.
- **Part I—Special entities.** Chapter 23 discusses the special rules that apply to small business entities, primary producers and special professionals. Chapter 24 examines how companies and their members are taxed and explains how the imputation system operates. Chapter 25 examines how the tax law applies to partnerships. Chapter 26 examines how the tax law applies to trusts. Chapter 27 discusses the taxation of special corporate, partnership and trust entities. Chapter 28 deals with the taxation of consolidated groups.
- **Part J—Tax Losses.** Chapter 29 explains how tax losses are calculated and treated under the tax law.
- **Part K—Tax Incentives and Reliefs.** Chapter 30 focuses on various tax incentives designed to encourage particular kinds of investments. Chapter 31 examines some of the special tax reliefs available for business and entity restructures.
- **Part L—Financial Transactions.** Chapter 32 examines a number of special financial taxation regimes.
- **Part M—International Transactions.** Chapter 33 deals with international tax issues, including the foreign income tax offset. Chapter 34 examines Australia's DTAs and their impact on the general income tax rules. Chapter 35 discusses tax havens and base erosion and profit shifting. Chapter 36 examines the transfer pricing rules. Chapter 37 examines withholding taxes. Chapter 38 discusses the accruals regimes, which tax certain income sheltered offshore. Chapter 39 explains how foreign currency transactions and foreign exchange gains and losses are taxed.
- **Part N—Tax Avoidance.** Chapter 40 discusses the concept of 'tax avoidance' and contrasts it with the concepts of 'tax evasion' and 'tax planning'. Chapter 41 examines the general anti-avoidance rules in the income tax legislation. Chapter 42 focuses on a number of specific anti-avoidance provisions targeted at income alienation schemes.
- **Part O—Tax Administration.** Chapter 43 examines various administrative aspects of the tax system, including the rules relating to tax returns, assessments, rulings, appeals and audits. Chapter 44 discusses the Tax File Number (TFN), Australian Business Number (ABN) and Pay As You Go (PAYG) systems. Chapter 45 outlines

the record-keeping and reporting rules and discusses the Commissioner's tax recovery powers. Chapter 46 focuses on tax offences and penalties.

Each chapter commences with a broad introduction to the topics covered, followed by a detailed discussion of the core legal principles. Although the chapters deal with discrete topics, they are closely linked and comprehensively cross-referenced to show how the rules interrelate. The chapters are peppered with diagrams, tables and examples to synthesise the law, explain complex concepts and illustrate practical situations. Each chapter also contains a set of study questions that tests the key issues covered. The questions are designed to be used in tutorial discussions and to assist students with their exam preparation. At the end of each chapter is a list of references to selected books, articles, reports, rulings and other material for those interested in conducting further research.

### PowerPoint slides and solutions to study questions

A special feature of the book is that it is supported by more than 1,000 PowerPoint slides directly cross-referenced to specific topics covered in the chapters. The slides are designed to serve as a handy teaching and learning aid for distilling the key points. They can be accessed online from [www.oxfordascend.com](http://www.oxfordascend.com) using the code provided on the inside cover of this book. In addition, solutions to the study questions in the book (which have been independently prepared by Tom Delany and Toni Chardon) are available free of charge to lecturers using the book from their Oxford University Press sales consultant. Students can also access solutions to selected questions via [www.oxfordascend.com](http://www.oxfordascend.com) using the code provided on the inside cover of the book.

## [1.2] Kinds of taxes

### Historical background

Taxation is deeply rooted in history. Records of taxation date back in antiquity to the times of the earliest civilisations. Evidence of taxation can be found on an inscription on an ancient Sumerian tablet from the city of Lagash (located in what is now Iraq) which states: 'You can have a Lord, you can have a King, but the man to fear is the tax collector.' Taxation also featured in the times of the ancient Egyptians and Greeks. Scribes of the Pharaohs collected tax on cooking oil, while the Athenians imposed taxes on slaves and foreigners. During the Roman Empire, customs duties, land taxes, farming taxes and sales taxes all featured prominently. In medieval England, feudal property and inheritance taxes were levied by kings and landlords. The famous *Domesday Book* (commissioned by William the Conqueror in 1086) was the first recorded survey of property holdings in England undertaken for the purpose of assessing taxes. Over the years, virtually every kind of product has been taxed in some form or another, including even the most basic commodities such as sugar and salt.

The fact that taxes can be imposed on virtually anything is vividly illustrated by the British window tax, which was levied between 1696 and 1851. The tax was imposed on property owners and was payable at rates that varied according to the number of windows in a dwelling. The aim was to tax the wealthy, who were more likely to have larger houses

with more windows. Critics, however, cynically viewed it as a tax on daylight, and some property owners simply bricked up their windows to avoid the tax.

It is fascinating to note that there have even been great archaeological discoveries related to tax. The most notable example is the famous Rosetta Stone discovered by a French soldier serving under Napoleon near the Nile. The Rosetta Stone contains inscriptions in Egyptian hieroglyphics, demotic script and ancient Greek, and has been prominently displayed at the British Museum since the early 1800s. The inscriptions were the key to deciphering hieroglyphics, which ultimately unveiled to the modern world many of the hidden mysteries of ancient Egypt. Less well known, however, is the fact that the Rosetta Stone contained a decree recording a tax immunity granted by King Ptolemy V to the priesthood. This led Alvin Rabushka from the Hoover Institute at Stanford University to quip: 'Which is why, of course, it was engraved in stone and not written on papyrus.'

### Income tax

The most important and widely imposed modern tax is income tax. As its name suggests, income tax is a tax on income (ie earnings). Income tax was first introduced in Great Britain in 1799 by the Prime Minister, William Pitt, to fund the war against Napoleon. The tax was repealed for a short time in the early 1800s following the signing of the *Treaty of Amiens*. However, renewed fighting resulted in Henry Addington, who had replaced William Pitt as Prime Minister, reintroducing income tax in 1803. Income tax continued to be levied until 1816 (one year after Napoleon's defeat by the Duke of Wellington at the Battle of Waterloo). It was subsequently reintroduced for budgetary reasons in 1842 by Robert Peel and it has been levied in the United Kingdom ever since.

The introduction of income tax in the United Kingdom was radical and controversial at the time. Taxing income was regarded by many as an inappropriate intrusion by government into the personal affairs of its citizens, and was criticised as being a tax on the fruits of labour that discouraged work. Despite these objections, income tax was found to be an effective and practical way to raise revenue. Personal income tax is now levied by almost every country in the world (some notable exceptions include the Bahamas, the United Arab Emirates, the Cayman Islands, Oman, Qatar, Monaco, Brunei and Vanuatu).

One of the first countries to follow the United Kingdom in imposing income tax was the United States, which levied income tax from 1862 to 1872 to pay for the Civil War. Congress reintroduced income tax in 1894. However, the United States Supreme Court held in *Pollock v Farmers' Loan & Trust Co* (1895) 157 US 429 that the legislation imposed a 'direct tax' and therefore breached the provisions of the Constitution, which required direct taxes to be apportioned among the states. This eventually led to the *Sixteenth Amendment to the Constitution* in 1913, which allows Congress to levy income tax without apportionment among the states. Income tax is the bedrock of the United States tax system and has been the largest single source of federal revenue for many decades. Income tax is also levied by more than 40 states. State income tax is allowed as a deduction in calculating federal income tax.

In Australia, income tax was introduced by the Commonwealth in 1915 to support the country's World War I effort. Earlier on, the colonies (which subsequently became the states) had already introduced their own income taxes. The Commonwealth and the states

levied income tax in parallel until the middle of World War II, when the Commonwealth took over the income tax field as a consequence of the introduction of its Uniform Tax Scheme [¶4.2]. Ever since, income tax has remained Australia's major source of federal tax revenue.

Although Australia was influenced by the United Kingdom's income tax laws, Australia did not adopt the United Kingdom's 'schedular' model for its legislation. Under the United Kingdom legislation amounts were only taxed if they fell within one of six schedules. The schedules covered items such as rents from land and buildings (Sch A), farming profits (Sch B), interest and annuities from public funds (Sch C), trading and professional profits and income not covered by the other schedules (Sch D), employment income, annuities and pensions (Sch E) and dividend income (Sch F). Each schedule had its own computation rules. As a result, different rates of tax could be charged on different categories of income, and deductions relating to one category of income could not be applied against income of another category.

By contrast, Australia's income tax legislation does not use schedules to assess taxpayers. Instead, income tax is simply levied on a taxpayer's 'taxable income', which is calculated as the taxpayer's 'assessable income' less 'deductions' [¶8.5]. Different rates of tax do not apply to different categories of income and there are no general quarantining rules which specify that deductions relating to particular categories of income can only be applied against income of the same category. Australia's income tax legislation is, therefore, based on a 'global' model, as it generally allows all kinds of income and deductions to be considered together and set off against each other.

Despite the underlying structural differences between the Australian and United Kingdom income tax legislation, Australia has nevertheless borrowed certain concepts from the United Kingdom. Most importantly, like the United Kingdom, Australia distinguishes between 'income' and 'capital' amounts, and the Australian courts have drawn considerably on the United Kingdom jurisprudence in this area to help characterise various receipts. Australia also followed the United Kingdom in introducing a statutory CGT regime, which forms an integral part of its overarching income tax system [¶18.1]. In Australia, income tax is payable by individuals, companies and certain other entities, such as trustees of superannuation funds.

## Consumption taxes

In addition to income tax, most countries also impose some form of consumption tax. A consumption tax is a tax whose economic incidence falls on the consumer (eg through the increased cost of goods or services). It is the antithesis of income tax, as it taxes consumption rather than earnings.

The most widely encountered consumption tax is value added tax (VAT). VAT was first imposed in France in 1954 and has been adopted throughout the European Union (EU). It is a requirement for EU membership that Member States impose VAT at a minimum rate of at least 15% (although reduced rates are allowed for certain supplies).

Australia imposed its own version of VAT, known as GST, on 1 July 2000 [¶7.1]. Interestingly, it was the last of the Organisation for Economic Cooperation and



Development (OECD) countries to do so (apart from the United States, which still does not have a VAT/GST).

VAT/GST is directed at taxing the value that has been added to the supply of goods and services. Registered entities charge VAT/GST on supplies they make, and are generally allowed credits for VAT/GST charged on their acquisitions. The cost of VAT/GST is ultimately borne by end consumers who are not registered and, therefore, not entitled to credits for the VAT/GST charged on their acquisitions.

VAT/GST may be contrasted with sales tax, which is a much older and more traditional form of consumption tax. Sales tax is imposed on the sale of goods and is payable by the seller, who adds the tax to the price charged for the goods so that the burden of the tax is ultimately passed on to the purchaser. In the United States, many states impose retail sales tax. To ensure that this tax is charged only on retail sales and not on wholesale sales, registered persons who acquire goods for resale (ie not for their own consumption) provide a resale certificate to the seller, which enables them to acquire the goods free of sales tax.

In 1930, Australia introduced a wholesale sales tax. This tax was levied at the last point of wholesale sale of goods (eg from wholesaler to retailer). From the point of view of end consumers, wholesale sales tax was a 'hidden tax', as it was charged by wholesalers rather than retailers. The cost of the tax was, nevertheless, embedded in the price of the goods charged by retailers. As a result of the introduction of GST, wholesale sales tax was repealed from 1 July 2000. One of the main reasons for replacing sales tax with GST was that GST is levied on a much broader base, as it applies to the supply of goods and services (not just to the sale of goods).

### Other taxes

A broad range of other kinds of taxes is also levied around the world. For example, many countries impose customs duties (on the importation and exportation of goods) and excise duties (on the production and manufacture of goods).

It is also common for countries to levy land taxes (on the ownership of real estate) and estate duties (on the assets of deceased estates). These taxes are really forms of wealth taxes as they are levied on the value of a person's property. There are also several kinds of employment taxes, including payroll taxes (on the payment of wages) and fringe benefits taxes (on the provision of non-salary remuneration). In addition, there are many varieties of transactional taxes, such as stamp duties (on the execution of certain documents), gambling taxes (on betting at casinos, races and lotteries), financial taxes (on deposits and withdrawals to and from bank accounts) and bed taxes (on accommodation provided in hotels).

Some countries also impose taxes on profits from the exploitation of their natural resources. In 1987, Australia introduced a petroleum resource rent tax (PRRT) on profits from petroleum projects [¶4.3]. In 2012, the Gillard Labor Government introduced a minerals resource rent tax (MRRT) on profits from iron ore and coal mining projects [¶5.9]. At the same time, it also introduced a carbon tax on large greenhouse gas emitters to combat climate change [¶5.10]. The Abbott Liberal–National Coalition Government, however, abolished both the MRRT and carbon tax in 2014.

## Determining the mix of taxes

As each nation has the sovereign right to determine its own tax system, virtually anything can be made the subject of taxation. In *R v Barger* (1908) 6 CLR 41, Griffith CJ, Barton and O'Connor JJ recognised (at 68):

The power to tax necessarily involves the power to select the subjects of taxation. In the case of things the differentiation or selection is, in practice, usually made by reference to objective facts or attributes of the subject matter, so that all persons or things possessing those attributes are liable to the tax. The circumstance that goods come from abroad or from a particular foreign country, or that particular processes or persons have been employed in their production, or that they possess certain ingredients, are instances of attributes which have been chosen for the purpose of differentiation.

Ultimately, each country determines who and what it subjects to tax and the particular attributes of its tax system. Each country inevitably adopts its own mix of taxes designed to suit its particular needs and circumstances. While there are many similarities between tax systems around the world, there are also many differences in the ways that taxes can operate, making each country's tax system unique.

Before examining how Australia's tax system works, it is necessary to have a conceptual framework for studying taxation law. In particular, it is important to recognise that taxation has wide-ranging social, political and economic dimensions that need to be considered in parallel with any legal analysis. This chapter canvasses some of these broader policy issues and lays the theoretical foundations for the detailed technical discussion contained in the rest of the book.

## [¶1.3] Functions of taxation

### Taxation's revenue-raising function

The most important and immediately recognisable role of taxation is its revenue-raising role. It is widely acknowledged that without taxation, a government would not be able to properly function. As the United States Supreme Court stated in *Nicol v Ames* (1899) 173 US 509 (at 515):

The power to tax is the one great power upon which the whole national fabric is based. It is as necessary to the existence and prosperity of a nation as is the air he breathes to a natural man. It is not only the power to destroy, but the power to keep alive.

At the most basic level, taxes redirect economic resources from citizens to governments for use in their spending programs. Taxation therefore involves diverting wealth from the private sector to the public sector. Governments use revenue raised from taxes to fund the public service and defence force, to provide a legal system and law enforcement, to construct roads and airports, to run hospitals and education institutions, and to pay social security benefits. Without taxation, governments could not provide their citizens with the many kinds of infrastructure and services that they have come to expect. Government spending is often justified on the basis that in a capitalist society, certain 'merit' goods and services may not necessarily be adequately provided by the free-market, and it is therefore

both necessary and appropriate for the government to intervene and provide these things to make society a better place.

### Taxation's social and political functions

It is important to understand that taxation is a powerful political engineering device that governments can use as either a 'carrot' or a 'stick' to promote their objectives. For instance, in Australia, the Federal Government provides a range of tax concessions under various 'tax expenditure programs' [¶1.4] to encourage particular kinds of investment, such as private retirement savings under the superannuation regime [¶20.1]. On the other hand, it imposes excise duties on cigarettes, not only to raise revenue, but also to discourage smoking and thereby reduce the nation's health costs. Similarly, it imposes the MLS on high-income earners who do not have private health insurance, to encourage them to take out appropriate cover in order to lessen the burden on the publicly funded health system [¶8.7]. The benefit of a concession or the burden of taxation can thus be a useful tool in sculpting social behaviour.

### Taxation's economic functions

Taxation also has important micro-economic ramifications. For instance, taxing particular goods adds to their cost, making them more expensive than similar kinds of untaxed goods. Taxation can therefore be used to modify consumer behaviour by encouraging spending on one product rather than another. Governments around the world have frequently used taxation to protect their domestic industries by taxing imported goods more heavily than locally produced goods. This provides the local goods with a competitive advantage over the imported goods which, in turn, encourages spending on local products. A government's ability to tax goods will, of course, be subject to its obligations under any international agreements it has entered into (eg with the World Trade Organization).

Governments also often use taxation as a macroeconomic device to speed up or slow down the economy. Higher taxation usually leads to less spending as taxpayers have less disposable income. This typically has a deflationary effect on the economy. Lower taxation, on the other hand, usually results in increased spending as taxpayers have more disposable income. This, in turn, can have an inflationary effect on the economy.

### Taxation's redistribution function

Taxation can also operate as a mechanism for creating economic equality between citizens. It can be used by governments to make their citizens richer or poorer. A tax system that 'taxes the rich' so that the government can 'give to the poor' promotes a more egalitarian society, redistributing wealth among citizens, which can result in a more level 'playing field'.

Another, more cynical, way of looking at taxation is that it is simply a form of state-based confiscation which interferes with individual freedoms and rights. Some people complain that they pay a lot of tax, but get little direct benefits in return from the government. However, this kind of argument fails to recognise the fact that taxation enables a government to provide a range of services that can benefit society as a whole, and therefore make the state a better place to live. For instance, although some taxpayers might not directly use the public health system, they indirectly benefit from it as other members

of society are cared for and public health, in general, is protected. Likewise, people without children should not complain that their taxes are being used to fund primary and secondary education, as public education has broad-ranging spillover benefits for the community.

Without taxation, living conditions within a country would be quite different. It would be up to each person to provide for themselves, since no one could rely on state-funded goods and services. Society would be more polarised, and wealth more concentrated. Those less able to support themselves would clearly suffer, and the community as a whole would arguably be worse off.

### Perspectives on taxation

Taxation is one of the greatest powers a government has over its citizens. From a government's perspective, taxation enables the state to benefit from the fortunes of its citizens and the enterprises that they carry on. From a citizen's perspective, taxation is a cost of undertaking transactions, owning property, carrying on business and earning income. While taxation is one of the major factors that can affect a citizen's wealth, it also pays for the privileges associated with the kind of society in which a person lives. Accordingly, although taxation has been cynically described by some as a form of 'legalised robbery', it is more appropriate to view taxation, as Sabine observed in *A Short History of Taxation*, as 'part of the price of civilisation'. In the words of Justice Oliver Wendell Holmes (Jr) in *Compania General de Tabacos De Filipinas v Collector of Internal Revenue* (1927) 275 US 87 (at 100): 'taxes are what we pay for civilized society'.

### [¶1.4] Tax expenditures

In addition to its obvious revenue-raising function, governments also use the tax system to provide incentives and financial assistance. Professor Surrey, in his seminal work, *Pathways to Tax Reform: The Concept of Tax Expenditures*, identified this aspect of the tax system as the system of 'tax expenditures'. Surrey recognised that tax systems contain two conceptually and functionally distinct components. One of these comprises the provisions that make up the 'normative tax structure' (ie the 'benchmark tax system' for collecting revenue) and the other comprises the provisions designed to effect government spending (ie the system of 'tax expenditures').

Tax expenditures may in turn be divided into two broad categories:

- 'tax incentives' (designed to induce certain activities or behaviour), and
- 'tax concessions' (designed to provide welfare assistance to those in need).

Tax expenditures are deviations from the benchmark tax system that are designed to provide benefits to targeted taxpayers. They can be delivered in a number of ways. For instance, under the income tax system, tax expenditures may be provided to taxpayers by way of special tax exemptions, tax deductions, tax offsets or concessional tax rates.

### Tax expenditure reporting

The Commonwealth Government's tax expenditures are reported in its *Tax Expenditures Statements*, which are published annually as required by the *Charter of Budget Honesty Act 1998*. The aim of these statements is to increase transparency of the tax system and allow greater scrutiny of tax expenditures.

*Tax Expenditures Statement 2017* identified more than 250 different tax expenditures. A ‘revenue forgone’ approach is generally used to measure the cost of these concessions. This approach essentially compares the difference in tax paid as a result of the provision of a particular tax concession relative to the tax that would have been paid under the benchmark tax system if the tax concession had not been available (assuming taxpayer behaviour remained unchanged). A ‘revenue gain’ approach is also used to measure the cost of certain large tax concessions. This approach takes into account potential changes in taxpayer behaviour that would arise if a tax concession were abolished.

### Tax expenditure programs

Over the years, tax expenditures have become more prevalent in Australia, and several intricate tax expenditure programs have been developed by the Federal Government. Some of the main tax expenditure programs examined in this book are:

- the superannuation program (which provides tax incentives to encourage retirement savings) [¶20.2]
- the Early Stage Investors (ESI), Pooled Development Fund (PDF), Venture Capital Limited Partnership (VCLP) and Early Stage Venture Capital Limited Partnership (ESVCLP) programs (which provide tax incentives to encourage venture capital investment) [¶30.2], [¶30.3], [¶30.4]
- the Research and Development (R&D) program (which provides tax incentives to encourage research and development activities) [¶30.5], and
- the film production program (which provides tax incentives to encourage Australian film production) [¶30.6].

The rationale for introducing these programs is that they address market failures and promote private investment in areas considered to be publicly desirable.

Tax expenditures are also provided to support specific categories of taxpayers. For instance, to support farmers, the government provides a range of tax incentives to people who carry on ‘primary production businesses’ [¶23.3]. Likewise, to support taxpayers who operate small businesses, a range of special tax concessions are provided to ‘small business entities’ (SBEs). SBEs are basically entities (eg individuals and companies) that carry on business and have ‘aggregated turnover’ below the prescribed threshold for the relevant year (\$10m for 2018/19) [¶23.2].

Tax expenditures may also be used to achieve broader economic objectives. For example, the Rudd Labor Government introduced a temporary tax incentive, known as the ‘investment allowance’, which provided a ‘bonus’ tax deduction for eligible expenditure incurred from 13 December 2008 to 31 December 2009 on tangible depreciating assets. The objective of this incentive was to stimulate economic activity during the ‘global financial crisis’ (GFC) [¶1.14].

### Cost of tax expenditures

Tax expenditures are costly as governments collect less revenue from taxpayers because of the concessions. The largest tax expenditures relate to the CGT main residence exemption

[¶18.12] and the concessional treatment of superannuation [¶20.2]. Together, these concessions make up more than half the estimated cost of all Australia's tax expenditures.

### Tax expenditures versus direct spending

It is important to realise that there is arguably no difference between providing tax concessions and providing subsidies or grants—both are forms of government spending. Collecting less tax because a concession is in place ultimately achieves the same result as collecting ordinary amounts of tax under the benchmark tax system and then redistributing the revenue as subsidies or grants. While the subsidy or grant is a 'direct' form of government spending, tax expenditures are an 'indirect' form of government spending.

### Arguments for and against tax expenditure programs

Advocates of tax expenditure programs argue that they are efficient as they overcome 'double handling' issues (ie the government does not need to first collect tax and then distribute it as a subsidy or grant). Instead, the government simply collects less tax from those who enjoy the benefit of the relevant tax expenditure. However, others argue that such programs are often poorly targeted and can provide benefits to unintended recipients. In this regard, it is sometimes said that the tax law is a 'blunt' instrument for achieving a government's policy objectives.

Furthermore, where tax expenditures are provided in the form of income tax exemptions or deductions, the value of such concessions differs between taxpayers depending on their respective tax rates. Taxpayers subject to higher tax rates stand to benefit more than taxpayers on lower tax rates, and this produces what Surrey referred to as an undesirable 'upside-down effect'.

Another significant argument against tax expenditure programs is that they add considerably to the volume and complexity of the tax law. Tax expenditures create exceptions to general rules, and these exceptions inevitably increase the size of the tax legislation and reduce its simplicity. The fact that tax expenditures are 'hidden' in the tax legislation also means that they may be confused with the provisions that make up the benchmark tax system, and may be overlooked when reforms are being considered. Many critics of tax expenditures argue that, because such programs are embedded within the tax law, they are less visible and therefore often escape the same rigorous scrutiny that other government spending programs experience. As a consequence, their effectiveness in achieving policy objectives may not be as closely monitored and this can result in inefficient and costly programs remaining in existence.

## [¶1.5] Structural features of taxes

Although taxes vary greatly in their design and coverage, most taxes share the following four basic structural features:

- **Taxpayers.** Each tax regime subjects particular 'taxpayers' to tax. Taxpayers are the legal entities (eg individuals or companies) who are liable to pay the tax and are penalised if it is not paid. In Australia, income tax is payable by 'income earners' [¶8.5], GST is payable by 'suppliers' and 'importers' [¶7.3] and FBT is payable by 'employers' [¶19.2].

- **Tax base.** Each tax regime has its own ‘tax base’. The tax base consists of some form of property, transaction, activity or concept upon which the tax is imposed. In Australia, income tax is imposed on ‘taxable income’ [¶8.5], GST is imposed on ‘taxable supplies’ and ‘taxable importations’ [¶7.3] and FBT is imposed on ‘fringe benefits taxable amounts’ [¶19.2].
- **Tax periods.** Each tax regime has its own ‘tax periods’. Taxpayers are required to pay tax on amounts that fall within the tax base during the relevant period. The tax period can be of any length of time (eg a month, a quarter, or a year). In Australia, the income tax period is the ‘income year’ (ie the ‘financial year’—1 July to 30 June) [¶8.3]. Monthly or quarterly tax periods apply in the case of GST [¶7.4]. An annual period that runs from 1 April to 31 March applies in respect of FBT [¶19.2].
- **Tax rates.** Each tax regime has its own ‘tax rates’. Depending on the nature of the tax and the kind of taxpayer involved, tax rates may be set at a single rate (ie flat rate) or at differing rates (eg rates that vary with the level of the tax base). In Australia, companies generally pay income tax at flat rates of either 27.5% (if they are ‘base rate entities’) or 30% (in other cases) [¶24.3]. Individuals, on the other hand, pay income tax at progressive ‘marginal rates’ of up to 45%, and they may also be required to pay certain levies (such as the ML and MLS) [¶8.7]. GST is imposed at a flat rate of 10% [¶7.3]. FBT is imposed at a flat rate of 47% [¶19.2].

### Proportional, progressive and regressive taxes

Taxes may be described as being either ‘proportional’, ‘progressive’ or ‘regressive’:

- **Proportional taxes.** These taxes (also known as ‘flat’ taxes) are imposed at the same rate on all taxpayers. In Australia, the GST is an example of a proportional tax—it is levied at a flat rate of 10%.
- **Progressive taxes.** These taxes are imposed at rates that increase with the amount of the tax base. In Australia, income tax is an example of a progressive tax—individuals pay income tax at rates that increase depending on the amount of their taxable income.
- **Regressive taxes.** These taxes are imposed at rates that decrease with the amount of the tax base.

Most taxes imposed around the world are either proportional or progressive taxes.

### Marginal, average and effective tax rates

When dealing with progressive taxes, such as the Australian income tax, it is important to understand the difference between ‘marginal’, ‘average’ and ‘effective’ tax rates:

- **Marginal tax rate.** A taxpayer’s marginal tax rate is the rate of tax that is applied to the incremental amounts of the tax base. With a progressive tax, the marginal rates will rise with the amount of the tax base. This is illustrated in the examples at [¶8.7].
- **Average tax rate.** A taxpayer’s average tax rate is calculated by dividing the taxpayer’s total tax liability by the tax base.

- **Effective tax rate.** A taxpayer's effective tax rate is calculated by dividing the taxpayer's total tax liability by the taxpayer's total 'economic income'. A person's economic income is not necessarily the same as their taxable income as it may include, for example, amounts that are exempt from tax.

### Direct and indirect taxes

In describing taxes, economists often distinguish between 'direct' and 'indirect' taxes:

- **Direct tax.** A tax is a direct tax if the economic burden of the tax is borne by the person who pays the tax.
- **Indirect tax.** A tax is an indirect tax if the person who pays the tax is able to pass the economic burden of the tax on to third parties.

The cost of income tax is borne by the person who earns the income; it is therefore described as a direct tax. In contrast, the cost of GST, although paid by the supplier of goods or services, is ultimately borne by the consumer through the increased price charged for those goods or services by the supplier.

The distinction between direct and indirect taxes is premised on the assumption that the economic incidence of some taxes can be shifted from one party to another. However, the distinction has no legal significance and is not really helpful, as the cost of most taxes is usually passed on in one way or another. For instance, the owner of a business needs to factor in the cost of income tax in determining his or her net profit, and will therefore take this into account when setting the price to charge for any goods or services.

### [¶1.6] Tax system design

The design of a country's tax system and the way taxation revenue is redistributed reflect much about a country's values and the demands and expectations of its citizens. The amount of taxes collected from a citizen less the amount of benefits the citizen obtains from the redistribution of taxation revenue ultimately affects the citizen's wealth and prosperity. The 'tax-transfer' system therefore has a direct bearing on living standards.

In designing tax systems, governments obviously need to focus on ensuring that they collect the desired amount of revenue. However, they also need to consider a broad range of social, economic and political factors. As the Finance Minister of King Louis XIV, Jean Baptiste Colbert, cynically observed:

The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing.

### Tax systems and national stability

A tax system underpins a country's economic, social and political stability. Governments that impose tax systems which are perceived to be 'unfair' are often faced with political strife. At the extreme, wars have erupted over disputes about taxation. The famous phrase 'no taxation without representation' encapsulated the complaints of the American colonists in the mid-1700s. The colonists argued that taxes were imposed by Great Britain without their consent as they were not represented in Parliament. One of the events that sparked



the American Revolution was the Boston Tea Party in 1773, which was a revolt against Great Britain over its tax on imports.

History vividly highlights that it is in a government's interests to develop tax systems that are popular (or at least acceptable) in the eyes of the community that bears the burden of payment. There are many instances of unpopular taxes creating problems for governments. A classic illustration is the 'community charge' (better known as 'poll tax') introduced by Britain's Conservative Government in the late 1980s. The poll tax was designed to fund local government and replaced a rates system imposed on the rental value of housing. The poll tax was imposed at a flat rate per person with some limited exemptions. The tax was viewed by a large portion of the British population as manifestly unfair, and it prompted mass protests and riots which ultimately contributed to Margaret Thatcher's resignation as Prime Minister in 1990.

Experiences such as those involving the poll tax have led governments to tread cautiously before introducing new taxes. Politicians are acutely aware that new taxes are unpopular. Ultimately, in democratic countries, it is the citizens who will have the last say about taxes as they have the power to vote governments out of office. As a general rule, the community will accept taxation more willingly if it sees the justification for a tax and considers its level appropriate. Although most citizens would naturally prefer to pay as little tax as possible, they have also come to expect a certain level of government services and generally accept that taxes play a critical role in funding such things.

### Forecasting tax revenue

From a government's perspective, it is vital that the cost of its spending programs is balanced against the revenue it receives. In this regard, governments need to be able to forecast the amount of tax that they will collect each year and predict how variables, such as economic factors, may impact on revenue collection. If their estimates are incorrect, they risk falling into funding deficits. The Australian Commonwealth, state and territory governments publish annual *Budget Statements* that contain economic data, including details of their respective revenues and expenditures. These statements also include fiscal outlooks for coming years.

The difficulties that governments face in predicting tax revenue can be illustrated by a simple example. Suppose a government imposes a fuel excise at a flat rate on petroleum products. If oil prices rise during the year, revenue will increase (resulting in a windfall), but if oil prices drop during the year, revenue will be lower (resulting in a shortfall). As oil prices depend on extraneous economic factors, many of which are outside a government's control, it is impossible to know exactly how much tax will be collected. Governments therefore need to take into account a range of variables when undertaking their fiscal modelling, and they may sometimes miss their forecasts.

### Challenges faced by Australia

Australia is a highly developed country with a strong rule of law, stable political system and open economy. The country enjoys one of the highest living standards in the world and has benefited from more than 100 quarters of consecutive economic growth without a recession. Australia also performs well on many global indicators—it is ranked second in

the United Nations' Human Development Index, 14<sup>th</sup> in the World Bank's Ease of Doing Business Rankings and 20<sup>th</sup> in the Central Intelligence Agency's GDP (Purchasing Power Parity) Rankings. The continuing challenge for the nation is to maintain these standards in the rapidly changing and competitive international economic environment.

While globalisation presents many opportunities for Australia, the reality is that the world economy is still recovering from the GFC and could be hit by another 'black swan' event at any time. In Europe, a number of countries, such as Greece, Italy, Portugal and Spain, continue to struggle with high levels of debt. There is also ongoing uncertainty in world financial markets caused by events such as the United Kingdom's decision to leave the EU and President Trump's decision to introduce tariffs in the United States.

The negative impact of the GFC on business confidence and investment activity has led to banks adopting tighter lending practices, making it harder for businesses to raise finance. At the same time, the Australian dollar has been trading at relatively high values, which has had a negative effect on Australian exporters. A high Australian dollar makes their products more expensive, which makes it more difficult for them to compete in international markets. Although the Australian dollar has come down considerably from its highs a few years ago, the environment for Australian exporters remains challenging because of the relatively subdued global economic conditions.

Although Australia weathered the GFC better than most countries, its economic future is ultimately entwined with international economic conditions. Australia's economic future will, no doubt, be heavily influenced by whether its major trading partner, China, can continue its economic growth. Australia is rich in coal, iron ore, copper, gold, silver, nickel and zinc, and it benefited greatly from the mining boom. Higher commodity prices leading up to 2008, fuelled particularly by demand from China, resulted in mining companies making increased profits, which translated into greater tax revenues from the mining industry. However, increased supply over the last few years coupled with the economic slowdown after the GFC inevitably led to a dampening of commodity prices. Although commodity prices have recently been recovering, it is widely accepted that the mining boom is now over. As a consequence, Australia will not be able to rely as heavily as it has in the past on revenue from mining companies and will need to count on other sectors to drive economic growth.

To succeed in the twenty-first century and stay ahead of many rapidly advancing developing countries, Australia needs to be a leading knowledge-based economy. Science and technology have become more important than ever. As Innovation and Science Australia noted (at 1) in its 2018 report, *Australia 2030 – Prosperity through Innovation – A Plan for Australia to Thrive in the Global Innovation Race*:

Australia needs to find new sources of growth and improve productivity to maintain our standard of living. The biggest growth opportunities will come from knowledge intensive companies that innovate and export, as they are the most profitable, competitive and productive.

While Australia has a reputation for being a 'clever country' with good universities and talented researchers who have developed many ground-breaking inventions and technologies, the reality is that it has often failed to capitalise on these opportunities

as many Australian discoveries end up being commercialised overseas. Australia needs to ensure that its innovation ecosystem supports talented entrepreneurs to develop new businesses and commercialise their innovations. This requires investment in R&D and the development of a domestic venture capital market large enough to meet the needs of Australia's entrepreneurs. While Australia has been attempting to address some of these challenges through various initiatives, including the Turnbull Government's *National Innovation and Science Agenda* [¶15.7], it still has a long way to go to compete with thriving innovation hubs such as Silicon Valley and Tel Aviv.

In the modern world, where the internet is increasingly used for international trade and commerce, Australia, like many other countries, is also confronting the challenge of dealing with cross-border digital transactions. The electronic economy has become more important than ever, and the Government has acknowledged that this places stresses on Australia's tax system and exposes it to the risk of revenue leakage. Technological developments contribute to the ease with which taxpayers can mobilise capital and transfer it offshore. Cryptocurrencies such as Bitcoin cause particular concern because they can facilitate tax evasion and money laundering.

Australia also needs to be constantly alert to the threats of international tax competition. Unless Australia has a competitive tax system, it risks struggling to compete for international investment. Many countries in the region offer generous investment incentives and have lower tax rates than Australia, which may encourage some businesses to relocate overseas. At the same time, Australia needs to protect its tax base from international tax avoidance practices employed by certain multinational enterprises that seek to divert their profits to tax havens.

Like many other western countries, Australia is confronting the demographic challenges of an ageing population. An ageing population means a shrinking proportion of people in the workforce who are able to earn income and pay taxes and an increasing proportion of older people who are expected to live longer and require costly healthcare and welfare support. In its 2015 *Re:think* tax discussion paper, the Government projected that the proportion of the population participating in the workforce will decline from 64.6% in 2014/15 to 62.4% in 2054/55.

As Australia is the driest inhabited continent on the planet, it is also likely to incur significant costs in coping with climate change. Adverse environmental and ecological issues can negatively impact many sectors, including agriculture, which supports a significant portion of the Australian workforce and is critical for the nation's food security and exports. Being a large country with a population of only about 25 million people, Australia also faces unique challenges in maintaining and upgrading its vast national infrastructure. The cost of building roads, railways, ports and communication systems is likely to be higher in Australia than in smaller, more densely populated countries. At the same time, housing affordability issues in the large capital cities place pressure on younger families, who often struggle to acquire their first home. Household debt in Australia has also been rising, and this poses additional risks for the nation.

Together, the many issues outlined above are likely to impact on economic growth and living standards. They should therefore be carefully taken into account in policy considerations affecting the design of the Australian tax system.

## [¶1.7] Features of a good tax system

In his famous 1776 treatise *The Wealth of Nations*, Adam Smith, the renowned Scottish economic philosopher, expressed the following views about taxation:

- The subject of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.
- The tax each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, and the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.
- Every tax ought to be levied at the time, or in the manner in which it is most likely to be convenient for the contributor to pay it.
- Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.

Smith's 'maxims' have become foundation stones for the design of a good tax system and are still often referred to today by policymakers. Whether or not a tax system is 'good' obviously involves a qualitative judgment. Although people naturally have different opinions about what constitutes a good tax system, there are some generally accepted criteria by which tax systems may be evaluated. These criteria, evolving out of Smith's work, have been extensively discussed in the academic literature and closely analysed in government papers and reports, such as the Asprey Committee's *Full Report* (1975), Treasury's *Reform of the Australian Tax System: Draft White Paper* (1985) and the Review of Business Taxation's *A Tax System Redesigned* (1999). The following discussion outlines some commonly articulated views regarding tax system design and focuses on what are, arguably, the key attributes of a 'good tax system'.

### Fiscal and policy objectives

Obviously, one of the key measures by which a tax system is judged is whether it meets the government's fiscal targets. A good tax system should collect the amount of revenue that the government has set out to collect; otherwise, it will fail in its primary objective. A good tax system should also operate in harmony with the government's broader socio-economic policy agenda. Ideally, a country's tax system should be designed to support the government to achieve optimal outcomes, such as increased productivity, employment growth, improved welfare and higher living standards. A country's tax system should also not unduly interfere with the advancement of the country's broader economic imperatives, such as boosting national savings, encouraging investment and supporting business activity.

### Simplicity, certainty and stability

Most people would agree that simplicity and certainty are desirable features of a good tax system. If these criteria are not met, taxpayers will find it difficult to comply with the tax laws and apply them to their specific circumstances. Ideally, tax laws should be clear, unambiguous and uncomplicated. They should therefore not be bogged down in complex and voluminous legislation that is difficult to comprehend or navigate. Ultimately, revenue

authorities as well as taxpayers should be able to identify the incidence of tax and calculate tax liabilities with ease and certainty.

Unfortunately, the reality is that tax laws are often highly complex, and they are frequently criticised for that reason. Australia's income tax legislation, in particular, is notorious for containing many long and cryptic technical provisions that are difficult to understand. Even senior judges have been open critics of the legislation. In an article appearing on the front page of the *Australian Financial Review* on 21 January 2011, Justice Keane (the former Chief Justice of the Federal Court and now a High Court justice) was reported as saying: 'Opening the Tax Act is like entering the door of a parallel universe.'

The Federal Government acknowledged that the Australian tax system is too complex and gave a number of reasons for this in its 2015 *Re:think* discussion paper (at 2):

One reason is the prevalence of tax concessions aimed at assisting particular groups. Another reason is the regular 'patching' of the law to fix narrow problems or provide certainty for taxpayers and transactions without fully considering consequences for the system as a whole. Overly risk-averse attitudes from policy advisers and administrators, combined with complex legislative drafting styles, have also led to complexity.

Complexity in the tax system is problematic, as it can divert time and resources away from productive activities. Governments should therefore strive to simplify their tax systems where possible. It is also sensible for them to periodically review their tax laws to ensure that they continue to meet their fiscal and policy objectives. Where a country's tax laws are failing to have their desired effect, they should be amended or repealed. It is, nevertheless, also important to recognise that continual reform of a country's tax system can contribute to uncertainty about its operation. It is therefore generally desirable for a country to maintain relatively stable tax laws, as this allows business and investment decisions to be made with confidence. Frequently changing tax laws can have a negative impact on the economy, as taxpayers will be reluctant to make commercial and financial decisions where their tax impact is not clear.

### Transparency and integrity

It is widely accepted that a good tax system should be transparent. Revenue authorities have considerable statutory responsibilities and powers, and their actions should be closely monitored by government and be subject to parliamentary scrutiny. At the same time, tax laws should be administered free of political interference and in accordance with the rule of law. Revenue authorities should interpret and apply tax laws consistently, so that taxpayers in similar circumstances are treated equally. While it is important that revenue authorities can readily enforce tax laws if they are breached, the rights of taxpayers also need to be closely protected. As there is often a great imbalance between the resources of revenue authorities to prosecute tax disputes and the capabilities of taxpayers to defend themselves, it is imperative that taxpayers are treated fairly and not denied natural justice. In particular, taxpayers should be able to contest their tax assessments before the courts if they believe they have been incorrectly assessed.

It is also desirable for general taxation statistical data to be easily accessible, as this helps promote transparency in the tax system and community engagement. The availability of statistical data enables a tax system to be analysed and evaluated by academics and other

commentators, who may be able to identify issues that need to be addressed. This can contribute significantly to future tax reform.

A good tax system also needs to be robust and resilient to ensure that it is not open to abuse. A country's tax laws should therefore be designed in such a way that they are difficult to avoid or evade. A tax system with loopholes will not be respected by taxpayers and will result in revenue leakage, as some people will inevitably choose to exploit the weaknesses in the system. To protect the government's revenue base, tax laws need to be drafted tightly so they cannot be easily manipulated. Appropriate anti-avoidance rules in the legislation can provide added protection and serve as an integrity measure to prevent abuse of the general provisions. In addition, to ensure compliance, it is important for tax laws to be vigorously enforced. Tax administrators and law enforcement agencies need to have appropriate resources and powers to pursue and prosecute tax cheats.

### Efficiency and flexibility

Another generally accepted feature of a good tax system is that it should be efficient, in the sense that it has low collection and compliance costs. Taxes that are expensive for a government to collect, or cumbersome, time-consuming or costly for taxpayers to comply with, are inefficient, as they divert resources from productive activities. In designing an optimal tax system, government efficiency requirements should be carefully balanced against taxpayer compliance obligations to ensure that the tax laws operate both fairly and effectively. The Australian Government in its 2015 *Re:think* tax discussion paper noted that the annual cost of administering the Commonwealth tax system was around \$3.6 billion and that taxpayer compliance costs were around \$40 billion.

Linked to the concept of efficiency is the concept of flexibility. A good tax system should be able to cope with, and where necessary, respond to, changes in economic circumstances without requiring major overhauls. For example, if a tax system is not broad-based and is skewed towards taxing commodities, then a fall in commodity prices will have a major impact on revenue collection. For this reason, governments usually impose many different kinds of taxes with broad tax bases to spread risk. Having a broad tax mix also ensures the burden of taxation is spread more widely among the community and does not fall disproportionately on only certain persons. However, having many different kinds of taxes can add to the overall complexity of the tax system and increase compliance costs for taxpayers. Governments should bear this in mind in deciding on their overall tax mix.

### Neutrality

It is often argued that a good tax system should be neutral, in the sense that it should not distort commercial decisions or skew the market mechanism. Taxes can interfere with the way the market operates, as they affect the cost of the activities or products upon which they are imposed, causing taxpayers to alter their behaviour. Tax laws that increase or decrease the attractiveness of one arrangement ahead of another can alter the way taxpayers choose to organise their affairs. A tax imposed on a particular product discourages spending on that product and makes similar products which are not taxed, or are taxed to a lesser extent, more attractive. For instance, if a tax is imposed on black shoes but not white shoes, consumers may buy more white shoes than black shoes, even if they actually prefer

the latter. Likewise, taxing one kind of legal structure more concessionally than another is likely to lead to greater adoption of the preferentially taxed structure as a business or investment vehicle, even if the less preferentially taxed structure has other advantages.

A tax system that contains inherent biases can affect market efficiency and result in tax considerations, rather than commercial considerations, driving economic activity and business decisions. This can have an adverse impact on a country's economic competitiveness and produce distorted commercial outcomes. To ensure that taxes do not drive a wedge between optimal business and investment decisions, they should generally have a neutral effect on similar kinds of underlying business and investment choices. The reality is that, in practice, many tax systems have built-in structural biases. For example, in Australia, resident individuals are generally fully assessable on interest earned from bank deposits, but are generally only assessable on half the capital gains made from investments (provided they have held them for at least 12 months). As a consequence, capital gains are treated more concessionally than income gains.

However, governments often intentionally design tax systems not to be neutral in order to achieve specific policy objectives. For instance, they may tax imported goods specifically to support locally produced products. Strictly, any tax will operate to discourage the activity upon which it is imposed, and any tax incentive will encourage the activity in relation to which it is provided. Tax expenditures, in particular, are often used to address market failures. For example, the Australian Government's ESVCLP program was introduced to address the failure of the market to provide venture capital to Australian early-stage businesses [¶30.4]. Investments made under this program benefit from tax exemptions and tax offsets that are not available for other kinds of investments.

While it is generally accepted that a tax system should not influence business decisions unnecessarily, fiscal neutrality is not something a government should pursue at all costs. In specific situations it may be appropriate to impose taxes or provide tax incentives for particular activities. A fiscal bias may be justified where a valid reason to change taxpayer behaviour exists. For instance, if the market is not operating at its optimal level, taxes or tax expenditures may be necessary to improve economic efficiency. A government may also have wider political or social goals that might best be achieved by creating distortions in the tax system. For example, it might consider that the best way of stopping its citizens from smoking—thereby reducing national health costs—is to tax cigarettes to make them less affordable.

## Equity

Of the many hallmarks of a good tax system, the most important is generally considered to be equity. Equity is critical not only on moral grounds, but also because it is more likely that taxpayers will respect and support their tax system if it is perceived to be fair. It is widely accepted that taxpayers should bear responsibility for their appropriate share of the overall tax burden of the country in which they live, do business or make investments. This is often expressed as the simple principle that 'each taxpayer should pay their fair share of tax'. What is 'fair' between a wide range of taxpayers is, however, not necessarily straightforward. It ultimately depends on an equitable sharing of responsibilities between members of society, judged by reference to the general standards and norms of that

society. Different interest groups and generations within society may have quite different perspectives on this subject, and their values may gradually shift over time. The reality is that fairness, like beauty, lies in the eye of the beholder.

It is generally acknowledged that the concept of equity has two important dimensions—horizontal equity and vertical equity. A tax is described as ‘horizontally equitable’ if people in similar economic circumstances are treated similarly. For instance, if A and B each derive \$40,000 of income, they should each pay the same amount of tax. In contrast, a tax is described as ‘vertically equitable’ if people in different economic circumstances are treated differently, with those who are better off bearing a greater share of the burden. For instance, if A derives \$100,000 of income and B derives \$30,000 of income, A should pay more tax than B.

The notion of vertical equity is also sometimes referred to as the ‘ability to pay’ concept. According to this concept, the level of taxation should be linked to a person’s wealth. Vertical equity is justified on the basis that those who have benefited the most from living in a particular country should contribute the most to their government. Some people, however, dispute this, arguing that to be fair, the level of taxation should be measured by reference to the degree of services and benefits a particular person receives from the government rather than their capacity to pay tax. But this argument ignores the fact that taxation is a social contribution imposed on the citizens of a state for the benefit of the state as a whole, rather than for the benefit of particular individuals.

Ultimately, the extent to which a tax is viewed as equitable depends on community perceptions. As a general rule, taxes are more readily accepted if the burden is spread widely among the community rather than directed at only specific groups. Taxes that adversely affect certain members of the community more than others are generally viewed unfavourably, particularly where the criterion of vertical equity is not satisfied (ie where the burden is placed on those less able to pay).

While ‘flat taxes’ are administratively convenient, and may seem to be fair in that they are levied at the same rate on all taxpayers, they do not take a person’s ability to pay into account. Flat taxes can operate regressively, as they impose a relatively greater burden on the income of poorer members of society than the wealthier ones. An example of a flat tax is the GST, which is presently imposed at a standard rate of 10% [¶7.1]. This tax is arguably more directly felt by poorer members of society. For instance, assume that because of the introduction of GST, the price of certain goods that previously cost \$100 increases by 10%. The extra \$10 payable represents a greater slice of a poor person’s income than a rich person’s income.

In contrast to the flat-rate GST, the Australian income tax system is described as a ‘progressive tax system’, meaning that it is imposed at rates that increase with an individual’s taxable income [¶8.7]. The tax is designed to fall more heavily on those with a greater ability to pay. However, it is not always easy to achieve fairness. For instance, while two people earning \$50,000 may pay the same amount of income tax, one of those people might be single, while the other may have several children and a spouse to maintain. Accordingly, the burden of the tax is not felt uniformly by these two economic units.



## [¶1.8] The tax unit

One of the basic issues to consider in the design of any tax system is who should be the subject of taxation. In other words, who is the appropriate ‘tax unit’ (ie taxpayer)?

### Individuals and families

The Australian income tax system treats each individual as a separate tax unit. By taxing individuals rather than families, the income of spouses is not aggregated and taxed as if they were a single taxpayer, or split equally between them. Instead, each pays tax as a separate unit, on an individual basis, on their own taxable income.

In calculating a person’s income tax liability, there is also no general account taken of any dependants requiring support. A person with children does not pay income tax at lower rates than a person without children. Instead, support for families is available through the Department of Human Services, which provides means-tested social security payments such as the Family Tax Benefit and the Child Care Benefit.

The concept of a family is, however, not totally irrelevant for income tax purposes. A person may, for instance, be able to benefit from a tax offset for maintaining certain dependants [¶8.8]. Special thresholds and phase-in arrangements also exist for families in respect of the ML and MLS [¶8.7].

### Legal entities and their members

As business and investment income is often earned through legal structures (eg partnerships, trusts and companies), governments need to consider how best to tax the income earned by these entities. Should they be treated as separate taxpayers, or should their ultimate owners (the individuals who hold membership interests in the entities) be taxed instead?

Australia generally treats partnerships and trusts as ‘flow-through entities’, which means their income is not taxed at the entity level, but rather in the hands of their members. As a result, partnerships and trusts do not give rise to a separate taxing point. Instead, they simply operate as conduits. It is, therefore, usually the respective partners [¶25.3] or beneficiaries [¶26.5] who are taxed.

In contrast, Australia treats companies as ‘opaque entities’, which are taxed as separate taxpayers from their members (eg shareholders) [¶24.1]. To prevent double taxation of corporate profits—once in the hands of the company and again when they are distributed to shareholders as dividends—Australia has an ‘imputation system’ which provides resident shareholders with credits for tax paid by the company on its underlying profits [¶24.6].

## [¶1.9] Tax evasion, tax avoidance and tax planning

All tax systems are potentially susceptible to tax evasion. Tax evasion involves the illegal underpayment of tax, usually by means of fraudulent concealment or misrepresentation. It is a serious offence that can result in significant pecuniary penalties and jail terms.

Governments need to prevent tax evasion, as it not only results in less revenue being collected but also places a greater overall burden on law-abiding members of society to fund government spending. The fact that some people evade tax can cause considerable resentment in the community and, if not addressed, leads to a loss of confidence in

the integrity of the tax system. This can have significant social, economic and political consequences.

The seriousness of tax evasion was recognised by the Court of Appeal of the Victorian Supreme Court in *DPP (Commonwealth) v Goldberg* (2001) 184 ALR 387, where it was noted that:

Tax evasion is not a game, or a victimless crime. It is a form of corruption and is, therefore, insidious. In the face of brazen tax evasion, honest citizens begin to doubt their own values and are tempted to do what they see others do with apparent impunity. At the very least, they are left with a legitimate sense of grievance, which is itself divisive. Tax evasion is not simply a matter of failing to pay one's debt to the government. It is theft and tax evaders are thieves.

Although tax evasion is clearly a crime that needs to be prosecuted by law enforcement agencies, it is important to understand that nobody is required to pay any more tax than they are legally obliged to pay. There is no legal requirement for taxpayers to arrange their affairs in ways that produce the greatest tax revenue for their governments. This concept has been colourfully encapsulated in a frequently cited Morgan Stanley advertisement:

You must pay taxes. But there's no law that says you gotta leave a tip.

It is quite natural for taxpayers to want to organise their affairs to legitimately minimise their tax liabilities, and it is a generally acceptable practice for them to seek tax planning advice on how to achieve this under the law. Tax is part of the commercial landscape and, in economic terms, there is no difference between a dollar of tax saved and any other dollar. In many instances, the tax legislation itself gives taxpayers express choices and options which can lead to quite different tax outcomes. Governments also often specifically encourage taxpayers to undertake particular kinds of activities by providing incentives under various tax expenditure programs. Legitimately taking advantage of such options is not an abuse of the tax system.

Taxpayers should, however, take extreme care in structuring their affairs, as the tax legislation contains both general and specific anti-avoidance provisions designed to combat a broad range of tax avoidance schemes. These provisions are inserted in the legislation as integrity measures to combat abusive arrangements designed to circumvent the spirit of the tax laws. Tax avoidance schemes are often artificial and contrived, and usually seek to exploit specific loopholes in the tax system. They sometimes involve transactions or steps that appear to have little or no substantial commercial purpose other than to create a situation that would give rise to some form of tax benefit. Where anti-avoidance provisions apply to a scheme, they can have a significant negative impact on its effectiveness and usually result in liability for substantial penalties for those involved. There is, however, often a fine line between what constitutes legitimate tax planning and illegitimate tax avoidance. The distinction lies at the heart of many philosophical debates about taxation. It also raises important professional and ethical issues for tax advisers.

## ¶1.10] Sovereign right to tax

Each nation has the sovereign right to design its own tax system. Subject to any restrictions imposed under their respective constitutions, governments are generally free to determine the nature and scope of their country's tax laws and the persons whom they subject to tax.

### Enactment, administration and adjudication of tax laws

A country's tax laws are made by its appropriate legislative body and its tax system is administered by its relevant revenue authority. In Australia, federal tax legislation is enacted by the Commonwealth Parliament under its powers in the Constitution [¶3.4] and the federal tax system is administered by the Australian Taxation Office (ATO), which is headed by the Commissioner of Taxation [¶6.2].

Disputes between taxpayers and revenue authorities concerning the application of a country's tax laws are usually litigated before the country's tribunals and courts. In Australia, Commonwealth tax disputes are heard, at first instance, by the Administrative Appeals Tribunal (AAT) or the Federal Court. Appeals from these decisions may be available to the Full Federal Court and (with special leave) the High Court [¶43.5].

Some countries, such as the United States and Canada, have established specialist Tax Courts that deal exclusively with tax disputes. Specialist Tax Courts do not exist in Australia. The principal reason traditionally advanced for establishing such courts is that since tax legislation is so complex, it is appropriate that tax cases should be heard by judges with special expertise in the field (see S Chapple, 'Income Tax Dispute Resolution: Can We Learn from Other Jurisdictions?' (1999) 2 *JAT* 312). Certain prominent Australian judges have, however, rejected the need for such courts on the basis that it is preferable for judges hearing tax disputes to have general law expertise to ensure that tax law is not divorced from the ordinary commercial and legal environment (see D Hill, 'Great Expectations: What Do We Expect from Judges in Tax Cases?' (1995) 30 *TLA* 21). It has been pointed out that there is a risk that specialists may be too 'inward looking', and that knowledge of other areas of law can 'spark ideas' which someone with only limited or specialised expertise may not perceive (see M Kirby, 'Hubris Contained: Why a Separate Australian Tax Court should be Rejected' (2007) 42 *TLA* 161).

### Fiscal convergence and divergence

While the tapestry of a country's tax system is a sovereign issue, countries are inevitably influenced by one another in designing their tax rules. Globalisation has contributed to increasing economic integration and fiscal convergence among nations. It is therefore not surprising to find many broad similarities between tax systems around the world. This is especially the case where countries have formal links (eg through membership of international organisations such as the OECD). Each country's tax system is, nevertheless, unique, and its architecture ultimately depends on the individual approach the country has adopted. While international influences often play an important part in the broad design of a country's tax rules, the tax policies it ultimately adopts will be most heavily influenced by its own particular social, political and economic factors.

Close economic and political relations between nations can help foster 'tax harmonisation' (ie the adoption of similar, although not necessarily identical, tax laws

within different jurisdictions). Tax harmonisation can lead to economic and administrative efficiencies, but is usually difficult to achieve in practice, as it requires a coordinated approach to taxation policy between nations that often have competing interests. An example of a coordinated approach to taxation is found in Australia and New Zealand's 'trans-Tasman triangular imputation arrangements' [¶24.7].

Tax harmonisation is perhaps most evident in the EU, where it is a requirement of membership that each Member State impose VAT at the rate of at least 15% (reduced rates are allowed for certain supplies). In recent years, the EU has also had a limited degree of success in harmonising certain direct taxes (eg aspects of corporate and savings taxes). It is, however, extremely difficult to achieve broad-based tax harmonisation within the EU, as it does not have any general taxation powers of its own—these powers remain with the individual Member States. The introduction of 'directives' in the field of taxation requires unanimity of the EU Council of Ministers, composed of the 28 National Ministers of each of the Member States. Progress towards further integration of European taxes therefore remains an excruciatingly slow and drawn-out process.

## [¶1.11] Jurisdiction to tax

### General jurisdictional rules

Most countries' tax systems are based on a set of general rules that define the jurisdictional limits of their respective tax laws. A country's general jurisdictional rules may be cast narrowly or widely, and often operate subject to numerous exceptions. The following discussion outlines the two main jurisdictional approaches used by countries around the world in relation to income tax. At the heart of these approaches is the requirement that there be some clear nexus between the taxing jurisdiction and either the taxpayer (the 'tax subject') or the income-generating transaction (the 'tax object').

- **Territorial (source-based) jurisdictional rules.** The narrow, 'territorial' approach to income taxation focuses on the source of the income. Countries that adopt this approach only tax income sourced within their geographic borders, irrespective of where the taxpayer resides.
- **Worldwide (residence-based) jurisdictional rules.** The wider, 'worldwide' approach to income taxation focuses on the taxpayer's country of residence. Countries that adopt this broader approach tax their residents on both their domestic and foreign source income, but only tax foreign residents on their locally sourced income.

### Justifications for territorial and worldwide jurisdictional rules

The territorial and worldwide approaches to taxation produce different economic efficiencies. A territorial approach promotes 'capital import neutrality', as investments made in the source country are treated in the same manner regardless of where the investor resides. A worldwide approach promotes 'capital export neutrality', as it does not influence an investor's decision about where to make investments (ie at home or abroad).

The territorial approach to taxation can be justified on the basis that there is an economic connection between the taxpayer and the taxing jurisdiction. It is based on a link between the income earned and the source country. This link may exist for a variety

of reasons, including the fact that the business or employment activities take place in the source country, or the property that generates the income is located there. A territorial approach is defensible on the grounds that it is fair that persons who benefit from earning income in a particular country should also contribute to the country's costs of providing the economic environment that enables their income-earning activities to take place.

The worldwide approach to taxation can be justified on the basis that there is a personal connection between the taxpayer and the taxing jurisdiction. It is founded on the rationale that, as residents of a particular country are usually based in the country and benefit from the broad range of public goods and services provided by their government, it is appropriate to tax them on their worldwide income, as these things support their way of life and overall economic activities, both locally and abroad. Moreover, as residents usually have a personal allegiance to the country in which they choose to reside, and are usually entitled to derive benefits from their government that are not necessarily also available to foreigners (eg various forms of social security), it is possible to justify applying wider jurisdictional rules to them.

### Credits for foreign taxes to prevent double taxation

The practical problem with the worldwide approach is that it leads naturally to double taxation, since a taxpayer's foreign income is taxed not only in their country of residence but also in the source country. To alleviate this problem, it is common for countries that adopt the worldwide approach to grant their residents credits for tax paid on foreign income in the source country. However, if credits for foreign taxes were granted in excess of the tax paid in the country of residence, the excess credits could be utilised to reduce the tax payable on the resident's domestic income. Accordingly, to counteract erosion of their domestic tax bases, countries generally cap credits for foreign taxes so that they cannot exceed the amount of tax that would otherwise be payable on the foreign income in the country of residence.

### Australia's general jurisdictional rules

Australia's general jurisdictional rules are based on the worldwide approach (see Chapter 9). Accordingly, Australian residents are generally taxed on their worldwide income, while foreign residents are generally taxed only on their Australian-sourced income. At the same time, Australia also provides a credit, known as the 'foreign income tax offset', for foreign taxes paid on income that is also assessed in Australia [¶33.3].

It is important to understand that while Australia's income tax laws are based on the worldwide approach, Australia does not have a 'pure' worldwide system of taxation, as its jurisdictional rules operate subject to numerous exceptions. For example, Australia generally exempts resident companies that carry on business through a 'permanent establishment' in a foreign country from tax on their foreign business income (s 23AH ITAA36) [¶33.5]. Likewise, Australia also generally exempts resident companies from tax on dividends paid by foreign companies in which they have at least a 10% 'participation interest' (s 768-5 ITAA97) [¶33.6]. The practical effect of these exemptions is that a de facto territorial approach applies to certain forms of corporate income. The reason for

adopting this approach is to enable resident companies to compete with foreign companies in international markets.

Like Australia, most developed countries tax their resident individuals on their worldwide income. The United States is a special case, as it not only taxes its residents on a worldwide basis but also taxes non-residents who are United States citizens on a worldwide basis. This results in the United States having one of the broadest jurisdictional rules of any developed country. To mitigate double taxation, United States citizens who reside outside the United States and are physically present in foreign countries for at least 330 days during any 12-month period may exclude a portion (up to US\$103,900 for 2018) of their foreign income provided they lodge United States tax returns.

In contrast to Australia, jurisdictions that adopt the much narrower territorial approach to taxation, such as Malaysia and the Special Administrative Region of Hong Kong, generally only tax income that is sourced within the jurisdiction. Residents of these jurisdictions do not therefore generally pay tax on their foreign income in their country of residence.

### International tax enforcement

It is important to recognise that while countries have the sovereign right to determine the jurisdictional scope of their tax laws and can enact legislation that imposes liabilities on foreigners who earn income within their territories, it is quite another matter for governments to enforce their tax laws against such persons. As foreigners reside outside a country's borders and may have all their assets located abroad, it can be very difficult to enforce their payment of taxes.

As a general principle, countries do not enforce each other's tax laws (*Government of India, Ministry of Finance (Revenue Division) v Taylor* [1955] AC 491). This principle was recognised by the Supreme Court of Queensland in *Rothwells Limited (In Liquidation) v Connell* 93 ATC 5106, where the Court stated (at 5113) that it was 'a settled rule of private international law that the courts do not assist the enforcement of foreign revenue laws, or claims made under those laws.' To address this issue, many countries have entered into bilateral and multilateral international tax enforcement arrangements [¶35.4].

### [¶1.12] International taxation agreements

A country's general jurisdictional rules usually operate subject to the terms of any international tax agreements the country has entered into with other countries. In practice, these agreements are made after lengthy negotiations between the respective governments. They are typically bilateral in nature, as it is much more difficult to achieve multilateral agreements. For this reason, these treaties are often referred to as 'Double Taxation Agreements' (DTAs).

DTAs are very common, particularly in the field of income tax. One of the main functions of DTAs is to address the problem of double taxation, which is widely recognised as a major impediment to cross-border trade and investment. Double taxation arises where more than one country asserts taxing rights over the same income. For instance, this can easily occur in respect of business profits—both the country in which the taxpayer is a resident and the country in which the income is earned may seek to tax the profits. The

country of residence may seek to tax the profits on the basis of a worldwide approach to taxation, while the country of source may seek to tax the profits on the basis of a territorial approach to taxation.

To prevent double taxation of income, one of the countries needs to surrender its taxing rights in favour of the other country. The problem is that countries naturally want to protect their revenue bases and are reluctant to unilaterally give up their taxing rights. Nevertheless, in order to promote international trade and investment, they may be prepared to surrender their taxing rights if fair and appropriate reciprocal arrangements are in place. DTAs provide the framework for these arrangements. They also contain special tie-breaker rules that operate where a taxpayer would otherwise be a dual resident.

The main way that DTAs deal with the problem of double taxation is by allocating taxing rights between the respective countries (referred to as ‘Contracting States’) according to a set of agreed principles that are set out in the DTAs. Where both the country of residence and the country of source share taxing rights, the DTAs usually require the country of residence to provide relief in the form of a credit for the payment of foreign tax [¶33.3].

DTAs also contain exchange of information clauses designed to assist tax authorities in the relevant countries to administer their respective tax laws and prevent tax avoidance and tax evasion.

Australia has entered into DTAs with more than 40 countries. These DTAs are broadly based on the OECD *Model Tax Convention on Income and on Capital* and are examined in Chapter 34. Australia has also entered into Tax Information Exchange Agreements (TIEAs) with a number of jurisdictions with which it does not have DTAs. TIEAs are special bilateral agreements that contain rules for exchanging tax and financial information. They are designed to combat tax avoidance and tax evasion involving the use of tax havens. Australia’s TIEAs are discussed in Chapter 35.

### [¶1.13] Level of taxation

It is difficult to compare the overall level of taxation in one country with that in another country. The main reason for this is that the mix of taxes in each country is often quite different. In order to determine how heavily a country’s citizens are taxed, it is necessary to take account of all kinds of taxes imposed at every level of government—federal, state and local. A broad range of taxes need to be considered, including:

- direct taxes (eg income and capital gains taxes)
- indirect taxes (eg goods and services taxes and customs and excise duties)
- employment taxes (eg payroll taxes and fringe benefits taxes)
- property taxes (eg land taxes and estate duties)
- local taxes (eg council rates), and
- environmental taxes (eg carbon taxes).

## Comparing levels of taxation

When comparing the level of taxation in Australia with that in other countries, it is simplistic merely to focus on the rates of tax imposed in each jurisdiction. Obviously, the amount of revenue collected by a government from a particular tax will also depend on a range of other factors, including whom it subjects to tax and how broadly its tax base is defined.

For example, while CGT forms part of the Australian income tax base, not all countries around the world impose CGT. Countries that do not have a general CGT regime therefore have a much narrower tax base. It is worth noting that a number of countries located close to Australia in the Asia–Pacific region do not have a general CGT regime, including Singapore, Malaysia and New Zealand. By way of way contrast, capital gains are taxed in countries such as the United States and the United Kingdom. However, these countries' tax regimes are different from Australia's. For instance, in the United States, individuals pay tax at lower rates on their long-term capital gains than on their short-term capital gains. Australia, on the other hand, imposes CGT at ordinary income tax rates, but generally provides individuals with discounts on capital gains made on assets held for at least 12 months [¶18.9]. There are also many differences in CGT exemptions and reliefs. In the United Kingdom, for example, an individual's net capital gains for a year are first reduced by an annual exempt amount. No corresponding exemption exists in Australia.

Australia's tax expenditure programs are also quite different from those in other countries. For instance, Australia provides tax concessions to encourage activities such as retirement savings, research and development, local film production and venture capital investment. Similar kinds of tax expenditure programs are not necessarily available in other jurisdictions. On the other hand, foreign countries may offer other forms of tax incentives that are not available in Australia. For instance, some countries, such as Singapore and Malaysia, provide 'tax holidays' (ie exemptions from tax for specific periods) to encourage the establishment of pioneer enterprises and to promote the development of various industries. The vast differences that exist between tax systems make it very difficult to compare regimes.

## Data on levels of taxation

In 2006, the Treasurer commissioned Dick Warburton and Peter Henty to compare Australia's tax system with those of other developed economies. Their detailed report, *International Comparison of Australia's Taxes*, compared Australia's taxes with taxes imposed in other developed economies (particularly nine OECD countries that were selected because of similar tax-to-GDP ratios). The report provides interesting (although now dated) information on the overall levels, mixes, bases and rates of taxes imposed in various countries around the world.

Useful data on comparative taxation can also be found in the OECD's *Revenue Statistics 1965–2016*, which detail the tax revenue as a percentage of GDP for OECD countries in 2015. Measuring tax-to-GDP ratios is the traditional way of comparing the relative levels of taxes raised across different countries as it takes into account the size of their respective economies. It is interesting to note that Australia's tax-to-GDP ratio for



2015 was 28.2%—well below the OECD average of 34%. This suggests that Australia imposes a relatively lower tax burden than many other countries. In 2015, seven OECD countries had tax-to-GDP ratios above 40%, namely Denmark (45.9%), France (45.22%), Belgium (44.81%), Finland (43.93%), Austria (43.67%), Italy (43.29%) and Sweden (43.28%). The countries with the lowest tax-to-GDP ratios were Ireland (23.12%), Chile (20.51%) and Mexico (16.23%).

### Balancing level of taxation against provision of services

The level of taxation imposed by a government needs to be balanced against the level of services the government seeks to provide its citizens. Greater revenue raised from taxes allows a government to provide more public services. Taxpayers who complain about a lack of government services such as public hospital beds, childcare facilities, or funded university places need to recognise that these things come at a significant cost. If citizens want more government services, they need to be prepared to pay more taxes. As the OECD's *Revenue Statistics 1965–2016* indicate, Scandinavian countries are among the highest tax-to-GDP ratio countries. These countries, however, traditionally have a more socially orientated outlook than many other countries, and are well known for their generous pension and welfare systems. A government's ability to provide social services comes at a cost, and it is not surprising that this is usually largely funded out of taxation revenue.

### Increasing and decreasing levels of taxation

Governments may require different levels of taxation revenue at different times. For instance, in times of crisis, such as war or natural disaster, they may need to impose higher levels of taxation than they would impose at other times. Additional revenue may also be required to pay for major one-off public infrastructure projects, such as the construction of freeways, telecommunication networks and hospitals. Governments may also be forced to increase taxes to repay their borrowings. This situation has recently been faced by the Greek Government, which has had to increase taxation as well as curb public spending in order to address its sovereign debt crisis and comply with its Eurozone bailout conditions. Greece has increased a number of its taxes and introduced heavy spending cuts, including cuts to government pensions. These austerity measures have placed considerable pressure on Greek citizens, who ultimately bear the cost of bailing out their government. Not surprisingly, this has created much internal turmoil and resulted in protests and riots around the country. One of the most noticeable tax reforms has been the increase of Greece's VAT rate from 21% to 23%. Greece is, however, not alone in increasing its VAT rate—several other countries adversely affected by the GFC have also recently increased their VAT rates. These countries include Hungary, Iceland, Ireland, Italy, Portugal, Spain and the United Kingdom.

Governments can increase taxation by raising tax rates and widening their tax bases. They can also benefit from bringing forward the time at which tax is collected in order to gain early access to the revenue. Governments can also reduce tax spending by limiting the incentives and concessions provided under their tax expenditure programs. However, when governments increase taxation and cut back on tax expenditure programs it can have a negative effect on the country's economy, as it generally results in decreased private

spending and investment. Paradoxically, this can dampen overall government revenues, as there may be fewer transactions to tax.

Reducing the level of taxation, on the other hand, encourages private spending and therefore stimulates the broader economy. During the GFC, several governments around the world introduced temporary tax incentives to encourage economic activity. One example was the introduction of the investment allowance in Australia under Div 41 of the *Income Tax Assessment Act 1997* (ITAA97). The investment allowance provided a ‘bonus deduction’ at rates that ranged from 10% to 50% for entities that incurred eligible expenditure on tangible depreciating assets. To qualify for the bonus deduction, a taxpayer must have committed to investing in the asset during the period 13 December 2008 to 31 December 2009 (ie the height of the slowdown). The incentive, therefore, operated as a stimulus measure to encourage taxpayers to bring forward spending on income-producing assets that they may have otherwise deferred on account of the uncertainty caused by the crisis.

Reducing the level of taxation also makes a country more attractive to foreign investors. This, in turn, can provide a range of related economic benefits, such as enhanced business and employment opportunities. Through increased foreign investment, a country’s pool of potential taxpayers is also broadened. Thus, when considering the level of taxation and the form it will take, governments need to carefully weigh up several factors, including the effect taxation has on a country’s international competitiveness.

### [¶1.14] Study questions

1. Why is it important and useful to study taxation law? [¶1.1]
2. What are some of the different kinds of taxes imposed around the world? [¶1.2]
3. Is it correct to say that the only role of taxation is to raise government revenue? If taxation has other functions, what are they? [¶1.3]
4. What is a ‘tax expenditure program’? Provide some examples of such programs. What are some of the criticisms faced by such programs? [¶1.4]
5. What structural features do many tax systems have in common? [¶1.5]
6. What is the difference between a ‘proportional tax’, a ‘progressive tax’ and a ‘regressive tax’? [¶1.5]
7. Explain the different ways in which a taxpayer’s ‘marginal’, ‘average’ and ‘effective’ tax rates are calculated. [¶1.5]
8. Why is the design of a tax system important? What challenges does Australia face in relation to the design of its tax system? [¶1.6]
9. Discuss some of the characteristics of a ‘good’ tax system. What are some of the problems associated with working out whether a tax system is ‘equitable’? [¶1.7]
10. What is the difference between a ‘flow-through entity’ and an ‘opaque entity’? Provide an example of each kind of entity. [¶1.8]
11. What is ‘tax evasion’ and what problems does it cause? Provide some examples of what might constitute tax evasion. [¶1.9]

12. Which bodies make, administer and adjudicate a country's tax laws? [¶1.10]
13. What is 'tax harmonisation'? Why is it difficult to achieve tax harmonisation? [¶1.10]
14. How do Australia's general jurisdictional rules operate? [¶1.11]
15. What are DTAs and TIEAs? [¶1.12]
16. Why is it difficult to compare the levels of taxation in different countries? What benefits may flow from reducing the level of taxation? [¶1.13]

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### PowerPoint slides



PowerPoint slides for this chapter are available from [www.oxfordascend.com](http://www.oxfordascend.com).