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

Ewen McCann[*] and Tim Edgar[**]

Abstract
A country's net flow of capital consists of simultaneously occurring imports and exports. Because a tax on the income from capital imports affects the quantity of capital exports and vice versa, tax policies toward inbound and outbound capital should

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

Perhaps somewhat surprisingly, the development of national policies toward the taxation of income from inbound and outbound capital flows does not reflect either the bi-directional nature of those flows or the interdependence of lenders and borrowers, both resident and non-resident, which arises from their participation in the same market. Taxes on capital imports or capital exports are usually developed and viewed as independent regimes, notwithstanding the private-price linkages and their

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

As noted above, we limit our focus in this paper to bi-directional flows of portfolio debt capital. We have done so primarily because of the deduction/inclusion income tax treatment of interest expense and income, which is broadly consistent across countries.

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

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

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

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

[9] Feldstein and Hartman (1979) have an early paper expressing this result.
[10] These results are obtained in Gersovitz (1987); Gordon (1986); and Gordon (1992).
[11] Altshuler (2000, at 1581).
[12] Id, at 1580-81.
[13] See, for example, Graetz (2001, at 272).

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

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

In contrast with the heated debate over the optimal taxation of income from foreign direct investment, the treatment of income from foreign portfolio investment has received little attention. Indeed, it seems to be accepted that an exclusively residence-based system dictated by CEN is optimal.[17] This position is even advocated by some analysts who see an exclusively source-based system as desirable for foreign direct investment, and draw on the concept of CIN as tantamount to a requirement of equality of after-tax returns to ensure

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

The organizing principle underlying the formal derivation is that the private cost of capital should equal its social cost.[19] The social cost of capital is the amount per unit of inbound capital that the small country as a whole sends abroad. This cost of capital consists of two components for the small country: (i) the after world tax world rate of interest that a large country investor must receive from every investment;[20]

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

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

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

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

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[25] The standard approach to constrained optimization is to set up a Lagrange multiplier expression and to optimize it with respect to the c

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

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

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

ILLUSTRATIVE EXAMPLE AND FORMAL DERIVATION

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

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

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

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

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

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

so

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

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

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

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

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

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

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

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

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

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

The social rate of return for capital exports is,

$$r_s=(1-\tau^w{}_I)r^w \qquad (14)$$

Equating (13) and (14) so that $r_s=r_p$

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

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

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

"Warning Signs" that Part IVA may apply

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

- The arrangement differs from the normal arrangements used to achieve the commercial objectives of the transaction;

that serve no purpose other than to obtain a tax benefit, such as a company being

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

> ministers when formulating policy…should at all times be asking themselves and asking parliamentary counsel: 'Is this concept too refined to be expressed in basic English? If so, is there some way in which we can modify the policy so that it can be so expressed?'

Precondition One: A Scheme

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

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

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

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

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

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

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

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[20] See *Corporate Initiatives Pty Ltd v Commissioner of Taxation* 2005 ATC 4392.
[21] (2004) 217 CLR 216.
[22] *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 382.
[23] Paragraph 58 of PS LA 2005/24.
[24] (2004) 217 CLR 216.
[25] Ibid.
[26] Ibid, 223.
[27] Ibid, 237-241.

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

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

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

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

Precondition Two: Tax Benefit

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

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

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

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

[30] (2004) 217 CLR 216.

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

[32] Cooper above n 29, 4. It appears from the judgement Gleeson CJ, McHugh and Callinan JJ's judgements in *Hart* Ibid that whilst they did not specifically affirm *Peabody*, they all still contemplated a situation where a set of circumstances could constitute part of a scheme rather than a whole scheme. The opposite view was adopted by Gummow and Hayne JJ who firmly rejected an interpretation of *Peabody* which necessitated a scheme "standing on its own feet."

- a foreign tax credit.

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

- the tax benefit **would not have been obtained** if the scheme had not been entered into or carried out; or
- the tax benefit **might reasonably be expected not to have been obtained** if the scheme had not been entered into or carri

- does not establish whether the taxpayer who received the monetary

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

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

The counterfactual that nothing would have been done

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

> In some cases, it may be that nothing would have been done by the taxpayer if the scheme had not been carried out. This is particularly likely to be true if the scheme mainly results in a taxpayer artificially obtaining a tax deduction.[43]

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

The fact that this type of argument could work in a taxpayer's favour was obviously contemplated by parliament. In the Ralph Report[44] it was proposed that the reasonable expectation test be strengthened to address this kind of argument. The Ralph Report states at 6.4:

> That operation of the existing reasonable hypothesis test (in s 177C) be improved by ensuring the counterfactual to a tax avoidance scheme reflects the commercial substance of the arrangement.
>
> Currently, in order to demonstrate the existence of a tax avoidance scheme, the Commissioner of Taxation is required to construct a reasonable alternative transaction or counterfactual which does not give rise to the tax benefit. In some tax avoidance cases promoters of the scheme have argued that the reasonable alternative to the scheme may be that the taxpayer would not have done anything. The recommendation will confirm that this is not the case. For example, if the sale of property had an attached tax benefit, the alternative transaction would be constructed on the basis that the sale of property, without the tax benefit, would have taken place.

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[43] PS LA 2005/24 also addresses this issue and states at Paragraph 75 that:
"If the scheme had no effect or outcome other than the obtaining of the relevant tax benefit(s), it will be reasonable to assume that nothing would have happened if the scheme had not been entered into or carried out."

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

The "amount" of a tax benefit

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

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

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

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

> It is submitted that sec 177C(1)(a) does not apply to these characterisation schemes as they do not involve any overall reduction in a taxpayer's assessable income. This argument is based on the proposition that the reference to " a tw

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

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

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

Exceptions to Precondition Two – A Limited Choice Principle?

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

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

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

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[51] Ibid. De Winj and Alpins Ibid, 374 state:
"Rather the issue will be whether taking into account the correct amount of the tax benefit would have materially affected the Commissioner's determination. This would raise issues such as the extent to which the quantum of the tax benefit has been overstated. The result of such analysis, depending on the facts of the case, may show that the Commissioner's discretion has miscarried."

[52] Ibid.

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

exception for taxpayers. Hartigan J referred to the section in *Case W58*[54] as the: "escape hatch to Pt IVA."

There has, however, been little judicial

Both the Guide and PS LA 2005/24 divide the 8 factors into three overlapping groups.

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

Factor 2: Form and Substance

Factor two requires that the "substance of what is being done" be considered and compared to the form that the transaction takes. Where there is a discrepancy between the commercial or practical effect of the scheme and its legal form, this would point towards a conclusion that Part IVA would apply, particularly if the scheme could be achieved in a more straightforward or commercial manner. PS LA 2005/24 states that[67]:

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

Factor 3: Timing Issues

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

Group 2: Scheme Effect

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

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

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

[67] See Paragraph 96 of PS LA 2005/24.

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

[69]

PS LA 2005/24 and the Guide suggest that the absence of a practical change in a taxpayer's overall financial, legal or economic position will "add weight" towards a conclusion being reached that the dominant purpose was to obtain a tax benefit. It is difficult to understand why PS LA 2005/24 suggests that this conclusion would be reached. Arguably, if the taxpayer entered into a scheme to obtain a tax benefit their overall financial position **would be** financially changed for the better (they would

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

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

Conclusion of law

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

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

AN EXERCISE OF THE COMMISSIONER'S DISCRETION

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

> It is much less easy to understand why it [it [iaa uTw c[(X)-13t1 1n he

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

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

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

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

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

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

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

[102] (1971) 127 CLR 106.

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

> The question, which comes back to the words "may allow", is not to be solved by concentrating on the word "may" apart from its context. Still less is the question answered by saying that "may" here means "shall". While Parliament uses the English language the word “may" in a statute means may. Used of a person having an official position, it is a word of permission, an authority to do something which otherwise he could not lawfully do. If the scope of the permission be not circumscribed by context or circumstances it enables the doing, or abstaining from doing, at discretion, of the thing so authorized…Here the scope of the permission or power given is circumscribed. Conditions precedent for its exercise are specified as

manner.[104]

> of cases)….has done its work of both exposing for annihilation a sought-for 'non taxable' position and quantifying the amount of the 'tax benefit' that stands to be cancelled. The essential function of section 177F is to enable the Commissioner of Taxation, against the background of the other sections mentioned, to determine precisely what tax adjustments would be made in the assessments of the taxpayer concerned and of other taxpayers affected by the scheme.
>
> Sub-section 1 effectively calls on the Commissioner to make a formal determination as to how much of the amount of the identified tax benefit is to be cancelled and directs him, where he has made such a determination, to take such assessing and other action as he considers necessary to give effect to it. There are two kinds of determination possible – under paragraph (a), that the whole or a part of any amount that is not otherwise included in assessable income be so included and, under paragraph (b), that the whole or a part of a deduction or of a part of a deduction that is otherwise allowable be not allowable.

The EM appears to contemplate that the Commissioner

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

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

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

  It is unlikely that this would be a reason why the Commissioner would not exercise his discretion as arguably, the Commissioner would want the correct taxpayer to be assessed, so the fact that another taxpayer was assessed for that and the scheme presented no "fiscal risk" would appear not to be a relevant consideration.
- Where the Part IVA determination would not increase the tax actually payable.[111] On this issue Murphy states:

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

[109] Brabazon above n 89, 34. Also see Murphy above n 103, 204.
[110] Murphy above n 103, 205.
[111] Murphy above n 103, 205.

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

Arguably, however, where the taxpayer was bankrupt the Commissioner would still make a Part IVA determination to ensure in

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

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

THE COMPENSATING ADJUSTMENT PROVISIONS

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

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

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

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

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

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

A real discretion?

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

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[113] D Galligan, *Discretionary powers : a legal study of official discretion* (1986), 31.
[114] Section 177F(3)(a) of ITAA 1936.
[115] Section 177F(3)(b) of ITAA 1936.
[116] Section 177F(3)(c) and (d) of ITAA 1936.
[117] Section 177F(5). Wilson-Rogers, 'Compensating adjustments: The limits on the Commissioner's discretion' (2004) 7(5) *The Tax Specialist*

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

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

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

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

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

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

The example provided in PS LA 2005/24 is where the scheme involves the diversion of personal services income to a family trust. The income has been distributed to beneficiaries and the income was taxed in the hands of the beneficiaries. The Commissioner then makes a determination with respect to the scheme including the income in the assessable income of the taxpayer. In this situation the Commissioner

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

“Fair and reasonable”

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

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

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

Timing of a compensating adjustment

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

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

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

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

Similarly, Section 177B(4) states:

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

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

> Officers should be aware that Part IVA is a general anti-avoidance provision

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

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

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

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

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

> In the absence of unusual features, therefore, Part IVA would not apply to such husband and wife partnerships. The sort of unusual features that could see Part IVA apply include where the:
>
> - income generating activity was in reality a disguised employment arrangement; or
> - use of the partnership is prohibited by regulatory or other laws.
>
> In employee-like arrangements, provisions in the income tax law which specifically deal with the alienation of personal services income may apply in any event. This would mean that the partner performing the main bulk of the work is taxed on all of the partnership income. In such cases, Part IVA would have no application.

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

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

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[130] Ibid.
[131] *Case W58* 89 ATC 524.
[132] *Case X90* 90 ATC 648.
[133] See ATO Test Case Program Statement "Refocus of the income-splitting test case program" available at http://www.ato.gov.au/corporate/content.asp?doc=/content/67313.htm.

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

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

THE APPLICATION OF PART IVA TO THE SCENARIO IN THE GUIDE

Precondition One: Scheme

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

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Precondition Three: Dominant Purpose

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

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

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

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

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

Case W58 stated:

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

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

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

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

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

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

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

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

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

[136] *Case W58* 89 ATC 524, 535.

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

Factor 8 The Relationship between the parties.
The partners are husband and wife and therefore, splitting the income will benefit the family as a whole. It is unclear whether this factor would point for or against a dominant purpose of obtaining a tax benefit. In *Case W58* the fact that the arrangement would have benefited the family's overall wealth was not sufficient to stop a finding that Part IVA would apply.

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

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

CONCLUSION

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

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

> subject to a penalty. However as well as the underpaid tax, we may ask you to pay an interest charge[137]

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

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

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

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The Case for Measuring Tax Gap

Jacqui McManus and Neil Warren[*]

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

INTRODUCTION

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

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

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

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

This paper surveys some of the larger studies of tax gap that are publicly available to identify the reasons why they are now considered feasible and more reliable. In doing so, the benefits and limitati

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

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

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

Identifying the sources and level of non-compliance

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

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

> The tax gap can be divided into the assessment error (i.e. the difference between the theoretical tax and the tax actually billed to the taxpayer) and the collection loss (the difference between the tax bill and the tax actually paid). In Sweden collection losses are small, less than 1% of the total tax bill. Although difficult to estimate, the assessment error can safely be assumed to be much larger. Most estimates of the

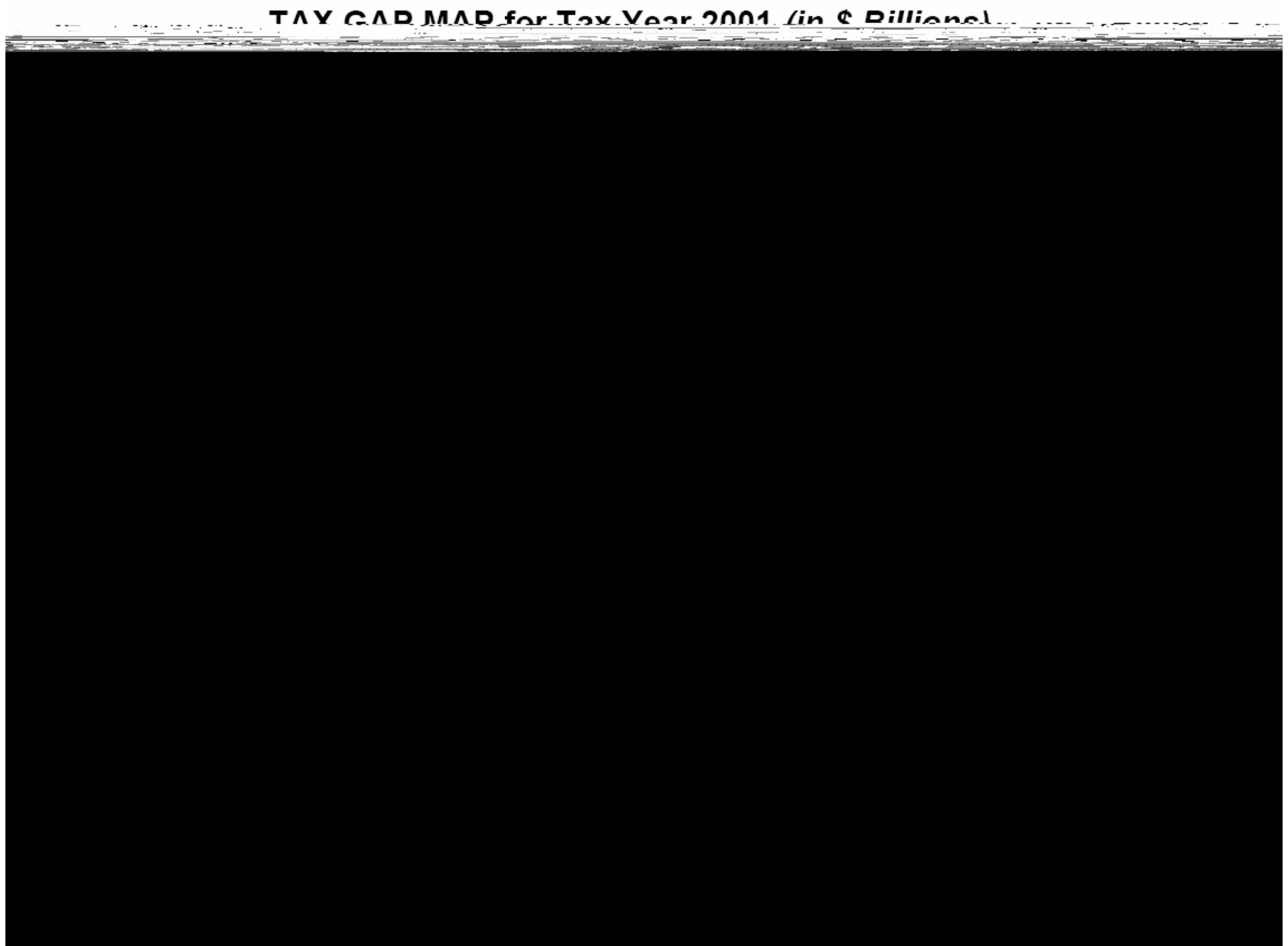
addressing the case of 'missing trader intra-community fraud'[16] and other areas of increasing non-compliance.

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

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

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

FIGURE 1 - IRS TAX GAP MAP



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

Resource allocation efficiencies

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

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

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

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

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

Revenue authority performance measure

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

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

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

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

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

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

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

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

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

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

LIMITATIONS OF TAX GAP STUDIES

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

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[23] Ibid. pp 5.6 and 29.

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

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

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

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

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

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

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

> …feels that a rigorously derived estimate of the tax gap is required as an

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

Clearly outlining the purpose and the limitations of performance indicators renders

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

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

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

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

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Abstract

This article considers Information Technology (IT) adoption strategies as applied to the particular circumstances of e-filing UK Self Assessment (SA) Tax returns[1]. It reports the findings from a study that involved three interested groups in the UK; tax advisers, tax authorities and software providers. IT adoption issues, as applied to a wide range of business situations, are considered in detail in order to set the study into context.

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

Tax advisers in the study were clear about areas that could influence their decisions to e-file SA tax returns. Getting over the apprehensiveness of the reluctant IT adopters required good software products that fitted in with other office functions, overcoming any reluctance to trust HMRC IT capabilities and ope TD0e35.ou35.1(a)-1.s e7 88t i16C opee35.o2 (1)3.9(t)otss of littl
ssessment of e-filing SA tax returns. The study showed that e-filing was expected to expand to
lviser practices within the next five years.

INTRODUCTION

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

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

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

[3] http://www.cabinetoffice.gov.uk/moderngov/.

of the Exchequer) confirmed that it would be possible to e-file tax returns and it was

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

The following section reviews the IT adoption strategy literature to explore the principles of adoption of IT solutions gleaned from other domains that are potentially

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

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

These perspectives[22] on exploring influencing factors to IT adoption were utilised in an Australian study seeking to explore the factors that have enabled the diffusion, adoption and operationalisation of electronic lodgement within the tax system of that country.[23] This study used an eight factor framework to analyse diffusion and adoption based on IT adoption strategies, such as that outlined in Karahanna et al., and wider social interaction and innovation theories (e.g. Rogers' Diffusion of Innovation Theory).[24] These factors were: circulation of ideas, national context, tax policy

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

[20] Karahanna, E, Straub, D and Chervany, N (1999) 'Information technology adoption across time – A cross-sectional comparison of pre-adoption and post-adoption beliefs'. *MIS Quarterly*

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

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

Others have called for more focused research on the contextual factors affecting IT adoption success – including the characteristics of the technology, their interaction with the task characteristics, the impact of multiple implementation stages in a process of innovation and so on.[25] These are pertinent issues to this particular case of IT innovation where not only the technology characteristics are changing (manual systems through a proprietary ELS to web-based e-filing) but also the fact that this innovation is being seen by tax advisers as part of an ongoing process of change they can choose to adopt, or not and instead just wait for the next phase to comther00technologlf3.5(mTm0

In addition to the issues of how IT adoption occurs in practice, a secondary issue in understanding patterns of e-filing adoption is the question of Internet access amongst tax advisers – given this is critical to ease

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

In a recent Australian study exploring e-filing adoption[34] the two factors of 'path of entry' and effectiveness of champions located in government officials were crucial in encouraging adoption and implementation of innovation. Issues of 'policy context' was also a factor considered to affect the adoption levels (e.g. the fact that personal taxation is a federal tax not state tax meant the federal government had more control and influence over the policy development). Early adopters were also seen to be important in acting as influencers over subsequent adopters.

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

A Malaysian study into changing to an Electronic Filing system[35] concluded that the level of discomfort with emerging technologies must not be ignored when devising the e-filing system. A good e-filing system, they claimed, needs to be user-friendly, easy to gain access to and easy to use in the context of tax compliance. It also highlights the need for tax authorities to be aware of the intended users' technological readiness to make changes in order to adopt IT systems. These factors therefore feature highly in this study's exploration of adoption factors in the UK situation.

e -FILING AND SA DEVELOPMENTS IN THE UK

The above studies re-affirm the conclusions of a widely quoted early study[36] that tax advisers have an important role to play in achieving compliant taxpayer behaviour. Another joint UK study[37] undertaken by Inland Revenue (now part of HMRC) and the Chartered Institute of Taxation (CIOT)[38] again highlighted that greater co-operation between tax authorities and tax advisers can make a substantial difference to the development of better tax policy and practice.

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

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

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

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

RESEARCH METHODS

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

A companion study to this paper[40] detailed a quantitative exploration undertaken with a large number of tax preparers in the UK. While such studies provide good data to describe collective opinions and facts about a population, they are not easily used for in-depth review of issues. The decision was therefore made by the research team to develop the initial perspectives the quantitative study had revealed with an additional qualitative review.

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

RESULTS

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

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

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

[40] Lymer A, Hansford, A & Pilkington C (2005) 'Filing By Internet in the UK: The barriers to

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

Delivery of service issues

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

In looking in more depth at the reasons behind this general comment it is clear that the type of client was a key factor for this interviewee. They reported that e-filing does not fit with their internal review processes, particularly for the 'complex' end of the client spectrum. There was a perception that if e-filing enables the firm to 'skill down' something may be missed in the review process. Advisers fitting into this group

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

When asked to identify any areas of change to benefit e-filing, the committed e-filing/IT-adopters elaborated at length on the benefits they perceived to have gained to their firms, and for their clients, from their decision to move to e-filing. This suggests strong evidence for the IT adoption factor of *beliefs of usefulness.* These interviewees

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

Visibility issues

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

Developments for e-filing

recommendation of the Carter report[52], to take effect from 2008, is that income tax self assessment returns should be filed by 30 September on paper or by 30 November

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

CONCLUSIONS

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

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

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

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

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

Tax advisers interviewed as part of this study were clear about areas that could influence their decisions to e-file SA tax returns. Getting over the apprehensiveness of the reluctant e-filing adopters required good software products that fitted in with other office functions, and overcoming any reluctance to trust the HMRC's IT capabilities and operational efficiencies e.g. attachments and utilising white space effectively. Payments to act as an incentive to e-file, perhaps similar to the 2005 system for PAYE, wde liate

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

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