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Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes

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“Whoever hopes a faultless tax to see, hopes what ne'er was, is not, and ne'er shall be.”
Alexander Pope

Abstract

In the 2008 Australian Federal Budget, Treasurer Wayne Swan announced a comprehensive ‘root and branch’ review of the Australian tax system to help create the foundation for Australia’s future tax system. This Review is now underway. This article argues that a pivotal part of the review is clarifying and outlining *how* a tax will be evaluated because this functions as the context for the evaluation and can significantly influence the overall conclusion that is reached. The central

internationally competitive, and that creates the incentives to invest in our productive capacity. One that supports national prosperity beyond the mining boom.³

The review designed to create Australia's future tax system (AFTS Review) is far-reaching – expressed by the Prime Minister Kevin Rudd to be a 'root-and-branch' review of the Australian tax system and is planned to cover all the following areas:

- Interactions between federal, state and local taxes;
- The interaction of the tax system with the proposed emission trading system and the welfare system;
- How to reduce inefficient taxes;
- The balance between work, investment and consumption taxes;
- Enhancing the taxation of savings, assets, property (including housing), investments, consumption (including excise but excluding GST), and other types of taxation collected by the states;
- The role and structure of company taxation;
- The role for environmental taxes; and
- The interrelationship between elements of the tax system.

The AFTS Review is now underway. An initial Discussion Paper: *The Architecture of Australia's Tax and Transfer Systems* was released on 19 August 2008.⁴ The AFTS Review Panel⁵ then requested public submissions guided by four consultation questions.⁶ The public submissions received⁷ contributed to the development of a Consultation Paper released in December 2008.⁸ The Consultation Paper outlines key issues, sets focus questions and establishes the foundation for further public and community consultation.⁹ The Review Panel is due to make specific recommendations to the Australian Government by the end of 2009.

Whilst most would agree that a holistic review of taxes that aims to achieve the principles of equity, efficiency, simplicity, sustainability and policy consistency is a worthy exercise, the history of tax reform in Australia has shown that it is difficult, if

³ Treasurer Wayne Swan, Budget Speech 2008-2009 (Speech delivered 13 May 2008) <http://www.budget.gov.au/2008-09/content/speech/html/speech-01.htm> at 15 May 2008.

⁴ Commonwealth Government, *Australia's Future Tax System: Architect*

The third part of the article puts forward an integrated evaluation framework, by defining the three stages at which a tax can be evaluated: policy, drafting and administration. The framework specifies which of the criteria should be considered at each stage and attributes a priority to each of the criteria. Notably this is only a suggested ranking and this may differ depending on the government's stated intention or policy goals in respect of each taxation measure. However it is imperative that whatever ranking is attributed to particular criteria it should be made explicit or transparent in any evaluation framework that is utilised.

The final part of the article draws conclusions and identifies areas for further possible research.

1. DEFINING THE CRITERIA FOR ASSESSING WHAT IS AN EFFECTIVE TAX

1.1 Defining the Criteria

The Consultation Paper outlines several design principles that submissions have identified which can be used to critique the "effectiveness" of a tax or tax reforms. These include equity efficiency, simplicity, sustainability and policy consistency.

For convenience, these principles will be adopted for the purposes of this article as the criteria used to evaluate a taxation measure for the purposes of the AFTS Review. However, it will be argued that the AFTS Review should also utilise a further pivotal design principle and this is adherence to the Rule of Law. The Consultation Paper appears to include one of the key elements of the Rule of Law - certainty within the criteria of simplicity. This article argues that, simplicity is not necessarily synonymous with certainty and that therefore, adherence to the Rule of Law (which includes certainty) should be included as a further fundamental design principle or criteria against which to evaluate a tax or tax reform measure.

These design principles represent characteristics that an effective tax or tax reform should display. However, a tax does not need to possess these characteristics in order for it to be constitutionally valid.¹² For example, in *Giris Pty. Ltd v Federal Commissioner of Taxation*¹³ the High Court commented on the utility of Adam Smith's canons of taxation when considering the constitutional validity of section 99A

- *Sex Discrimination Act 1984.*

In conclusion on this point it is recognised that it can be problematic determining what is “fair” or equitable and that further detailed work is required in refining the definition of equity. The Asprey Report recognised these difficulties when it stated that that equity is: ‘an ideal exceedingly difficult to determine and harder still to measure.’²¹

agreement between tax academics, it must be that tax simplicity...is itself a complicated notion.²⁷

The difficulty in defining simplicity arises because simplicity is a subjective concept. For example, a taxation practitioner with several years of experience may find a particular tax very simple to apply, relative to a taxpayer with no specialised knowledge of the taxation law.

Simplicity is defined very broadly in the Asprey Report:

... A tax will be called simple, relative to others, if for each dollar raised by it the cost of official administration is small, and if the 'compliance costs', the costs in money and effort of all kinds to the taxpayer, are also small.²⁸

Based on the Asprey Report and for the purposes of this article, simplicity will be viewed in the context of compliance and administration (also known as administrative efficiency).

The first element is taken to be satisfied if a taxpayer (or their adviser) can understand and apply the tax with minimal compliance costs. The meaning of compliance costs is based on the definition assigned to it in the Report on the Review of Aspects of Income Tax Self Assessment²⁹ and includes direct financial costs, opportunity costs and non-financial compliance costs.

Direct financial costs include the costs to the taxpayer of engaging tax experts for managing their tax affairs. Opportunity costs include the time spent by the taxpayer complying with their tax obligations that may have been spent doing other activities (such as leisure or work). Non-financial compliance costs include any mental stress that may result from uncertainty placed on the taxpayer about whether they have discharged their tax obligations.

The second element provides that in order for a tax to be simple it must have minimal administration costs. Administration costs include the costs of tax policy planning, resolving taxation disputes (including taxation litigation), and the costs of administering the law including taxpayer education, rulings, circulars and the provision of other types of ATO information. One factor that can affect simplicity is the number of taxpayers affected by a taxation measure. For example the fewer taxpayers from which the tax is collected the simpler the tax. The Asprey Report states that: 'The sheikhdom that can raise all the revenues it requires (and maybe much more) from a single tax on a single oil company has what is unquestionably the simplest tax of all.'³⁰

It is important to note that a brief tax law will not necessarily be simple. This is because brevity does not necessarily translate into simplicity. The Review of Business Taxation acknowledged this and stated:

²⁷ Binh Tran-Nam, 'Tax Reform and Tax Simplicity: A New and 'Simpler' Tax System' (2000) 23(2) *University of New South Wales Journal* 241.

²⁸ Asprey Report, above n 21, 3.20.

²⁹ Report on the Review of Aspects of Income Tax Self Assessment (2004 AGPS) <http://selfassessment.treasury.gov.au/content/report.asp> at 23 March 2009.

³⁰ Asprey Report, above n 21, 3.22.

Complexity and simplicity...are concepts lacking simple definitions. It may be anecdotally convenient, and not unduly misleading, to equate complexity to some index of the growth

discretions would make it difficult for a taxpayer (or their adviser) to predict when the tax will apply.

The attainment of certainty, used for the purposes of this article, alters the traditional definition of certainty. The traditional definition (as outlined by Smith above) requires

there are difficulties also for taxpayers and their advisors and the potential for disputation increases.⁴²

2. RELATIONSHIPS BETWEEN THE CRITERIA

A tax or tax reform measure that exhibited all of the above attributes could only be achievable in 'Fiscal Utopia', as many of the criteria discussed above are conflicting or mutually exclusive. The corollary of this is that trade offs between the attainment of individual criterion are inevitable. Accordingly, part three of this article discusses the priorities to be assigned to the criteria defined above. However, to do this the relationships between the criteria must first be examined. This examination enables a ranking to be attributed to the criteria and assists in determining, where there is a conflict, which criteria should take precedence.

2.1 Equity and Efficiency

Traditionally, it is well recognised that there can be trade offs between achieving equity and efficiency. Vertical equity requires that those on higher incomes pay a higher amount of tax. This can impact efficiency as it may reduce incentives to enter into business transactions or invest, work, save or consume. As the Organisation for Economic Co-operation and Development (OECD) states in its Booklet on the Comparative Assessment of OECD Countries:

Governments are often faced with trade offs between equity and efficiency goals of tax policy. There is an abundance of examples of conflicts between equity and efficiency inherent in the taxation of income generating activity... Specifically the choice of progressive tax rate structures reduces vertical inequality but increases inefficiency by reducing incentives to utilise labour and capital resources and prompt avoidance and evasion. Indeed this conflict between equity and efficiency lies at the heart of the debate.

The impact of complexity in the tax-transfer system tends to be regressive, falling most heavily on those with the least capacity to deal with it and the least means to get professional help. These people may make less advantageous decisions or be unaware of the transfers to which they are entitled.⁴⁵

That is that lower income taxpayers may be more significantly impacted by complexity within a revenue statute. The corollary of this is that if legislation is simple, the accessibility of the legislation is not governed by the financial means of the taxpayer and will assist in maintaining equity. Consequently, equity and simplicity

A certain tax measure should not contain broad discretions. Broad discretions may compromise equity by vesting in the administrator the discretion to determine the treatment of individual taxpayers. This may result in individuals, in the same situation, being treated differently as the discretion may be exercised by different people (eg delegates of the Commissioner). The accessibility of a tax that is uncertain would also

(Report 410):' A simpler system will deliver savings to both taxpayers and

in this regard the two criteria have a complementary relationship. The Consultation Paper states:

Instability in tax-transfer settings...may also reduce economic efficiency by increasing the level of uncertainty about the expected payoffs to long-term investment decisions.⁵⁵

2.8 Efficiency and Policy Consistency

Efficiency and Policy Consistency have a largely complementary relationship.

If a taxation measure has an internally consistent policy with other provisions in the same taxation act it will provide the basis for a more stable revenue act and will

To ensure environmental sustainability a revenue act may need to embrace non-revenue raising goals which may compromise the simplicity of the act.

However, in order to obtain institutional sustainability and a positive community attitude towards the taxation system arguably it is fundamental that the system is not overly burdensome on taxpayers . Furthermore in order for a tax system to be fiscally sustainable the costs of raising revenue must be minimised (administrative simplicity) to ensure that the tax system is able to meet the revenue of Australian governments.

2.11 Simplicity and Policy Consistency

2.16 Summary –Relationship Matrix

The table below indicates the relationships between the various criteria and the number reference where they are discussed, in this chapter, above.

TABLE 1: RELATIONSHIP MATRIX

Equity	Efficiency	Simplicity	Sustainability	Policy Consistency	Rule of Law
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based on the delineation made of the three “core processes” outlined in the Review of

from 1986/1987 in relation to income tax. Under this system the onus is upon the taxpayer to calculate their tax liability. The ATO will usually accept the tax return upon lodgement; however, they retain specific rights of amendment for errors of

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 it can be expressed?'⁶⁷

Uncertainty will inevitably flow through to the drafting stage and will make it extremely difficult, if not impossible, for the drafters to implement the tax in a certain way.⁶⁸ In this regard, the Review of Business Taxation states: 'Nor is the issue of complexity solely one of legal language: no application of plain English may be able to render intelligible a poorly defined policy.'⁶⁹

Certainty should be paramount in critiquing a tax at the policy (and also at the drafting and administration levels as discussed below). A major factor influencing the primacy that should be assigned to certainty arises because many Australian taxes rely on a self assessment system. The self assessment system is built on the presumption that a taxpayer or their adviser can calculate and ascertain their taxable liability. If a tax is uncertain then a taxpayer or their adviser will be unable to determine when the tax will apply and would not be able to self assess.⁷⁰

However, the importance of certainty transcends self assessment. Certainty can potentially enhance the attainment of many of the other criteria such as efficiency, equity, sustainability and policy consistency, as discussed above.⁷¹

A further reason to require certainty in the policy of tax legislation is that there is some evidence to suggest that uncertainty in the taxation law can result in an increase

3.2.2 Equity

The importance of the policy underlying a tax being equitable cannot be overstated. Equity is pivotal because it encourages the perception of fairness by taxpayers, which supports voluntary compliance with the taxation law.⁷⁴ The Review of Business

3.2.5 Policy Consistency

A critical criterion at this stage is to ascertain if the taxation measure is consistent with the policy underlying other taxation measures within the same Act and whether it is consistent with broader policy goals. This will enhance the stability of the taxation measure and make it easier to draft at the drafting stage as consistent terminology and structures can be utilised.

3.2.6 Summary of the Criteria Relevant for Evaluating Taxation Policy

It is important, at the policy stage, that a taxation measure adheres to the requirements of the Rule of Law and is equitable, efficient, has policy consistency and is sustainable. Whilst there may not necessarily be a trade off between these criteria for certain taxation measures, if trade offs do occur it is suggested that priority should be given to the design principles of adherence to the Rule of Law, equity, efficiency and sustainability. As a subsidiary goal it is desirable that the taxation policy should be

circumscribe its application in a tax context, especially one characterised by, say, a high degree of artificiality and a motive which taints the taxpayers position.⁷⁸

This article argues that the Rule of Law should be attributed high importance in assessing the drafting of a tax. Certainty of application should be contained in the words of the tax. Furthermore, as taxpayers operate in the self assessment system have a right for their obligations to be contained in the text of the Act that also assesses (and can penalise) them.

Thus, in critiquing a tax at the drafting level it is important to consider if the tax is certain. There is some debate surrounding how certainty can be achieved in the drafting of a tax. Some scholars argue that “broad-based principled” drafting can result in shorter taxes that are still capable of certain application. Broad based-principled taxes utilise drafting that seeks to convey the intended result of the legislation, rather than set out the mechanics to achieve it. Certain application, however, will only be obtained by the tax being supplemented with extraneous materials such as rulings, guidance papers and binding ATO advice which clarifies the application of the tax. The Review of Business Taxation, for example, states:

- 6.133 It is administratively desirable that taxpayers have certainty with regard to their income tax liability and how the law operates. As noted above, certainty can be achieved through other means apart from ever more complex legislation (which often can produce the opposite result). As is now done, the tax administration can provide mechanisms like rulings to clarify the operation of the law in particular cases. Reliability also requires consistency in decision making and is assisted by a more cohesive administration that has increased coordination across its functions and over time.
- 6.134 There are, however, some tensions in trying to achieve certainty or reliability in tax administration. Certainty and reliability are enhanced by a stable system that is not subject to constant change, leading to a recurring need to re-educate taxpayers. Yet it is also important that an administration be flexible and responsive where necessary. Additionally, while it is desirable that taxpayers receive consistent treatment, decision makers must still have sufficient discretion to be able to respond to taxpayers’ individual circumstances within the general policy principles of the tax system.⁷⁹

The converse of this argument is that certainty can only be achieved by the drafting of sometimes lengthy and highly prescriptive taxes, particularly where the policy, that the tax seeks to convey, is itself, complicated. This argument will not be addressed in this article. However it is acknowledged that achieving certainty is an extremely important goal at the drafting level. Taxpayers should have the law available to them to undertake an assessment of their tax affairs and this can only occur where the legislation is certain. Previously, the judiciary was one of the strongest proponents of the need for taxation legislation to be certain and overtly clear in its operation. For example in *Westraders v FCT*⁸⁰ Chief Justice Barwick stated: “It is for the Parliament to specify, and to do so, in my opinion, as far as language will permit, with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax.”

⁷⁸ Cooper, above n 33.

⁷⁹

In more recent times, however, the judiciary has been more amenable to give effect to legislation by interpreting it in a purposive manner.⁸¹ This approach has been formalised by the enactment of section 15AA of the *Acts Interpretation Act (1901)* (Cth).⁸² Section 15AB of the *Acts Interpretation Act (1901)* (Cth) also advocates the use of extrinsic material to assist in the interpretation of a provision of an Act.⁸³

Despite this change in statutory interpretation and the recognition, by the *Acts Interpretation Act (1901)* (Cth), that regard can be had to extraneous materials; it is argued that this does not diminish the importance of aiming for certainty in drafting of the tax to begin with. Therefore, in this regard and for the reasons discussed under stage one, adherence to the principle of the Rule of Law that legislation be certain is held to be paramount in evaluating drafting of a tax. This involves ascertaining whether the taxpayer can determine when and to what extent the legislation applies to any transaction they enter into.

3.3.2 Equity

Just as it is important that the overall policy of the tax is equitable, it is equally important that the drafting of the tax maintains this equity. In this regard it must be ensured that the drafting of the taxation measure captures all the attributes of a taxpayer that are necessary to ensure a fair basis of comparison and that equity is achieved by the practical operation of the Act. Equity aids voluntary compliance and encourages the perception of fairness by taxpayers. This is pivotal for any system of taxation but particularly a taxation system that relies upon self assessment.

3.3.3 Simplicity

At an Australasian Tax Teachers Conference when asked about complexity in the tax laws, Michael D'Ascenzo the Commissioner of Taxation stated: '...in a sense, who cares?'⁸⁴ He then went on to explain that 73 percent of people engage tax agents and the tax profession and ninety-five percent of companies utilise the tax profession. He stated that if you live a complex society it must be expected that the laws may also be complex. The Consultation Paper for the AFTS review recognises that the tax/transfer system is extremely complex and acknowledges that to some degree this reflects a system that has equity and efficiency objectives. However, it states that complexity adds cost and risk to business and personal activities and that complexity has an impact on choices to work, save and consume.

⁸¹ *Cooper Brooks (Woolongong) Pty Ltd v FCT* (1980) 147 CLR 297.

⁸² Section 15AA(1) states:

In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.

⁸³

In short, simplicity is not always desirable or possible. In some cases simplicity may only be possible where the policy underlying the tax is not complex. Realistically, in many respects, much of the Australian tax legislation is seeking to serve and convey

For these reasons, simplicity is seen as a desirable principle and not one that should be aimed for at the expense of other essential design principles.

3.3.4 Summary of the Criteria Relevant for evaluating Drafting at Stage Two

The most important criteria in stage two is that a tax be implemented with certainty (thereby satisfying the Rule of Law) and maintains equity. Whilst an ideal tax would also satisfy the criterion of simplicity to the extent that this means the taxation measure conflicts with the attainment of certainty or equity arguably this should be attributed lower (desirable) importance when critiquing a tax under stage two.

FIGURE 3: STAGE TWO - DRAFTING

3.4 Step Three – Evaluating the Administration of the Tax

Stage three involves evaluating the administration of the tax. The three criteria that are relevant under the administration stage are adherence to the Rule of Law, administrative equity, efficiency and simplicity.

3.4.1 Adherence to the Rule of Law

The main consideration here is whether

refer to extrinsic materials to determine in what circumstances the tax is designed to apply?

- Does the tax contain a discretion? If it does contain a discretion has the administrator indicated when it would exercise this discretion? Is it clear what considerations will be relevant and irrelevant in the exercise of the discretion?
- Are the avenues of review open to the taxpayer transparent and easily accessible? Does the tax allow for independent review of its application?
- Has the Commissioner followed any Court decisions regarding the particular provision? Recommendation 11 in *Report 410: Tax Administration* suggests that if the ATO has concerns about a decision of the Court it should publicly announce these concerns in the decision impact statement and commit to resolving the issue within 12 months.

3.4.2 Administrative Equity

In looking at whether the tax has been administered equitably the overall question is has horizontal equity been maintained in the administration of the tax?

In this regard some anecdotal evidence regarding administration of the tax may be relevant. It will again be relevant to consider whether like cases have been treated alike, have economically equivalent transactions been afforded the same taxation treatment. Again it is relevant to determine whether the tax contains broad discretions, which have the potential to be exercised inequitably? If the tax does contain broad discretions are there sufficient safeguards to ensure that the tax will be administered equitably and fairly? Such safeguards may include the existence of opportunities for independent review, guidelines as to how the tax will be administered or the opportunity to obtain a private ruling in a timely manner.

3.4.3 Simplicity

At this stage it is relevant to consider wh

legislative provision, it is arguable that the provision is uncertain or has been administered in a way that has not enhanced transparency or taxpayer certainty. Furthermore, where there have been a large number of private ruling requests or the need to issue a number of public rulings in relation to a particular provision this would appear to indicate that a particular provision is ambiguous or unclear and is resulting

The first stage evaluates the policy underlying the tax. At this stage, five criteria are relevant. The policy of the tax should comply with the Rule of Law, be equitable,

7. Recognises that there are several different views as to the meaning of each criterion and therefore, that the meaning attributed to each criterion must be explicitly set out in the AFTS Review evaluation framework.

It is accepted that further work could usefully be undertaken on the suggested integrated evaluation framework put forward in this article. For example, significant work needs to be conducted into how to measure each of the criteria and on mapping the relationships between the criteria. However, it is suggested that by adopting the methodology outlined in this article, the framework advocated in this Article could help the effectiveness of the AFTS Review because it:

- (a)

APPENDIX 1: STRUCTURE OF THE PROPOSED THREE STAGE E

APPENDIX 2: REPORT CARD FORMAT FOR THE INTEGRATED EVALUATION FRAMEWORK

Stage One – Policy