



A U S T R A L A S I A N
TAX TEACHERS ASSOCIATION

JOURNAL OF THE
AUSTRALASIAN TAX TEACHERS
ASSOCIATION

2010
Vol.5 No.1

Edited by
Fiona Martin and John Taylor

Postal Address:
Atax, Faculty of Law,
UNSW, NSW 2052
Australia
m.mckerchar@unsw.edu.au

The Journal of the Australasian Tax Teachers Association (JATTA) is a double blind peer review refereed journal. It is normally published annually and subsequent to the Association's annual conference.

The Australasian Tax Teachers Association (ATTA) is a non-profit organisation established in 1987 with the goal of improving the standard of tax teaching in educational institutions across Australasia. Our members include tax academics, writers and administrators from Australia and New Zealand. For more information about ATTA refer to our website (hosted by the University of New South Wales) at www.atax.unsw.edu.au/atta

Direct enquiries regarding the Journal to:

Professor Margaret McKerchar
The University of New South Wales
NSW Sydney 2052
Australia

Editorial Board of the Journal of Australasian Tax Teachers Association:

Professor Dale Pinto, *Curtin University* (Editor-in-Chief) [2005 -]
Professor Margaret McKerchar, *University of New South Wales* [2005 -]
Professor Adrian Sawyer, *University of Canterbury, NZ* [2005 -]
Professor Natalie Stoianoff, *University of Technology Sydney* [2005 -]
Associate Professor Miranda Stewart, *University of Melbourne* [2005 -]
Associate Professor Andrew Smith, *Victoria University, NZ* [2005 -]
Associate Professor Kerry Sadiq, *University of Queensland* [2007 -]
Dr Paul Kenny, *Flinders University* [2007 -]

ASSN: 1832-911X

Volume 5 Number 1 published November 2010

Copyright © 2010 Australasian Tax Teachers Association

TABLE OF CONTENTS

FOREWORD

ASSESSABILITY OF RECEIPTS FROM PERSONAL EXERTION

Dr Ranjana Gupta 1

PROPOSALS FOR ASSESSMENT IN TAX TEACHING

Audrey Sharp and Kalmen Datt 46

EXEMPTIONS AND CONCESSIONS IN THE AUSTRALIAN TAX SYSTEM:

EQUITY AT THE EXPENSE OF SIMPLICITY *Kathrin Bain* 66

THEORIES OF DISTRIBUTIVE JUSTICE: FRAMEWORKS FOR EQUITY

Helen Hodgson 86

EXCHANGE OF INFORMATION AGREEMENTS WITH TAX HAVENS: HOW WILL THIS AFFECT THE RIGHTS OF NON-RESIDENT TAXPAYERS AND

INVESTORS? *John McLaren* 117

PERFORMANCE MANAGEMENT FOR A TAX ADMINISTRATION: INTEGRATING ORGANISATIONAL DIAGNOSIS TO ACHIEVE SYSTEMIC

CONGRUENCE *Muzainah Mansor* 137

AN ANALYSIS OF THE EXEMPTION FROM INCOME TAX OF CANADIAN

'INDIANS' EITHER AS INDIVIDUALS OR 'BANDS' *Fiona Martin* 165

THE SCIENCE OF TAXING THE ARTS *Lisa Marriott* 183

FOREWORD

The 22nd Annual Conference of the Australasian Tax Teachers Association was held from 20th to 22nd January 2010 at the University of New South Wales and was jointly sponsored by the Australian School of Taxation (ATAX) and the School of Business Law and Taxation. Many of the papers appearing in this edition of the *Journal of the Australasian Tax Teachers Association* (JATTA) were presented at the 2010 conference. Some papers have been carried over from previous conferences.

The Deputy Vice Chancellor of the University of New South Wales, Professor Richard Henry, opened the conference and welcomed delegates. Plenary presentations at the conference were given by the Secretary of the Australian Treasury, Dr Ken Henry, by the Australian Commissioner of Taxation Michael D'Ascenzo, by the Patron of ATTA, Professor Gordon Cooper, by Justice Richard Edmonds of the Federal Court of Australia, and by Professor Catherine Brown of the University of Calgary.

The theme of the conference was 'Changing Taxes For Changing Times' an apt one given that the conference was held in the immediate aftermath of the global financial crisis and after the completion but before the release of the Henry Report into Australia's Future Tax System. Many of the papers at the conference and in this edition of JATTA focussed on this theme but also dealt with many other important issues relating to tax policy, tax design and tax administration. We hope that the papers published here will make a significant contribution to the literature on the diverse range of topics that they deal with. This edition includes Lisa Marriott's paper 'The Science Of Taxing The Arts' which won the prize for 'Best Senior Paper' at the conference.

Many contributed to making the 2010 ATTA Conference the success that it was. One product of their efforts has been the publication of this peer reviewed edition of JATTA. We thank the organising committee for the 2010 conference, the editorial board of JATTA, the referees for their timely and insightful reviews of papers sent to them, and Marie Louise Taylor for her professional editorial work. Most importantly our thanks go to ATTA members without whose involvement and support ATTA conferences and editions of JATTA would not be possible.

Fiona Martin (ATAX, UNSW)

John Taylor (School of Business Law and Taxation, UNSW)

Assessability of Receipts from Personal Exertion

Dr Ranjana Gupta*

ABSTRACT

This paper explores the gaps that exist with regard to the taxation of receipts from personal exertion. This research examines both the New Zealand legislation and leading cases in New Zealand and other jurisdictions in this area, to arrive at some conclusions about the circumstances in which those receipts will be found to be either gross income or simply a gift. To determine the legal criteria that identify gifts as personal exertion income within the context of s CA 1(1) and s CA 1(2) of the *Income Tax Act 2007* (NZ), the paper sets out and analyses the following propositions:

- (1) Ordinary concepts (s CA 1(2)) includes employment income (s CE 1) and business income (s CB 1); or
- (2) Ordinary concepts (s CA 1(2)), employment income (s CE 1) and business income (s CB 1) are disparate concepts (with different tests to determine each).

The paper shows that sections CA 1(1) and CA 1(2) are not mutually exclusive and s CA 1(2) of the Act supplements specific provisions of the Act defining income.

In the absence of a clear statutory provision in the *Income Tax Act 2007* (NZ), the paper attempts to explain the underlying principles on which such receipts may be taxed within the broader context of the *Income Tax Act 2007* (NZ). The author hopes that this analytical paper will serve as a guide for policymakers to take steps to ensure that unfairness caused by those deficiencies does not ultimately undermine the tax system.

*Senior Lecturer, Taxation, Law School, Faculty of Business and Law, Auckland University of Technology. With thanks to anonymous referees for critical advice on an earlier draft of this paper, which significantly improved it.

1 Introduction

There are many ways in which a taxpayer receives payments in a personal capacity which result from a direct or indirect employment relationship. The character of such receipts as either income (revenue) or capital is controversial. As Jeff Waincymer has noted¹, '[t]he income/capital distinction leads to immense problems of factual characterisation'. Items that are clearly gross income are, for example, wages, salaries, commissions and bonuses. Items such as reimbursement of private expenses or expenses incurred by the employee on behalf of the employer and gifts given to employees not as a token of appreciation of their work like a wedding gift are clearly not gross income. There is a distinction between these categories: receipts that are not income because they are capital in nature and receipts that are not income for another reason, such as, gifts.² A present given by a parent to a child is certainly a gain to the recipient but, due to love and affection, it is a gift and not income. Lotto or raffle winnings or a reward by the police or by the owner for finding stolen goods is not income for other reasons such as the one-off nature of the receipt.

The leading cases demonstrate the legal concept of income as a flow and it has been constrained by judicial rules developed over time. Lehman and Coleman³ argue that the view of C J Jordan in *Scott v C of T*⁴ that ordinary concepts and common usage determine the parameters of income is no longer acceptable. They note that income is a

¹ Jeff Waincymer, 'If at First You Don't Succeed ... Reconceptualising the Income Concept in the Tax Arena'

(1994) 19 *Melbourne University Law Review* 977, 1000. Also Stephen Barkoczy, 'Income According to Ordinary Concepts — Part 1: Mere Realisation or Business Operation?' (1997) 3:2 *New Zealand Journal of Taxation Law and Policy* 75 at 96: 'The income/capital tightrope is certainly an awkward one to traverse. Courts need to identify what is the relevant business and what is an ordinary incident of that business in order to determine whether a gain is of an income or capital nature. The outcome of a given case will depend on these crucial findings which in turn depend on whether the Courts choose to adopt broad or narrow approaches in their fact finding mission.'

² R L Deutsch et al, *Australian Tax Handbook 2009* (Australian Tax Practice, Sydney, 2001) 43.

³ Geoffrey Lehman and Cynthia Coleman, *Taxation Law in Australia*, (Australian Tax Practice, 5th ed, 1998) 84. Yet the High Court in *FCT v Stone* adopted the test of the ordinary concepts in common usage in the definition of income. Refer to *FCT v Stone* (2005) ATC 4234 at [8].

⁴ *Scott v Commissioner of Taxation* (1935) 3 ATD 142 at 145; (1935) 35 SR (NSW) 215.

concept shaped by the views of experts.⁵ The fundamental question is whether there is any logical distinction between the treatment of receipts from personal exertion and those from gifts. This study attempts to explore the inconsistencies that exist with regard to the taxation of receipts from personal exertion.

The present study examines legislation and leading cases in New Zealand and other jurisdictions relating to the taxation of receipts from personal exertion (PEI).⁶ It looks at the scope, strength and limitations of the law to arrive at a conclusion about the circumstances in which a receipt in return for personal exertion will be found to be either gross income or a mere gift. It also provides an outline of the draft solution to the problem raised.

The *Income Tax Act 1976* (NZ) was rewritten in plain English in 1994 and went through several versions until the current 2007 Act.⁷ The *Income Tax Act 2007* (NZ) (the Act)⁸ taxes net income. Net income is a reference to gross receipts less deductions. When cases referring to earlier New Zealand taxation legislation are discussed in the paper the equivalent 2007 section(s) are referred to.

There is no statutory test of the overall concept neither of 'income' nor of personal exertion income. The term income is a judicially created term of art.⁹ To examine the taxation of personal exertion income, the paper considers the application of the key statutory provisions, ss CA 1(2), CE 1 and s CB 1 of the Act. Gifts from personal exertion income may be analysed in two ways:

- (1) Ordinary concepts (s CA 1(2)) includes employment income (s CE 1) and business income (s CB 1); *or*
- (2) Ordinary concepts (s CA 1(2)), employment income (s CE 1) and business income (s CB 1) are disparate concepts (with different tests to determine each).

Following on from this introduction, Part 2 sets out the economic and statutory concept of income. Part 3 of the paper expands on the analytical framework, specifically

⁵ Lehman and Coleman, above n 3.

⁶ The earning activity is employment or the rendering of services (PEI).

⁷ Adrien J Sawyer, 'New Zealand's Tax Rewrite Program — In Pursuit of the (Elusive) Goal of Simplicity' (2007) 4 *British Tax Review* 405.

⁸ The *Income Tax Act 2007* (NZ) and *Tax Administration Act 1994* (NZ) represent the statutory source of taxation law in New Zealand.

⁹ John Prebble, 'Can Income Tax Law Be Simplified?' (1996) 2:4 *New Zealand Journal of Taxation Law and Policy* 187 at 190.

related to personal exertion income. Part 4 of the paper develops a conceptual framework and Part 5 outlines concluding comments and observations.

2 Concept of income

To examine the application of the key statutory provisions — sections CA 1 (2), CE 1 and CB 1 of the Act — with regard to personal exertion income, the economic concept of income must be evaluated within the statutory framework of these three sections.

2.1 Economic concept of income

Economists, it seems, cannot agree on a single definition of income. Proposed definitions includes: (a) ideas of capital maintenance, income as a flow and the comprehensive income concept associated with the work of H C Simons;¹⁰ (b) the power to consume rather than the actual consumption;¹¹ (c) increase in the economic power of the recipient to control goods and services; and (d) an all-encompassing concept recognising all gains as income regardless of the source or the form the gain takes.¹²

In economic terms, ‘income’ and ‘gain’ are interchangeable terms that correspond to increases in wealth.¹³ ‘Thus, the economist might define the income of a period as the difference between what the taxpayer was worth at the beginning of the period and what he or she was worth at the end of the period, plus the value of his or her consumption during the period.’¹⁴ Simons saw the relationship between the time period and the income concept as being ‘fundamental’.¹⁵

¹⁰ Phillip Burgess et al, *Income Taxation: Commentary and Materials* (Thomson Reuters, 6th ed, 2009) at 19 cite H C Simons’ work ‘Personal Income Taxation – The Definition of Income as a Problem of Fiscal Policy’ as the best known articulation of the economic concept of income policy (University of Chicago Press, 1938).

¹¹ Robert M Haig (ed), *The Concept of Income: Economic and Legal Aspects* (The Federal Income Tax, Columbia University Press, 1921). At 7 Haig states: ‘It [the economic income concept] has the effect of taxing the recipient of income when he receives the power to attain satisfactions rather than when he elects to exercise that power.’

¹² Richard Vann, ‘Income as a Tax Base’ in Richard Kreyer (ed), *Australian Taxation: Principles and Practice* (Longman Professional, 1987) 62 at 63.

¹³ Richard Goode, ‘The Economic Definition of Income’ in J Pechman (ed), *Comprehensive Income Taxation: A Report of a Conference Sponsored by the Fund for Public Policy Research and the Brookings Institution* (Brookings Institution, 1977).

¹⁴ S Ross and P Burgess (ed), *Income Tax: A Critical Analysis* (The Law Book Company, 1996) 31.

¹⁵ Burgess et al, *above n 10*.

Every person's accretion to wealth in any period falls within the tax base. Haig¹⁶ and Simons¹⁷ recognised that the receipt of gifts and windfall gains enhanced the economic power and capacity of the recipient. Simons defined income as follows:¹⁸

personal income may be defined as an arithmetic sum of (1) market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning.

However, it has been argued that income should be taxed when earned.¹⁹ Whether or not income is consumed or saved is not material. Every person's accretion to wealth in any period falls within the tax base. Stephen Barkoczy supports the economists in this.²⁰

2.2 Statutory concept of income

The concept of income is different for tax law and economists.²¹ An Income Tax Act that was drafted on economic concepts would in the author's view be unworkable because increments in wealth would fall within the tax base whether or not they have actually been received by the taxpayer.

¹⁶ Haig, above n 11.

¹⁷ Henry Simons (ed), *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) 49.

¹⁸ Simons, above n 17, at 50, as cited in Kevin Holmes, *The Concept of Income: A Multi-Disciplinary Analysis* (IBFD Publications BV, 2001) 66.

¹⁹ Kevin Holmes, 'Should Accountants Determine How Much Tax We Pay?: International Accounting Standards vs Taxable Income and Capital Gains' (2008) 14:3 *New Zealand Journal of Taxation Law and Policy* 316 at 318. The broad economics notion of income can be conceptualised as the base of a pyramid and includes unrealised value changes, consumption expenditure and psychic elements.

²⁰ Stephen Barkoczy, 'Income According to Ordinary Concepts — Part 3: Net Profits or Gross Receipts?' (1997) 3:4 *New Zealand Journal of Taxation Law and Policy* 195 at 196: 'Whichever way one looks at the matter, the "thrust" of the economic view is that "income is merely a gain". The source of the gain is irrelevant as is the issue of whether the gain has been realised.'

²¹ The 'income' envisaged by an economist may not be the same 'income' that is liable to tax. The reason for this is that economists, as government advisors (eg in the Treasury Department) on income based concepts, maintain fundamentally different beliefs as to the make-up of 'income' than do lawyers who have the task of interpreting legislation. The result is that on occasion the 'income' envisaged by economists may not be the same 'income' that is liable to tax. Prebble has suggested that the concept of income is 'in some senses an artificial construct, to the extent that it may almost be thought of as a fiction', John Prebble, 'Fictions of Income Tax' (Paper presented at the 14th Annual Australasian Tax Teachers' Association Conference, 2002) at 2, <<http://pandora.nla.gov.au.ezproxy.aut.ac.nz/pan/23524/20020412/c.fong.unsw.edu.au/prebblepa per.doc>>.

In New Zealand core provisions in Part B of the Act set out the key principles and presumptions on which all other parts are based. They are intended to impose a tax liability and to set out procedures that taxpayers must follow to calculate and satisfy their tax liability.

Section YA 1 of the Act refers to s BD 1(1) of the Act for the definition of income. Section BD 1(1) provides that: ‘an amount is income of a person if it is their income under a provision in Part C (Income)’. Part C of the Act contains a number of specific provisions outlining what is included in the term income for income tax purposes. It also defines amounts that would be income but by the Act are exempt or excluded from income tax liability. Amounts that are not included as income under Part C are not subject to income tax.

The assessment to tax of income from what is referred to in New Zealand as personal exertion lies primarily upon the inter-relationship of a number of key sections in the Act. The pivotal section is section CA 1.

Section CA 1(1) sets out specific categories of income. These are employment income, business income, income from property (personal property, real property) and accrual income. These categories are not comprehensive because if a receipt is not listed as a specific category it may still be considered income according to ordinary concepts as per s CA 1(2) of the Act. Section CA 1 (2) is the statutory mechanism which to some extent incorporates the economists’ view of income.

In 2004, the Inland Revenue Department published an article titled ‘Income Tax Act’ (2004), which examined different parts of the *Income Tax Act 2004* (NZ) (the 2004 Act).²² The article stated that Part C contained, ‘An exhaustive list of provisions that state the circumstances in which a transaction or other event gives rise to income’.²³ The Inland Revenue noted that section BD 1(1) ITA 2004 ‘identifies that Part C is a code in relation to its role of determining whether an amount arising from a transaction or event is income’.²⁴ This is arguably incorrect and against this, Clinton Alley and Andrew

²² Inland Revenue Department, ‘Income Tax Act’ (2004) 16:5 *Tax Information Bulletin* 46. Part C of *Income Tax Act 2004* is equivalent to Part C ITA 2007. The Income Tax Act was rewritten in 2004.

²³ Ibid. The *Tax Information Bulletin* also uses the phrase ‘exhaustive list’ at 48 and 54.

²⁴ Inland Revenue Department, above n 22, 46 and 51. Section BD 1(1) ITA 2004 is equivalent to ITA 2007, section BD 1(1).

Maples commented that the Inland Revenue statement does not give the complete picture and there is no actual definition outlined in the 2004 Act and we have to look to the cases for that definition.²⁵

Alley and Maples believe that s CA 1(2) of the 2004 Act served as a catch-all provision, providing that amounts that were not specifically referred to elsewhere in that legislation could still constitute income according to ordinary concepts and be taxed under Part C.²⁶ Section CA 1(2) is the most important provision in the Act.²⁷ Some charging provisions precede it, and (rather more) follow it.²⁸ Other commentators on the scope of Part C have noted that since it: ‘includes “income under ordinary concepts”, what is (and what is not), income remains to a large extent a matter of common law principle’.²⁹

The Australian *Income Tax Assessment Act 1997* (Cth) (ITAA 1997)³⁰ is of little assistance. Section 6-5 (2), ITAA 1997 brings to tax net ‘assessable income’ derived by Australian residents. Assessable income consists of ‘ordinary income’ and ‘statutory income’ (s 6-1(1) ITAA 1997). Ordinary income consists of income according to ordinary concepts from any source (s 6-5(5) ITAA 1997). Section 6-5(4) ITAA 1997 provides that a taxpayer is taken to have received an amount of ordinary income as soon as it is applied or dealt with in any way on the taxpayer’s behalf or as the taxpayer directs. So the ITAA 1997 also does not define the concept of income according to ordinary concepts or the concept of derivation. However, section 6-5(4) ITAA 1997 is an

²⁵ Clinton Alley and Andrew Maples, ‘An Analysis of the Framework and Terms Used in Determining Assessable Income in the Core Provisions of the Income Tax Act 2004’ (2007) 13:3 *New Zealand Journal of Taxation Law and Policy* 462 at 463.

²⁶ Ibid.

²⁷ Committee of Experts on Tax Compliance, Report to the Treasurer and Minister of Revenue *The Rewrite Project* (Chapter 2, 2.159), <<http://www.taxpolicy.ird.govt.nz/publications/files/html/coe/index.html>>.

²⁸ Ibid.

²⁹ Craig Macalister and Therese Turner, *The Income Tax Act 2004: The New Rules* (Brookers Ltd, 2005) 287. If an amount arising from a transaction is not income under Part C, then it would be outside the scope of the Act.

³⁰ Part 3 of the paper undertakes a review and analysis of the leading cases from Australia and the United Kingdom. The United Kingdom *Income Tax Act 1952* is Scholastic and there is no provision equivalent to s CA 1(2).

umbrella provision.³¹ It ensures that nothing that is income, according to the ordinary meaning of the word, escapes tax.

3. Analytical framework

Before one can arrive at tentative conclusions based upon established tax precedents, it is important to consider statutory and judicial concepts of income. This section develops the analytical framework for the concept of income, considering specifically s CA 1(2), s CE 1 and s CB 1 of the Act.

3.1 Ordinary income

As previously discussed, s CA 1(2) of the Act functions as a catch-all provision, providing that amounts that are not specifically referred to in the legislation constitute income under ordinary concepts.

The Act does not comprehensively define *income* and it was left to courts and commentators to arrive at a sustainable meaning.³² Therefore, taxpayers, their advisors and the Inland Revenue Department have had no choice but to work within the ambits of such an indefinite concept of income.³³ The New Zealand courts have relied on cases from other jurisdictions in order to derive a general concept of income. In the Australian decision of *Scott v Commissioner of Taxation*³⁴ C J Jordan concluded³⁵ that the word *income* was not a term of art. He suggested that the forms of receipt which were comprehended within income and the principles which were to be applied in ascertaining which of these receipts ought to be treated as income must be determined in accordance with the ordinary concepts and usages of humankind. However, the statute must be

³¹ Committee of Experts on Tax Compliance, above n 27, 2.151.

³² The judicial approach to identification of income is different from the economic concept. In *A Taxpayer v CIR* (1997) 18 NZTC 13 350 (CA) when the Inland Revenue Department was relying on American and Canadian courts' economic concept, P Richardson at page 13 556 commented: 'The approach taken to the reach of taxes over income in other jurisdictions with their different economies and with different assumptions as to the influence of property and other concepts in the making of gains is not necessarily a sound basis for determining the scope and application of the New Zealand legislation. Thus, the United Kingdom of 200 years ago when income tax was first introduced was very different from the pioneering, entrepreneurial, less static and more mobile United States of 1913. The American cases on which Mr McKay drew need to be read in their economic and social context.'

³³ Alley and Maples, above n 25, 462.

³⁴ *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215.

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

followed if it states or indicates an intention that receipts which were not income in ordinary parlance were to be treated as income, or the special rules were to be applied in arriving at the taxable amount of such receipts.

Kevin Holmes notes that the courts when determining income for tax purposes ‘refer to adoption of the “ordinary” or “natural” meaning, or the “customary usage” of the word income’.³⁶ He also noted that to constitute income receipts required ‘the presence of: An incoming or inflow; Convertibility into cash; Periodicity or recurrence; A reward from employment or vocation or property; Realisation; Separation from source; A profit-making purpose, and conformity with the “ordinary” meaning of income.’³⁷

In 1985 Professor Ross Parsons³⁸ identified some propositions which provide the hallmarks of income according to ordinary concepts. Parsons noted that the concept of income denotes two components. First, there must be a gain for the taxpayer.³⁹ Second, once a gain has been established there must be something which comes in.⁴⁰ The second component relates to the concept of derivation. So first of all, a gain with an income character must be identified and then a determination needs to be made about whether it has been derived by the relevant taxpayer. Parsons’ definitive text makes a number of assertions, or propositions, which can be used in a general way to identify receipts as income.

The main criterions needed to satisfy the judicial concept of income are as follows.

3.1.1 Realisation — gain must be derived

Holmes observes that a gain must be realised (come in) before it can be treated as income in the legal sense.⁴¹ Parsons suggests that ‘An item is income of a taxpayer, in the amount

³⁶ Kevin Holmes, *The Concept of Income: A Multi-Disciplinary Analysis* (IBFD Publications BV, 2001) 233.

³⁷ Holmes, above n 19, 316 at 320.

³⁸ R W Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (The Law Book Company, 1985).

³⁹ Parsons, above n 38, proposition 4 [2.38] at 36.

⁴⁰ Parsons, above n 38, proposition 1 [2.10] at 27. The second proposition is generally true, but it has been departed from and criticised on two occasions since Parsons’ publication. Refer to the comments of J Hill in *Warner Music Australia Pty Ltd v FCT* 96 ATC 5046 at 5054. Other citations: (1996) 34 ATR 171 (1996) 70 FCR 197.

⁴¹ Holmes, above n 36, 178.

of its realisable value, if it has been derived by him and the item is a gain derived in circumstances which give it in other respects an income character.’⁴² Conceptually, income derivation is a hard area.⁴³ Writing about the concept of income derivation, Sir Ivor Richardson has noted the fact that the judicial concept of income must work in the real world.⁴⁴

Section BD 3(2) of the Act provides that assessable income must be allocated to the income year in which the amount is derived by the taxpayer and section BC 5 provides that income tax is imposed on the taxable income derived by the taxpayer during the income year. The term *derived* is not defined in the Act. The Act does not set out any procedures that a taxpayer must follow to determine the amount of income derived by them. The word ‘derived’ is not necessarily equivalent in meaning to ‘earned’.⁴⁵ In *Brent v Federal Commissioner of Taxation* J Gibbs said:⁴⁶

It has become well established that unless the Act makes some specific provision on the point the amount of income derived is to be determined by the application of ordinary business and commercial principles and that the method of accounting to be adopted is that which is calculated to give a substantially correct reflex of the taxpayer’s true income.

Section BD 3(4) of the Act provides that employment income is derived when it is credited in the employee’s bank account.⁴⁷ In *Commissioner of Taxes (SA) v Executor, Trustee and Agency Co of South Australia Ltd (Carden’s Case)* J Dixon noted:⁴⁸ ‘Speaking generally, in the assessment of income the object is to discover

⁴² Parsons, above n 38, [2.6] at 26.

⁴³ J Shewan and P Boyce, ‘Derivation and Deductions Revisited’ (2002) 8:2 *New Zealand Journal of Taxation Law and Policy* 182.

⁴⁴ I L R Richardson, ‘The Impact and Influence of Accounting and Economic Principles on Taxation Law’ (1998) 4 *New Zealand Journal of Taxation Law and Policy* 18.

⁴⁵ *Brent v FCT* (1971) 125 CLR 418, 423.

⁴⁶ *Brent v FCT* (1971) 125 CLR 418, 429.

⁴⁷ In *Case D14* (1979) 4 NZTC 60 507, an accountant was paid a salary for services to be performed the following year. The Taxation Review Authority held that the salary was derived by the accountant in the year he received it.

⁴⁸ *Commissioner of Taxes (SA) v Executor, Trustee and Agency Co of South Australia Ltd (Carden’s Case)* (1938) 63 C.L.R.108, 155.

what gains have during the period of account come home to the taxpayer in a realised or immediately realisable form.’ Section BD 3(3) of the Act provides that for individuals (except self-employed people) income is derived on a cash/receipt basis.

Where the taxpayer is carrying on a business the most appropriate method to determine derivation may be accruals rather than cash. In *Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* the prepayments made for dancing tuition which could extend beyond the current year were held to be income in the year that the lessons were provided and not in the year the fees were paid.⁴⁹ *Arthur and Murray* was a company (in business) so therefore the accrual basis of accounting was applied.

3.1.2 A gain must be ‘revenue’ in nature

The Act defines the concept of revenue on the basis of its ordinary meaning. Ultimately it is a matter of commonsense. In ascertaining whether a gain constitutes income, tax law has focused on gains made from services rendered,⁵⁰ the carrying on of a business⁵¹ or from property (personal).⁵² These gains were recognised as being of an income nature and thus taxable. Interest, rents, dividends and royalties are also generally recognised as having the character of income.⁵³

The general concept of net income is based on identification of transactions which give rise to net income.⁵⁴ As the tax law concept of income evolved, the courts identified

⁴⁹ *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 at 318 the court observed: ‘It refers to amounts which have not only been received but have ‘come home’ to the taxpayer; and that must surely involve, if the word ‘income’ is to convey the notion it expresses in the practical affairs of business life, not only that the amounts received are unaffected by legal restrictions, as by reason of a trust or charge in favour of the payer - not only that they have been received beneficially - but that the situation has been reached in which they may properly be counted as gains completely made, so that there is neither legal nor business unsoundness in regarding them without qualification as income derived.’

⁵⁰ ITA 2007, s CA1, s CE 1.

⁵¹ ITA 2007, s CB 1.

⁵² ITA 2007, sections CB 3 to CB 5 (Personal Property) and ss CB 6 to CB 23 (Real Property).

⁵³ Parsons, above n 38, 89 at [2.234].

⁵⁴ *A Taxpayer v CIR* (1997)18 NZTC 13 350, at 13 355 P Richardson observed: ‘Again, income is a flow of

a number of common elements that were present in established types of income. However, an all-encompassing definition has not yet been developed, partly due to the fact that, as Phillip Burgess et al⁵⁵ state, judicial pronouncements will always be subject to varied interpretations. Holmes⁵⁶ also concludes that the distinction between income and non-income receipts and benefits turns on statutory interpretation.

In *Scott v Commissioner of Taxation*, C J Jordan observed that⁵⁷ the word ‘income’ appears ‘on both sides of the equation’. The definitions adopted in cases, however, did serve to flag the fact that property and personal exertion represented, at the very least, the principal sources from which income may be said to be derived. In *Eisner v Macomber*⁵⁸ the concept of income advocated by Pitney J includes gains from the sale of assets.

New Zealand tax legislation did not develop alongside the United States Supreme Court concept as stated in *Eisner v Macomber*. Unlike in the United States, in New Zealand profits made upon the realisation of an asset do not constitute income for income tax purposes. Intention or purpose of the recipient must be considered.⁵⁹ A receipt may constitute income if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer’s business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction.⁶⁰ However, Justice

money or money’s worth, a series of periodic receipts arising from the ownership of property or capital, or from labour, or a combination, eg rent, interest and dividends, salary and other personal exertion receipts, annuities and business receipts.’

⁵⁵ Burgess et al, above n 10, 52–3.

⁵⁶ Holmes, above n 36, 192–3.

⁵⁷ *Scott v Commissioner of Taxation* (1935) 3 ATD 142 at 145; (1935) 35 SR (NSW) 215 at 220.

⁵⁸ *Eisner v Macomber* (1919) 252 US 189. The Supreme Court of the United States of America in *Eisner v Macomber* said: ‘The fundamental relation of “capital” to “income” has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop: the former being depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time ...’

⁵⁹ Though in this context there is some overlap between motive and intention. In *Californian Copper Syndicate v Harris* (1904) 5 TC 159 at 166 according to Lord Macdonald the question to be asked was, ‘is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in the operation of business in carrying out a scheme for profit making?’ Also in *Plimmer v CIR* [1958] NZLR 147 at 150 according to Chief Justice Barrowclough intention and purpose are not one and the same although sometimes purpose may mean intention.

⁶⁰ See, eg, s CB 4 of the Act. In *FCT v The Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363,

Edmonds⁶¹ notes that the High Court in *Myer* when referring to a one-off transaction left the door ‘half open’ when it stated ‘in which event the extraordinary character of the transaction may reveal that any gain resulting from it is capital, not income’.⁶²

In *A Taxpayer v Commissioner of Inland Revenue* P Richardson said:⁶³ ‘A further underlying notion is the idea of gain from the carrying on of an organised activity — an employment, a business or profession, an adventure in the nature of trade, or a business deal — directed to the making of gain.’ In another case the court states that sums which are received annually or periodically are often revenue in nature but that factor is an evidential test not a decisive test in determining the revenue nature of the sums.⁶⁴ In *Sun Newspapers Ltd v Federal Commissioner of Taxation* the Australian High Court stated that it is necessary to look at the primary purpose for which the amount is received.⁶⁵

Tax law has recognised the ability to tax personal exertion receipt as being dependent upon the nature of the receipt. In this case it is the character of the receipt in the hands of the recipient.⁶⁶ In *G v Commissioner of Inland Revenue*⁶⁷ the taxpayer, an evangelist, received gifts regularly and which were a recurrent reward for the performance of services. The gifts were received by the taxpayer in anticipation that they would be a means of support for him and were considered income.⁶⁸ In *Reid v Commissioner of Inland Revenue* when deciding whether the student allowance was assessable to the taxpayer, J Richardson observed:⁶⁹

4370 the High Court added the qualification that: ‘at least in the context of carrying on a business or carrying out a business operation or commercial transaction’. In *Westfield Ltd v FCT* (1991) 21 ATR 1398, J Hill made it clear that the actual transaction contemplated at the time of entry must be carried out.

⁶¹ Justice R Edmonds, ‘A Finding that a Taxpayer Carries on a Business: What is Required, Related Issues and What are the Tax Consequences’ (2010) 39 *Australian Tax Review* 71 at 81.

⁶² *FCT v The Myer Emporium Ltd* 87 ATC 4363, 4372; (1987) 163 CLR 199 at 215–16, 209.

⁶³ *A Taxpayer v CIR* (1997) 18 NZTC 13 350 at 13 355.

⁶⁴ *Scott v FCT* (1966) 117 CLR 514; [1967] ALR 561.

⁶⁵ *Sun Newspapers Ltd v FCT* (1939) 61 CLR 337 at 363.

⁶⁶ *Hayes v FCT* (1956) 96 CLR 47; *Scott v FCT* (1966) 117 CLR 514.

⁶⁷ *G[raham] v CIR* [1961] NZLR 994.

⁶⁸ *G[raham] v CIR* [1961] NZLR 994, 999. It was cited by the Australian High Court in *Commissioner of Taxation v Stone* (2005) 215 ALR 61 at [84]. Profit-making intention or purpose was not essential to the carrying on of the business.

⁶⁹ *Reid v CIR* (1985) 7 NZTC 5176 at 5183–4.

If it has that quality of regularity or recurrence then the payments become part of the receipts upon which the recipient may depend for his living expenses, just as in the case of a salary or wage earner, annuitant or welfare beneficiary. But that in itself is not enough and consideration must be given to the relationship between payer and payee and to purpose of the payment, in order to determine the quality of the payment in the hands of the payee. Therefore it is submitted that to determine whether a receipt from personal exertion would be considered as income, the relevant factors identified by the courts are: a gain is derived by a person for services rendered; periodicity, recurrence or regularity; an expectation of reward; and the intention of the donor and the donee.⁷⁰

3.1.3 Capital gains are excluded

The default rule of New Zealand tax law (s BD 1(1) of the Act) is that capital gains, whether realised or unrealised, are not taxable in the hands of the recipient even though it represents a gain to that person. However, many types of capital gains, which prima facie are not taxable, are being drawn into the tax base by virtue of particular legislative provisions.⁷¹

According to Ivor Richardson⁷² and Phillip Burgess et al⁷³ trust law concepts of income have been influential in shaping the tax law concept of income. Burgess et al⁷⁴ cite an example of the exclusion of capital gains from the tax law concept of income as having its origins in trust law, which recognised a difference between those beneficiaries entitled to receive income from the property and those beneficiaries entitled to receive the property itself. But Professor John Prebble⁷⁵ has argued that it is more likely due to the general concept of income in English law.

⁷⁰ *G[raham] v CIR* [1961] NZLR 994; *Reid v CIR* (1985) 7 NZTC 5176 at 5183–4; *Moore v Griffiths (Inspector of Taxes)* [1972] 3 All ER 399 at 411.

⁷¹ See, eg, section CB 6 to s CB 23 of ITA 2007, which contains a series of provisions to catch land sales.

⁷² Sir Ivor L M Richardson, 'The Concept of Income and Tax Policy' (1990) 4 *Canterbury Law Review* 203.

⁷³ Burgess et al, above n 10, 53.

⁷⁴ Ibid. This theory was expounded by Professor Parsons.

⁷⁵ John Prebble, 'Fictions of Income Tax' (Paper presented at the Australasian Tax Teachers' Association 14th

Annual Conference, Manukau Institute of Technology, Auckland, 17–19 January 2002) 22
<<http://pandora.nla.gov.au.ezproxy.aut.ac.nz/pan/23524/20020412/c.fong.unsw.edu.au/prebblepaper.doc>>.

The treatment of increases in capital as constituting a profit or gain under the United Kingdom Income Tax Act 1918 was considered in *Ryall v Hoare* where J Rowlatt concluded that⁷⁶ ‘a capital accretion is outside the words “profits or gains”, as used in these Acts’. Therefore, profits made from the isolated buying and selling of an item fell outside the scope of income/gain as per J Rowlatt’s idea of income.

3.1.4 Windfall gains are excluded

Flow chart B2 (calculating and satisfying income tax liabilities) of the Act provides that windfall gains are not income and therefore are not taxed. A state of mind test applies to determine whether a receipt is a windfall gain.⁷⁷ A windfall gain relates neither to the income-earning process nor to the framework which enables the income activity to take place. It is never received with a profit-making purpose.⁷⁸

Alley and Maples⁷⁹ observe that there is an overlap between the terms ‘windfall gain’ and ‘gift’. They believe that windfall gains may not be earned, but arise by virtue of luck and payments made by way of personal esteem or testimonial are gifts.⁸⁰ Ross and Burgess⁸¹ refer to a gift as a windfall payment.

In *G v CIR* the New Zealand Supreme Court adopted the position of English law and observed that:⁸² ‘Though gratuitous payments amount to income in the widest sense of the word — namely something which comes in — it has generally been accepted that they are not part of the taxpayer’s assessable income unless they can be shown to be embraced by some specific provision of the tax law which makes them taxable.’

Ross and Burgess stated:⁸³

[w]hy the courts exclude gifts from income has never been clearly explained in the case law, but perhaps the isolated nature of these receipts, their general unpredictability and lack of control the recipient has over their derivation qualifies gifts for special treatment.

⁷⁶ *Ryall v Hoare* [1923] 2KB 447 at 454.

⁷⁷ Garth Harris et al, *Income Tax in New Zealand* (Thompson Brookers, 2004) 113 at 3.2.4 (a).

⁷⁸ *Scott v FCT* [1967] ALR 561; (1966) 117 CLR 514 at 527.

⁷⁹ Alley and Maples, above n 25, 462 at 472.

⁸⁰ *Ibid.*

⁸¹ Ross and Burgess, above n 14, 54.

⁸² *G[raham] v CIR* [1961] NZLR 994 at 997.

⁸³ Ross and Burgess, above n 14, 44.

In *FCT v Squatting Investment Co Ltd* J Kitto commented as follows:⁸⁴ ‘the test of whether a “gift” is income in the ordinary sense of the word is whether it is “made in relation to some activity or occupation of the donee of an income-producing character”.’ According to the income and non-income distinction developed by the English courts,⁸⁵ a gift is not a reward for a donee’s labour in an office or employment. Nor is the gift a product of the donee’s property. A gift might also be viewed as a distribution of the donor’s income or property rather than an income receipt of the donee. The value the recipient places on a gift is also significant, as discussed later

Therefore, each gift is considered on its own facts. Only those gifts which are related to the income-producing activities of the taxpayer are assessable and mere personal gifts made purely as a mark of affection, esteem or respect are therefore not assessable.

3.2 Section CE 1 employment income

Payments to an employee constitute payments of salary or wages which are subject to the pay as you go (PAYE) system. For a payment for personal exertion to constitute a payment of salary or wages it must be paid on account of an employment relationship. The term ‘employment relationship’ is not defined in the Act and relies on general law. However, income from an employment relationship is captured by s CE 1 (amounts derived in connection with employment) of the Act.

The use of the phrase in s CE 1: ‘The following amounts derived by a person in connection with the employment or service of the person’⁸⁶ allows the inclusion in income of benefits in money derived in connection with employment.⁸⁷ The words refer to existing employment or service, and cannot be treated as extending to an employment or service which has come to an end. Employment income is an amount which is a

⁸⁴ *FCT v Squatting Investment Co Ltd* (1953) 86 CLR 570 at 633.

⁸⁵ *Ibid* and *FCT v Dixon* (1952) 5 AITR 443. Income must come in; Income must be convertible into money or money’s worth; Income must generally comprise a periodic or recurrent flow; Income must be a reward for effort or the produce of property.

⁸⁶ ITA 2007, s CE 1. *Naismith v CIR* (1981) 5 NZTC 61 046 is the authority for this proposition.

⁸⁷ The employee is taxed on income derived, employee expenses discharged by the employer and non-cash benefits from the provision of accommodation and share investments.

reward for services.⁸⁸

Section 15-2 of the *Income Tax Assessment Act 1997* (ITAA) states that an amount is income if it is: ‘in respect of, or for, or in relation directly or indirectly to, any employment of or services rendered by you’.⁸⁹ This similarity in wording to the Act allows greater reliance on the Australian cases than the English cases.⁹⁰

To prevent the erosion of the tax base of the country, the sections of the New Zealand Income Tax Act which specifically make employment income assessable have been amended from time to time. For example the word ‘emoluments’, which appeared in section 88(1) (b) of the *Land and Income Tax Act 1954* and in the *Income Tax Act 1976* via the definition of ‘monetary remuneration’, was dropped from s CE 1 of the Act.⁹¹

3.3 Section CB 1 business income

Section CB 1 of the Act states that an amount that a person derives from a business is income of the person.⁹² ‘Business’ is defined in s YA 1, inter alia to include any profession, trade or undertaking carried on for profit.⁹³

⁸⁸ *A Taxpayer v CIR (1997) 18 NZTC 13 350* at 13 368.

⁸⁹ Section 15-2(1) ITAA 1997 states that ‘Assessable income includes the value to the taxpayer of all allowances, gratuities, compensation, benefits, bonuses and premiums provided to you in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by the taxpayer (including any service as a member of the Defence Force). It replaces s 26(e) *Income Tax Assessment Act 1936* (AU).

⁹⁰ See A P Molloy, *Molloy on Income Tax* (Butterworths, 1976) 503 and accompanying text for further discussion of the difference in reliance on English and Australian cases. Schedule E to the *Income Tax Act 1952* (UK) states: ‘Tax under [Schedule E] shall also be charged in respect of any office, employment or pension, the profits or gains arising or accruing from which would be chargeable to tax under Schedule D but for the proviso to paragraph 1 of that Schedule.’ The payments come within Schedule IX, which referred, in respect of an office or employment of profit mentioned in Schedule E, to ‘all salaries, fees, wages, prerequisites or profits whatsoever therefrom’.

⁹¹ The effect of the changes in the 2007 Act is to remove a direct reference to ‘emoluments’ from the source rules which existed up until and including the 2004 Act. It was believed by officials that the word used was superfluous and presumably the breadth of s CE 1 ITA 2007 would now catch such personal exertion amounts.

⁹² It is important to note the interpretation of the words ‘derived from any business’. This excludes capital receipts; see, eg, *CIR v City Motor Service Ltd* [1969] NZLR 1010. In terms of the derivation of income in the case of business income, the most appropriate method is the accruals method of tax accounting. The *accruals* method treats income as having been earned when it is legally payable but not yet paid.

⁹³ The words ‘manufacture’ and ‘pecuniary’ have been dropped from the definition of business in the Act. The *Income Tax Act 2004* and prior Acts used the term ‘pecuniary profit’.

The concept of a business involves the exercise of an activity in an organised and coherent way to attain the end result of pecuniary profit. The word pecuniary was not defined in the earlier Acts. In *Grieve*, J Richardson noted that⁹⁴ ‘it simply reflects the underlying notion of income as being money or money’s worth. The profit sought must be in money or money’s worth and the business must be carried on for pecuniary profit.’ There are no further statutory criteria set out in the Act to assist in identifying a business. The concept of carrying on a business has been developed through the case law.

The leading decision in New Zealand on the definition of a business is that of the Court of Appeal in *Grieve v Commissioner of Inland Revenue*.⁹⁵ In this case the Court of Appeal applied *G v CIR*⁹⁶ and J Richardson sets out the test of what is a business. The test involves a two-step analysis:⁹⁷

(a) Nature of the activity

‘Business’, in the sense in which it is used in the legislation conveys a notion of imposing a charge for tax in respect of revenue earning activities. The activity undertaken must be capable of being classified as a commercial or mercantile activity customarily engaged in as a means of livelihood and typically involving some independence of judgment and power of decision. It must be a pursuit or occupation demanding time and attention; a serious employment as distinct from a pastime.

(b) Is the activity carried out with an intention to make profit?

Intention refers to the expectation that income will be derived. It is not the same as purpose which is the reason why the taxpayer does something. An expectation and willingness of profits to arise as a result of activity undertaken is material and not the purpose.⁹⁸

⁹⁴ *Grieve v CIR* [1984] 1 NZLR 101 at 110. Following *Grieve* the Inland Revenue Department (IRD) released *Technical Policy Circular* 84/24, March 1984. The circular outlines IRD’s policy for determining whether a person is carrying on a business.

⁹⁵ *Grieve v CIR* [1984] 1 NZLR 101.

⁹⁶ *G[raham] v CIR* [1961] NZLR 994.

⁹⁷ *Grieve v CIR* [1984] 1 NZLR 101 at 110. The term ‘business’ has broad application and any activity meeting the two-step criteria would constitute business.

⁹⁸ *Grieve v CIR* [1984] 1 NZLR 101 at 106, J Richardson stated: ‘Some organised commercial operations may

In *Grieve*, J Richardson was of the opinion that the test of whether a business existed turned on the intention of the taxpayer as evidenced by his conduct.⁹⁹ Conduct of the taxpayer is an objective test and the intent of the taxpayer is a subjective test, which is determined by examining external evidence apart from their stated intentions. In *Grieve* J Richardson stated that a commitment to engage in business is not sufficient; rather a profit-making structure must be established and ordinary current business operations begun. In *Calkin*¹⁰⁰ J Richardson held that commencement of a business must involve real transactions and not just exist in the mind of the taxpayer. To decide whether the taxpayer has the necessary intention to make a profit factors to look at are:¹⁰¹ ‘Nature of the activity, the period over which it is engaged in, the scale of operations and the volume of transactions, the commitment of time, money and effort, the pattern of activity, and the financial results.’

Considering the particular facts in a situation, the intention test also determines when a business commences and terminates.¹⁰²

4 The conceptual framework

4.1 Section CE 1 employment income

The difficulty arises in drawing a distinction between gifts which are additional remuneration and are therefore assessable as profits from employment and gifts which are purely personal and have no relation to employment.

A critical element is the nature of the employment relationship: whether it is direct or indirect. The existence of a direct employment relationship with the donor strongly increases the likelihood of a receipt being found to be gross income. In *Smith* the

be embarked on without any motivation of profit-making and it is well settled that such activities may constitute trading.’ The joint judgment in *FCT v Stone* (2005) 215 ALR 61, 222 CLR 289 at [55] also established that activities can constitute a business even in the absence of profit motive.

⁹⁹ *Grieve v CIR* [1984] 1 NZLR 101 at 107. In *G v CIR* [1961] NZLR 994 at 999 J McCarthy stated that the

essential test as to whether a business existed was the intention of the taxpayer as evidenced by his or her conduct, and other factors such as recurrence were tests to ascertain the existence of that intention.

¹⁰⁰ *Calkin v CIR* (1984) 6 NZTC 61 781 at 61 787.

¹⁰¹ *Grieve v CIR* [1984] 1 NZLR 101 at 110.

¹⁰² *Amalgamated Zinc (De Bavay's) Ltd v FCT* (1935) 54 CLR 295 at 309; *Inglis v FCT* 80 ATC 4001 at 4005.

allowance was paid ‘in consequence of’ the employment, and thus was paid ‘in respect of ... or in relation ... to’ the employment.¹⁰³ The benefit was indirect, but the fact that Smith was still employed by the bank was crucial in finding the receipt to be gross income. In *Naismith* the key factor in finding the receipt of salvage money to be gross income was that the taxpayer performed services beyond his contractual obligations during paid employment.¹⁰⁴ A direct relationship also existed in *Shell*,¹⁰⁵ *Clayton v Gothorp*,¹⁰⁶ *FCT v Holmes*,¹⁰⁷ *Mudd v Collins*¹⁰⁸ and *Laidler v Perry*¹⁰⁹ and the receipts in question were found to be taxable.¹¹⁰ In *Hochstrasser v Mayes*,¹¹¹ Mayes was employed by ICIL, and a direct employment relationship existed. However, the payment to Mayes was during his employment but it did not proceed out of employment and was not a reward for services rendered. He was being compensated for a loss in his capacity as a

¹⁰³ *Smith v FCT* (1987) 19 ATR 274 at 280 J Brennan. The case was decided under section 15-2 of the ITAA 1997 (formerly s 26(e) of ITAA 1936). In this case a bank had an ‘encouragement to study’ scheme under which payments were made to employees who successfully completed approved courses of study. Smith was an employee of the bank who successfully completed an appropriate course and was accordingly awarded \$570 by the bank.

¹⁰⁴ *Naismith v CIR* (1981) 5 NZTC 61 046 at 61 052. In this case Naismith was the captain of a tug boat and was employed by the Northland Harbour Board. The tug boat rescued a vessel which had foundered off the Northland coast. The Board realised the vessel and its stores and subsequently distributed salvage moneys to the crew, including Naismith, for performing services beyond contractual obligations.

¹⁰⁵ *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11 303. In this case at 11 306 the court stated that: ‘... the words “emolument (of whatever kind), or other benefit in money, in respect of or in relation to the employment or service of the taxpayer” are words of the widest possible scope.’

¹⁰⁶ *Clayton v Gothorp* [1971] 47 TC 168.

¹⁰⁷ *FCT v Holmes* 95 ATC 4476. In this case Holmes, a tug worker, was also taxed on a salvage payment, even though he was not acting in the course of employment at the time. The court relied on section 15-2 of the ITAA 1997 (formerly s 26(e) of ITAA 1936), which is a catch-all for employment benefits generally.

¹⁰⁸ *Mudd v Collins (HM Inspector of Taxes)* (1925) 9 TC 297.

¹⁰⁹ *Laidler v Perry* [1965] Ch 192 (CA).

¹¹⁰ Earlier cases such as *Barson v Airey* (1925) 10 TC 609 reinforce this point. In this case employees received bonuses for exceptional work. The taxpayers argued that the receipts were not in consideration for carrying out the work for which they were employed. But the nexus between the receipts and the employment was too close for the finding to be anything else but income. Such payments are clearly captured in New Zealand by the s CE 1 of the Act (amounts derived in connection with employment).

¹¹¹ *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376. In this case Mayes was an employee of ICIL. He was required by the company to often move from one part of the country to the other. Under the company housing scheme the company agreed that it would make up any loss on the sale of a house by an employee when the employee was required to relocate. Mayes did make such a loss of £350 and it was reimbursed by the company.

householder rather than in his capacity as an employee and was not therefore deriving income. In addition the amount was not income as there was no gain.

If there is an indirect employment relationship and a sufficient nexus can be found between the receipt and the employment relationship, then the receipt will be gross income. In many cases there was not a direct employment relationship with the donor. The receipts may have been donated by the public,¹¹² or by a former employer.¹¹³ In some cases the donor was even more remote.¹¹⁴ Often the court has found as in *Dixon*¹¹⁵ that '[t]he fact of the respondent's employment explains the selection of him as a recipient, but in no degree characterises the payment.'¹¹⁶ In many of the cases the receipt was found not to be gross income as a result of insufficient causal nexus between the receipt and the employment relationship. However, in *Blakiston*¹¹⁷ the receipt was found to be gross income, partly because of the letter written by the bishop. The letter clearly linked the receipt to Blakiston's office of clergyman so there was sufficient nexus. In *Wright v Boyce*¹¹⁸ the payments were made in pursuance of a custom every year which clearly linked the receipt to Wright's office of huntsman and therefore there was the sufficient nexus present for the receipt to be income. In *Dooland*,¹¹⁹ Dooland's contract entitled him to the collections so again the sufficient nexus was present.

In *Seymour*¹²⁰ the taxpayer was a cricketer who would not have received the benefit in question 'but for' his employment relationship with the cricket club yet the receipt was not income. Was *Seymour* therefore wrongly decided? Even though an employment

¹¹² *Blakiston v Cooper (Surveyor of Taxes)* [1909] AC 104; *Seymour v Reed* [1927] AC 554; *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284; *Wright v Boyce* [1958] 1 WLR 832 (CA).

¹¹³ *Louisson v Commissioner of Taxes* [1942] GLR 477; *FCT v Dixon* (1952) 5 AITR 443; *Hayes v FCT* (1956) 96 CLR 47; *FCT v Harris* (1980) ATC 4238; *FCT v Blake* (1984) ATC 4661.

¹¹⁴ *Moore v Griffiths* [1972] 3 All ER 399 at 411; *Kelly v FCT* (1985) ATC 4283; *Reid v CIR* (1985) 7 NZTC 5176.

¹¹⁵ *FCT v Dixon* (1952) 5 AITR 443.

¹¹⁶ *FCT v Dixon* (1952) 5 AITR 443 at 453.

¹¹⁷ *Blakiston v Cooper (Surveyor of Taxes)* [1909] AC 104.

¹¹⁸ *Wright v Boyce* [1958] 1 WLR 832 (CA).

¹¹⁹ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284.

¹²⁰ *Seymour v Reed* [1927] AC 554.

relationship existed, the benefit received was found to be ‘a mere gift or present ... made to [Seymour] on personal grounds and not by way of payment for his services’.¹²¹ It was a special mark of esteem for the career of the cricketer.

A close reading of the cases shows that it is possible that, even if an employment relationship exists, a receipt which can be explained by this employment relationship may still not be gross income. For the receipt to be gross income, a receipt must be a product or consequence of employment and benefits must be received for being or acting as an employee. The nexus between employment and receipt in *Seymour v Reed*¹²² is not as obvious as in *Dooland*¹²³ where there was an actual contract. But the rules of the club in *Seymour*¹²⁴ allowed members to have a benefit match and Seymour knew of these rules and would surely have had the hope or expectation of being rewarded by a benefit match as long as he performed his duties well.¹²⁵ If the match had been an ordinary match and not a benefit match, the gate takings would have been gross income to the club. The nexus is stronger than that present in *Kelly*¹²⁶ where the \$20 000 was given to Kelly by a television station. However, Kelly earned it because he performed his normal contractual duties so well over the season.

In *Moore v Griffiths*,¹²⁷ an English case, the receipt was found not to be gross income but the connection was more remote between the donor(s) and the employment than in *Seymour*.¹²⁸ Other distinguishing factors were also present. Moore was not aware that the prize money was available when he played in the World Cup, and the money was given

¹²¹ *Seymour v Reed* [1927] AC 554 at 559.

¹²² *Seymour v Reed* [1927] AC 554.

¹²³ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284. In this case Dooland was a professional cricketer. Under his contract of employment he received a salary and other allowances but was also entitled to have collections on the field if he performed well. (There were strict guidelines as to when a player was entitled to a collection.)

¹²⁴ *Seymour v Reed* [1927] AC 554.

¹²⁵ *Seymour v Reed* [1927] AC 554 at 563 L J Atkinson.

¹²⁶ *Kelly v FCT* (1985) ATC 4283.

¹²⁷ *Moore v Griffiths* [1972] 3 All ER 399 at 411.

¹²⁸ *Seymour v Reed* [1927] AC 554.

to all the players in the England squad, irrespective of whether they had actually played. In *Case VI35*¹²⁹ while on Special Studies Program Leave the taxpayer was entitled to her usual salary in addition to the fellowship awarded by an overseas university. The decision in *Case VI35* must be open to some doubt because such a receipt is likely to be an ordinary incident of an academic's employment. It is submitted that if *Seymour v Reed*¹³⁰ came before a court today the benefit receipt would be found to be gross income.¹³¹

If the receipt is a result of a systematic scheme under which payments are made to a group of recipients, not just the taxpayer, the receipt is more likely to be gross income. The converse also appears to be true: if a receipt is motivated by the personal qualities of the taxpayer it is less likely to be gross income. In *Blakiston v Cooper*¹³² and *Smith*¹³³ the payments were made to all persons of the same class as the recipients and were found to be gross income. The receipts were not personal testimonials as for example in *Seymour v Reed*.¹³⁴ In cases such as *Hayes*,¹³⁵ *Ball*¹³⁶ and *Case VI35*¹³⁷ the receipts were personal gifts and thus not part of any scheme.

Does the test in *Blakiston v Cooper*¹³⁸ represent an effective test for distinguishing between a mere gift and a gift made to reward services rendered? The test may be worded as: if a receipt is given to a person substantially by virtue of his office or employment,¹³⁹ then the receipt will be gross income. A line must be drawn between receipts which arise substantially by virtue of the employment and those which are either gifts given in a

¹²⁹ *Case VI35* (1988) 88 ATC 855.

¹³⁰ *Seymour v Reed* [1927] AC 554. Section CA 1 ITA 2007 provides that such payments constitute assessable income.

¹³¹ *Kelly v FCT* (1985) ATC 4283; *Commissioner of Taxation v Stone* (2005) 2005 HCA 21 demonstrates that the courts are more prepared to find an amount as income where the payments are made to a professional sportsperson.

¹³² *Blakiston v Cooper (Surveyor of Taxes)* [1909] AC 104.

¹³³ *Smith v FCT* (1987) 19 ATR 274 at 277.

¹³⁴ *Seymour v Reed* [1927] AC 554.

¹³⁵ *Hayes v FCT* (1956) 96 CLR 47.

¹³⁶ *Ball v Johnson* (1971) 47 TC 155.

¹³⁷ *Case VI35* (1988) 88 ATC 855.

¹³⁸ *Blakiston v Cooper (Surveyor of Taxes)* [1909] AC 104.

¹³⁹ *Laidler v Perry* [1965] Ch 192 (CA).

personal capacity (and the employment may be merely background) or for which no services have been rendered. Ultimately the courts have to examine the facts in each case to see on which side of the line a receipt lies. In some of the cases the drawing of the line is very difficult. For example in *Seymour v Reed*¹⁴⁰ and *Case VI35*¹⁴¹ the line was drawn on the side of the receipts not being gross income although there was a reasonable nexus between the payments and Seymour's and the Australian academic's employment. In *Kelly*,¹⁴² on the other hand, the line was drawn on the side of the receipt being gross income although the connection was more remote. In Kelly's case the payment was seen as a usual incident of the practice of professional football.

A wedding gift is not assessable when given by an employer to an employee because 'it amounts to a gift to [the employee] in his personal capacity ... a benefit conferred out of affection'.¹⁴³ If a wedding gift is not assessable, what of an ex gratia payment to a successful athlete by his and her employer? In *Seymour v Reed*¹⁴⁴ there was much discussion about whether the benefit was 'a mere gift or present (such as a testimonial) ... made to (Seymour) on personal grounds'¹⁴⁵ or whether it was assessable income. The judgments in other cases such as *Moorhouse v Dooland*,¹⁴⁶ *Moore*,¹⁴⁷ *Kelly*¹⁴⁸ covered similar ground. What distinguishes these 'sports' cases and the example of a gift given by an employer to a successful athlete is that in the 'sports' cases the player performed their normal contractual duties well and earned the reward. Sometimes gifts are taxable if the tie relates to the action of the player, for example batting, that triggered the gift. In *Moorhouse v Dooland*, Sir Raymond Evershed MR said:¹⁴⁹

¹⁴⁰ *Seymour v Reed* [1927] AC 554.

¹⁴¹ *Case VI35* (1988) 88 ATC 855.

¹⁴² *Kelly v FCT* (1985) ATC 4283 at 4286.

¹⁴³ *Hayes v FCT* (1956) 96 CLR 47 at 57.

¹⁴⁴ *Seymour v Reed* [1927] AC 554.

¹⁴⁵ *Seymour v Reed* [1927] AC 554 at 559.

¹⁴⁶ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284.

¹⁴⁷ *Moore v Griffiths* [1972] 3 All ER 399 at 411.

¹⁴⁸ *Kelly v FCT* (1985) ATC 4283 at 4286.

¹⁴⁹ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284 at 297.

It follows, in my view, that a gift or present made either upon some special occasion such as a wedding, a century at cricket, a birthday or at a season of the year when it is customary to make presents, does not necessarily cease to be non-taxable merely because the ties that link the recipient and giver are or are substantially those of service and are not or not exclusively those of blood or friendship; and this may still be so, although the present is (for example, whenever another century is made or according to custom at Christmas) repeated.

In other words, the existence of an employment relationship does not mean that all receipts by the employee from the employer are gross income. For example, payments for humiliation, injury to feelings and so on under s 123(c)(i) *Employment Relations Act 2000* (NZ) and s 92M(1)(c) of the *Human Rights Act 1993* (NZ) are not taxable.¹⁵⁰ In order for the gift to be taxable there must either be a causal nexus between the employment and the gift,¹⁵¹ or it could be caught as gross income according to ordinary concepts (very unlikely if the payment was one off).

4.2 Section CB 1 business income

How important is the existence of a business relationship in deciding whether a receipt constitutes gross income? Under what circumstances might it be found that a receipt which results from the existence of a business relationship is not gross income?

The difficulty arises in drawing a distinction between gifts which are an ordinary incident of taxpayer's business and are therefore assessable as profits from business and gifts which are purely personal and have no relation to business.

In *G v CIR*¹⁵² the receipts were the result of his ordinary activities of preaching the word of God, the very services he was supplying to support himself. The fact that his motive was not profit making was not essential to the carrying on of a business. His intention to make profit was inferred from the facts of the case. Profit-making purpose or

¹⁵⁰ Inland Revenue Department public binding ruling BR Pub 06/05 assessability of payments under the *Employment Relations Act 2000* for humiliation, loss of dignity, and injury to feelings and public binding ruling BR pub 05/12 taxability of payments under the *Human Rights Act 1993* for humiliation, loss of dignity, and injury to feelings.

¹⁵¹ *Herbert v McQuade* (1902) 4 TC 489. Richard Collins MR held (at 500) that the test is whether from the standpoint of the person who receives it, it accrues to him in virtue of his office. It was held to be irrelevant whether the payment was voluntary or not. Also refer to *Payne v FCT* (1996) 32 ATR 516; *Scott v FCT* [1967] ALR 561.

¹⁵² *G v CIR* [1961] NZLR 994.

intent is one consideration to be applied in deciding whether there is a business, but it is not crucial.

In *Stone*¹⁵³ a taxpayer received from her javelin activities prize money, government grants, appearance fees and sponsorships amounting to AU\$136 448. Ms Stone had used her athletic talent to earn money and that was held to be carrying on a business since all the rewards of that business were held to be incidental to that business. The judges emphasised the importance of the ‘intention’ of the taxpayer in relation to identifying a business objective and established the principles underlying the concept of intention from *G v CIR*.¹⁵⁴ The *Stone*¹⁵⁵ case shows that there is a harder attitude today towards the realities of professional sport and what comprises the income of a professional sportsperson.

It is clear from *Californian Copper Syndicate*¹⁵⁶ that an isolated or one-off transaction is capable of being a trading venture if the taxpayer entered into the transaction with a profit-making purpose or intention. In *Squatting Investment Co*,¹⁵⁷ the Australian government did not have a legal obligation to make the payment to the farmers, but it felt it had a moral obligation. The government passed the law enabling it to distribute the surplus to the farmers. The court held that payment was related to the amount of wool supplied and made in the course of their trade therefore the receipt was a trade receipt. In *McGowan v Brown and Cousins*,¹⁵⁸ the taxpayers received the payment to compensate for inadequate remuneration for past services provided. The additional payment brought the taxpayers’ remuneration up to an adequate level. Therefore even though no business

¹⁵³ *Commissioner of Taxation v Stone* (2005) 2005 HCA 21; 215 ALR 61; 222 CLR 289.

¹⁵⁴ *G v CIR* [1961] NZLR 994 at 1000 per J McCarthy: ‘I do not suggest that the appellant was motivated by the thought of the money which he expected to flow to him; I accept that his motives were of a higher order, but I think it would be unreal to believe that after some seven or eight years of this activity and these means of livelihood, he did not intend that his work should lead to gifts being made to him, gifts which he knew he would accept and use for his support. This, of course, was not the only purpose or intention of his activity; but intention to make a profit is commonly only one of the intentions of those in business.’ The unsolicited donations received by an evangelist were held to be assessable.

¹⁵⁵ *Commissioner of Taxation v Stone* (2005) 2005 HCA 21; 215 ALR 61; 222 CLR 289.

¹⁵⁶ *Californian Copper Syndicate v Harris* (1904) 5 TC 159.

¹⁵⁷ *FCT v Squatting Investment Co Ltd* (1954) 88 CLR 413.

¹⁵⁸ *McGowan (Inspector of Taxes) v Brown and Cousins* [1977] 3 AII ER 844.

relationship existed at the time of payment, the receipt was part of the business or revenue-producing activity carried on by the taxpayers.

In *Scott*¹⁵⁹ and *Walker v Carnaby Harrower*¹⁶⁰ the receipts were personal gifts and not part of any scheme or part of their income-earning process. In *Scott*,¹⁶¹ the defendant had already been paid for his services as a solicitor. Similarly in *Walker v Carnaby Harrower*¹⁶² the firm of accountants had been paid for the annual audit. In *Simpson v John Reynolds*¹⁶³ the taxpayer company had been paid properly for its services. In the *Carnaby Harrower, Barham & Pykett*;¹⁶⁴ *Scott*;¹⁶⁵ and *John Reynolds & Co*¹⁶⁶ cases the amount was received after the business connection had ceased and therefore it was a gift in recognition of past services rendered to the client company over a long period and not income. Ironically the size of the payment (£10 000) and no business relationship existing at that time in *Scott* probably increased the likelihood that it would be found to be a gift. The amount was so much greater than Scott could have charged for services rendered that it had to be given ‘predominantly in recognition of personal qualities.’¹⁶⁷

In *Federal Coke Co*¹⁶⁸ the compensation payment was not a part of Federal Coke’s business or the carrying on of a revenue-producing activity. The wholly owned subsidiary company gave no consideration for the payment made for variation of a long-term supply contract and there was no business relationship between the parties. The receipt by a subsidiary was in consideration of the closure of the company’s coking works necessitated by the change of supply contract. The relevant income-producing activities and corresponding losses were those of the supplier, Bellambi. If the

¹⁵⁹ *Scott v FCT* [1967] ALR 561 at 567.

¹⁶⁰ *Walker v Carnaby Harrower, Barham & Pykett* (1969) 46 TC 561, [1970] 1 All ER 502.

¹⁶¹ *Scott v FCT* [1967] ALR 561.

¹⁶² *Walker v Carnaby Harrower, Barham & Pykett* [1970] 1 WLR 276.

¹⁶³ *Simpson (Inspector of Taxes) v John Reynolds & Co (Insurances) Ltd* [1975] 2 All ER 88.

¹⁶⁴ *Walker v Carnaby Harrower, Barham & Pykett* [1970] 1 WLR 276.

¹⁶⁵ *Scott v FCT* [1967] ALR 561.

¹⁶⁶ *Simpson (Inspector of Taxes) v John Reynolds & Co (Insurances) Ltd* [1975] 2 All ER 88.

¹⁶⁷ Parsons, above n 38, 62.

¹⁶⁸ *Federal Coke Co Pty Ltd v FCT* [1977] 34 FLR 375; 77 ATC 4255.

compensation had been paid to Bellambi itself, it would have been be treated as ordinary income in the course of carrying on the business.

The relationship between payer and recipient and the purpose of the payment determines the character of the receipt. The analysis shows that a gift is taxable when there is a causal nexus between the existence of a business relationship and the gift. A gift is taxable under s CB 1 of the Act if received in the ordinary course of the taxpayer's business or as an ordinary incident of the business.

4.3 Section CA 1 (2) services rendered

How important is the existence of services rendered in deciding whether a receipt is gross income? Under what circumstances will a receipt be found to be gross income under ordinary concepts even if no services have been rendered?

Section 15(2) ITAA 1997 provides for the inclusion in a taxpayer's assessable income of all allowances, gratuities, compensations, benefits, bonuses and premiums allowed, given or granted to the taxpayer which relate directly or indirectly to the taxpayer's employment or to services rendered by the taxpayer. The New Zealand ITA 2007 includes in income amounts received 'in connection with their employment or service',¹⁶⁹ which is fairly close to directly or indirectly services rendered.¹⁷⁰ However, in New Zealand the more likely approach to whether an amount is gross income is to consider the presence of services rendered as an indicator of gross income according to ordinary concepts. This distinction is not crucial because either way the presence of services rendered increases the likelihood of a receipt being found to be gross income. The decision in *Mudd v Collins*¹⁷¹ illustrates this principle. In *Mudd* the test established by the court is that if the receipt is in return for services rendered beyond the scope of the person's duties, it is monetary remuneration and becomes assessable to income tax.

It is not necessary for services to be rendered for a receipt to be gross income as long as other factors which indicate gross income according to ordinary concepts are strongly

¹⁶⁹ ITA 2007, s CE 1.

¹⁷⁰ *Reid v CIR* (1983) 6 NZTC 61 624, at 61 627–8 J Quilliam commented that a person may give service without necessarily being in employment. But his judgment was not final.

¹⁷¹ *Mudd v Collins (HM Inspector of Taxes)* (1925) 9 TC 297 at 300.

present. In *Dixon*¹⁷² and *Louisson*¹⁷³ the payments were periodic, were a means of support and were supplementing their army wages (which were clearly gross income). The payments were related to an income-earning process. In *Harris*¹⁷⁴ the taxpayer was not rendering any services to the bank in return for the supplement to his pension. Other factors which indicate gross income according to ordinary concepts were not strongly present. There was no real periodicity in the payments and Harris did not rely on the payments as a means of support. The receipt was a supplement to his pension, which clearly had the quality of gross income, but the presence of this factor was not enough to lead to a finding that the pension supplements were assessable. In *Hayes*¹⁷⁵ also no services were rendered to his former employer. Likewise in *Ball*¹⁷⁶ the payment was a mark of the personal success of the employee. In *Hochstrasser*¹⁷⁷ a reimbursement amount was paid to the taxpayer in his personal capacity as a home owner and was not gross income.

The courts have distinguished between payments which can be said to have been earned by the recipient and are taxable, and those payments which have been deserved and are not taxable.¹⁷⁸ A significant factor in determining whether a payment is related to the work or the conduct of the recipient is whether the gift was unexpected and unsolicited by its recipient. It would normally follow that if the receipt does not relate to any particular work of the recipient (ie unexpected and unsolicited) then it has been deserved but not earned.¹⁷⁹

In a number of cases, courts have considered the factor of whether the recipient has been properly paid for the services rendered. If it is found that the recipient has been properly paid for services rendered then the receipt is less likely to be gross income. In

¹⁷² *FCT v Dixon* (1952) 5 AITR 443.

¹⁷³ *Louisson v Commissioner of Taxes* [1942] GLR 477.

¹⁷⁴ *FCT v Harris* (1980) ATC 4238. Now supplements to annuities are statutory income under s 27H (1) (b) of ITAA 1936.

¹⁷⁵ *Hayes v FCT* (1956) 96 CLR 47.

¹⁷⁶ *Ball v Johnson* (1971) 47 TC 155.

¹⁷⁷ *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376.

¹⁷⁸ *Ball v Johnson* (1971) 47 TC 155.

¹⁷⁹ *Ball v Johnson* (1971) 47 TC 155; *Hayes v FCT* (1956) 96 CLR 47.

Hochstrasser v Mayes,¹⁸⁰ Mayes' salary was commensurate with others in work similar to his. However, the author believes that this is true in almost every case. The gifts were made because of the personal relationship that had developed and the way services were performed.¹⁸¹ A voluntary payment or gift that is not related in any way to personal exertion is not assessable. The work of the recipient is considered to be the activity upon which the tax is imposed but the conduct of the recipient is merely how the work is performed and is not the activity itself. In *McGowan v Brown and Cousins*¹⁸² taxpayers were inadequately remunerated for their services, therefore receipts from the new owners for those services were held as assessable.

Should the prizes received by a participant in quiz shows be assessed as gross income because services have been rendered? An employment relationship would not exist between the contestant and the quiz show company. Therefore, for the prizes to be assessed as income there would need to be strong factors indicating gross income according to ordinary concepts. A service rendered is one of these factors and if a reward is a consequence of the provision of a service it is income even if it is one off: *Brent v FCT*¹⁸³ and *FCT v Cooling*.¹⁸⁴ It is arguable that the contestant is rendering services to the quiz show company. The prize given in pursuance of a service should be income in general principles even if the reward is contingent upon successful performance.¹⁸⁵

In the case of Olympic champions, it would be unrealistic nowadays to view these people as anything other than professionals. Any receipts connected with the performance of their sport are in the nature of gross income according to ordinary concepts and thus would be assessable.¹⁸⁶ In *Stone*¹⁸⁷ the taxpayer, Ms Stone, agreed that sponsorship

¹⁸⁰ *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376.

¹⁸¹ *Ball v Johnson* (1971) 47 TC 155; *Moore v Griffiths* [1972] 3 All ER 399 at 411; *Walker v Carnaby Harrower, Barham & Pykett* [1970] 1 WLR 276; *Scott v FCT* [1967] ALR 561; *Simpson (Inspector of Taxes) v John Reynolds & Co (Insurances) Ltd* [1975] 2 All ER 88.

¹⁸² *McGowan (Inspector of Taxes) v Brown and Cousins* [1977] 3 All ER 844.

¹⁸³ *Brent v FCT* (1971) 125 CLR 418.

¹⁸⁴ *FCT v Cooling* (1990) 21 ATR 13 at 22 J Hill.

¹⁸⁵ *FCT v Holmes* (1995) 95 ATC 4476.

¹⁸⁶ This approach is supported by the New Zealand Inland Revenue Department's publication *The Rule Book* (IR248), which outlines the tax requirements for all sportspeople (professional or amateur) who derive income from their sport. In line with *Seymour v Reed*, however, sportspeople are advised to seek advice if they receive any amounts from testimonials or benefits, <<http://www.ird.govt.nz/forms-guides/keyword/individualincometax/ir248->

payments were assessable on the basis that the sponsorship amounts were rewards for services rendered. In *G v CIR*¹⁸⁸ the receipts were not the result of a personal relationship; they were for the services an evangelist was supplying.

4.4 Section CA 1 (2) periodicity, recurrence and regularity

How important is the existence of periodicity, recurrence and regularity¹⁸⁹ in deciding if a receipt is gross income according to ordinary concepts? Under what circumstances might it be found that even if receipts are regularly received, the receipts are not gross income?

While the existence of periodicity is often cited as a sign of the presence of income, as submitted by Lehman and Coleman, ‘the recurrent nature of a receipt, where it is not an annuity, is a weak indicia of its income nature’.¹⁹⁰ A payer may simply make a series of gifts to the recipient, ‘conferred out of affection or pity’.¹⁹¹ A mother for example may decide to give her son, a student, \$50 a week to help support him. The decision in *Louisson*¹⁹² illustrates this principle. The court held that the supplements to Louisson’s army wages were gifts given entirely voluntarily. A similar decision might have been reached in *Dixon*,¹⁹³ but the court went on to consider whether other elements which indicated gross income, including periodicity, recurrence and regularity, were also present. In *Moorhouse v Dooland*¹⁹⁴ the fact that the collections were repeated was *one* element in finding they were gross income. L J Jenkins, for example, said ‘the fact that the voluntary payment is of a periodic or recurrent character affords a further, but I

guide-the-rule-book.html>. *Commissioner of Taxation v Stone* (2005) 2005 HCA 21; 215 ALR 61 the judgment also clarifies the approach to testimonials, benefits or prizes given to sportspeople.

¹⁸⁷ *Commissioner of Taxation v Stone* (2005) 2005 HCA 21; 215 ALR 61.

¹⁸⁸ *G[raham] v CIR* [1961] NZLR 994.

¹⁸⁹ *Parry v CIR* (1984) 6 NZTC 61 820, at 61 824 J Tompkins stated that ‘regular’ involves recurring at uniform or near uniform intervals. He further said: ‘[t]he Court must ... consider the number of transactions and the intervals of time between each thereby assessing the degree of uniformity or consistency of occurrence. In the end it will have to determine as a matter of fact and degree whether the events that occurred demonstrate a regular pattern of such transactions.’

¹⁹⁰ Geoffrey Lehman and Cynthia Coleman *Taxation Law in Australia* (Australian Tax Practice, 5th ed, 1998) 115.

¹⁹¹ *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376 at 388.

¹⁹² *Louisson v Commissioner of Taxation* (No 2) [1942] GLR 477.

¹⁹³ *FCT v Dixon* (1952) 5 AITR 443.

¹⁹⁴ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284.

should say less cogent, ground ...'¹⁹⁵ for finding that it is assessable. The presence of periodicity in *Moorhouse v Dooland*¹⁹⁶ was an important distinction from *Seymour v Reed*¹⁹⁷. In the *Moorhouse* case, in distinguishing Mr Dooland's circumstances from those of Mr Seymour, Sir Raymond Evershed MR at the Court of Appeal emphasised that, except in the rarest circumstances, Mr Seymour would have only one benefit towards the end of his professional career, and that the sum subscribed was very large compared with his regular salary. The court held that these factors were not present in *Dooland* and that the collections paid to him were properly treated as taxable income. However, the judge has no objective test to determine what is a large and a small subscription amount in relation to the recipient's regular salary.

In *Moore v Griffith*¹⁹⁸ and *Scott*¹⁹⁹ lack of periodicity, recurrence and regularity in the payments led to finding that the receipts were not income. In *Reid*²⁰⁰ the presence of periodicity, recurrence and regularity contributed to finding that the student teacher allowance was assessable. In *Harris*,²⁰¹ C J Bowen said that '[t]he regularity and periodicity of the payment will be a relevant though generally not decisive consideration'.²⁰² In fact, the element of recurrence in *Harris*²⁰³ was somewhat contrived given that Harris only received a few lump sum annual payments. In *Blake*²⁰⁴ periodicity was much more strongly present because Blake received the cost of living supplements fortnightly along with his pension. In *G v CIR*²⁰⁵ and *Stone*²⁰⁶ the presence of periodicity, recurrence and regularity contributed to finding that the particular activities were business.

¹⁹⁵ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284 at 304.

¹⁹⁶ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284 at 304.

¹⁹⁷ *Seymour v Reed* [1927] AC 554.

¹⁹⁸ *Moore v Griffiths* [1972] 3 All ER 399.

¹⁹⁹ *Scott v FCT* [1967] ALR 561.

²⁰⁰ *Reid v CIR* (1985) 7 NZTC 5176.

²⁰¹ *FCT v Harris* (1980) ATC 4238.

²⁰² *FCT v Harris* (1980) ATC 4238

²⁰³ *FCT v Harris* (1980) ATC 4238.

²⁰⁴ *FCT v Blake* (1984) ATC 4238.

²⁰⁵ *G v CIR* [1961] NZLR 994.

²⁰⁶ *Commissioner of Taxation v Stone* (2005) 2005 HCA 21; 215 ALR 61; 222 CLR 289.

The general consensus from the cases is that periodicity is an indicator of gross income according to ordinary concepts but is not an essential or even a strong element. Certainly in *Harris*²⁰⁷ its (somewhat weak) presence did not lead to a finding that the supplementary pension paid to Harris was assessable. Other factors indicating gross income according to ordinary concepts must be present in force as in *Dixon*,²⁰⁸ *Reid*,²⁰⁹ *Louisson*,²¹⁰ *Blake*,²¹¹ *G v CIR*²¹² and *Stone*.²¹³

4.5 Section CA 1(2) expectation of reward

How important is the idea of ‘expectation of reward’ in deciding if an action can be characterised as ‘services rendered’? If a person performs an action unaware that another person intends to (or may) reward them for their action, can the action be characterised as ‘services rendered’?

Gifts are precarious in nature; their receipt is unexpected by the recipient. Since there is no legal obligation for the gifts to be made, they cannot be relied on with certainty. However, precarious income refers to earned income as opposed to unearned income²¹⁴ and then although they are unexpected and uncertain, they are not regarded as being earned either, although they are often deserved.

In *Laidler v Perry*,²¹⁵ in the context of a £10 gift voucher given to Dr Laidler as a Christmas gift by his employer, Lord Denning stated:²¹⁶

[S]uppose it had been £100 a year which had been given to all the staff ... at Christmas.

In that case it would clearly be open to the commissioners to find that it was a reward,

²⁰⁷ *FCT v Harris* (1980) ATC 4238.

²⁰⁸ *FCT v Dixon* (1952) 5 AITR 443.

²⁰⁹ *Reid v CIR* (1985) 7 NZTC 5176.

²¹⁰ *Louisson v Commissioner of Taxation* (No 2) [1942] GLR 477.

²¹¹ *FCT v Blake* (1984) ATC 4238. It is ironic that if it is shown that a taxpayer relies on a receipt as a means of

support it is more likely to be found to be income. This was certainly the situation in *Blake* and *Dixon*.

²¹² *G v CIR* [1961] NZLR 994.

²¹³ *Commissioner of Taxation v Stone* (2005) 2005 HCA 21; 215 ALR 61; 222 CLR 289. Now in New Zealand

under s CF 1(1) of the Act and in Australia under s 27 H of ITAA 1936, a payment made to a taxpayer to supplement a superannuation pension is included in assessable income.

²¹⁴ Kevin Holmes *The Concept of Income: A Multi-Disciplinary Analysis* (IBFD Publications BV, 2001) 218.

²¹⁵ *Laidler v Perry* [1965] Ch 192 (CA).

²¹⁶ *Laidler v Perry* [1965] Ch 192 (CA) at 199.

remuneration or a return for services rendered. But now suppose that, instead of £100 it was a box of chocolates or a bottle of whisky or £2, it might be merely a gesture of goodwill at Christmas without regard to services at all. So it is a question of degree. It seems to me that in this case when one finds that £10 a year was paid to each of the staff year after year, each of them must have come *to expect* the £10 as a regular payment, which went with their services. It was, I think, open to the commissioners to find that it was made in return for services. It is, therefore, taxable in the hands of the recipient.

The idea of expectation of reward as an indicator of assessable income is discussed in *Moore v Griffiths*.²¹⁷ J Brightman listed the factors which led him to the conclusion that the prize money received by Moore was not assessable. Included in this list was the fact that ‘There was no expectation of reward. The taxpayer was totally unaware of the prospect of the payment prior to the services which he performed. The terms of his contract with his club did not contemplate that gratuitous payments of that or any type would be made.’²¹⁸ In *Case VI35*²¹⁹ the taxpayer was aware of fellowship being awarded but no services were rendered for the fellowship. It was given on personal grounds. In *Ball*,²²⁰ the taxpayer was unaware of any reward. Kelly in *Kelly v FCT*²²¹ on the other hand did know of the existence of the award he eventually won and this knowledge counted against him. Similarly in *FCT v Dixon*,²²² *Louisson*²²³ and *Reid*²²⁴ the taxpayers were aware of the receipts and these receipts were relied upon as a means of support. In *G v CIR*,²²⁵ after every assembly Mr G expected substantial gifts or donations that he then used to live on. The donations were associated with some income-earning process and were earned income.

²¹⁷ *Moore v Griffiths* [1972] 3 All ER 399.

²¹⁸ *Moore v Griffiths* [1972] 3 All ER 399 at 411.

²¹⁹ *Case VI35* (1988) 88 ATC 855.

²²⁰ *Ball v Johnson* (1971) 47 TC 155.

²²¹ *Kelly v FCT* (1985) ATC 4283.

²²² *FCT v Dixon* (1952) 5 AITR 443.

²²³ *Louisson v Commissioner of Taxation* (No 2) [1942] GLR 477.

²²⁴ *Reid v CIR* (1985) 7 NZTC 5176.

²²⁵ *G v CIR* [1961] NZLR 994.

In *Scott*²²⁶ the taxpayer, a solicitor, was unaware that his client, Mrs Freestone, had any intention of giving him a gift over and above the amounts he charged her for his professional services. This factor helped the court to decide that the gift was not assessable. Similarly in the *Walker v Carnaby Harrower Barham & Pykett*²²⁷ and *Simpson v John Reynolds & Co*²²⁸ cases the gift was unexpected, and therefore held as not being assessable. In *McGowan v Brown and Cousins*,²²⁹ since the taxpayers were inadequately remunerated the gift was expected by them, and they were not surprised to receive it. The taxpayers considered that while they had no legal right to the payment, they were morally entitled to it, and therefore it was held to be assessable income.

In conclusion, if a taxpayer acts without expectation of reward this will be a strong factor in finding that a receipt is not gross income. The reward will be received without profit-making purpose or intention and the taxpayer is not relying on it to support them and their dependants. Such payments are not earned but arise spontaneously and are made as a mark of personal esteem and a testimonial.

4.6 Section CA 1 (2) intention of the donor and donee

How important is the intention of the donor in deciding if a receipt is gross income?

In some of the cases the donors clearly intended the payments to be gifts. In *Blakiston v Cooper*,²³⁰ for example, the bishop requested that the parishioners make personal, non-official freewill gifts to the clergy and no doubt the parishioners thought they were making gifts. We can assume in the two ‘cricket’ cases that the fans intended that their donations to Seymour and Dooland were gifts for excellent play. In *Ball*,²³¹ *Case VI35*,²³² *Scott*²³³ and *Hayes*²³⁴ the intention of the donors was quite clearly that the

²²⁶ *Scott v FCT* [1967] ALR 561.

²²⁷ *Walker v Carnaby Harrower, Barham & Pykett* [1970] 1 WLR 276.

²²⁸ *Simpson (Inspector of Taxes) v John Reynolds & Co (Insurances) Ltd* [1975] 2 All ER 88.

²²⁹ *McGowan (Inspector of Taxes) v Brown and Cousins* [1977] 3 All ER 844.

²³⁰ *Blakiston v Cooper (Surveyor of Taxes)* [1909] AC 104.

²³¹ *Ball v Johnson* (1971) 47 TC 155.

²³² *Case VI35* (1988) 88 ATC 855.

²³³ *Scott v FCT* [1967] ALR 561.

²³⁴ *Hayes v FCT* (1956) 96 CLR 47.

payments were personal gifts. In *Federal Coke Co*²³⁵ the intention of the donor was to compensate the taxpayer for the closure of the coking works. In *McGowan v Brown and Cousins*²³⁶ the intention of the donor was to compensate the taxpayer for underpayment for the work done and therefore is held as assessable. On the other hand, in *Hochstrasser*²³⁷ and in *Shell*,²³⁸ the donors intended that the payments they made to employees to compensate them for the costs of moving were reimbursements. However, in *Hochstrasser v Mayes*²³⁹ the receipt was found not assessable because there was evidence that it was not a reward for services rendered. The source of payment was the housing agreement, but actually it had no purpose other than to advance the interests of the employer.

In other cases the donors appear to be motivated by different forces. For example, in *Dixon's case*²⁴⁰ the donor was probably motivated by patriotism. In *Harris*²⁴¹ the motivation appears to be a paternalistic desire to assist former employees against the effects of inflation. It was also suggested in *Harris* that the ex gratia inflation increases would be a 'good look' to present employees. In the *Walker v Carnaby Harrower Barham & Pykett*²⁴² and *Simpson v John Reynolds & Co*²⁴³ cases the gift was made as a consolation for the fact the services will no longer be performed by the taxpayer for the donor. In *Reid*²⁴⁴ the motive was clearly that the payment to Mr Reid was for his day to day living expenses. It is submitted that, while the motives of the donors in the cases are diverse and frequently not articulated, there is no discernible relationship between these motives and the decisions reached by the courts as to the assessability of the payments.

²³⁵ *Federal Coke Co Pty Ltd v FCT* [1977] 34 FLR 375; 77 ATC 4255.

²³⁶ *McGowan (Inspector of Taxes) v Brown and Cousins* [1977] 3 AII ER 844.

²³⁷ *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376.

²³⁸ *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11 303.

²³⁹ *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376.

²⁴⁰ *FCT v Dixon* (1952) 5 AITR 443.

²⁴¹ *FCT v Harris* (1980) ATC 4238.

²⁴² *Walker v Carnaby Harrower, Barham & Pykett* [1970] 1 WLR 276.

²⁴³ *Simpson (Inspector of Taxes) v John Reynolds & Co (Insurances) Ltd* [1975] 2 AII ER 88.

²⁴⁴ *Reid v CIR* (1985) 7 NZTC 5176.

The motive of the recipient is also not significant. In *G v CIR*²⁴⁵ the motive of Mr G was preaching and was not profit making, but receipts were held as business income. It is the character of the receipt in the recipient's hands that is significant; the motive of the donor is only significant so far as it bears, if at all on that character.²⁴⁶ In *Reid*, J Richardson stated:²⁴⁷ 'It is accepted ... that the question as to the true character of the payment should be ascertained and judged in relation to the recipient rather than to the payer.' In *Californian Copper Syndicate*²⁴⁸ the taxpayer entered into the transaction with a profit-making purpose or intention, therefore it was deemed a trading venture. In *Squatting Investment Co*²⁴⁹ the receipt was a part of their income-earning process and hence was a trade receipt. In *Dixon*,²⁵⁰ *Louisson*,²⁵¹ *Reid*,²⁵² *Moorhouse*,²⁵³ *Blakiston*,²⁵⁴ *G*²⁵⁵ and *Stone*²⁵⁶ the donees received payments with a profit-making purpose or intent, in anticipation that they will be the means to support them and their dependants. It was this anticipation that gave the receipts the character of income.

4.7 A matrix summarising the conceptual framework

Factor	Assessable? ML = more likely LL = less likely N = neutral	Cases that support the decision in column 2	Cases that refute the decision in column 2
<i>Direct employment relationship</i>	ML	<i>Smith, Shell Naismith, Clayton Mudd, Wright</i>	<i>H v Mayes</i> — even though Mayes was an employee the receipt was found to

²⁴⁵ *G v CIR* [1961] NZLR 994.

²⁴⁶ *Murray v Goodhews* [1978] 2 All ER 40 at 46 per L J Buckley.

²⁴⁷ *Reid v CIR* (1985) 7 NZTC 5176 at 5184.

²⁴⁸ *Californian Copper Syndicate v Harris* (1904) 5 TC 159.

²⁴⁹ *FCT v Squatting Investment Co Ltd* (1954) 88 CLR 413.

²⁵⁰ *FCT v Dixon* (1952) 5 AITR 443.

²⁵¹ *Louisson v Commissioner of Taxation* (No 2) [1942] GLR 477.

²⁵² *Reid v CIR* (1985) 7 NZTC 5176.

²⁵³ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284.

²⁵⁴ *Blakiston v Cooper (Surveyor of Taxes)* [1909] AC 104.

²⁵⁵ *G v CIR* [1961] NZLR 994.

²⁵⁶ *Commissioner of Taxation v Stone* (2005) 2005 HCA 21; 215 ALR 61; 222 CLR 289.

			be not assessable
Indirect employment relationship	LL — but each case must be determined on its merits	<i>Seymour, Dixon, Harris Hayes, Louisson</i>	<i>Blakiston, Dooland Kelly, Blake</i>
Direct business relationship	ML	<i>Californian Copper, Squatting Investment, Brown and Cousins, Stone</i>	<i>Walker, John Reynolds, Federal Coke, Scott</i>
Systematic scheme — payment to all people of same class	ML — but only just	<i>Blakiston, Dixon, Smith, Dooland, Blake, Wright Laider</i>	<i>Seymour, Harris Moore, Blake</i>
Personal one-off payment	LL	<i>Scott, Hayes, Seymour</i>	<i>Kelly</i>
Voluntary payment	LL	<i>Ball, Harris, Hayes, Federal Coke, John Reynolds, Walker v Carnaby, Scott, Moore</i>	<i>Kelly, Mudd, Brown and Cousins, G v CIR, Dooland</i>
Relied on as a means of support	ML	<i>Dixon, Harris, Blake Reid, G v CIR</i>	<i>Louisson</i>
Presence of services rendered	ML	<i>H v Mayes, Harris, Scott, Walker v Carnaby, John Reynolds, Hayes, Case VI35, Ball, Louisson — in these cases no services were shown to be rendered, therefore not assessable</i>	<i>Smith, Dixon — no services were rendered but still found to be assessable</i>
Periodicity	ML — but a weak indicium	<i>Dixon, Reid, Dooland Blakiston, G v CIR, Blake, Reid</i>	<i>Louisson, Harris — periodicity was present but not assessable</i>
Payee has an expectation of reward	ML	<i>Dixon, Dooland, Moore, Kelly, Smith, Blake, Reid, Brown and Cousins, Stone, G v CIR</i>	
Same quality as other receipts which are gross	ML	<i>Dixon, Brown and Cousins, Blake, Reid, G v CIR, Californian</i>	<i>Harris, Ball, Seymour</i>

income		<i>Copper, Squatting Investment</i>	
Intention of donor and donee that the receipt is not gross income	Neutral — not a very relevant factor		

4.8 Results and discussion

In *Dixon, Louisson, Reid, Blake, Moore, Ball, Hayes, Case VI35, Harris* and *Hochstrasser* payments were neither made to the recipient as an employee nor were they related to the recipient's employment and thus were held not to be assessable under s CE 1. However receipts by *Dixon, Reid, Blake* would have been found taxable under equivalent sections of earlier versions of the ITA, under s CA 1 (2). In *Louisson* the New Zealand court did not consider s CA 1(2) of the Act. Like the Australian case *FCT v Dixon, Louisson* has somewhat similar facts, if the New Zealand court would have considered s CA 1(2) of the Act, then extra pay would have been *income*. The presence of periodicity, recurrence and regularity was considered in *Moorhouse* and *Blakiston* but was not decisive. In *Ball, Hayes, Case VI35, Seymour* and *Moore*, payments were made based upon the personal attributes of the recipients and not their employment statuses. The payments were not regular and or periodic. There was no expectation of reward and they were not derived in circumstances which gave them an income character under s CA 1(2). In *Harris* there was no contractual entitlement. The circumstances were exceptional, and unexpected. No regularity or periodicity existed and Harris was not depending on the payments to support himself and his dependants. Therefore the payment did not have an income character under s CA 1(2). In *Shell*,²⁵⁷ the New Zealand Court of Appeal did not follow *Hochstrasser*²⁵⁸ and held that the payment was related to the recipient's employment under the then equivalent of s CE 1 of the Act.

In *Scott, Carnaby Harrower, John Reynolds & Co* and *Federal Coke Co* payments were not related to services provided or the recipient's business activity and thus were not held assessable under s CB 1. The payments were made based upon the personal attributes of the recipient or to compensate them for change of supply contract. Since

²⁵⁷ *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11 303.

²⁵⁸ *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376.

there was no profit-making purpose or intent, no services were provided, payments were not regular or periodic, and there was no expectation of reward. They were not derived in circumstances which gave them an income character under s CA 1(2).

In the cases where gifts received by the taxpayers were held assessable under s CE 1, something has come in,²⁵⁹ has been received with a profit-making purpose or intent, in anticipation that they will be the means to support the recipient and their dependants, the payments were made by the donor for services rendered by the recipient and there was an expectation of reward to catch those receipts under s CA 1 (2). In *Shell, Naismith, Smith, Clayton, Mudd* the payments being instalments of a fixed sum were not periodical or recurrent. However, the general consensus from the cases is that periodicity is only an indicator of gross income according to ordinary concepts but is not an essential or even a strong element.²⁶⁰

In the cases, where gifts received by the taxpayers were held assessable under s CB 1, the payments came in, were received with a profit-making purpose or intent (a trade venture), in anticipation that they will be the means to support recipient, the payments were made by the donor for services rendered or goods supplied by the recipient, and there was an expectation of reward. These factors also capture these receipts under s CA 1(2).

This analysis shows that the receipts which were assessed under s CE 1 and s CB 1 will also have a character of income according to the ordinary meaning of the word income under s CA 1(2). It is submitted that there is support from several important conclusions for the first proposition. This result appears to be consistent with the relationship between s CA 1(2) and specific provisions s CE 1 and s CB 1 defining income. The default rule is that the various characteristics of income under s CA 1(2) apply to all kinds of income. However in practice, since under s CA 1(1) specific categories of income include employment income (s CE 1) and business income (s CB 1) if a receipt (according to its ordinary meaning) is not captured as income as a result of an

²⁵⁹ A payment in money, or a non-cash benefit, that is convertible into money. *Tennant v Smith* [1892] AC 150.

²⁶⁰ *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 Ch 284 at 304 ; *FCT v Harris* (1980) ATC 4238 at 4240. *FCT v The Myer Emporium Ltd* 87 ATC 4363 at 4366–67 — one-off payments received with a profit-making purpose or intention may be income.

employment relationship and business activity, usually the courts will explore the possibility that the receipt may be gross income according to ordinary concepts. In *Reid J Richardson* said:²⁶¹ ‘To come within the residual paragraph of s 65(2) [equivalent to s CA 1(2) of the Act] the payments received must be income according to ordinary concepts and be derived from a source not otherwise covered in the earlier paragraphs of the subsection.’²⁶² John Prebble²⁶³ suggested that there are gaps in the formal coverage of an income tax statute and that the statute needs a general, substance-over-form rule to protect the tax base. The manner in which s CA 1(1) and s CA 1(2) have been drafted suggests that when considering different sources of income, the drafters have given examples of income under s CA 1(1) and at the end they thought no omissions existed, so to cover any other income they inserted s CA 1(2) stating that amounts can be income according to ordinary concepts.

5 Conclusion

As tax law does not follow the economic definition, it draws a distinction between income and gains.²⁶⁴ While the economist recognises all accretions to economic or spending power as income, tax law does not. The default rule in New Zealand is that gifts are not taxable in the hands of the recipient notwithstanding they represent a gain to that person.²⁶⁵ However, gains that are income are specifically taxable under s CA 1(1) which includes s CB 1 and s CE1 and s CA 1(2) of the Act.²⁶⁶ Many types of capital gains, which prima facie are not taxable, are being drawn into the tax base by virtue of particular legislative provisions.²⁶⁷ Nevertheless, the existence of the capital/revenue distinction in the Act is perhaps the most striking difference between the legal and economic concepts of income.

²⁶¹ *Reid v CIR* (1985) 7 NZTC 5176 at 5182.

²⁶² Earlier paragraphs of the subsection included employment income and other specific provisions.

²⁶³ Prebble, ‘above n 75, at 2 John Prebble stated: ‘Tax law’s concept of income is not the fact of income itself but a legal simulacrum of income.’

²⁶⁴ W Chan, ‘Income – A subjective Concept’ (2001) 7:1 *New Zealand Journal of Taxation Law and Policy* 26.

²⁶⁵ *Ibid.*

²⁶⁶ Sections CB 3 to CB 5 (sales from personal property) are not covered in this paper.

²⁶⁷ Sections CB 6 to CB 23 of ITA 2007 contain a series of provisions to tax land sales.

In an economic sense, the judicial criteria designed to distinguish gifts from payments for personal exertion are artificial. Under the economic concept of income, receipts constitute an increase in wealth regardless of their label, their source and the circumstances (ordinary or exceptional) under which they are given. Recurrence and expectation criteria reflect deviations from the economic concept of income.²⁶⁸ There are a number of rules in income tax law that relate to the definition of income that exist only for the purposes of income tax law. They do not reflect any other economic reality and have no other purpose.

Professor Ross Parsons²⁶⁹ further notes that a ticket received as a payment for services may be income, whereas a prize won by the ticket is something else. Under this thinking the winnings merely constitute the convertibility of income already derived into another form. There is no real dispute between economists and lawyers that gains which are a reward for personal exertion, from employment or from the rendering of services, will be income.²⁷⁰

The courts strive to maintain a balance between the revenue authority and the taxpayer as impartial interpreters of the Legislature's intention. In each of the cases covered in this paper, the courts have had to identify elements which could indicate gross income and then decide whether the combined force of those elements is sufficient to say that a receipt is assessable. In many cases a unanimous decision has not been reached, which indicates a significant level of subjectivity. The facts in *Shell New Zealand*²⁷¹ were somewhat similar to *Hochstrasser*,²⁷² but the court came to a different decision finding that the reimbursement of moving costs was assessable in *Shell New Zealand*.²⁷³ If the gift is no more than an independent voluntary gift made on purely personal grounds, the payment or gift will not be assessable, regardless of the relationship between the donor

²⁶⁸ C C Plehn, 'The Concept of Income, as Recurrent, Consumable Receipts' (1924) 14 *The American Economic Review* March 1 at 9.

²⁶⁹ Parsons, above n 38, 68, proposition 9 [2.160].

²⁷⁰ Ibid proposition 13 [2.367].

²⁷¹ *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11 303.

²⁷² *Hochstrasser v Mayes (Inspector of Taxes)* [1960] AC 376.

²⁷³ *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11 303.

and the taxpayer.²⁷⁴ Each case is very much decided on a close reading of the facts.²⁷⁵ In the ‘business receipts’ context, the judges attempt to distinguish between receipts from a taxpayer’s ordinary business operations and capital gains from investments.

The Legislature, it is submitted, recognised the limitations of the sections which specifically make income from personal exertion assessable. To prevent the erosion of the tax base and to overcome the deficiency in the legislation in making income from employment or services assessable, the *New Zealand Income Tax Act* had been amended from time to time.²⁷⁶ Certainly the definition of employment income in the Act is broad enough to capture most disputatious receipts.²⁷⁷

The effect of the other change in the Act is to remove a direct reference to ‘emoluments’ which existed up until and including the 2004 Act. However, the author suspects that rather than being an attempt to change the law, the change in the Act was intended to simplify the language of the source rules while retaining the core concepts. The cross-reference to section CE 1 picks up concepts like allowance, bonus, extra pay and gratuity, and perhaps it is considered these are wide enough to cover emolument. The rewrite process review shows that in the future, while dealing with emoluments payments, the courts will consider that the term ‘extra pay’ is essentially synonymous with the term ‘emolument’. It also explains why the drafters of the Act thought it was unnecessary in s YD 4(4) to specify an emolument. If emoluments are received in respect of or in relation to employment or being an employee they will be taxable under s CE 1

²⁷⁴ *Tax Information Bulletin* ‘Cash Gifts Received by Voluntary Workers’ (1992) 14:5 at 42. Unconditional donations are non-assessable gifts as per *Tax Information Bulletin* ‘Distributions Made with Conditions Attached’ (1991) 3:1 at 30.

²⁷⁵ Dooland, eg, was described by U Birkett as ‘a very fine cricketer’, *Moorhouse (Inspector of Taxes)* v *Dooland* [1955] Ch 284, 308; and all the judges in this case expressed regret at having to find the collections to be gross income. J Brightman in *Moore v Griffiths* [1972] 3 All ER 399 began his judgment (at 403) with the comment: ‘In 1966 England won the World Cup for the first, but not, one hopes, the last time.’

²⁷⁶ The *New Zealand Income Tax Act 1994* (NZ) was amended in 2001 to include restrictive covenants and exit inducements paid to employees or contractor as assessable income. Section CHA 1 and s CHA 2 were inserted in the *Income Tax ACT 1994* with application to amounts derived on or after 27 March 2001. Section CHA 1 and s CHA 2 are equivalent to s CE 9 and s CE 10 of the *Income Tax Act 2007*. The payments to persuade staff to join (known colloquially as golden hellos) or to encourage bright staff to stay (golden handcuffs) are part of employment income and are assessable income as per *Public Information Bulletin*, 171, March 1988 as well.

²⁷⁷ Section CF 1(1) of the Act now provides that if the pension is payable regardless of whether the death or disability is attributable to service in one of the specified forces, and is in the nature of a normal service pension, it remains assessable income. This means that in a case similar to *FCT v Harris* (1980) ATC 4238 the pension supplements now will be assessable.

or s CA 1(2) of the Act (which acts as a catch-all provision) as income according to ordinary concepts.

The new legislation does little to remove the difficulties expressed by earlier cases. The analysis from several important decisions also shows that there is support for the first proposition that the receipts which were assessed under s CE 1 and s CB 1 will also have a character of income under s CA 1(2) of the Act, which supplements specific provisions of the Act defining income. Sections CA 1(1) and CA 1(2) are not mutually exclusive and the author believes they were never intended to be. Section CA 1(2) is there to cover any omissions and capture any forms of income which should be caught but are not included in the lists under Part C. Income according to ordinary concepts (section CA 1(2)) acts as an umbrella provision and includes employment income (s CE 1) and business income (s CB 1). Section 5(1) *Interpretation Act 1999* states that the statute meaning must be ascertained 'in the light of its purpose'. In *Commissioner of Inland Revenue v Alcan*,²⁷⁸ which deals with the approach of the New Zealand Court of Appeal to statutory interpretation, J McKay referred to purposive interpretation. In that case J McKay noted that where words can have more than one meaning and the object of the legislation is clear, in order to ensure the attainment of the object of the Act the words are to be given fair, large and liberal construction. The manner in which legislation has been drafted shows that if there is no better reason to give a technical meaning to a particular receipt then we start off with the ordinary meaning of the word. Hence for receipts from personal exertion we tend first to look at the specific provisions under s CE 1 and s CB 1 and only look later to see if a particular receipt comes within the ordinary meaning if it is not listed separately.

Therefore, the author believes New Zealand needs a conceptually sound Income Tax Legislation. The statutory concept of income creates artificial distinctions about the nature of receipts and is based on judicial interpretation and the presence of selective criteria for a receipt or gain to be treated as income. The judicial concept of income is not compatible with the statutory and economic concept of income. Often being subjective, judicial opinion inevitably varies, which undermines the objective of simplicity,

²⁷⁸ *CIR v Alcan NZ Ltd* [1994] 3 NZLR 4739.

accuracy, tax base protection, and certainty in taxation. These factors should be taken into account and analysed carefully when tax changes or tax reforms are proposed that aim at improving the efficiency, adequacy and equity of the tax system. Kevin Holmes states: 'Unfortunately legislative reforms that have been designed to enlarge the legal concept of income have been piecemeal. Selected real economic gains have been grafted onto the traditional legal interpretation of income.'²⁷⁹

The author hopes that the current paper will heighten the government's awareness of these issues and will encourage further policy analysis of the difficulties in defining income. In the author's view, it is fair to conclude that for a neutral tax base the government should focus on the need for reform by enacting legislation that embodies a provision specifically identifying income based on coherent income tax policy principles or objectives. In the author's opinion a definition of income should be enacted which provides that a receipt is income where the intention of the donor or payer is that it is a reward which is (i) a consequence of the provision of a service or an incident of activity (even if it is one off), (ii) contingent upon successful performance, (iii) relied on as a means of support and (iv) has the same quality as other receipts which are income. Such an approach would make it easier to see the dividing line between mere gifts and income. The author believes that it would achieve greater neutrality, coherence and theoretical robustness in the tax system, and Income Tax Legislation would be conceptually more sound and rational. A sustainable tax base would make the tax system simpler and fairer for individuals and businesses and thereby reduce taxpayer compliance costs.

²⁷⁹ K Holmes *The Concept of Income - A Multi-Disciplinary Analysis*, IBFD Publications BV, The Netherlands, 2001 573.

Proposals for Assessment in Tax Teaching

Audrey Sharp^{*}

Kalmen Datt^{**}

1 Purpose of article

This article compares the assessment methods used by Atax, a school in the Faculty of Law, UNSW (Atax), and the Commercial Law Department in the Faculty of Business at the University of Auckland (University of Auckland) for undergraduate students. It utilises the main attributes of the methodologies used in each program to offer improved methods of assessment.²⁸⁰ This proposal is reviewed against the backdrop of the literature to ensure it meets best practice.

The article expresses a view that assessment methods used in the teaching of taxation law²⁸¹ need to achieve two goals: student abilities to think critically, solve problems and to be technically competent must be evaluated; and the methods implemented must meet the needs of educators who may themselves be balancing both research and teaching in a subject area that is constantly changing.

2 Introduction

A primary purpose of an educational institution is to equip students with the necessary knowledge and skills they will require for professional practice. This is particularly true in the teaching of taxation law.²⁸² Students must be able to think as a member of the profession. They must know how to resolve problems. This means they must undertake high-quality research, decide the questions to ask and have the ability to communicate both orally and in writing in a discipline based context.

To equip students for working life it is essential that we instil a culture of learning and make our students information literate.²⁸³ It is essential that they are able to think laterally and operate in

* University of Auckland.

** Atax, University of New South Wales.

²⁸⁰ Note that Atax teaches tax primarily in a flexible distance mode whereas the University of Auckland teaches on a face-to-face basis.

²⁸¹ Taxation law is not a stand-alone subject but encompasses knowledge and skills in economics, property law, contract, psychology and a range of other subjects which in themselves are specialities.

²⁸² In addition to the skills and knowledge referred to in this article, studying taxation law requires students to know how to find and apply technical taxation information, to be able to read and interpret case law and to understand how to use this information practically in order to complete taxation returns for the Australian Tax Office (ATO), the New Zealand Inland Revenue Department or, due to globalisation, within other jurisdictions.

²⁸³ Information literacy has been defined by the Canberra-based Council of Australian University Librarians, in their 2001 publication *Information Literacy Standards*, as

the real world. In seeking to achieve these goals Atax and the University of Auckland strive to provide a basis for students to become critical thinkers, to enable them to continue their learning and understanding and maintain their excitement for their discipline for the rest of their lives.

As a benchmark for the effectiveness of their teaching and learning methods, Atax and the University of Auckland must ensure that the corporate and professional world looks to their graduates as employees of choice. Assessment forms an important tool in achieving this goal.

‘To assess’ derives from the Latin verb ‘assidere’, *to sit by* (originally, as an assistant-judge in the context of taxes). Hence, in ‘assessment of learning’ we *‘sit with the learner’*, and that implies it is something we *do with and for* our students rather than *to* them. The word ‘assessment’ has a variety of meanings within higher education (e.g., ‘institutional assessment’, ‘curricular and program assessment’, ‘course and learner-centered assessment’). For the purposes of this paper ‘assessment’ is the systematic collection and analysis of information to determine student performance in a university taxation course with a view to achieving optimal learning objectives on the part of the students themselves.

Assessment is an important tool in the teaching and learning process. The means of assessment determines not only whether a student passes or fails a particular course, but also whether there has been effective learning. As part of the assessment process teachers should make it clear that they have both high expectations of and a belief in the ability and skills of their students. Ken Bain identifies high expectations by teachers of their students as very important.²⁸⁴ These high expectations need to be reinforced by positive and constructive feedback. Inextricably linked to this is the need to overcome inhibitions evident in some students. For example, Bain²⁸⁵ states that certain students have been brought up to believe that certain tasks are beyond their abilities. Teachers can help these students by expressing clear expectations and demonstrating trust in the students that the expectations can and will be met, as well as providing positive and constructive feedback.²⁸⁶

follows: ‘Information literacy is an understanding and set of abilities enabling individuals to “recognise when information is needed and have the capacity to locate, evaluate, and use effectively the needed information”.’ Incorporating information literacy across curricula, and in all programs and services, requires the collaborative efforts of academics, staff developers and learning advisers.

²⁸⁴ Ken Bain, *What the Best College Teachers Do* (Harvard University Press, 2004) Chapter 4. Cate Jerram, ‘Applying Adult Education Principles to University Teaching’ (Paper presented to the Higher Education Research and Development Society of Australasia Annual International Conference, 7–10 July 2002, Perth, Australia), reflects a similar point of view.

²⁸⁵ Bain, above n 5.

²⁸⁶ In ‘Decoding the Disciplines: A Model for Helping Students Learn Disciplinary Ways of Thinking’ (2004) 98 *New Directions for Teaching and Learning* 1, Joan Middendorf and David Pace express a similar view: ‘Students often respond positively to instructors who are clearly dedicated to creating a level playing field on which students who have

Assessment methods reflect underlying assumptions such as the nature of learning, what the assessment is endeavouring to achieve and whether there are barriers to student learning. If teachers of taxation law are to equip their students with the attributes necessary for professional practice, to become critical thinkers and problem solvers as part of their lifelong learning, then it is important to examine the assessment methods used. In the authors' opinion teaching, learning and assessment are inextricably linked, with assessment being a very significant motivator in any student's learning process.²⁸⁷ The reason for this view is that what is taught, the expectations of the teacher and how these expectations are conveyed to students, and the manner of teaching must all correlate to what students learn. The literature reflects this link.²⁸⁸ Assessment, whatever form it takes, is the means by which a teacher is able to determine how the student has progressed not only in understanding concepts and principles and developing research and communication skills, but also in the ability of students to apply these in real-world situations.

Atax and the University of Auckland strive to provide a basis for students to become critical thinkers, to enable them to continue their learning and understanding and maintain their excitement for their discipline for the rest of their lives. Critical thinking is one of the most important fundamental tools that students of tax must acquire.²⁸⁹

The article now turns to a review of the literature.

3 Assessment of learning in higher education

Huba and Freed²⁹⁰ suggest assessment is the process of gathering and discussing information from multiple and diverse sources in order to develop a deep understanding of what students know, understand and can do with their knowledge as a result of their educational experiences. The process culminates when assessment results are used to improve subsequent learning.

Boud et al²⁹¹ believe assessment practices need to be matched to outcomes. They noted:

Assessment needs not only to reflect outcomes in a narrow technical sense, but in terms of the basic knowledge, understanding, communicative and competency aims which are being pursued

not been preeducated at elite institutions will have the same opportunity to succeed as those who have been more privileged.'

²⁸⁷ See, eg, Dr D J Hargreaves, 'Engendering Student Learning by Use of Specific Assessment Strategies' (Paper presented at the TEDI Conference, nd), <http://www.tedi.uq.edu.au/conferences/A_conf/papers/Hargreaves.html>.

²⁸⁸ See section 3 of this article where the thinking around assessment of learning in higher education is presented.

²⁸⁹ This skill is not exclusive to tax practitioners.

²⁹⁰ M E Huba and J E Freed, *Learner-Centered Assessment on College Campuses — Shifting the Focus from Teaching to Learning* (Allyn & Bacon, 2000).

²⁹¹ David Boud, Ruth Cohen and Jane Sampson, 'Peer Learning and Assessment' 24(4) *Assessment and Evaluation in Higher Education* 413–26, 420.

in a course ... assessment in higher education has a dual function of judging for the purpose of providing credentials and for the purpose of improving learning ... assessment should leave students better equipped to engage in their own self-assessments. Unless assessment fosters this, it acts to undermine an important goal of lifelong learning.²⁹²

Assessment has many purposes. It is about reporting on students' achievements and teaching them more productively through expressing to them more clearly the goals of our curricula. It is about measuring student learning and diagnosing misunderstandings in order to help students to learn more effectively. It concerns the quality of the teaching as well as the quality of the learning.²⁹³ Assessment is central to the learning process and is a crucial aspect of teaching.

Ramsden²⁹⁴ identifies the link between different ways of thinking about assessment and the quality of student learning. He notes that the conventional view of assessment is seen primarily as a way of assigning grades, which develops in students cynicism and negativity towards the subject matter and superficial approaches to studying. He advocates that teachers should choose assessment methods that are based on goals for student learning where students can demonstrate how much they understand rather than achieving a single score for comparative purposes.²⁹⁵

Hargreaves and Wallis²⁹⁶ found that current assessment practices indicate to students that their success depends not on 'how well' they have learned but rather 'how much'; that is, the development of quantitative rather than qualitative concepts of learning is encouraged. Naturally this can lead to surface rather than deep learning approaches depending upon what has been learnt.²⁹⁷

²⁹² Ibid.

²⁹³ P Ramsden, *Learning to Teach in Higher Education* (RoutledgeFalmer, 2nd ed, 2003).

²⁹⁴ Ibid.

²⁹⁵ Theoretically this is correct, but in the authors' experience when students seek employment the first thing they are usually asked by a prospective employer is what grade they achieved in their course. This practical consideration is hard to reconcile with Ramsden's position on assessment.

²⁹⁶ D J Hargreaves and E J Wallis, 'How Students Learn and Why They Adopt Certain Learning Approaches', in *Proceedings of the 6th Australasian Association for Engineering Education Conference* (Sydney, 1993) 131–5.

²⁹⁷ John Biggs, 'What the Student Does: Teaching for Enhanced Learning' (1999) 18(1) *Higher Education Research and Development* 57–75. Biggs distinguishes between surface and deep learning by giving the following examples. The first is Susan who comes to the lecture with relevant background knowledge and a question she wants answered. In the lecture, she finds an answer to that question; it forms the keystone for a particular arch of knowledge she is constructing. She reflects on the personal significance of what she is learning. This is deep learning. Surface learning is exemplified by Robert who is less committed than Susan, and has a less developed background of relevant knowledge; he comes to the lecture with no questions to ask. He wants only to put in sufficient effort to pass. Robert hears the lecturer say the same words as Susan heard, but he doesn't see a keystone, just another brick to be recorded in his lecture notes. He

There is, therefore, no doubt that assessment methods should be used to measure what students can do with what they are taught rather than the ability to regurgitate masses of facts. This is particularly relevant when the subject matter being taught has practical professional application as is the case with tax.

As stated by Ramsden,²⁹⁸ assessment in practice has two functions: to tell us whether or not the learning has been successful, and to convey to students what we want them to learn.

The literature on assessment reflects a number of different but complementary views, which are briefly considered below. It generally refers to the case where students are taught on a face-to-face basis rather than in a distance environment. Notwithstanding this, most of the views expressed are of universal application and others, with the necessary adaptation, could be applicable where learning is on a flexible distance basis.

According to Brown²⁹⁹ there should be a clear alignment between expected learning outcomes, what is taught and learnt, and the knowledge and skills being assessed. Lack of alignment is a major reason why students adopt a surface approach to learning. This also often results from such institutional policies that require assessment results to be reported in percentages or 'marks', or require results to be distributed along a predetermined curve. According to Biggs³⁰⁰

The first can be mitigated by assessing qualitatively by reporting quantitatively, but the second is crippling. There can be no educational justification for grading on a curve. Such practices exist for two reasons, which feed each other: administrative convenience, and genuinely confused thinking about assessment. The confusion arises because two quite different models of summative assessment co-exist.

Taylor³⁰¹ identifies two models of assessment: the measurement and the standards models. The measurement model was developed by psychologists to study individual differences for purposes of comparing individuals with each other or with general population norms. The standards model is designed to assess changes in performance as a result of learning for the purpose of seeing what, and how well, something has been learned. This latter kind of assessment is criterion-referenced and requires assessment tasks that are likely to link with objectives in the course. According to Biggs none of the assumptions of the measurement model apply to the assessment of learning because:

believes that if he can record enough of these bricks, and can remember them on cue, he'll keep out of trouble come exam time.

²⁹⁸ Ramsden, above n 14, 187.

²⁹⁹ George Brown, *Assessment: A Guide for Lecturers* (Learning and Teaching Support Network, 2001).

³⁰⁰ Biggs, above n 18.

³⁰¹ C Taylor, 'Assessment for Measurement or Standards: The Peril and Promise of Large-Scale Assessment Reform' (1994) 31 *American Educational Research Journal* 231–62.

- quantifying performances gives little indication of the *quality* of the performance [and] sends the wrong messages to students, and guarantees unaligned assessment;
- teaching is concerned with change, not stability;
- teachers shouldn't want a 'good spread' in grade distributions. Good teaching and quality assessment should *reduce* the gap between [individual students], not widen it.³⁰²

Biggs divides assessment into four groups: extended prose such as the conventional essay; the objective format such as a multiple-choice test, which can be assessed rapidly; performance assessment, which assesses understanding as put to work such as a project or seminar presentation or case study; and rapid assessments, which are useful for large classes and involve such things as short-answer three-minute essays, concept maps or diagrams establishing the relationships between various things in the course. Naturally each group has its own advantages and disadvantages, but thinking of assessment in this way provides the teacher with an alternative to traditional quantitative methods of assessment.

Biggs³⁰³ notes that the score an individual obtains reflects how well the individual meets preset criteria, those being the objectives of the teaching. He states that matching performance against criteria is not a matter of counting marks but a holistic judgment on the part of the marker. He suggests the advantages of this system of assessment are that it is more rewarding because teachers are forced to reflect on what is meant by understanding and how to foster it, students perceive that what they are learning is real, and the outcomes on graduation translate into informed action which is what the community wants.

In 2001 the Learning and Teaching Support Network published a book by George Brown entitled *Assessment: A Guide for Lecturers*.³⁰⁴ Brown considers the relationship between methods of assessment such as essays and problems with the person marking the project and the criteria used to determine the marking scheme. It is axiomatic that this trilogy (method, entity and criteria) of factors forms a close-knit relationship and should any one of the individual components fall down, the result sought would be affected. The point is made that markers often lose sight of the fact that different criteria have different weights depending on the level of the program reached by the student. Thus a well-argued paper at first year level will be different to one at say third year level.³⁰⁵

An essential feature of assessment is the feedback that accompanies a task that has been assessed. Feedback enables teachers to adapt and adjust their teaching and students to adjust their

³⁰² Biggs, above n 18, 69.

³⁰³ John Biggs, *Aligning Teaching and Assessment to Curriculum Objectives* (2002), <[http://www.heacademy.ac.uk/resources.asp?section=generic&process=search7pattern=Aligning %20 Teaching%20and %20Assessment%20to%20Curriculum%20Objectives](http://www.heacademy.ac.uk/resources.asp?section=generic&process=search7pattern=Aligning%20Teaching%20and%20Assessment%20to%20Curriculum%20Objectives)>.

³⁰⁴ Brown, above n 20.

³⁰⁵ Although there is no empirical evidence to reflect this, in discussion with staff at Atax this is something Atax keeps in mind when marking papers.

learning strategies.³⁰⁶ Generic feedback gives clarification of misconceptions on a broad scale with the advantage of having as a component a comparison with peer responses. From a learning perspective feedback must be timely, perceived as relevant, meaningful and encouraging, and offer suggestions for improvement. Often, it seems, students do not read the feedback they receive or use it to improve future performance and/or understanding of concepts they have failed to grasp. It is therefore necessary to teach students how to use the feedback they receive and to check to see whether they have applied the feedback in current assignments.³⁰⁷

The article now turns to the literature on the means that can be used to design an effective assessment process.

4 Designing effective assessments

When designing assessment methodologies consideration needs to be given to tasks which:

- promote engagement with learning,
- are within reasonable academic workload parameters,
- are reliable, valid and equitable, and
- are clearly communicated to students.³⁰⁸

Clearly, within the assessment design consideration needs to be given to the feedback being provided to students and also the opportunity for students to give feedback to the teacher.

According to Gibbs³⁰⁹ well-designed assessment can promote deep learning by structuring the way students engage with the content of the course. This can be done through:

- involving students in the assessment design,
- integrating assessment into the learning process,
- setting assignments which reward understanding and penalise reproduction,
- providing explicit marking criteria,
- designing assignments which involve interaction among students,
- focusing on 'real world' or authentic situations in assessment, and
- promoting interdisciplinary assessment tasks.

As stated earlier by John Biggs,³¹⁰ assessment has in practice two functions: to inform us whether or not the learning has been successful, and to convey to the students what they are required to learn.

³⁰⁶ Flinders University, Australia, *Teaching for Learning*, <<http://www.flinders.edu.au/teach/assess/feedback.htm>>.

³⁰⁷ It seems, without having any empirical data, that students only refer to their marks on an assessed piece of work and pay little attention to any specific or generic feedback given by the teacher. Giving feedback takes valuable marking time so teachers are advised to consider how students react to feedback and how it could be used to best advantage.

³⁰⁸ Hargreaves and Wallis, above n 17.

³⁰⁹ Graham Gibbs, 'Using Assessment Strategically to Change the Way Students Learn' in Sally Brown and Angela Glasner (eds), *Assessment Matters in Higher Education* (Buckingham: SRHE and Open University Press, 1999).

According to Joan Middendorf and David Pace³¹¹ the systematic identification of what students have difficulty learning and what they should know how to do makes the design of effective assessments relatively straightforward. To support effective teaching the Indiana University Faculty Learning Committee developed a model to enable teachers to develop strategies for introducing students to ‘the particular culture of thinking’ that is part of any specific discipline and to assist them in their understanding and knowledge within that discipline. Assessment, both formative and summative, forms an integral part of this model.³¹²

Step 1 involves identifying bottlenecks or obstacles in the course where a significant number of students have interrupted learning.³¹³ All teachers will have experienced an area in their course where learning has not happened in the way the teacher had hoped. This is the simple but effective point at which change can be made by the teacher to assist student learning.

Step 2 is difficult because it involves recognition, but essentially it requires the teacher to look at how an expert does these things; to examine in precise detail what an expert would do if faced with one of the tasks that students had difficulty completing. When reconstructing an expert’s approach teachers will find themselves using terms that require explanation or which are unclear and confusing. By continually asking questions — such as How is a student expected to do this? and What does the instruction assume students can do? — a teacher can probe beneath the surface and see what is required to develop the critical thinking students are required to have in order to master their course.

Step 3 requires the teacher to devise ways to demonstrate to students the steps that come naturally to an expert. Once a teacher has identified the basic operations that students should model, the teacher is then required to devise demonstrations/practice that will help students understand what this kind of thinking entails. The point is made that ‘complex ways of thinking

³¹⁰ Biggs, above n 18.

³¹¹ Middendorf and Pace, above n 7.

³¹² The University of New South Wales has developed *Guidelines on Learning that Inform Teaching at UNSW*. Guideline 15 describes the difference between formative and summative assessment inter alia in the following terms:

Use formative assessment (assessment designed for giving feedback and suggestions for improvement) as well as summative assessment (assessment designed for the purpose of measuring performance in relation to an identified standard). Formative assessment should occur early and often, whereas summative assessment usually occurs at the end of a course. In practice, many assessment tasks are both formative and summative.

<http://learningandteaching.unsw.edu.au/content/userDocs/ref4.1_guideline15_000.pdf>.

³¹³ J A Anderson, ‘Merging Teaching Effectiveness, Learning Outcomes and Curricular Change with the Diverse Student Needs of the 21st Century’ (Paper presented at the 21st Annual Conference of the Professional and Organizational Development Network, Salt Lake City, October 1996).

are rarely assimilated in a single presentation and that different groups of students internalize such learning in different modalities (for example, visually, orally, and kinaesthetically).³¹⁴

Step 4 focuses on getting students to practice the task and determining the best ways of gauging the proficiency of student attempts at the task or designing effective assessment to identify student knowledge.

Step 5 gets the teacher to think about what will motivate students. Conscious effort does need to be made to encourage the students to become partners in the learning process. By presenting yourself as an ally who has devoted considerable energy to creating a course in which success is possible and who really wants the students to do well, you will create a positive response among the students. This is possible by using a series of small manageable steps rather than great leaps.

Step 6 asks how well students are mastering the learning tasks required in the course. While the focus may be on content learning, developing critical thinking in students is also essential. As teachers have previously broken down bottlenecks into various parts for students to learn, it is easier to determine whether in fact students have mastered them. Assessment methods that emerge from the above series of steps should therefore make it easy to determine which of the basic operations are being mastered by most students and which need to be modelled, practised or repeated during the course.

Finally Step 7 asks how the resulting knowledge about learning can be shared with others. A student who can explain what they have learnt to someone else has truly understood something and gained genuine knowledge.

The steps for decoding the disciplines approach, as outlined above, is one way of learning and assessment that could enhance the learning experience for both teacher and student. It should not be viewed as a narrow, prescriptive formula for all course development, but rather seen as steps that 'evolved as part of a group process of shared pedagogical exploration'.³¹⁵

The design of assessment exercises for students in any course is also dependent upon the ability of staff to adequately review the student work and give appropriate and timely feedback. Some institutions teaching tax within New Zealand and Australia may find themselves constrained by a lack of staff resources, individual staff members being isolated within a faculty or school, budget constraints and administrative demands which hinder the ability of the teacher to creatively or innovatively assess their students in ways presented within this paper, and by educationalists.

The article now considers the approach to assessment adopted by Atax.

5 Atax

5.1 Introduction

³¹⁴ Ibid 7.

³¹⁵ Ibid 10.

The vast majority of Atax students are studying part-time while in full-time employment.³¹⁶ Atax offers both an undergraduate degree which qualifies students for entry into the Australian accounting profession and postgraduate degrees specialising in taxation law. Students demonstrably need to be more disciplined when studying part-time, in a delivery mode that is not entirely face to face and balancing work and family commitments. In the authors' opinion the reason for this is that these students need to accept ownership of and control both the teaching and learning process to a greater degree than that which is expected of students studying on a face-to-face basis.

The Atax student population is diverse. They come from different upbringings and cultures and have different life experiences. They are located throughout Australia and overseas.

As tax is multidisciplinary, Atax adopts a multidisciplinary approach to its teaching and uses not only lawyers but also accountants and economists to deliver its teaching program.

Students who are unable to study face to face may not feel part of a community. This should not be a problem if handled correctly. Sir John Daniel gave the example of his wife who undertook a distance learning course at the Open University UK, of which he was Vice-Chancellor. He described her experience³¹⁷ as follows:

When she worked with the course materials on the dining table it was all go. She moved from writing, to listening to cassettes, to grappling with grammar to watching videos. One weekend she was out both days: on Saturday to a five-hour tutorial group in Oxford, which is forty miles away, and on Sunday for three hours to a self-help group organized spontaneously by four local students at a coffee shop just a few miles away. Her course materials went into the suitcase when we travelled. Her main regret was missing meetings of the self-help group because of travel and other commitments. In no way was she the passive recipient of deliveries of instruction. She was an active member of a learning community and the beneficiary of a learning system that facilitated her study in various ways.

Unlike the practice at the Open University, Atax does not have students divided into tutorial groups, but self-help groups are encouraged and a list of willing persons is placed on a peer group list and is published in part to facilitate student contact and in part to encourage group work.³¹⁸ Members of self-help groups communicate either by direct contact between students or

³¹⁶ Neither of the authors has seen any empirical data to support this, but Kalmen Datt in discussion with students at Atax finds that most students are in full-time employment.

³¹⁷ Sir John Daniel, Vice-Chancellor The Open University United Kingdom, 'Distance Learning: The Vision and Distance Learning: The Reality — What Works? What Travels?' (Speech given at the conference Leadership in the Knowledge Economy, 10–12 January 1999).

³¹⁸ For a discussion of the support services offered to students at Atax refer Fiona Martin, Kate Collier and Shirley Carlon, 'Developing a Mentoring Program for First Year Distance Students Studying Taxation Law' (2009) 19(1) *Legal Education Review* 217–36.

via the internet-based platform used to deliver teaching materials. Such groups are entirely voluntary.

As this is a flexible delivery program, it is suggested the assessment process must be even more rigorous and aligned to outcomes than would be the case for a course or program taught on a face-to-face basis. Distance students do not have the advantage of being able to resolve misconceptions and problems promptly with their teacher. Therefore, the formative aspect of the learning experience should be designed to give these students more opportunities to evaluate their progress through self-directed activities.

As part of its philosophy of teaching, Atax has developed both study materials and a support base for students. Students receive with each course paper-based study materials that are designed to enhance effective self-directed distance learning and provide opportunities for self-assessment. Their purpose is to stimulate deep-level as opposed to surface-level learning and to give students the ability to study at times and for periods convenient to them. The American Distance Education Consortium has suggested that study materials be modular, stand-alone units that are compatible with short bursts of learning.³¹⁹ The Atax study materials are formatted this way.

Atax courses are designed to meet the needs of students³²⁰ and to cater to the needs of employers that require specific skills from graduates. Primarily teachers seek to instil a sense of excitement in students about their chosen discipline to enable them to continue to 'maximise their understanding of things, read widely, discuss issues and reflect on what they have seen and heard'.³²¹ It is said that the purpose of formal education is transfer; that students will use the skills and knowledge they acquire at school or university beyond the classroom.³²²

³¹⁹ADEC, *Guiding Principles for Distance Teaching and Learning*,
<http://www.adec.edu/admin/papers/distance-learning_principles.html>.

³²⁰ Students need to acquire skills which translate to the particular profession they are aspiring to enter. Some students are already working in professions and are therefore wanting to see the relevance of their learning to the profession. Both Atax and the University of Auckland publicly state that students will acquire certain graduate attributes upon leaving the university which will make them of value to the professional world outside of the university. For example, see the UNSW graduate attributes at <http://www.ltu.unsw.edu.au/ref4-4-1-1_unsw_grad_atts.cfm>. These graduate attributes form part of the skills which both Atax and the University of Auckland seek to instil in their students.

³²¹ 2004 Foundations of University Learning and Teaching material prepared by the UNSW Learning and Teaching Unit (LTU).

³²² Diane F Halpern and Milton D Hakel, '**Applying the Science of Learning to the University and Beyond: Teaching for Long-Term Retention and Transfer**' (July/August 2003) 35(4) *Change* 36,
<<http://proquest.umi.com/pqdweb?did=592363071&sid=2&Fmt=3&clientId=25620&RQT=309&VName=PQD>>.

It is accepted at Atax that:

[p]roperly conceived and executed, professional skills training should not be a narrow technical or vocational exercise ... rather it should be fully informed by theory, devoted to the refinement of the high order intellectual skills of students, and calculated to inculcate a sense of ethical propriety, and professional and social responsibility.³²³

Students must be able to communicate both orally and in writing. To be able to write well requires practice. Students must be able to undertake complex searches on a multitude of databases to ensure that they develop a thorough understanding of the law (both legislative and common) upon which they rely. They need to understand that in the study of the law there is rarely one right or wrong answer, but that a well-argued opinion, certainly from an academic perspective, will be rewarded.

Finally students must be able to work in groups and have the ability to communicate with their peers and others in such a way as to be able to convey sometimes complex facts, issues and arguments in a way that is easily understood by the target audience.

5.2 Current practice at Atax

The current approach to delivering and assessing a course³²⁴ is as follows:

Before the semester commences: students are invited to attend an orientation day at which students are given details about the program, research tools, Blackboard (formerly Web CT)³²⁵ and information designed to help them in the transition to university study. They are expected to assimilate a mass of information on issues that in many cases are entirely new (this orientation is designed primarily for first year students but can be of application to postgraduate students who have not studied in a flexible distance mode before).

Subsequently, study materials are couriered to the student. The course materials are divided into modules and refer to learning objectives and key concepts and contain material on each aspect to be covered in that module. Each module also has a reference to suggested and prescribed

³²³ Australian Law Reform Commission, *Managing Justice. A Review of the Federal Civil Justice System Report No 89* (AGPS, 1999) para 2.85. For an interesting article on the relationship between skills and graduate attributes see Sharon Christiansen and Sally Kift, 'Graduate Attributes and Legal Skills: Integration or Disintegration?' (2000) 11 (2) *Legal Education Review* 207.

³²⁴ Individual lecturers may adapt this format to meet their specific requirements, but overall the methodology is the same.

³²⁵ Since 2010 Atax moved from Web CT to Blackboard, which is a different operating system that serves the same purpose but has greater functionality. Blackboard and Web CT are online portals of study materials, past exam papers, bulletin boards and email facilities. Students can interact with the lecturer via email or join online study groups or discussion groups. These online portals are designed to extend and enhance student learning opportunities.

readings as well as activities designed to test the student's assimilation of matter contained in the study materials. Suggested answers to the activities are provided. The basis on which assignments are assessed form part of this material.³²⁶ Each module builds on the preceding one.

All of the above is designed to manage students' expectations, inform them about the skills required and, assessment criteria used, describe how the course material and skills fit into the 'tax' environment, and explain how the things learnt in the program will be used on a daily basis in their practice as tax professionals.

Audio conferences (each is a telephone link between lecturer and students scheduled for 90 minutes per session generally four times a semester, although some lecturers schedule five audio conferences for specific courses) are used to enable students to clarify any issues. Their prime function is to facilitate a discussion between the students themselves and the students and the lecturer. Prior to assignments and exams the assessment criteria are paraphrased and reinforced at these conferences. Audio conferences are not compulsory and are not assessed, but they will greatly assist the student in the formative assessment process used at Atax.

A full day 'regional class' is held once each semester as an intensive review of the skills to be acquired by the students and the technical issues of that course. A commonly used teaching approach is that the group works through a series of case studies in order to apply the legal principles learnt in a practical context. Lecturers travel to all the main centres in Australia, when student numbers warrant it, to deliver these classes. During these classes examples are given of what are considered good and bad responses to assignment questions. These are discussed in detail with students. Again students are given an opportunity to raise issues that are of concern to them. Regional classes are not compulsory and are not assessed. Where student numbers do not justify a regional class in a centre, it will be held by way of an audio conference that lasts about three to four hours.

In all communications with students they are encouraged to discuss any questions or queries with colleagues, peers, superiors or the lecturer to ensure a proper understanding of issues. The availability of the lecturer is stressed. This is in part an attempt to allow the students to feel part of a larger group and to help them communicate with peers and colleagues. Experience has shown that the act of verbalisation forces the student to crystallise a problem they may have, which often makes resolving it relatively easy.

5.3 Assessment at Atax

Atax takes the view that assessment forms a vital element in determining if students have achieved, and assisting students to achieve, required outcomes. Assessment is generally by way of two assignments and a final exam. Assignments usually consist of problems where students must demonstrate an ability to apply technical knowledge utilising acquired skills. Stress is placed on word limits in assignments as this avoids undue prolixity and ultimately assists students in composing clear and concise documents in a professional context.

³²⁶ See section 2 above for more detail of the assessment criteria.

The exam contains both problems and essays where an understanding of technical issues must be demonstrated.

As the vast majority of summative assessment takes the form of written assignments and exams, writing skills are particularly important.³²⁷ Anne Burns and Stephen Moore³²⁸ noted that the accounting profession has highlighted the importance of excellent spoken and written communication skills for professional practice. Atax in their distance mode of delivery are acutely aware of the importance of students being able to communicate both orally and in writing. Because being able to write well requires practice, assessment becomes an important tool in preparing students for their professional futures.

The assessment criteria for assignments include students having to identify the issues and material facts, evidence a critical mind at work, tie arguments back to the problem and to produce a properly referenced, concise, logical and a linguistically well-written paper. The assessment criteria appear before each assignment topic. Certain of these criteria are emphasised in each audio conference and the regional class. They also form part of the course profile in the study guides.

Maryellen Weimer in a paper entitled 'Focus on Learning, Transform Teaching'³²⁹ mentions a number of issues which in her opinion adversely affect learning. Certain of these factors must, in the authors' opinion, be taken into account in determining the methodology used in facilitating learning. These are firstly that for every act or omission on the part of a student there should be consequences. She asks:

Do students come to class without having done the reading? What happens to them as a result of that? Students should experience consequences when they come to class unprepared. They should not be rewarded with a carefully crafted summary supplied by the teacher.

This approach facilitates students' taking ownership and responsibility for their learning. It encourages and rewards effort. The hands on experience of the students make the audio conferences and regional classes stimulating and challenging as well as a source of information and interest. This is all part of the formative assessment process.

Secondly Weimer believes how students learn is at least as important as what students learn. She states:

With courses that introduce a discipline, it's easier for faculty to understand that students need to learn those habits of the mind characteristic of the discipline — how those in the field think

³²⁷ Wendy Larcombe and Ian Malkin, 'Identifying Students Likely to Benefit from Language Support in First Year Law' (December 2008) 27(4) *Higher Education Research and Development*, 319–29.

³²⁸ Anne Burns and Stephen Moore, 'Communication in Professional Accounting Contexts — Unexplored Territory' (November 2008) 43(5) *Taxation in Australia*.

³²⁹ Maryellen Weimer, 'Focus on Learning, Transform Teaching' (September/October 2003) 35(5) *Change* 49,
<<http://proquest.umi.com/pqdweb?did=592363011&sid=3&Fmt=3&clientId=25620&RQT=309&VName=PQD>>.

critically, ask questions, frame answers, explore controversies, and reason from problems to solutions.

This ‘mind characteristic’ encourages and is consistent with the approach the authors propose be adopted in the teaching of the skills mentioned in this paper. This concept is inextricably linked to the issue of critical thinking.

Diane F Halpern and Milton D Hakel³³⁰ in an article entitled ‘Applying the Science of Learning to the University and Beyond; Teaching for Long Term Retention and Transfer’ say:

Lectures work well for learning assessed with recognition tests, but work badly for understanding ... There are two related points in this principle. The first is the fact that lecturing is not optimal to foster deep learning. The second is the consequent reliance on recognition-based tests as an index of learning. [The] assessment used needs to match the learning objectives. High scores on traditionally constructed tests do not necessarily indicate enduring or transferable learning.

The views of Halpern and Hakel are a further reason for adjusting the methodology in conducting audio conferences to ensure that they are not used as a means to transfer information but rather as a means of practicing skills and application of knowledge in an environment where a significant amount of formative assessment is used.

For Halpern and Hakel ‘practice at retrieval’ is essential. They state:

This principle means that learners need to generate responses, with minimal cues, repeatedly over time with varied applications so that recall becomes fluent and is more likely to occur across different contexts and content domains. ... The effects of practice at retrieval are necessarily tied to a second robust finding in the learning literature — spaced practice is preferable to massed practice.

This means that students must be given as many opportunities as possible to apply technical knowledge using the essential skills acquired over a period of time. Atax follows this approach in both its support and assessment functions. Students are given many opportunities to practice their skills and the application of their knowledge.

An important part of the assessment process is what takes place in the audios, regional classes and other contacts with students. Here students are encouraged to raise issues and voice opinions that may not coincide with those of the lecturer provided they can support those views with reference to authority. The discussion itself ultimately assists students in the formative assessment process in that it stimulates a critical analysis of cases and issues and facilitates students communicating their ideas in a verbal but logical fashion. These opportunities to practise the application of skills and knowledge help the student attain the course objectives.

When setting exams, lecturers seek to ensure that they are sufficiently long to test the material that forms the subject matter of the course but not so long as to preclude students from finishing. Attempts are made to set exams at a level that would enable all students to pass but still allow the more gifted student to do well.

The assessment tasks, both formative and summative, require students to use the same

³³⁰ Halpern and Hakel, above n 43.

competencies, or combinations of knowledge, skills and attitudes that they need to apply in professional life.³³¹ Gulikers et al suggest that for authentic assessment students need to integrate knowledge, skills and attitudes as professionals do. This means the assessment task should resemble real-life situations utilising the same skills and knowledge a professional would use. If the real-life situation requires collaboration then the assessment task should take into account factors such as social interaction, positive interdependency and individual accountability. When, however, the assessment is individual, the social context should stimulate some kind of competition between learners.³³²

Each of the summative assessment tasks meets these criteria. Account is taken of the level at which students are studying. For example, third year students should be more accomplished than first year students and should be capable of handling more complex tasks. It is suggested that failure to do this may lead to cognitive overload and to unwanted outcomes.

Having considered Atax, the article now turns to the situation at the University of Auckland.

6 Assessment at the University of Auckland

6.1 Introduction

The University of Auckland teaches taxation to students who require New Zealand Institute of Chartered Accountants (NZICA) accreditation as part of their Bachelor of Commerce degree. As is the case with Atax, study materials are handed out in self-contained sections which incorporate both concepts and extracts from the relevant case law.

Internal assessment consists of three parts. First, students learn about tax research through an electronic based series of workbooks. This is followed by an online test, which they must complete in their own time within two weeks. The test is not meant to be failed³³³ and students are allowed up to 10 attempts to achieve the passing grade. The research component was introduced to make students aware of some of the electronic resources available on taxation law that they would need in professional practice.

³³¹ *Judith T M Gulikers et al, 'A Five-Dimensional Framework for Authentic Assessment' (2004) 52(3) Educational Technology, Research and Development 67, <<http://info.library.unsw.edu.au/cgi-bin/local/access/access.cgi?url=http://proquest.umi.com/login?COPT=REJTpuCwJlNNRD0xJkIOVD0wJIZFUj0y&clientId=25620>>.*

³³² *Ibid.*

³³³ Although students receive a grade of 2% for the test (this encourages them to participate), because learning to research taxation materials is the main goal, even when students fail to achieve the full 2% at the end of the semester the course co-ordinator will alter the grade mark stated online and give each student who completed the workbooks and the test the full 2% grade towards the final mark. The research component is an important learning tool which not only enables students to learn where tax material is located while studying, but is also transferable to their future professional employment.

Second, the introductory taxation course includes seven tutorial classes of one hour per week. Students are assessed on attendance and participation at the tutorial classes held over the semester. The tutorials have set questions on various key topics and require students to apply their knowledge of the case law and legislation to the tutorial questions. The scenarios given require critical thinking by the students and are linked to authentic situations that the students will face in the professional world.

The third internal assessment component is a mid-semester test. The test question(s) are made available three weeks ahead of the actual test date, allowing students time to research their answers which they then write under test conditions. There is also a series of four, 5 marks per question, multiple-choice pop-quiz (MCPQ) tests that can be marked electronically. The best two marks of the four MCPQ tests are included in the final assessment mark. The pop-quizzes were introduced in 2010 to give students practice for the multiple-choice component of the exam.³³⁴

For assessment purposes the above internal component is worth 30% and the final exam is worth 70% of the final mark. The exam has a practical component where students must *inter alia* complete a tax return and explain why, in their opinion, income and deductions are declared (or not) as well as 10 multiple-choice questions and two problem questions.

6.2 Assurance of learning

The test assessment method in introductory taxation underwent some changes in 2008 with the introduction of an Assurance of Learning rubric testing³³⁵ system in the University of Auckland Business School. The Assurance of Learning committee, set up in the business school and made up of representatives from the various departments including commercial law, developed a series of rubrics in order to evaluate the standard of student assessment in writing, ethics, critical thinking and knowledge.

The ethics component, which was a direct part of the set question in a test given to the introductory taxation students in 2008, was poorly understood and answered on grounds of morality rather than ethical principles. Consequently, there has been greater emphasis given in the taxation lectures to introducing ethical principles and several of the taxation tutorial questions pose ethical issues for discussion with students.³³⁶ Teaching ethical principles has also

³³⁴ While this component of the course has only been operating for one semester, it was interesting to see a substantial improvement in student performance in the multiple-choice section of the exam, with more than 80% of the class achieving a pass mark of 6 and above in the 10 multiple-choice questions set. This was a contrast to the previous two semesters where less than 50% passed the multiple-choice section.

³³⁵ Rubric testing is a method used to measure the standard of an item of student assessment in areas such as critical thinking, knowledge, ethics and writing. Each rubric measures whether the student is above, at or below the standard set by the particular rubric in the area being measured.

³³⁶ The ethical component has also been emphasised and tested in the earlier commercial law courses that students must complete as prerequisites before doing the introductory tax course, thereby adding more understanding of ethical principles in all areas of the commercial law programs.

been incorporated into the stage one and stage two commercial law courses. However, it is too early yet to evaluate the success of the new strategy on student understanding of ethical principles in taxation.

Atax, in contrast, includes two general education courses and an ethics course for students to undertake as part of their degree. Since the 2008 review, the University of Auckland allows students who are undertaking a Bachelor of Commerce degree to enrol in up to two university papers from any other faculty as part of general education; however, it has no specific ethics or general education course for students. There has been a recognition that general education complements the more specialised learning undertaken in a student's chosen field of study and that it contributes to the flexibility which graduates are increasingly required to demonstrate. Employers repeatedly point to the complex nature of the modern work environment and advise that they highly value graduates with the skills provided by a broad general education as well as the specialised knowledge provided in the more narrowly defined degree programs.³³⁷ The lack of a specific ethics program for those taking a commerce degree at the University of Auckland leaves this ethical training instead to the professional bodies such as the NZ Society of Chartered Accounts once students complete their degree.

Ethics and general education courses form an essential component in the skills that need to be acquired by tax graduates, so it is encouraging to see the various commercial law courses at the University of Auckland since 2009 including the ethical component in their courses. Widespread teaching of ethical principles in all business courses could ensure students have a greater awareness of ethics prior to them entering the workforce, making the training task simpler for professional bodies.

Having reviewed the literature and the methods adopted by both Atax and the University of Auckland, the authors now seek to utilise this knowledge in suggesting what in their opinion could facilitate enhanced teaching and learning outcomes when teaching tax.

7 The proposal for an assessment regime in tax

It is suggested that the following approach be adopted in the assessment process to achieve optimal learning results. This process seeks to utilise the best features used by both Atax and the University of Auckland to ensure students achieve their potential and become valued members of professional teams. In devising this process it is suggested that part of the assessment process

³³⁷ The introductory taxation course at the University of Auckland invites several guest lecturers to teach various components of the course. These people come from KPMG, PWC and Inland Revenue and have had a long involvement with the program. As potential employers, they have commented that they value general education as well as specialised teaching and recently one employer when talking to students about employment opportunities noted that very few of the degree courses in the Bachelor of Commerce were actually useful outside of the university except for the practical introductory taxation course. They valued students being able to think, reason and write, which are not specific to specialised areas of knowledge but could also come out of a general education course.

include the provision of materials that are easy to access but which also facilitate ongoing learning and the acquisition of skills. The methodology is set out below.

At the commencement of each course students should be given a set of materials that are modular, stand-alone units compatible with short bursts of learning. Each module should build on those that precede them and contain self-assessment tasks with suggested solutions or approaches to enable students to determine for themselves whether they have gained an understanding of key concepts and achieved the learning objectives of each module.

These study materials should be supplemented either by formal lectures and tutorials or, as is the case at Atax, audio conferences and regional classes. Lecturers should be available at fixed times (and if possible at other times as well) to clarify and explain issues students find challenging. Where possible, the lecturers should seek to understand the individual make-up (characteristics) of each student and especially be alert to any limitations students have set for themselves. This of course is far more difficult in a distance environment where there is little or no face-to-face contact with students. The support process is fundamental to an effective assessment program and forms an essential component of the formative assessment process.

There should be consequences in the event of students failing to comply with course requirements such as reading or submission of assignments on time. Students must learn that for every act or omission there are consequences and that each act or omission will affect their ability to achieve the results for which they strive. For example, at Atax late submission of assignments results in a progressive penalty (more than 10 days late results in a 100% penalty not of the mark obtained but of the total available marks for that assignment).³³⁸

The use of bell curves and similar devices should be avoided in determining marks of students. They should be assessed on that which they produce not on some formula that gives an artificial or contrived result.

As part of the formative assessment process for a tax program there should be at least one ethics course to enable students to operate effectively in the workplace plus at least one and possibly more general education courses unrelated to their program to ensure a well-rounded graduate able to function in the real world with an ability to think beyond the narrow confines of their speciality. Again these criteria may seem beyond a pure assessment regime, but in the authors' opinion assessment is not limited to one course in a program; it should be holistic, designed to ensure students are able to function effectively in their chosen profession.

Assessment tasks must include a requirement that students perform as they would in the professional environment — utilising lateral thinking, critical analysis, research skills and both oral and written communication skills. In order to facilitate and enhance research and communication skills, Atax has a moot as one of the assessment tasks in its undergraduate program.

³³⁸ Student services, not the lecturer, are given the power in appropriate cases to waive or reduce any late submission penalty.

Exams must be well timed so that they sample content well but allow most students to finish. They must afford all students the opportunity of doing well but allow the 'good student' to excel.

All assessment tasks should be designed to simulate real-life examples that must be approached as professionals would approach the specific issue. For all mid-semester assessment tasks, whether formative or summative, there should be early and sufficient feedback to enable students to understand not only the areas in which they have gone wrong but also to understand what steps need to be taken to improve. Subsequent assessments should, in so far as time permits, seek to ensure that early feedback has been assimilated.

Finally, all assessment tasks must test each student's ability to understand and apply concepts and principles. Simple regurgitation of information will not adequately prepare the student for professional life.

8 Conclusion

Assessment is an important tool used by teachers to measure student learning in any program or course because it tells the assessor whether the learning has been successful and conveys to students what they need to learn.

Effective assessment is important to any student learning and requires a teacher to balance administrative requirements with regard to grading and attaining a 'spread of marks' with a need to ensure students are prepared for future professional practice involving taxation law. The development of appropriate and carefully constructed assessments, support materials to assist student learning and opportunities to develop understanding and skills must be a priority in any course offered in the study of taxation law. An important aspect of this assessment regime is that sufficient teacher support is given to students to enhance and encourage the learning process. This latter aspect is integral to the formative assessment process.

Following a review of the assessment practices at both Atax and the University of Auckland, the authors have suggested an assessment regime that in their opinion encompasses the best aspects of both institutions and accords with best practice. Hopefully, the recommended assessment regime will result in both students and teachers achieving their desired goals.

Exemptions and concessions in the Australian tax system: Equity at the expense of simplicity

Kathrin Bain*

Equity is often viewed as the most important criteria of the Australian taxation system. As such, there are many examples in the Australian tax system of tax concessions and exemptions that have been introduced to promote equity — but these have usually been at the expense of simplicity. After discussing the characteristics of a ‘good’ tax system and the conflicts between such criteria, the treatment of food as GST-free under the goods and services tax regime, Family Tax Benefit (Part A and B), and the Education Tax Refund will be considered. Overall, it will be shown that these government initiatives, which have been introduced under the premise of promoting socio-economic objectives in the tax system, have resulted in increased complexity in the system, and further, have often not promoted the desired equitable result.

*Associate Lecturer, Atax, University of New South Wales

Exemptions and concessions in the Australian tax system: Equity at the expense of simplicity

Kathrin Bain*

Introduction

The primary objective of the tax system is to raise revenue to allow government expenditure.³³⁹ This has recently been reiterated in Australia's Future Tax System Review (colloquially known as the Henry Review), where it was stated numerous times that Australia's tax system must be sustainable.³⁴⁰ However, the overall success of a tax system is not simply evaluated by the extent of revenue raised. The Henry Review identified five design principles for the tax and transfer system: equity, efficiency, simplicity, sustainability and policy consistency.³⁴¹ For many years, equity, simplicity and efficiency have been the main criteria against which the Australian taxation system has been evaluated.³⁴² However, as shown by their inclusion as 'design principles', they are not only important after the fact (ie to evaluate a taxation system once it is in operation), but can also play a key role in designing a tax system in the first place. This is highlighted by the government's response to the Henry Review, where they have stated: 'The Government's tax reforms will build a stronger economy and a fairer, simpler tax system for Australian families and businesses'.³⁴³ Whether the reforms introduced achieve these objectives is a separate issue, but statements such as this reiterate the fact that these 'evaluative criteria' are at the forefront of policymakers' minds when designing or reforming the tax system.

Australia is a clear example of a taxation system that is designed not only to raise revenue, but also for socio-economic purposes,³⁴⁴ being highly redistributive compared to

³³⁹ Australian Treasury, *International Comparison of Australia's Taxes* (Commonwealth of Australia, 2006) 22; Binh Tran-Nam 'Tax Reform and Simplification: Some Conceptual Issues and a Preliminary Assessment' (1999) 21 *Sydney Law Review* 500, 500.

³⁴⁰ See, eg, Australia's Future Tax System, *Report to the Treasurer: Part One Overview* (Commonwealth of Australia, 2010) 17; Australia's Future Tax System, *Report to the Treasurer: Part Two Detailed Analysis* (Commonwealth of Australia, 2010) 142.

³⁴¹ Australia's Future Tax System, *Part One Overview*, above n 2.

³⁴² Taxation Institute of Australia, 'Tax Reform: Let There be No Half Measures' (1998) 1(4) *The Tax Specialist* 185, 187.

³⁴³ Commonwealth of Australia, *Tax Policy Statement: Stronger Fairer Simpler: A Tax Plan for our Future* (Commonwealth of Australia, 2010) 1.

³⁴⁴ Robin Woellner et al, *Australian Taxation Law* (CCH, 20th ed, 2010) 17; Guyonne Kalb, 'Interaction of the Tax and Social Security Systems in Australia: The Effect on Effective Marginal Tax Rates' (2007)

other OECD countries.³⁴⁵ Essentially, as stated by Young ‘tax systems are not merely revenue raising instruments. They are in fact massive spending programs and should be evaluated as such’.³⁴⁶ Such a statement recognises the fact that any redistribution does not only occur by direct government payments, but also through tax offsets and exemptions—known as tax expenditures.³⁴⁷ In Australia, tax expenditures are reported each year through the Tax Expenditures Statement, in order to improve transparency and allow for scrutiny of the expenditures, which, unlike direct expenditures, are not scrutinised through the annual budget process.³⁴⁸ The impact of tax expenditures on government revenue should not be underestimated, with measured tax expenditures in 2008–09 being estimated at approximately \$102 billion, or 8.5% of GDP.

While such tax expenditures exist to achieve socio-economic objectives through the taxation system, they have greatly increased complexity. The examples to be explored further in this paper to demonstrate this conflict between equity and simplicity are the exemption of food under goods and services tax (GST), Family Tax Benefit (FTB) Part A and B, and the Education Tax Refund (ETR). Not only have these concessions significantly increased the complexity of the tax system, but arguably they have not had the desired effect of making the tax system more equitable.

Equity versus simplicity in the tax system

As highlighted above, the key criteria used to evaluate a taxation system are equity, simplicity and efficiency. Unfortunately, as stated by Hill ‘these criteria are often, and probably always, incompatible with each other’.³⁴⁹ This paper will focus on the conflict that exists between equity and simplicity; that is, as concessions and offsets have been

40(2) *The Australian Economic Review* 186; Bettina Cass and Deborah Brennan, ‘Taxing Women: The Politics of Gender in the Tax/Transfer System’ (2003) 1(1) *eJournal of Tax Research* 37, 39.

³⁴⁵ Australian Treasury, *Architecture of Australia’s Tax and Transfer System* (Commonwealth of Australia, 2008) xvi, xvii, 167.

³⁴⁶ Claire Young, ‘Taxing Times for Women: Feminism Confronts Tax Policy’ (1999) 21 *Sydney Law Review* 487, 492.

³⁴⁷ Simon James, Adrian Sawyer and Ian Wallschutzky, ‘The Complexities of Tax Simplification: Progress in Australia, New Zealand and the United Kingdom’ (1998) 14 *Australian Tax Forum* 30, 37; Australian Treasury, *Tax Expenditures Statement 2009* (Commonwealth of Australia, 2010) 1.

³⁴⁸ Australian Treasury, above n 9, 15.

³⁴⁹ Graham Hill, ‘Tax Reform: A Tower of Babel; Distinguishing Tax Reform from Tax Change’ (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 1, <<http://www.austlii.edu.au/au/journals/JATTA/2005/9.html>>.

introduced to achieve equity objectives, complexity in the system has also increased. Before turning to an evaluation of the impact of the GST food exemption, FTB and the ETR on the equity and simplicity of the taxation system, what is meant by the concepts of equity and simplicity will be defined in further detail.

Equity (or fairness) is considered one of the fundamental requirements of a taxation system.³⁵⁰ For example, in the recently released Henry Review, when discussing the concept of sustainability, it was stated: ‘To be sustainable the tax system, together with the transfer system, must contribute to a fair and equitable society’.³⁵¹ Perhaps what is even more important than an equitable tax system is the public’s *perception* of equity. If taxpayers do not believe the tax system is fair, they are less likely to comply with their taxation obligations.³⁵² This is especially the case in tax regimes that rely on self-assessment such as Australia.³⁵³ However, what is considered ‘fair’ may differ between cultures and between individuals,³⁵⁴ making it very difficult to determine whether a tax system is fair or equitable. As noted by the Commonwealth Taxation Review Committee (the ‘Asprey Committee’), fairness ‘is an ideal exceedingly difficult to define and harder still to measure’.³⁵⁵

In discussions of fairness in the taxation system, distinction is made between two concepts: horizontal equity and vertical equity.³⁵⁶ Horizontal equity refers to the fact that persons with the same or similar ability to pay tax should bear a same or similar tax burden. Two taxpayers earning the same amount may not have the same ability to pay tax if, for example, one person is single with no dependants whereas the other has a dependent spouse and child. Therefore, a tax system that treats all taxpayers in exactly the same way will not result in equitable outcomes.³⁵⁷ Vertical equity is the notion that those who are in a better position to pay should pay a greater share of tax. Both concepts ‘reflect the ability to pay principle’.³⁵⁸ The clearest example of vertical equity in the Australian tax system is the use

³⁵⁰ Commonwealth Taxation Review Committee, *Full Report* (Commonwealth of Australia, 1975) 12.

³⁵¹ Australia’s Future Tax System, *Part One Overview*, above n 2.

³⁵² Taxation Institute of Australia, above n 4.

³⁵³ W H Pederick, ‘Fair and Square Taxation for Australia’ (1984) *Taxation in Australia* 575, 575.

³⁵⁴ Helen Hodgson, ‘More Than Just DNA — Tax, Welfare and the Family. An Examination of the Concept of Family in the Tax Transfer System, with Particular Reference to Family Benefits’ (2008) 43(4) *Australian Journal of Social Issues* 601, 602.

³⁵⁵ Commonwealth Taxation Review Committee, above n 12.

³⁵⁶ *Ibid.*

³⁵⁷ Young, above n 8, 492.

³⁵⁸ Commonwealth Taxation Review Committee, above n 12.

of progressive individual marginal tax rates. When an individual's taxable income increases, the percentage of income required to be paid also increases (if they move into a higher income tax bracket).³⁵⁹ However, as will be shown through the examples in this paper, there is often conflict between these two concepts of equity.

The Asprey Committee stated in 1975 that 'after equity, simplicity is perhaps the next most universally sought after of qualities in individual taxes and tax systems as a whole'.³⁶⁰ Tran-Nam has drawn the distinction between legal simplicity and effective simplicity.³⁶¹ Legal simplicity refers to the 'simplicity of rules'; that is, the 'ease with which particularly tax law can be read and understood'.³⁶² On the other hand, effective simplicity refers to the 'ease with which the correct tax liability can be determined',³⁶³ and will be reflected by the level of compliance costs (ie the cost to taxpayers in complying with their taxation obligations) and administration costs (costs of the revenue authority in administering the taxation system).³⁶⁴ In recent years, there have been many efforts to improve the simplicity of Australia's tax system — starting in 1993 with the Tax Law Improvement Project (TLIP), which aimed to make the legislation more user-friendly; through to 2006, where as a result of the *Taxation Laws Amendment (Repeal of Inoperative Provisions) Act 2006* (Cth) the volume of legislation was significantly reduced by repealing inoperative provisions.³⁶⁵ However, these efforts have focused on legal simplicity rather than effective simplicity, and as noted by Woellner et al 'the inherent difficulties in keeping tax laws simple are increased by the government's continued use of the tax system for complex "social engineering" purposes'.³⁶⁶ This will be highlighted in the examples following — that is, attempts to use the taxation system to achieve socio-economic objectives via exempting food from GST, the FTB and the ETR have increased the complexity of the system.

³⁵⁹ Woellner et al, above n 6, 74.

³⁶⁰ Commonwealth Taxation Review Committee, above n 12.

³⁶¹ Tran-Nam, above n 1, 505–8.

³⁶² Ibid 505.

³⁶³ Ibid.

³⁶⁴ Tran-Nam, above n 1, 507; Woellner et al, above n 6, 25.

³⁶⁵ Woellner, above n 6, 27.

³⁶⁶ Ibid.

Goods and services tax

The GST is a broad-based consumption tax levied at a flat rate of 10% on most goods and services supplied in the course of business. The supplier charges the consumer GST on the price of the goods or service, and then remits this to the ATO. The supplier may have also paid GST at points along the supply chain — this tax is effectively passed on to the final consumer, and the supplier is able to receive a credit for GST paid on their inputs.³⁶⁷ The notion of a broad-based consumption tax was first recommended by the Asprey Committee in 1975,³⁶⁸ but was not introduced in Australia until 1999 (with commencement from 1 July 2000).³⁶⁹

One of the main criticisms of consumption taxes such as GST is that they are regressive. A regressive tax, in contrast to the progressive structure of marginal income tax rates, imposes a greater burden (relative to economic ability) on lower income earners.³⁷⁰ Carlson and Patrick state: ‘The notion that a tax on consumption is regressive is based on consumer expenditure studies and surveys showing that the percentage of income spent on consumption declines as income rises.’³⁷¹ If a tax of the same rate is imposed on all goods and services, a low income family that spends a higher proportion of their income on consumption than a high income family will hence be paying a greater proportion of their income as consumption tax.

There are different ways to address the regressive nature of a consumption tax. The most common method is to either exempt certain goods and services (generally those that are considered ‘necessities’) or tax them at a lower rate than other ‘luxury’ goods and services. Alternatively, a tax credit method could be used, whereby lower income taxpayers are reimbursed ‘for the tax paid on a minimal or essential level of consumption’.³⁷² A further solution would be to provide low income families with a direct payment.³⁷³

³⁶⁷ Ibid 1766.

³⁶⁸ Commonwealth Taxation Review Committee, above n 12, 511.

³⁶⁹ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 1-2.

³⁷⁰ Alan Tait, *Value-added Tax: International Practice and Problems* (International Monetary Fund, 1988) 214.

³⁷¹ George Carlson and Melanie Patrick, ‘Addressing the Regressivity of a Value-added Tax’ (1989) 42(3) *National Tax Journal* 339, 339.

³⁷² Ibid 345.

³⁷³ Binh Tran-Nam, ‘Assessing the Revenue and Simplification Impacts of the Government Tax Reform’ (1999) 2(5) *Journal of Australian Taxation* 329, 343.

Taxing certain items at a lower or zero rate is ‘probably the most frequently used method of alleviating the regressivity of a consumption tax’.³⁷⁴ Indeed, it is the approach taken in Australia with a number of goods and services which tend to either be thought of as necessities or deemed to be ‘merit’ goods; that is, goods that are considered ‘worthy’ and should not be taxed. Certain food, health and medical related expenses, education and child care are GST-free.³⁷⁵ A GST-free supply is one where no GST is payable on the supply by the consumer, but the supplier can claim input tax credits for GST paid on the business inputs relating to that supply.³⁷⁶ However, the existence of GST-free categories of goods and services increases the complexity and associated operating and compliance costs of the tax system.³⁷⁷

This paper will further look at the GST-free category of ‘food’. There are three reasons for this. First, it is arguably one of the most complex categories of GST-free goods and services,³⁷⁸ due to only certain foods being GST-free.³⁷⁹ Second, it was considered one of the most necessary GST-free categories in terms of equity by some groups, with the Australian Democrats refusing to support the GST legislation until the Liberal National Coalition agreed to the GST-free status.³⁸⁰ Third, a review of the Tax Expenditures Statement reveals that out of all the GST-free categories, food has the largest monetary impact — estimated at \$5600 million for 2009–10, rising to \$6400 million in 2012–13.³⁸¹

‘The equity problem of taxing food at a flat rate occurs because of the greater proportional cost of food to income for low income earners as opposed to high economic earners.’³⁸² This is indicated in the table below. Taken from ABS statistics, it shows the percentage of household income spent on food and non-alcoholic beverages in 2003–04. Households in the

³⁷⁴ Carlson and Patrick, above n 33, 344.

³⁷⁵ Y H Cheung, ‘Will a Rise in Consumption Tax Share Increase the Effectiveness of Government Spending?’ (Working Paper No 0406, Edith Cowan University School of Accounting Finance and Economics and FIMARC Working Paper Series, 2004) 1.

³⁷⁶ Woellner et al, above n 6, 1795.

³⁷⁷ Tran-Nam, above n 35, 343.

³⁷⁸ Paul Kenny, ‘The GST Food Exemption’ (2000) 3(2) *Journal of Australian Taxation* 424, 425.

³⁷⁹ Michael Carmody, ‘Don’t Draw a GST Line Around Food’ (1999) 2(4) *The Tax Specialist* 170, 171.

³⁸⁰ Josh Gordon, ‘Costello “Impeded” GST Deal’ *The Age* (online) (20 June 2005), <<http://www.theage.com.au/news/National/Costello-impeded-GST-deal/2005/06/19/119119722872.html>>.

³⁸¹ Australian Treasury, above n 9, 192.

³⁸² Kenny, above n 40, 425.

lowest income quintile spent just over three times as much of their weekly household income on food and non-alcoholic beverages as households in the highest income quintile.

	Gross income quintiles					
	Lowest	Second	Third	Fourth	Highest	All
Mean gross household income per week (\$)	263	555	930	1385	2512	1128
Food and non-alcoholic beverages (\$)	78.36	111.72	145.73	181.56	247.25	152.87
Expenditure relative to income (%)	29.79	20.13	15.67	13.11	9.84	13.55

Table 1: Household food expenditure relative to gross household income³⁸³

As Kenny stated, ‘there is no doubt that the exemption of food from GST will add to complexity, imposing higher compliance costs on business and administration costs on the Government. It is also alleged that such an exemption will create definitional problems that would wreck havoc for business and the Australian Taxation Office.’³⁸⁴

The definitional problems become apparent when working through the necessary steps to determine whether a food item is to be treated as GST-free. First, it needs to be determined whether an item is ‘food’. Such a simple word has a relatively long definition in the GST Act,³⁸⁵ and it is worth noting that the first sub-part of the definition of food is ‘food

³⁸³ Data obtained from: Australian Bureau of Statistics, *Household Expenditure Survey, Australia: Detailed Expenditure Items 2003–2004* (5 March 2009), <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/6535.0.55.001>>.

³⁸⁴ Kenny, above n 40, 425.

³⁸⁵ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 38-4 states:

- (1) *Food means any of these, or any combination of any of these:*
- (a) *food for human consumption (whether or not requiring processing or treatment);*
 - (b) *ingredients for food for human consumption;*
 - (c) ** beverages for human consumption;*
 - (d) *ingredients for beverages for human consumption;*
 - (e) *goods to be mixed with or added to food for human consumption (including condiments, spices, seasonings, sweetening agents or flavourings);*
 - (f) *fats and oils marketed for culinary purposes;*
- but does not include:*
- (g) *live animals (other than crustaceans or molluscs); or*
 - (ga) *unprocessed cow's milk; or*
 - (h) *any grain, cereal or sugar cane that has not been subject to any process or treatment resulting in an alteration of its form, nature or condition; or*

for human consumption’³⁸⁶ and shows a clear example of poor drafting — defining ‘food’ by reference to ‘food’. If the item in question is in fact food, then the next step is to determine if the food falls under a taxable category. These categories are listed in Schedule 1 of the GST Act, and include food for consumption on the premises from which it is supplied, hot food for consumption away from those premises, prepared food, confectionery, savoury snacks, bakery products, ice-cream food or biscuit goods. It is a reasonably short list, but in the ATO *GST Food Guide* (a guide for food retailers to enable them to determine whether their food items are taxable or GST-free), retailers are told to ‘always check both the “GST-free food” and the “Taxable food” lists when determining the GST status of a food item’.³⁸⁷ The latest ‘detailed food list’ available on the ATO website contains over 850 items.³⁸⁸ It needs to also be noted that there are a number of food items that may or may not be taxable, depending on how they are prepared or sold. Bread rolls are a prime example. Bakery products are listed as a taxable category of food, but this category excludes bread or bread-rolls (ie bread and bread-rolls are generally GST-free). If you buy bread fresh from the oven at a bakery, it could be argued that as hot food it should be taxable under the category, ‘hot food for consumption away from those premises’. However, as it is not intended to be consumed hot, it will remain GST-free. But, if a restaurant supplies bread or bread-rolls, these items will then be taxable, as the good will be consumed on the premises where it is supplied.³⁸⁹

The above shows how a simple premise, that ‘basic’ food is GST-free, is fraught with complexities, particularly when whether a food is taxable is based on a number of different criteria, and the GST-free categories of food have themselves various exemptions.³⁹⁰ In a speech made by Michael Carmody (the then Tax Commissioner) in 1999, urging Parliament not to treat food as GST-free, he used an example from the UK, where VAT was payable on meat pies sold in a bakery before 3:00pm (when they were

(i) plants under cultivation that can be consumed (without being subject to further process or treatment) as food for human consumption.

(2) Beverage includes water.

³⁸⁶ A New Tax System (Goods and Services Tax) Act 1999 (Cth) s 38-4(1)(a).

³⁸⁷ Australian Taxation Office, *GST Food Guide* (3 August 2009), <<http://www.ato.gov.au/businesses/content.asp?doc=/content/18694.htm>>.

³⁸⁸ Australian Taxation Office, *GST Food Classification Decision Tool* (23 July 2009), <<http://www.ato.gov.au/businesses/content.asp?doc=/content/00198480.htm>>.

³⁸⁹ Australian Taxation Office, above n 49.

³⁹⁰ Taxation Institute of Australia, above n 4, 189.

considered snack food), but were not subject to VAT after 3:00pm (when they were considered a grocery).³⁹¹ It borders on the absurd, and would arguably be humorous if not for the fact that it is a real issue that affects retailers, consumers and taxation authorities, and significantly increases both compliance and administrative costs of the taxation system.

Apart from adding to the complexity of the system, there are arguments that treating certain goods and services as GST-free has not in fact succeeded in the goal of making the system more equitable. All consumers, regardless of their income level, receive the benefit of the GST-free status of food. Although the ABS figures shown earlier indicate that lower income households spend a higher proportion of their income on food, higher income families spend a higher amount in dollar terms. A study from New Zealand found that higher income families actually receive more of a benefit as a result of exempting food from the GST.³⁹² As noted earlier, the GST food exemption causes the largest 'cost' to the government out of all GST exemptions. With both low and high income households benefiting from this exemption, it is questionable whether the large cost to the government can be justified on equitable grounds.

Unfortunately, there is no perfect alternative, and possible reforms were not examined in the Henry Review, with the potential to broaden the GST-base outside the terms of reference. The provision of direct payments would arguably be a simpler solution and could allow the payments to be targeted specifically to low income households. However, such a solution would require means testing of payment to ensure it was distributed to the appropriate households. The discussion below in terms of FTB will demonstrate how complicated means testing can become.

Family tax benefit

From 1941 when child endowment was first introduced, the Australian government has provided some form of assistance to families through the tax and social security system.³⁹³ Depending on the payment or concession in question, these can be thought of as trying to

³⁹¹ Carmody, above n 41, 172.

³⁹² Roger Douglas, 'The New Zealand GST Policy Choice and its Political Implications' in Rick Krever and David White (eds), *GST in Retrospect and Prospect* (2007) 3, 8.

³⁹³ Helen Hodgson, 'An Historical Analysis of Family Payments in Australia: Are They Fair or Simple?' (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 318, <<http://www.austlii.edu.au/au/journals/JATTA/2005/20.html>>.

promote either horizontal or vertical equity. In terms of horizontal equity, the argument can be made that all families with children have additional costs not borne by individuals or couples without children, and therefore all such families should receive some form of benefit or tax concession.³⁹⁴ An example of this is the original child endowment payment — it did not have an associated income test and was paid to all mothers with dependent children. However, since the 1980s the objective of family benefits has shifted to alleviating poverty. For example, payments such as the Family Income Supplement introduced in 1983 under the Hawke Labor government was strictly income tested.³⁹⁵

Significant reform occurred to family benefits under the Howard Coalition government — a shift to greater use of the taxation system and a reduction in the number of payments. ‘In the Coalition’s first budget of 1996–97, a new measure of family income support was introduced, named the Family Tax Initiative, which authorised use of the tax system as well as the transfer system to deliver the additional benefits ... The measure signalled, both in its symbolic naming and in the mechanism of delivery of the benefit, a clear reversion to the use of the tax system (through a tax rebate method) to deliver family income support’.³⁹⁶ The system was further reformed by the Coalition government in 2000, with the introduction of Family Tax Benefit (FTB). The Explanatory Memorandum to the Bill introducing the legislation stated: ‘As part of the Government’s plan for a new tax system, the structure and administration of family assistance is being simplified with effect from 1 July 2000. Twelve forms of assistance, currently available under the tax and social security systems, will be reduced to three.’³⁹⁷ The three benefits being referred to were the FTB Part A, FTB Part B and the Child Care Benefit. Only the FTB Part A and B will be discussed in this paper. The FTB can hardly be considered simple, and the complexity will be shown through a discussion of the criteria that must be met to receive payments, and the problems that have arisen with these criteria and overpayments. As Hodgson stated, the ‘combination of benefits does not necessarily result in the simplification of benefits’.³⁹⁸

It is interesting to note that the actual provision of FTB Part A and B are not recognised as tax expenditures in the Tax Expenditures Statement, despite the fact that they

³⁹⁴ Ibid.

³⁹⁵ Cass and Brennan, above n 6, 43.

³⁹⁶ Ibid 51.

³⁹⁷ A New Tax System (Family Assistance Bill) 1999 (Cth), Explanatory Memorandum.

³⁹⁸ Hodgson, above n 55.

are tax offsets.³⁹⁹ What is recognised as a tax expenditure is the cost to the government in treating such benefits as exempt income.⁴⁰⁰ Generally speaking, in dollar terms, this exemption is the largest tax expenditure for exemption of government income support payments, with a cost of \$2010 million for 2009–10.⁴⁰¹

In regard to FTB, the preliminary eligibility criteria are not difficult — you must care for a dependent child at least 35% of the time and must meet certain residency requirements.⁴⁰² Where the complexity arises is in the calculation of the amount of FTB a family receives. In relation to FTB Part A, the Family Assistance Office states: ‘to assist the families that need it most there is a maximum rate of benefit for those on low incomes and a base rate for families on moderate income’.⁴⁰³ It is clear from this statement that vertical equity is a key policy objective behind the payment, but is also one of the reasons the calculation is so complex.

In order to determine the amount of FTB Part A, the ‘actual annual family income’ must first be calculated.⁴⁰⁴ This does not equate to taxable income, but is the sum of taxable income, employer provided or reportable fringe benefits, reportable superannuation contributions, total net losses from rental properties included in taxable income, tax free pensions or benefits, and foreign income (either exempt or not taxable in Australia). Any maintenance payments that are paid by the taxpayer are subtracted in this calculation.⁴⁰⁵ If ‘actual annual family income’ is less than \$44 165, the maximum rate of FTB Part A will be

³⁹⁹ Commonwealth Ombudsman, *Own Motion Investigation into Family Assistance Administration and Impacts on Family Assistance Office Customers* (Commonwealth of Australia, 2003).

⁴⁰⁰ Australian Treasury, above n 9, 52.

⁴⁰¹ For the 2009–10 year, the exemption of the Tax Bonus for Working Australians was the largest tax expenditure item in regards to exemption of government income support payments, ‘costing’ \$2070 million for the 2009–10 income year. However, as this bonus was a ‘one-off’, based on taxable income in the 2007–08 income year, the ‘cost’ of this exemption will drop significantly to \$95 million in 2010–11, with no further cost estimates past that time: Australian Treasury, above n 9, 57.

⁴⁰² Centrelink, *Family Tax Benefit Part A: Eligibility* (16 April 2010), <http://www.centrelink.gov.au/internet/internet.nsf/payments/ftb_a_eligible.htm>; Centrelink, *Family Tax Benefit Part A: Residence Requirements* (18 November 2009), <http://www.centrelink.gov.au/internet/internet.nsf/payments/ftb_a_residence.htm>; Centrelink, *Family Tax Benefit Part B: Eligibility* (4 May 2010), <http://www.centrelink.gov.au/internet/internet.nsf/payments/ftb_b.htm>; Centrelink, *Family Tax Benefit Part B: Residency Requirements* (18 November 2009), <http://www.centrelink.gov.au/internet/internet.nsf/payments/ftb_b_residence.htm>.

⁴⁰³ Family Assistance Office, *Family Assistance: The What, Why and How* (Commonwealth of Australia, 2009) 11.

⁴⁰⁴ *Ibid.*

⁴⁰⁵ Centrelink, *Taxable Income* (23 October 2009), <http://www.centrelink.gov.au/internet/internet.nsf/factors/income_taxable.htm>.

received.⁴⁰⁶ However, the maximum rate varies based on age of children and number of children. If the actual annual family income is above \$44 165, the maximum rate is reduced by 20 cents for each dollar over the amount until the 'base rate' of FTB Part A is reached. As the base rate varies based on the number of and age of children, the maximum income level a family can have will also vary based on these factors. Once a family's actual annual income reaches \$94 316 (plus \$3796 for each FTB child after the first), the base rate reduces by 30 cents for each dollar over that amount until the payment stops.⁴⁰⁷ If you receive an amount over the base amount, the maintenance income test may also apply, where the FTB Part A is reduced by 50 cents in the dollar if child support or spousal maintenance is received over certain amounts.⁴⁰⁸

FTB Part B provides further assistance to single parent families or a two parent family with one main income.⁴⁰⁹ If the family in question is a single parent family, the single parent can earn up to \$150 000 and still receive the maximum rate of FTB Part B (with the maximum rate varying based on whether the child is under or over 5 years). Once the \$150 000 is exceeded, no FTB Part B will be paid. In a two parent family, the main income earner must earn less than \$150 000, and then an income test is applied to the lower income earner. The secondary income earner can earn up to \$4672 and still receive the maximum rate of FTB Part B. Once the income exceeds this limit, the maximum rate of FTB Part B is reduced by 20 cents for each dollar over this amount. Based on current rates and payment thresholds, the secondary income earner can earn up to \$23 817 if the person has a child under 5 years of age or \$18 542 if the person has a child between 5 and 18 years of age.⁴¹⁰

One of the main issues regarding the FTB is the potential for overpayment.⁴¹¹ FTB can be paid in a number of ways: fortnightly, annually, or a combination of both. The majority of families receive the benefit as a fortnightly payment, but these payments are

⁴⁰⁶ This figure is current as at 22 May 2010. Centrelink, *Family Tax Benefit Part A: Income Test* (20 March 2010), <http://www.centrelink.gov.au/internet/internet.nsf/payments/ftb_a_iat.htm>.

⁴⁰⁷ Ibid.

⁴⁰⁸ Centrelink, *Maintenance Income Test* (20 March 2010), <http://www.centrelink.gov.au/internet/internet.nsf/payments/maintenance_iat.htm>.

⁴⁰⁹ Centrelink, *Family Benefit Part B* (4 May 2010), <http://www.centrelink.gov.au/internet/internet.nsf/payments/ftb_b.htm>.

⁴¹⁰ Centrelink, *Income Test for Family Benefit Part B* (20 March 2010), <http://www.centrelink.gov.au/internet/internet.nsf/payments/ftb_b_iat.htm>.

⁴¹¹ Family Assistance Office, above n 65, 6.

based on an *estimate* of actual income.⁴¹² The Family Assistance Office provides a list of circumstances where ‘you are at a high risk of being overpaid’. This includes items such as income changing because of being a casual or shift worker.⁴¹³ As pointed out by Hodgson, it is often low income families that are in casual employment.⁴¹⁴ The annual payment option means that FTB is not paid until the actual income is known. However, it is obviously low income households who are more likely to need to receive the payments fortnightly.

Both FTB Part A and B include a supplement payment, with all families who are eligible for FTB eligible to receive the supplement. These supplements can only be paid annually once the relevant tax returns are lodged with the ATO (or the Family Assistance Office has been advised that a tax return does not need to be lodged and annual income has been verified), and the Family Assistance Office has balanced the FTB payments. If necessary, the supplement can be used to reduce FTB or Child Care Benefit overpayments from the current year or previous years, and /or recover an outstanding tax debt.⁴¹⁵

Prior to 1 July 2009, the FTB could be claimed either through the ATO as a refundable tax offset or through the Family Assistance Office. However, from 1 July 2009, it has only been able to be accessed via the Family Assistance Office.⁴¹⁶ However, despite this, links with the taxation system are clear. First, taxable income, which forms part of ‘actual annual income’, is one of the key criteria for determining whether a family is eligible to receive FTB. Secondly, the supplement payment can be used to recover outstanding tax debts.⁴¹⁷

In the 2010–11 Budget, the ‘estimated actual expenses’ of FTB for the 2009–10 year was \$17 821 898⁴¹⁸ and this does not include the ‘cost’ to the government of exempting these payments from income tax, as discussed earlier. Although it is not being argued that assistance to families is unnecessary, with FTB being a significant cost to the government,

⁴¹² Family Assistance Office, above n 65, 4.

⁴¹³ Family Assistance Office, above n 65, 6.

⁴¹⁴ Hodgson, above n 55.

⁴¹⁵ Family Assistance Office, above n 65, 8.

⁴¹⁶ Family Assistance and Other Legislation Amendment (2008 Budget and Other Measures) Bill 2009 (Cth).

⁴¹⁷ Australian Taxation Office, *Family Tax Benefit – Cease Fortnightly Payments for Recipients Who Do Not Lodge a Tax Return* (29 May 2009), <<http://www.ato.gov.au/individuals/content.asp?doc=/content/00190508.htm>>.

⁴¹⁸ Family, Housing, Community Services and Indigenous Affairs Portfolio, *Portfolio Budget Statement 2010–11* (2010) 41.

the system should be as equitable as possible, but also simple enough so that families can understand their entitlements and obligations. In an attempt to be equitable the system is now overly complex and, due to the extent of overpayments, there was a Commonwealth Ombudsman inquiry into the administration of the FTB.⁴¹⁹ It can be safely said that if the purpose of the Howard government's reforms in 2000 were to simplify the system, they did not succeed.

It is also arguable that the FTB system is not equitable, regardless of whether the focus is horizontal or vertical equity. In terms of horizontal equity, all families with children should receive FTB, as all have costs not faced by those without children. By means testing the payment, higher income families, that still have the costs associated with raising children, do not receive assistance. If vertical equity is the policy objective behind FTB, then means testing the payment is necessary. However, the current method of means testing the payment is by no means equitable, particularly in regards to FTB Part B. Under this payment, any family with only one income earner who earns less than \$150 000 receives the maximum rate of the payment. It seems logical that a family with one income earner earning \$50 000 a year is more in need than a family with one income earner earning, for example, \$145 000.

The impact of the secondary income earner means test could result in further inequitable outcomes. Consider a family with one parent earning \$145 000 and the other partner not working. This family will receive the maximum rate of FTB Part B. In contrast, a family with both parents working, each earning \$50 000 a year, will not be entitled to any FTB Part B, as the secondary income earner thresholds will be exceeded. Overall, the second family earns less than the first family, and yet the first family will receive assistance. As stated by Hodgson, 'if there are two conclusions that must be drawn ... they must be that the current system of transfer payments to families fails the tests of both equity and simplicity'.⁴²⁰

Recommendation 90 in the recent Henry Review stated:

Current family payments, including Family Tax Benefit Parts A and B, should be replaced by a single family payment. The new family payment should:

⁴¹⁹ Commonwealth Ombudsman, above n 61.

⁴²⁰ Hodgson, above n 55.

- (a) cover the direct costs of children in a low-income family (that is, the costs associated with food, clothing, housing, education expenses); and
- (b) assist parents nurturing young children to balance work and family responsibilities.⁴²¹

As yet, this recommendation has not been specifically accepted or rejected by the Australian government.⁴²² If accepted, whether this recommendation improves the simplicity of the system, or is merely a repeat of the Howard government's earlier efforts to combine family payments is unknown. However, it seems unlikely that such a further combination of payments will simplify the system, unless the current method of means testing such payments is significantly simplified.

Education tax refund

The Education Tax Refund (ETR) was a Rudd Labor government initiative, introduced by the Tax Laws Amendment (Education Refund) Bill 2008, and contained in Subdivision 61-M of the *Income Tax Assessment Act 1997* (Cth). In the second reading speech of the Bill, although 'equity' was not mentioned per se, the requirements of the ETR (which are discussed below), as well as some of the phrases used in the speech, indicate that equity was a key reason for its introduction. For example, Treasurer Wayne Swan stated:

Education is the engine room of prosperity and helps create a fairer, more productive society. It is the most effective way we know to build prosperity and spread opportunity. A key part of the education revolution is helping parents meet the everyday costs of their children's education.

He further stated that 'education increases productivity and participation, it builds prosperity and it also offers the hope of breaking the intergenerational cycle of poverty'.⁴²³

Essentially, the ETR allows eligible families to claim 50% of eligible education expenses for their children incurred during the income year. The 50% refund applies to a maximum of \$750 per primary school student and \$1500 per high school student (ie a

⁴²¹ Australia's Future Tax System, *Part Two Detailed Analysis*, above n 2, 576.

⁴²² Institute of Chartered Accountants of Australia, *Henry Tax Report* (22 May 2010), <<http://www.charteredaccountants.com.au/files/documents/Henry%20Tax%20Review.pdf>>

⁴²³ Tax Laws Amendment (Education Refund) Bill 2008 (Cth), Second reading speech.

maximum refund of \$375 and \$750 respectively).⁴²⁴ Although the explanatory memorandum accompanying the Bill stated that the compliance cost impact would be low,⁴²⁵ the FAQ section on the ATO website contains 38 questions.⁴²⁶ There are a number of criteria that must be met in order to claim the ETR.

Persons who care for a child who is enrolled in primary or secondary school, and some independent students, may be eligible to claim the rebate. In terms of persons who care for a child, in order to be eligible for the ETR, they must receive FTB Part A in relation to that child. If they do not receive FTB Part A in relation to the child, that must be because either a payment was made to the child that prevented the person from receiving the benefit (such as youth allowance or a disability support pension) or the child stopped full-time school during the year and received income over the cut-out amount of FTB Part A.⁴²⁷

Independent students must be under the age of 25 and receive a payment such as youth allowance or ABSTUDY living allowance (and be considered independent for the purposes of that payment). Further, they must be an Australian resident who lives in Australia, and meet the schooling requirement, which is the undertaking of full-time secondary school studies.⁴²⁸

If it is determined that the carer or independent student is eligible for the ETR, they must calculate what their eligible education expenses were for the year, which also has a number of requirements. An eligible education expense is incurred by an eligible person (ie a person who meets the eligible requirements discussed above), relates to the education of the child or independent student, must be specified as an eligible education expense in the legislation, and is incurred on a day when the schooling requirement was met. Eligible education expenses specified in the legislation include computers and related equipment or repairs, software, textbooks or other learning materials, or trade tools prescribed for trade courses undertaken in secondary school.⁴²⁹

⁴²⁴ Ibid.

⁴²⁵ Tax Laws Amendment (Education Refund) Bill 2008 (Cth).

⁴²⁶ Australian Taxation Office, *Education Tax Refund — Frequently Asked Questions* (14 December 2009), <<http://www.ato.gov.au/individuals/content.asp?doc=/content/00166469.htm>>.

⁴²⁷ Australian Government, *Education Tax Refund — Am I Eligible?* (22 May 2010), <<http://www.educationtaxrefund.gov.au/am-i-eligible/default.asp?sid=42>>.

⁴²⁸ Ibid.

⁴²⁹ Australian Government, *Education Tax Refund — What Can I Claim?* (22 May 2010), <<http://www.educationtaxrefund.gov.au/what-can-i-claim/default.asp?sid=42>>.

As stated above, the maximum expenses allowed are \$750 for primary school students and \$1500 for secondary school students. If expenses are incurred above this amount, the excess may be carried forward for a maximum of one year (and the eligibility requirements must be met in the year the claim is made). If a person shares care of a child, they claim an amount based on the FTB Part A shared care percentage. However, further complications arise if a person shares the care of a child with a person who is not the person's current partner and a payment was made to the child that prevented the person receiving FTB Part A. In this case, the ETR eligible to be claimed is based on the number of nights during the year that the child was in the person's care.⁴³⁰

The above should show that any tax rebate, even one with a simple premise of paying a tax refund for educational expenses, has a number of layers. It is less complex than FTB in terms of calculation; that is, every person who meets the initial eligibility requirements can claim up to the maximum amount based on expenses incurred. However, by being linked to FTB Part A, some of the complexities associated with its calculation pass over to the ETR. It is administered through the tax system, and for those who are not required to lodge a tax return, requires the lodgement of an additional form to access the tax rebate.⁴³¹

It also arguably does not meet the criteria of either horizontal or vertical equity. Due to the eligibility requirements, not all taxpayers who have eligible educational expenses can claim the rebate, and therefore the ETR is inequitable in terms of horizontal equity. However, once the eligibility criteria are met, persons with various levels of income may be eligible to claim the same amount (assuming they had the same amount of eligible educational expenses).

The expenses claimed must be able to be substantiated, with the Treasurer stating in the second reading speech: 'This offset will apply to eligible expenses incurred from 1 July 2008. Those eligible for the education tax refund should start keeping their receipts — I cannot stress this enough — to allow them to claim the tax offset in their 2008–09 income

⁴³⁰ Australian Government, *Education Tax Refund — How Much Can I Claim?* (22 May 2010), <<http://www.educationtaxrefund.gov.au/how-much/default.asp?sid=42>>.

⁴³¹ Australian Taxation Office, *Education Refund Instructions and Claim 2008–09* (3 July 2009), <<http://www.ato.gov.au/individuals/content.asp?doc=/content/00194402.htm&pc=001/002/067/001/001&mnu=&mfp=&st=&cy=1>>.

tax return from 1 July 2009.⁴³² However, this raises an issue as the legislation was not introduced into the House of Representatives until almost four months into the 2008–09 financial year. It was not passed by the Senate until 27 November 2008 and did not receive royal assent until 9 December 2008. Therefore, it seems quite possible that an eligible person could have incurred eligible expenses from the period 1 July 2008 until the ETR was publicised, and not kept receipts. This could further violate the principle of horizontal equity, as persons in the same economic position who incurred a similar level of expenses at different times of the year may be eligible for a different amount of the rebate.

As with FTB Part A and B, the ETR itself is not included in the Tax Expenditures Statement (despite the fact that it is also a tax offset).⁴³³ However, the cost of exempting the ETR from income tax is included in the Tax Expenditures Statement and is estimated at \$180 million for the 2010–11 year, increasing to \$190 in 2011–12 and 2012–13. The cost listed in the explanatory memorandum over three years (2008–09 through to 2011–12) is \$4410 million.⁴³⁴

The Henry Review recommended (Recommendation 6) that the ETR be removed from the income tax system, and instead be included in a single family payment and paid as an advance lump-sum-amount at the start of the school year.⁴³⁵ ‘The proposed reform would reduce the compliance burden (substantiation requirements) for family payment recipients, provide more timely compensation and reduce complexity and administration costs in the tax system.’⁴³⁶ This recommendation has not been accepted (although also not specifically rejected) by the Australian government.

Conclusions

No tax system will be able to fully achieve the goals of tax simplicity, equity and efficiency. In the Australian tax system, equity is considered paramount, and as such there are a number of instances where attempts to make the tax system more equitable have occurred at the expense of simplicity. Further, as shown through the examples in this paper, it is arguable that such attempts have not in fact achieved the goals of either horizontal or vertical equity.

⁴³² Tax Laws Amendment (Education Refund) Bill 2008 (Cth), Second reading speech.

⁴³³ Australia’s Future Tax System, *Part Two Detailed Analysis*, above n 2, 89.

⁴³⁴ Tax Laws Amendment (Education Refund) Bill 2008 (Cth).

⁴³⁵ Australia’s Future Tax System, *Part Two Detailed Analysis*, above n 2, 32.

⁴³⁶ Australia’s Future Tax System, *Part Two Detailed Analysis*, above n 2, 89.

Although the Henry Review suggested changes to FTB and the ETR, these recommendations have not yet been accepted by the Australian government. Further, due to the review panel's terms of reference, no recommendations could be made to broaden the base of the GST. It therefore seems unlikely that any changes will occur in the near future to any of the examples discussed in this paper.

The government itself has stated that the primary goal of a taxation system is to raise revenue, and yet it continues to use the tax system to achieve socio-economic objectives. If the government continues to use the tax system to achieve socio-economic objectives, greater emphasis needs to be placed on how to achieve such objectives without further complicating the system. Further, attention needs to be given to whether the tax concessions and offsets introduced under the premise of ensuring the tax system is equitable actually achieve that objective. As demonstrated through the examples in this paper, it is arguable whether the GST food exemption, FTB and the ETR achieve either horizontal or vertical equity.

If vertical equity is a policy objective, this will be best achieved by maintaining progressive tax rates. Further assistance can then be given to those in need via direct payments, rather than the use of tax expenditures and offsets. Each method is a significant cost to the government, but the complexities that have resulted in the tax system due to tax expenditures have caused additional (and arguably unnecessary) administrative and compliance costs.

Theories of Distributive Justice: Frameworks for Equity **Helen Hodgson***

Abstract

In the wake of the global economic crisis of 2008/09 public concern has focused on inequities within society. Over the period leading up to the economic crisis, Western liberal democracies adopted market based economic policies that allowed disparities between the income and wealth of the highest and lowest income earners to flourish.

The tax transfer system is one of the tools available to governments to regulate such inequities: progressive tax systems can apply higher taxes to those with a greater ability to pay, while transfer systems can redistribute taxes to those in need.

However, fairness is a subjective assessment based on morals and ethics as interpreted by economists and policymakers. Why does society agree to redistribution through the tax system, and to what extent is redistribution justified? How have concepts of distributive justice evolved, and to what extent do these concepts reflect culture and prevailing economic theories?

In this article I review four major theories of distributive justice that can be applied to interpret equity. I draw extensively on the views of several prominent 20th century economists and philosophers who represent different schools of economic thought: Robert Nozick (libertarianism), the utilitarians, John Rawls' 'Theory of Justice' and Amartya Sen's capabilities approach.

The purpose of this review is to make these theories accessible to students of tax policy in order to assist them in understanding how the values and ethical positions taken by policymakers can impact on fairness and equity in the tax transfer systems.

Introduction

The concept of economic equality is hard to define or to measure. It might be impossible to recognise complete equality if it existed; but inequality is very easy to recognise.⁴³⁷

* Senior Lecturer, Australian School of Taxation, University of New South Wales.

⁴³⁷ Arthur M Okun, *Equality and Efficiency: The Big Tradeoff*, The Godkin Lectures (The Brookings Institute, 1975).

While there are a number of formulations as to what is required of a ‘good’ taxation system,⁴³⁸ we are accustomed to including efficiency, equity and simplicity as essential criteria. The difficulty with the concept of equity is in understanding exactly what is meant by the term. While efficiency and simplicity are measurable, equity is a subjective concept, capable of different interpretation depending on the moral and ethical frameworks, the experiences and the understanding of the person making the interpretation.

However, there is a clear perception in the community that inequality is growing, and that the structure of the tax transfer system contributes to this inequity.⁴³⁹

Taxation, including tax policy principles, is generally taught within law and business degrees, with a focus on the black letter legal and constitutional principles or the economic impact of particular policy directions. There is rarely scope in such programs to step back and examine the moral and ethical underpinnings of the tax and transfer system and to locate this inquiry in philosophies of distributional justice. A consequence of this is that students who encounter the concept of equity in reading tax policy may not recognise that it may mean different things to different writers. For example, readers need to recognise and interpret some of the underlying issues, including:

- the choice of indices to use when attempting to measure distributional shifts;
- whether equity should be measured by reference to the needs of society or the individual, balancing any competition between those needs;
- how the policy settings of the tax transfer system should be adjusted to achieve a preferred equitable distribution of resources; and
- the role of the institutions within a given society in helping to decide some of these questions.

Equity is a fundamental consideration in the development or review of tax policy in conjunction with economic efficiency, simplicity and international competitiveness. The taxation system is used by governments as a tool to improve the welfare of society, whether

⁴³⁸ See, eg, K W Asprey, ‘Taxation Review Committee Full Report’ (1975); Adam Smith, *The Wealth of Nations* (1776, Petersfield Harriman House, 2007 available at <www.netlibrary.com>); J E Meade, ‘The Structure and Reform of Direct Taxation’ (Allen & Unwin, 1978); Australian Treasury, ‘Architecture of Australia’s Tax and Transfer System’ (Australian Government, 2008).

⁴³⁹ OECD, *Growing Unequal? Income Distribution and Poverty in OECD Countries* (OECD, 2008).

through the implementation of economic programs that will have a beneficial impact or through the raising of money for direct redistribution. However, there are variations in political and economic views on what equity means, and the best way to deliver equitable outcomes in policy.

We can break down the concept of equity into different aspects. Traditionally taxation issues have been explored through the concepts of vertical equity, which requires that people earning more should pay more tax, and horizontal equity, which is the understanding that persons earning the same should pay the same tax. Modern theorists will also consider other subgroups within the community that face particular systemic challenges, such as gender equity, queer equity or indigenous equity.

The field of welfare economics is concerned with examining the impact of economic policy on social welfare. Much of the literature in this field tends to be concerned with the measurement of shifts in social welfare,⁴⁴⁰ or of the distribution of resources throughout society. In particular, the economists Lorenz and Atkinson developed the Lorenz Curve and the Atkinson Index respectively, as measures of income inequality based on the distribution of income among the population that use shifts in the distribution to measure improvements in social welfare.

However, such normative measures are not the concern of this paper. In this paper I will examine a number of theories of distributive justice and their relevance in designing social policies, particularly tax transfer regimes. This strays beyond the realm of economists into political philosophy because it requires an examination of the moral and ethical philosophies that underpin theories of justice.

The various theories of distributional justice that students are most likely to encounter in their reading are all derived from liberal theory, and much of the debate stems back beyond the age of enlightenment: references to John Locke, John Stuart Mill, Jeremy Bentham and Rene Descartes all appear regularly in the modern debate.

⁴⁴⁰ Jonathan R Kesselman and Ron Cheung, 'Tax Incidence, Progressivity and Inequality in Canada' (2004) 52(3) *Canadian Tax Journal* 709.

Andersson⁴⁴¹ identifies three stages of moral theory: ‘real freedom for all’, ‘democratic community’ and the emerging area of ‘sustainable development’:

‘Real freedom’ is a value formulated on the level of the individual. ‘Democratic community’ is a value pertaining to a collective of people. ‘Sustainable development’ relates to the global and ecological system as a whole. It is hardly possible to derive one of these values directly for the other two. There are genuine conflicts between them ... this means that we are often unable to say which ethical position or political solution is preferable in any absolute sense; we have to accept valuational differences and ethical compromises.⁴⁴²

I will examine these issues through the writings of four 20th century philosophers and economists who represent four modern theories of distributive justice: Robert Nozick represents the libertarian view; the utilitarians including John Harsanyi; John Rawls’ ‘Theory of Justice’;⁴⁴³ and Amartya Sen’s capabilities approach. The debate between these contemporaries is a rich source of material.

To apply Andersson’s typography to these philosophers: libertarians are recognised as free market philosophers focused on individual rights, but Sen also believes that freedom is obtained by allowing individuals the freedom to maximise their own capability, and resource reallocation must be a means toward that end. Democratic communities are represented by the utilitarian school, which looks toward the greater good for the greatest number of people but also by John Rawls’ ‘Theory of Justice’ which is based on a social contract between members of society.

In this paper I will begin by examining the difference between the concepts of equity, equality and distributive justice. I will then outline the four theories of distributive justice that have had most impact over the past four decades: libertarianism, utilitarianism, Rawls’ ‘Theory of Justice’⁴⁴⁴ and Sen’s capability framework. The next section of this paper will

⁴⁴¹ Jan Otton Andersson, ‘Real Freedom, Democratic Community and Sustainable Development as Fundamental Values in Economic Enquiry’ in Ralf Eriksson and Markus Jantti (eds), *Economic Value and Ways of Life* (Avebury, 1995) 157.

⁴⁴² Ibid 160.

⁴⁴³ John Rawls, *Justice as Fairness: A Restatement* (Harvard University Press, 2001) (referred to as the ‘Theory’).

⁴⁴⁴ Ibid.

contrast these theories, drawing on contemporary discussion between the various proponents to identify key points of difference. Finally, the conclusion will place this debate in the context of current trends in growth in inequality and the global financial crisis of 2008/09.

Equity, equality and distributive justice

Equity in the economic context can be broadly defined as fairness, based on the access to, or distribution of, the resources necessary for welfare:

Equity is a general concept that can be given alternative meanings when formalized. As a general concept it refers to the belief that the distribution of economic welfare matters, and that increasing the equality of distribution is a laudable objective.⁴⁴⁵

In order to establish the preferred distribution of economic welfare, economists and philosophers refer to theories of distributive justice. These theories examine the extent to which resources are distributed throughout society:

Principles of distributive justice are normative principles designed to guide the allocation of the benefits and burdens of economic activity.⁴⁴⁶

As Roemer notes⁴⁴⁷, the work of economists and philosophers in this field is entwined:

The economist's way of thinking can check the consistency of a philosophical theory or provide a concrete formulation (a model) to make precise some of its still vague assertions ... The key new concepts in the last thirty years in the theory of distributive justice — primary goods, functioning and capability, responsibility in its various forms, procedural versus outcome justice, midfare — have all come from the philosophical way of thinking.⁴⁴⁸

⁴⁴⁵ J Black, N Hashimzade and G Myles, *A Dictionary of Economics* (Oxford University Press, 2009),
<<http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t19.e1025>>.

⁴⁴⁶ Julian Lamont and Christi Favor, 'Distributive Justice' in *The Stanford Encyclopedia of Philosophy* (Fall 2008 edition),
<<http://plato.stanford.edu/archives/fall2008/entries/justice-distributive/>>.

⁴⁴⁷ John E Roemer, *Theories of Distributive Justice* (Harvard University Press, 1996).

⁴⁴⁸ Ibid 3.

In the context of the tax transfer system, equity is usually considered under the two criteria of vertical equity and horizontal equity. They have been described as ‘refinements of the ability to pay principle’⁴⁴⁹. While horizontal equity requires that people in the same economic position should pay the same tax, people in a different economic situation should be treated differently. The major difficulty is in determining what is meant by the ‘same’ or ‘different’ economic position. Other criteria, such as gender or race, can also be applied in examining equity or distributive justice.

To what extent does equity require equality? The term equity is usually used in preference to equality because the only society in which people could be regarded as truly equal would be the perfect egalitarian ideal aimed for by philosophers such as Karl Marx. The reality of the experience with communism shows that even a society that claims equality of all citizens through redistribution of resources cannot ensure true equality of all citizens. Other than a handful of ‘strict egalitarians’, few theorists argue that equality is achievable — or even desirable. Modern egalitarian theory seeks a more equal distribution of resources, rather than seeking an equal distribution.

Equality as such may not be the most appropriate system to ensure that economic activity is directed to maximise welfare of specific individuals, groups of individuals or a society as a whole.

While access to income and wealth are an important determinant of a person’s welfare, there are other characteristics that will affect on a person’s welfare. John Rawls in the ‘Theory’⁴⁵⁰ refers to three factors that shape a person’s access to resources:

1. Social factors: a person’s class of origin can ensure access to resources including wealth and power;
2. Natural factors: a person may have inherent natural endowments that can be fully exploited given the opportunity; and
3. Fortuitous factors: a person may encounter circumstances that limit or enhance access to resources from time to time, such as ill health, unemployment or winning the lottery.

⁴⁴⁹ Australian Treasury, above n 2, 180.

⁴⁵⁰ Rawls, above n 7.

Redistribution of income and wealth may enhance or ameliorate these factors: for example, a person with a natural talent as an artist may need assistance to allow them to fully explore and develop this talent; or transfer payments may be available to assist a person who is facing financial difficulties as a result of ill health or unemployment. However, equality may not be achievable due to limitations in one or more of the three factors.

Accordingly, the concept of equity is generally now seen as more appropriately referring to ensuring that all have a sufficiency of resources, being money or wealth, to meet their needs. However, even this requires subjective judgments: as wealth within a society increases, so do the demands of all within that society — including those who are not wealthy.⁴⁵¹ Thus the focus shifts to the distribution of resources within the society.

Amartya Sen developed a capability framework to consider equality, which extends beyond the economic issues of equity. Sen⁴⁵² argues that the specific factors that affect whether a person can access the resources allocated to them must be taken into account in determining equity:

A person less able or gifted in using primary goods to secure freedoms, (e.g. because of physical or mental disability, or varying proneness to illness, or biological or conventional constraint related to gender) is disadvantaged compared with another more favourably placed in that respect even if both have the same bundle of primary goods.⁴⁵³

As expressed in his most recent book:⁴⁵⁴

In contrast with the utility-based or resource-based lines of thinking, individual advantage is based in the capability approach by a person's capability to do things he or she has reason to value. A person's advantage in terms of opportunities is judged to be lower than that of another if she has less capability — less real opportunity — to achieve those things that she has reason to value. The focus here is on the freedom that a person actually has to do this or be that — things that he or she may value doing or being ... [The capability approach] is thus linked closely

⁴⁵¹ Smith, above n 2, Book 2 Chapter 3.

⁴⁵² Amartya Sen, *On Economic Inequality* (Clarendon Press, 1973).

⁴⁵³ Ibid 148.

⁴⁵⁴ Amartya Sen, *The Idea of Justice* (Allen Lane, 2009).

with the opportunity aspect of freedom, seen in terms of ‘comprehensive’ opportunities, and not just focusing on what happens at ‘culmination’.⁴⁵⁵

Accordingly, capability becomes an important consideration in the distribution of resources: does the recipient have the capability to utilise the resources to improve his position, and are the resources that are made available to the recipient the appropriate resources to maximise his capability?

Theories of distributive justice

There are a number of theories of distributive justice that view the issue of equity through a coherent framework. This paper compares libertarianism, utilitarianism, Rawls’ ‘Theory’ and the capability approach as expressing a range of modern views. At different periods, and within different economic and political regimes, different views have achieved pre-eminence among policymakers.

These theories stem from the liberal tradition, which values liberty and equality: ‘The core substantive principle of liberalism is this: *As many people as possible should have as much say as is feasible over the direction their lives will take.*’⁴⁵⁶ Although egalitarianism in its strict form is the exception in that it is more collective in its outcomes, the contribution of Rawls in the ‘Theory’⁴⁵⁷ and other modern egalitarian philosophy is grounded in liberal ideology. The different approaches discussed try to balance three views of the allocation of resources, which can be defined as follows:

- Deserts (or merits): a person deserves a particular allocation of resources. Generally the theory of deserts reflects merit or effort because a person has acted in a manner that enhances their resource allocation. It is argued that recognition of deserts is necessary to ensure efficiency as people are rewarded for effort. Within the tax transfer system this discussion is often considered in the context of disincentive effects, for example through the application of high marginal tax rates or the withdrawal rates for benefits — a person may limit their participation in the labour market because they do not consider that they are receiving adequate reward for their effort.

⁴⁵⁵ Ibid 231–2.

⁴⁵⁶ Alan Wolfe, *The Future of Liberalism* (Alfred A Knopf, 2009) 10.

⁴⁵⁷ Rawls, above n 7.

- Entitlement: a person is entitled to an allocation of resources. This concept is related to deserts because a person who deserves an allocation will also be entitled to those resources. However, it also encompasses holdings that may be accumulated through other legal means, such as inheritance or market purchase. The discussion over capital or wealth taxation encompasses the notion of entitlement. While some would argue that unearned income should be taxed at higher rates, others contend that the taxation of capital or wealth interferes with productivity by limiting investment in productive assets.
- Needs: in contrast to deserts and entitlements, a needs based allocation of resources will give priority to ensuring that a person is allocated sufficient resources to meet their needs. It raises the problem of determining the base level of resources that a citizen needs to support a useful life, either as a class or in the case of a particular individual. The needs principle is inherent in income support systems.

A welfare system contemplates redistribution of resources among citizens, generally based on need. However, deserts and entitlements will be taken into account to a varying extent, depending on the priorities that are applied in the design of the system. For example, income support systems that are based on a social security contribution will incorporate elements of deserts, entitlement and needs based ideologies. To the extent that a person has contributed to the system, they are deserving of and entitled to support. However, there will still be a safety net level of support available for those who have not contributed but are in need of income support. It is worth noting that it is rare to implement a theoretical framework in an ideal form.⁴⁵⁸ For example, a neoliberal economy will still have some level of redistribution based on need — but the desert and entitlement principles will be more prominent than in a socialist economy.

Libertarianism/neoliberals

Libertarians and neoliberals regard the rights of individuals as taking primacy over any collective rights of society. Further, they believe this is best achieved through the free operation of the market. Clearly this can lead to a broad range of political views, ranging from anarchism to free thinking liberalism. Freidrich Hayek drew a distinction between

⁴⁵⁸ Liam Murphy and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford University Press, 2002).

true individualism, which argues that ‘if left free, men will achieve more than individual human reason could design or foresee’⁴⁵⁹ and the Cartesian school in which individualism is seen as a form of social contract. Hayek argues that the latter form of individualism in fact leads to socialism because a condition of free society is to treat all individuals equally. In its economic context, libertarians believe that the market mechanism allows the operation of free will by participants in the market. If the market mechanism operates freely, producers and purchasers have the choice as to whether to trade at the set price. It is the exercise of choice that allows the market to find equilibrium. Accordingly, an individual establishes their own economic wellbeing through the exercise of choice. In its purest form, there is no scope for government intervention in libertarian theory.

Hayek, in his essay on individualism, says that:

When we turn to equality, however, it should be said at once that true individualism is not equalitarian in the modern sense of that word. It can see no reason for trying to make people equal as distinct from treating them equally.⁴⁶⁰

Robert Nozick applied entitlement theory in rejecting the concept of government intervention to redistribute resources because the market is the appropriate redistributive mechanism:

There is no central distribution, no person or group entitled to control all the resources, (jointly) deciding how they are to be doled out. What each person gets, he gets from others who give to him in exchange for something or as a gift. In a free society, diverse persons control different resources, and new holdings arise out of the voluntary exchanges and actions of persons.⁴⁶¹

Similarly, Nozick rejects taxation as being on a par with forced labour because a person is forced to work to earn money to pay taxes which will be reallocated according to some principle that is not chosen by the taxpayer.⁴⁶²

⁴⁵⁹ Friedrich A Hayek, *Individualism and Economic Order* (Routledge & Kegan Paul Ltd, 1949) 11.

⁴⁶⁰ Hayek, above n 23, 30.

⁴⁶¹ Robert Nozick, ‘Distributive Justice’ (1973) 3(1) *Philosophy and Public Affairs* 45, 46.

⁴⁶² Nozick, above n 25, 65.

In his essay Nozick explored the libertarian framework through the entitlement theory, arguing that as people can be entitled to holdings of capital as well as to earnings, in a free market based society they have the right to transfer those holdings to another person — in which case the transferee becomes entitled to the property, and prima facie this is the only valid method of transferral. ‘Justice in holdings is historical; it depends upon what actually has happened.’⁴⁶³ There is a modification to this principle where the acquisition of the rights in the asset may interfere with the liberty of others to use an asset that was freely available and is necessary to life, such as a waterhole. Drawing on Locke’s Theory of Acquisition, a person’s rights to deal with such property should be restricted, and there is a role for state intervention in such cases.⁴⁶⁴

Nozick argued that welfare economics disregards the historical nature of entitlements, looking only at the current distribution of resources. He rejected patterned distributions, redistributions that are allocated to accord with some moral principle — whether merit, needs, effort or some other chosen principle — claiming that any such patterning can be overturned by the participants who may choose an alternative distribution and exercise that choice through the market mechanism.

Utilitarianism

Utilitarianism measures the welfare of society as the sum of the utilities of all members of that society. The basic principle was summed up by Jeremy Bentham as ‘that principle which approves or disapproves of every action whatsoever, according to the tendency it appears to have to augment or diminish the happiness of the party whose interest is in question: or, what is the same thing in other words, to promote or to oppose that happiness.’⁴⁶⁵ Accordingly if the welfare of an individual within that society increases, as long as the decrease in the welfare of other individuals is less than the increase of the member who benefits, then the welfare of society as a whole has increased. To illustrate: if a millionaire pays an additional \$1000 in tax, and this is transferred to health services for low income earners, society will be better off because the marginal utility of the low

⁴⁶³ Nozick, above n 25, 48.

⁴⁶⁴ Nozick, above n 25, 70–8.

⁴⁶⁵ Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation* (Clarendon Press, 1907), Library of Economics and Liberty, <<http://www.econlib.org/library/Bentham/bnthPML1.html>>.

income earners who use the service has increased by at least as much as the marginal utility of the millionaire has decreased.

The field of welfare economics is largely based on utilitarian philosophy, as it is concerned with ensuring that resources are allocated among a community to maximise the welfare of that community. Unlike egalitarianism, utilitarianism does not require the redistribution of resources to ensure that all citizens have equal resources. However, it is distinguished from libertarianism because it does acknowledge that redistribution may be required to maximise the welfare of the community ahead of the interests of individuals, and the state will intervene to facilitate this redistribution.

It is this concept of summing the utilities of all members within a society to measure the welfare of the society that both enables measurement of a society's welfare and gives rise to criticism because the summation can disguise individual movements in welfare. One of the criticisms of utilitarianism is that the measurement of aggregate utility does not take into account the relative position of the winners and losers in the transfer. For example, in relation to education or health a private, user pays system may operate in parallel with a government funded system. When the government makes a co-contribution to the cost of such schools or medical treatment the funding comes from taxes, which spreads the cost across the entire community. However the beneficiaries are the users of the private service, who are often higher income earners. In contrast, when funding is provided to government schools or medical services, the whole community has access.

Transaction costs are significant in the utilitarian analysis because the leakage that may occur through such costs can reduce the benefit to the extent that there is no longer any improvement in the overall welfare of the society. This was explored by Okun in his 'Leaky-Bucket' experiment,⁴⁶⁶ which explored the extent to which a person will accept inefficiencies in the transfer between the donor and the recipient in a tax transfer arrangement, using the analogy of a bucket that leaks while transferring benefits from the rich to the poor. While most people would agree to the transfer if the total amount was made available to the beneficiaries of the program, opinion will change if inefficiencies in the program reduce the amount that is made available. Okun makes the point that this will be a personal judgment made by the observer:

⁴⁶⁶ Okun, above n 1.

If your answer, like mine, lay somewhere between 1 and 99%, presumably the exact figure reflected some judgement of how much the poor needed the extra income and how much the rich would be pinched by the extra taxes.⁴⁶⁷

Pareto optimality, which is fundamental to utilitarian redistribution concepts, is the equilibrium position that is reached where the overall utility of a society is maximised; that is, any further increase in the welfare of one person will result in a decrease in the welfare of someone else. This requires an understanding of social choice theory, which examines how collective decisions are formed and ranked based on the values held by individuals, and has been described as ‘the aggregation of the multiplicity of individual preference scales about alternative social actions’.⁴⁶⁸ The utilitarian view focuses on welfare as a collective function, yet it is based on the values of individuals, and respects the autonomy of individuals within the context of striving for the common good.⁴⁶⁹

Arrow’s Impossibility Theorem⁴⁷⁰ shows that when individual preferences are aggregated to develop a social welfare function the final determination of the policy will be made by a nominated person. The theorem states that any social welfare function that meets the following conditions:

- 1) The collective preference order is based on a set of individual preferences (unrestricted domain);
- 2) The pareto condition is met; and
- 3) The individual preferences are based solely on the alternatives available

Cannot also meet a fourth condition:

- 4) An individual cannot override the preferences of the others (non-dictatorship).

While this person is called a dictator in the theorem, it may well be an elected politician, cabinet minister or secretary who holds the ultimate power. Utilitarians rely on the theory that decision makers act rationally when making economic and distributional decisions.

⁴⁶⁷ Okun, above n 1, 94.

⁴⁶⁸ Kenneth Arrow, ‘Values and Collective Decision Making’ in F H Hahn and Martin Hollis (eds), *Philosophy and Economic Theory* (Oxford University Press, 1979) 110.

⁴⁶⁹ John C Harsanyi, ‘Morality and the Theory of Rational Behavior’ (1977) 44(4 Winter) *Social Research* 623.

⁴⁷⁰ Kenneth Arrow, *Social Choice and Individual Values* (Wiley, 1951).

Game theory is used in economics to predict how individuals would act in specific circumstances, and has shown that in making moral judgments a rational person will disregard self-interest because they can clearly differentiate a self-interested position from a position of general moral application. The morality of a decision can be viewed individually in terms of the specific act (act utilitarianism) or in terms of the general rules that apply when making decisions (rule utilitarianism). Although a person will frequently express an irrational or illogical desire, this expressed preference can be differentiated from the true preference, which can only be determined when the person has access to all relevant information. The decision will ultimately be based on moral preferences combined with rational understanding of outcomes.⁴⁷¹

Egalitarianism

The philosophy that comes closest to equating equality with equity is egalitarianism, and in its strict form it moves further from the liberal tradition than the other philosophies under review. Egalitarians argue that society should strive to ensure equality for all people, and income and wealth should be shared equally among all. The two major arguments against egalitarianism are firstly that effort is not recognised; and secondly that redistribution of wealth and resources will only go part of the way to creating equality because natural skills and luck cannot be redistributed.

The first argument raises the issue of deserts and reward: that rewarding a person for their contribution will encourage participation. In order for an economy to function efficiently, freeloading must be discouraged and production encouraged. If every person is guaranteed an equal share of the output then there is no encouragement to increase levels of production above a base level. Further, there is no incentive to contribute if resources are to be shared equally irrespective of input to the process. Although Karl Marx was an egalitarian, he did recognise the need to reward participants. Marx was primarily concerned with the reform of production, through the dismantling of capitalism: from each according to his ability, to each according to his need.⁴⁷² The redistribution of wealth would follow the reform of production and was a second stage in economic reform. Accordingly, he argued that every

⁴⁷¹ Ibid 469.

⁴⁷² Karl Marx, *Critique of the Gotha Program (Part 1)* (1875; Progress Publishers, 1970), <<http://www.marxists.org/archive/marx/works/1875/gotha/ch01.htm>>.

person has a right to get back what they have put in: if a person puts in more, they are entitled to receive more. It is only when production reform has been implemented, so that the distinction between capital and labour inputs is no longer significant and the overall wealth of society has increased, that the second stage can proceed: in the first phase of socialism, the analysis of exploitation addresses the issue of desert, while the second phase addresses the issues of need.⁴⁷³

The distribution of natural skills, resources and chance has been explored by modern egalitarian theorists who have been concerned with the moral frameworks that underpin redistribution of resources, although these frameworks will usually not result in an ‘equal’ allocation of resources. Egalitarian theories can be categorised as resource based or welfare based,⁴⁷⁴ with a further development of egalitarian theory, known as ‘luck egalitarianism’ focusing on the role of chance in resource allocation. Resource based philosophers, including Dworkin and Rawls, argue that resources — whether material resources or rights — should be distributed to maximise opportunities for all citizens, whereas welfare based egalitarianism is more concerned with ensuring that the welfare of all citizens is equalised: the difference in approach is in relation to inputs as opposed to outcomes. Sen falls into the second category, although his capability theories are based on allowing individuals to choose between options, as do libertarians; and in spite of his criticism of utilitarianism, Sen’s theories require some consideration of social benefit when making decisions in relation to the efficient distribution of resources.

The role of chance, or luck, in the distribution of resources is problematic to egalitarians. While natural skills can be developed and used in particular ways, and material resources can be redistributed through government intervention, the role of chance is more difficult to evaluate and adjust. Luck egalitarians distinguish between outcomes that are chosen and outcomes that are forced upon the recipient:

In my view, a large part of the fundamental egalitarian aim is to extinguish the influence of brute luck on distribution ... Brute luck is an enemy of just equality,

⁴⁷³ Amartya Sen, *Inequality Reexamined* (Oxford University Press, 1992).

⁴⁷⁴ Mark S Stein, *Distributive Justice and Disability: Utilitarianism Against Egalitarianism* (Yale University Press, 2006).

and, since effects of genuine choice contrast with brute luck, genuine choice excuses otherwise unacceptable inequalities.⁴⁷⁵

Luck egalitarians seek to address the inequalities that may arise from circumstances that a person does not choose: redistribution is seen as a way of addressing bad fortune, rather than as a means to remove good fortune.

Rawls: the social contract

Rawls approach is based on the theory of social contract, which postulates that individuals enter into a contract with society, and that their rights and obligations to society are based on this contract. Equity and justice flow from this contract. The origins of this theory can be seen in the Cartesian school of philosophy, which was criticised by Hayek⁴⁷⁶ as leading to collective decision making and socialism.

While Okun discusses the trade-off that may be required between equity and efficiency,⁴⁷⁷ Rawls gives priority to equity, even where the outcomes are inefficient.

The contribution of Rawls to the debate on equality was first published in 1971.⁴⁷⁸ He continued to review and revise the 'Theory' until his death in 2002.⁴⁷⁹ He essentially regarded equality as a function of the pluralistic society in which we participate.

Participants in society form a social contract that allows them to participate fully as long as they observe the rules of that society; however, the rules must be seen to be fair before people will accept the contract.

The 'Theory' consists of two core principles, which (as revised in 2001) state that:

- a) Each person has the same infeasible claim to a fully adequate scheme of equal basic liberties, which scheme is compatible with the same scheme of liberties for all; and
- b) Social and economic inequalities are to satisfy two conditions: first, they are to be attached to offices and positions open to all under conditions of fair equality of

⁴⁷⁵ G A Cohen, 'On the Currency of Egalitarian Justice' (1989) 99(4) *Ethics* 906, 931.

⁴⁷⁶ Hayek, above n 23.

⁴⁷⁷ Okun, above n 1.

⁴⁷⁸ John Rawls, *A Theory of Justice* (Harvard University Press, first published 1971, revised 1999 ed).

⁴⁷⁹ John Rawls, *Justice as Fairness: A Restatement* (Harvard University Press, 2001).

opportunity; and second, they are to be to the greatest benefit of the least-advantaged members of society (the difference principle).⁴⁸⁰

The ‘Theory’ has been praised as a holistic approach that is fundamentally different from the views circulating at the time — and criticised as setting up an unrealistic set of assumptions that cannot be replicated in an actual society under examination. It is based on what Rawls terms the ‘original position’, which establishes the parameters of the society. One of the criteria is that decisions are shrouded by the ‘veil of ignorance’, which assumes that the decision makers do not have any knowledge of the characteristics of the parties affected by the decision in order to ensure that the decisions made are not biased by the original structure.

The ‘original position’ assumes that all members of the society enter the social contract without any history — either of privilege or disadvantage. This is in order to ensure that the parties are negotiating as equals, not just in the contractual process but in the context of their position in society. Given that in a developed democracy Rawls’ requirements (a) and the first part of (b) are met, the next point of discussion is the application of the ‘difference principle’ which allows inequalities to exist where they are to the benefit of the least advantaged. In allowing some difference in favour of the least advantaged, Rawls lists what he classes as the primary goods needed to be a fully co-operating and equal member of society. The list includes the intangibles of basic rights and liberties; freedom of movement and occupation; powers and prerogatives of office; the social bases of self-respect and the more tangible element of income and wealth ‘generally needed to achieve a wide range of ends, whatever they may be’.⁴⁸¹ The issues surrounding the distribution of tangible assets of income and wealth are relevant to economists concerned with tax and transfer programs, while the intangible aspects are essential in the social contract framework, and may be used to justify programs such as affirmative action programs.

Although some commentators refer to this as the ‘maximin rule’, in the ‘Theory’ that terminology is reserved for the rule to be applied in cases of uncertainty. Where a redistribution of income or wealth is clearly to the benefit of the least advantaged, and is

⁴⁸⁰ Ibid 42–3.

⁴⁸¹ Ibid 58–9.

within the contract, the redistribution is to the benefit of society as a whole. However, in a pluralistic society there may be a number of alternatives. When choosing between alternatives the ‘maximin rule’ applies: consider the worst outcome under each alternative, and apply the alternative where the worst outcome is better than the alternatives. There are three preconditions that should exist for the maximin rule to be applied:

- a) In line with the veil of ignorance, there is no basis to estimate probabilities;
- b) As the decision makers are evaluating worst outcomes they must be able to guarantee that the worst outcome is satisfactory; and
- c) All other alternatives are unacceptable.⁴⁸²

Sen: the capabilities approach

A different perspective on equality can be seen in the writings of Amartya Sen.⁴⁸³ His writing is based on the capabilities approach, which would distribute resources to ensure that each individual has sufficient resources to function fully in society, based on their personal capabilities. He structured his 1992 work around the question ‘Equality of What?’ recognising that there are many aspects of a person’s life in which they may seek equality.⁴⁸⁴

Equality is judged by comparing some particular aspect of a person (such as income, or wealth, or happiness, or liberty, or opportunities, or rights, or need-fulfilments) with the same aspect of another person. Thus, the judgement and measurement of inequality is thoroughly dependant on the choice of the variable (income, wealth, happiness, etc) in terms of which comparisons are made.⁴⁸⁵

While economists are normally concerned with the variables of income and wealth, the appropriate allocation of other resources can be important in facilitating capabilities to achieve other basic human needs or entitlements. Thus this approach focuses on equality, with its broader meaning than equity.

⁴⁸² Ibid 147.

⁴⁸³ See notes 16, 18 and 36.

⁴⁸⁴ See also M Walzer, *Spheres of Justice: A Defence of Pluralism and Equality* (Blackwell, 1983).

⁴⁸⁵ Sen, above n 37, Chapter 1.

The difference between this approach and that adopted by other writers lies firstly in the acknowledgement of diversity between individuals. It has been categorised as a pluralist approach in contrast to other approaches that focus on one moral value: such as utility or freedom. In that context, Sen's approach could be seen to place more importance on horizontal equity than vertical equity: it acknowledges that access to equal resources will not of itself lead to equity between individuals. Sen has worked extensively in the field of developmental economics, which is reflected in his theory. Sen argues that individuals must have access to the appropriate set of resources to allow the individual to make appropriate choices from the range of options available.

If we are interested in the freedom of choice, then we have to look at the choices that the person does in fact have, and we must not assume that the same results would be obtained by looking at the resources that he or she commands.⁴⁸⁶

Sen differentiates his approach from other writers as being concerned with the elements necessary to wellbeing, while other approaches are based on the instruments that provide the means to freedom. Libertarian approaches are also based on the individual rather than collective approaches, but the basis of libertarian philosophy is that the individual uses the market mechanism to acquire resources based on their own preferences. Sen argues that redistribution is necessary to ensure that a person has the resources required to maximise their capability.

He is critical of utilitarian welfare economics for not taking sufficient account of the diversity of individuals and their specific capabilities:

social welfare may be seen as a function of individual utilities, as in the welfarist framework of which utilitarianism is a distinguished case, involving 'sum-ranking' (i.e. simply adding up the utilities). Or alternatively, social welfare may be seen as a function directly of the vector of incomes (without being intermediated by the utilities related to those incomes), or of the combination of multiple-attribute characteristics of individual economic status or opulence.⁴⁸⁷

⁴⁸⁶ Sen, above n 37, 38.

⁴⁸⁷ Sen, above n 37, 94.

Poverty is seen as a problem of income inadequacy, rather than ‘lowness of income’: an individual needs sufficient income to convert it into the relevant capabilities. For example a person may spend more on food than their neighbour, but it still may be inadequate because, say, that person has specific nutritional requirements. This framework is applicable to the problem of poverty both in third world countries and in more affluent countries:

In explaining the apparent paradox [of food deprivation in rich America] the capability perspective can help in two different ways. First, hunger and undernutrition are related both to food intake and the ability to make nutritive use of that intake ... Second, being poor in a rich society itself is a capability handicap ... In a country that is generally rich, more income may be needed to buy enough commodities to achieve the same social functioning, such as ‘appearing in public without shame’.⁴⁸⁸

The capability approach is particularly well suited to addressing specific aspects of disadvantage, such as gender,⁴⁸⁹ race or disability. By identifying what resources are required to ensure that a person can operate to their full capacity, that person can be assisted to make a full contribution to society.

Contrasting the theories

During the late 20th century these noted economists and philosophers — Nozick, Harsanyi, Rawls, Sen and others — engaged in vigorous debate as to the merits of each other’s theories. Some of the conflicts between the approaches are irreconcilable, but ultimately, the differences in relation to the use of the tax transfer system lie largely in the balance between reliance on the market or the need for government intervention to redistribute income and wealth. However, it is instructive to review the criticisms that each has of the alternative theories.

Libertarianism is criticised on a number of grounds. First, are moral obligations adequately recognised within a framework of individual rights? For example, does a person

⁴⁸⁸ Smith, above n 15, 111, 115.

⁴⁸⁹ Martha Nussbaum, *Women and Human Development: The Capabilities Approach*, The Seeley Lectures (Cambridge University Press, 2000).

interrupting a violent attack violate the rights of the attacker?⁴⁹⁰ Further, Sen argues that liberal values inherently conflict with the Pareto principle because the liberal right to exercise free choice overrides the social decision function.⁴⁹¹

Utilitarianism is also criticised for disregarding the position of individuals in favour of a measure of the welfare of society as a whole because sum total measurements disregard distributional shifts in the chosen criteria. Welfare indices are described as ‘measures of *distributional badness* ... of the particular configuration of personal incomes; they are not specifically measures of *inequality per se*’.⁴⁹² In contrast the capability approach is based on maximising the position of each person within a community, taking account of their capacity to utilise distributions. In this sense the capability approach is more concerned with the effect of resource distribution on the individual than on society as a whole.

One of the difficulties in making decisions between alternative social policies is that individuals may have different choices, and different outcomes may arise from those choices. Where the welfare of individuals has primacy, **if the rights attached to the alternatives can co-exist no social choice needs to be made, and the decision can be left to the individuals. Any attempt to impose another outcome is an interference with individual liberties.**⁴⁹³ Alternatively, given that individual utility functions reflect the higher needs of the poor relative to the rich, the social welfare function already has priority over individual utilities, and is properly reflected in a linear social welfare function.⁴⁹⁴

However, it is also argued that **the social welfare function is not linear because it must reflect the different needs and capabilities of individuals. Where they are incompatible a third party will ultimately be called upon to make a decision,**⁴⁹⁵ **resulting in an outcome similar to Arrow’s Impossibility Theorem.**

⁴⁹⁰ Amartya Sen, *On Ethics and Economics*, The Royer Lectures (Basil Blackwell Ltd, 1987).

⁴⁹¹ Amartya Sen, ‘The Impossibility of a Paretian Liberal’ in *Choice, Welfare and Measurement* (Basil Blackwell Ltd, 1982).

⁴⁹² Sen, above n 37, 98.

⁴⁹³ Hayek, above n 23, 62–3.

⁴⁹⁴ John C Harsanyi, ‘Nonlinear Social Welfare Functions: Do Welfare Economists Have a Special Exemption from Bayesian Rationality’ in *Essays on Ethics, Social Behaviour, and Scientific Explanation* (D Reidel Publishing Co, 1976) volume 12.

⁴⁹⁵ Amartya Sen, *Collective Choice and Social Welfare* (Holden-Day, 1970).

A further criticism of utilitarianism is the emphasis it places on rational behaviour. A rational individual will have two sets of preferences: personal preferences based on self-interest, and moral preferences based on perceptions of society. Utilitarian theory leads each individual to choose the better personal outcome, which also produces the best result for the society. Accordingly, Okun style trade-offs will arise, this time between moral and economic objectives:

anybody who wants to adopt a moral position more egalitarian than the utilitarian position already is, must admit that the well-being of the individual members of society is not his ultimate moral value, and that he *is* willing in certain circumstances to sacrifice humanitarian considerations to egalitarian objectives when there is a conflict between the two.⁴⁹⁶

However, this assumption of rationality is contested⁴⁹⁷ because many decisions are made without access to full information, or in a state of mind where such information cannot be adequately processed.

Rawls' 'Theory',⁴⁹⁸ generated much criticism when it was first published because a number of the views contained were considered to be radical: particularly in the use of the original position, the difference principle and the maximin rule. However, even critics of Rawls acknowledge his work as a watershed in modern philosophy, presenting as it does a coherent framework for justice.

The most common criticism of the 'original position' is that it is divorced from reality because it is not possible to ignore existing circumstances, such as existing rights.⁴⁹⁹

However, this has similar outcomes to the utilitarian perspective, as expressed in the equiprobability model which states that if human beings share the same experiences, they will arrive at the same judgments.⁵⁰⁰ If the parties to a moral contract do not have any previous experience to influence outcomes, they will see the outcome in the same way and

⁴⁹⁶ Harsanyi, above n 58, 48.

⁴⁹⁷ Amartya Sen, 'Rationality and Social Choice' (1995) Mar 1995(85) *American Economic Review*; see also Nussbaum, above n 53.

⁴⁹⁸ Rawls, above n 7.

⁴⁹⁹ Hayek, above n 23, 89.

⁵⁰⁰ Harsanyi, above n 33, 634.

the social decision function will lead to Pareto optimality. It is only when matters of inequality of experience or risk enter the decision process that individual preferences will emerge.⁵⁰¹

However, it is the combination of the ‘original position’ with the maximin rule that is most problematic. When ranking decisions, the level of risk attached to a certain outcome will weight that decision — however the maximin rule does not allow any external considerations, such as risk, into the process. For example, in a case where a person is offered two jobs, one of which has higher rewards but also involves plane travel which has a low probability of the plane crashing causing catastrophic injury. While most people would consider the risk to be low enough to decide to take the high reward job, the maximin rule would prescribe the low risk, low reward job be chosen.⁵⁰²

The difference principle is framed in terms of groups within society, rather than individuals. The inclusion of this principle has been questioned on the grounds that under the ‘Theory’ all groups within society benefit from the agreement of social co-operation: this is the purpose of the negotiation from the original position. To specifically further benefit the least advantaged produces an asymmetrical result, leading to efficiency losses that are unacceptable to liberals.⁵⁰³ Further, this ignores the benefit to society that may arise if additional resources are allocated to the purpose where they can do most good rather than to a particular person,⁵⁰⁴ as advocated by libertarians.

Sen specifically contrasts his approach with the work of Rawls, characterising Rawls’ work as focusing on equality of opportunity, particularly through his concentration on the distribution of primary goods. Although the maximin rule does not have regard for capabilities, it focuses on the least advantaged as a class, whereas the capability approach is more concerned with the capacity of the individual to fully utilise the opportunities made available, and Sen specifically distinguishes capability from

⁵⁰¹ Ken Binmore, ‘Social Contract I: Harsanyi and Rawls’ (1989) 99 (Conference 1989) *Economic Journal* 84.

⁵⁰² John C Harsanyi, ‘Can the Maximin Principle Serve as a Basis for Morality? A Critique of John Rawls’s Theory’ in *Essays on Ethics, Social Behaviour, and Scientific Explanation* (1976) volume 12, 39.

⁵⁰³ Hayek, above n 23, 89.

⁵⁰⁴ Sen, above n 59.

primary goods and from achievements.⁵⁰⁵ Rawls in turn responded that these primary goods are essential to develop capabilities, and are a part of the framework of the ‘Theory’.⁵⁰⁶

Applying the merit principle to ‘native endowments’ is also contentious. While the ‘Theory’ regards such endowments bestowed on an individual as common assets that must be developed and enhanced through access to appropriate education before being used for the good of society,⁵⁰⁷ the entitlement theory argues that such assets should be exploited by the individual in their self-interest, and that this of itself provides benefits to the society.⁵⁰⁸ Alternatively, applying the capabilities approach ensures that a person has the best opportunity to develop those natural assets. A meritocracy that is truly based on abilities that the person has been able to develop fully will lead to the best utilisation of those assets for the society.

Alternatively, the ‘luck egalitarian’ approach argues that the distinction between choice and luck is not sufficiently recognised in Rawls’ ‘Theory’. While the influence of fortuitous factors is recognised, the difference principle as expressed does not take account of such factors, except to the extent that a person may benefit from the difference principle based on any resulting disadvantage. Where a person may choose to undertake a risky course of action, the moral question becomes whether they are entitled to be a beneficiary of the difference principle.

Cohen⁵⁰⁹ argues that the difference principle allows incentives to encourage behaviour for the good of the community — but this can in effect perpetuate inequalities.

The difference principle can be used to justify paying incentives that induce inequalities only when the attitude of talented people runs counter to the spirit of the difference principle itself: they would not need special incentives if they were themselves unambivalently committed to the principle. Accordingly, they must be

⁵⁰⁵ Sen, above n 37, 81.

⁵⁰⁶ John Rawls, ‘The Concept of Justice in Political Economy’ in Frank Hahn and Martin Hollis (eds), *Philosophy and Economic Theory* (Oxford University Press, 1979) 164, 168.

⁵⁰⁷ Rawls, above n 7, 75.

⁵⁰⁸ Hayek, above n 23, 123.

⁵⁰⁹ Gerald A Cohen, *Rescuing Justice and Equality* (Harvard University Press, 2008).

thought of as outside the community upholding the principle when it is used to justify incentive payments to them.⁵¹⁰

Further, the social contract on which the ‘Theory’ is based assumes that people within a community have agreed to the ethos of that contract. The theory is based on just institutions that will ensure a just allocation of resources. To the extent that an individual chooses not to conform to that community, they are outside the social contract. Cohen argues that institutional justice and an egalitarian profile of rewards do not necessarily co-exist:

My own fundamental concern is neither the basic structure of society, in any sense, nor people’s individual choices, but the patterns of benefits and burdens in society: that is neither a structure in which choice occurs nor a set of choices, but the upshot of structure and choices alike ... A just society, here, is one whose citizens affirm and act upon the correct principles of justice, but justice in distribution, as here defined, consists in a certain egalitarian profile of rewards. It follows that a just distribution might obtain in a society that is not just.⁵¹¹

Reviewing the differences between the approaches, and the criticisms that emerge in the literature, it is clear that Nozick and Sen are more concerned about the consideration of individuals within the system — although Nozick is concerned with preserving entitlement, while Sen is concerned with distributing appropriately to those individuals to maximise capability. Utilitarians and Rawls apply their theories to society as a whole, through redistribution among the groups that make up society. Rawls, however, goes beyond the issues of financial resources to consider non-financial resources — as does Sen.

Current trends in inequality

In reviewing these theories of distributional justice, two striking features emerge. First, there was a period in the 1970s, prior to the political ascendancy of neoliberal economics, when this debate flourished: at the same time that the economists Anthony Atkinson, Joseph Stiglitz and others were developing measures of equity, the philosophers Robert Nozick, John Rawls, Amartya Sen, John Harsanyi and others were developing moral and ethical frameworks. Clearly the debate between these writers stimulated ideas and theorems based on their own economic philosophy, and expanding into areas of morality. For

⁵¹⁰ Ibid 32.

⁵¹¹ Cohen, above n 73, 126, 128.

example, while there was much criticism of Rawls, there was also much respect expressed for the new framework that he presented.

It is worth noting that the increasing trends in inequality that have emerged during the dominance of neoliberal policies were observed by distributional justice theorists with concern before the impacts emerged so dramatically in 2008/09, with a number of important contributions to the literature being published in the last two years⁵¹² while the global economy has been dealing with the effects of the market shifts.

Second, these philosophers continued to reflect on, develop and refine their philosophies throughout their careers. It is interesting to compare their early work with subsequent iterations: Rawls republished his theory in 2001,⁵¹³ the year before his death, addressing some of the concerns raised by other writers. Twenty-four years after the initial publication, Sen published an expanded edition of his work *On Economic Inequality* to address developments during that period,⁵¹⁴ and in his most recent book he has presented ‘a theory of justice in a very broad sense’.⁵¹⁵ While Nozick’s early work has been used here as an example of libertarianism, in his later writings he moved away from the position so clearly outlined in 1973.⁵¹⁶

More recently the debate on equity has shifted to incorporate the third phase of Andersson’s typology,⁵¹⁷ discussion of the sustainability of resource allocation. It is becoming increasingly apparent that natural resources are limited, and that there is competition for the allocation of such resources. This is commonly discussed as an intergenerational or temporal issue because the impact of current practices will be felt by future generations. In accordance with their belief in a self-regulating market, neoliberals

⁵¹² See notes 18, 20 and 72; Michael Sandel, *Justice: What is the Right Thing to Do?* (Farrer, Strauss and Giroux, 2009).

⁵¹³ Rawls, above n 43.

⁵¹⁴ Amartya Sen, *Inequality Reexamined: Expanded Edition* (Oxford University Press, 1997).

⁵¹⁵ Sen, above n 18, ix.

⁵¹⁶ Simon A Hailwood, *Exploring Nozick Beyond Anarchy, State and Utopia*, Avebury Series in Philosophy (Avebury, 1996).

⁵¹⁷ Andersson, above n 5.

rely on price controls, growth and technology to address issues of scarcity.⁵¹⁸ Models are being developed to integrate sustainability into economics, from the well-known ‘triple bottom line’ reporting to more sophisticated 3-D models.⁵¹⁹ However, as long as economic, social and environmental policies are developed by national governments, based on national interests, global interests will come second — as seen in the current inability to reach agreement over the implementation of measures to counter global warming.

The most recent impacts have been felt though the globalisation of financial markets, rather than natural resources. Economic policy during the most recent economic expansion was dominated by free market theorists, who advocate that the market is most efficient when it is freed from restrictions. However, following the events of 2008/09, questions are being asked as to whether the free market philosophy encouraged financial practices that were fundamentally unsound.

In particular, there are questions as to the extent and distribution of inequality within society. In 2008 the OECD study of the extent of inequality within OECD countries found that:

Overall, over the entire period from the mid-1980s to the mid 2000s the dominant pattern is one of a fairly widespread increase in inequality (in two thirds of all countries) ... Across the 24 OECD countries for which data are available the cumulative increase is of around 0.02, i.e. about 7%, with most of the rise experienced in the first decade ...⁵²⁰

While this calculation is based on the Gini coefficient, an empirical measure of the welfare of society as a whole, it is also clear that measures which compare the relative position of the lowest income earners with the highest show a more dramatic increase than the Gini coefficient, with the OECD report concluding that the widening of inequality over the past 20 years is ‘moderate but significant’.⁵²¹ Data on the share of total pre-tax income earned

⁵¹⁸ William E Rees, ‘An Ecological Economics Perspective on Sustainability and Prospects for Ending Poverty’ (2002) 24(1) *Population & Environment* 15.

⁵¹⁹ Volker Mauerhofer, ‘3-D Sustainability: An Approach for Priority Setting in Situation of Conflicting Interests Towards a Sustainable Development’ (2008) 64(3) *Ecological Economics* 496.

⁵²⁰ OECD, above n 3, 28.

⁵²¹ *Ibid.*

by the top 1% of income earners shows a significant upswing from the mid-1980s to 2000 so that in most jurisdictions the share of income earned by the top 1% of income earners is now comparable to the levels that existed before 1940.⁵²²

An examination of trends in the tax systems of OECD countries since the 1980s clearly shows the influence of the neoliberal market based doctrine, particularly in liberal democracies. The overall ratio of tax to GDP has not changed dramatically, but the mix of taxes and the basis of transfer payments has. The trends identified show:⁵²³

- decreases in top marginal personal income tax rates and a consequent reduction in the progressivity of the personal income tax system;
- decreases in corporate tax rates coupled with systems to reduce the tax on corporate distributions;
- increases in broad based consumption taxes compared to other forms of consumption taxes and increases in social security taxes; and
- the design of transfer payments has tended to focus more on targeting payments to those in need, specifically those in poverty or the aged and imposing obligations on recipients.⁵²⁴

This data could be interpreted to demonstrate two of the issues raised earlier:

1. Neoliberal policies that rely on market growth to produce equity result in gains to those who already have property or income, who are generally in the high income deciles; and
2. Utilitarian welfare measures such as the Gini coefficient reflect the overall distribution of income and wealth within a society, but further analysis is necessary to identify shifts between groups within the society.

A detailed empirical analysis of these trends relative to prevailing economic advice from time to time would be an interesting further examination.

⁵²² OECD, above n 3, 32.

⁵²³ Åsa Johansson et al, 'Tax and Economic Growth' (OECD Economics Department Working paper No 620, OECD, 2008).

⁵²⁴ OECD, above n 3.

What appears to be happening is that certain groups within society are benefitting under current policies. In the liberal democracies of New Zealand, UK, USA and Canada the gains appear to be among high and low income earning groups, possibly as a result of tax policy reducing the taxes paid by the rich and poverty alleviation policies that assist the poor. There is also evidence that the elderly are more likely to suffer poverty than younger people.⁵²⁵ The tax and transfer policies of a government will have significant impacts on inequality: for example the extent of progressivity in the system, taxation of capital compared to the taxation of income from labour, and the redistribution of taxes (often through direct transfer payments) to target pockets of disadvantage will all impact on the extent of inequality and the relative positions of the highest and lowest income earners in society.

An examination of economic cycles of developed economies over the 20th century shows the effect that the adoption of different economic policies has had on distributional equity. While specific policies in the English-speaking liberal welfare states⁵²⁶ differ, they tend to show similar trends in tax and transfer policies and in economic cycles.⁵²⁷ The early part of the 20th century featured laissez faire market based policies which were moderated after the two world wars and the intervening recession to adopt welfare policies that allowed government intervention to correct market failure and facilitate redistribution of resources. Welfare economics grew out of this period. However, the latter decades of the 20th century saw a resurgence in neoliberal philosophies in order to curb government spending and shift economic activity back to the free market.

In the same ways that economies experience cycles of expansion and contraction, governments will also change their economic policies to comply with prevailing economic theories — and these changes cannot always be explained by the popular perception of whether the elected government is conservative or liberal: governments of the expansionary

⁵²⁵ OECD, above n 3.

⁵²⁶ Gosta Esping-Andersen, *The Three Worlds of Welfare Capitalism* (Polity Press, 1990). Generally speaking the English-speaking countries of Australia, Canada, UK and USA are categorised as liberal welfare states.

⁵²⁷ Neil Brooks, 'Taxing the Wealthy' (Paper presented at the Conference Australia's Future Tax System: A Post-Henry Review, Sydney, 21–22 June 2010).

post-war years applied different policies to those of the 1970s and 1990s, irrespective of the political party that was in power.

In the current economic climate there is more attention on apparent inequalities in society: the excessive pay packets received by executives who are seeking government support to prop up ailing industries, compared to the loss of jobs among casual and part-time workers. For example in the UK, in response to the economic crisis, the 2009 Budget announced changes to increase taxes and reduce benefits to high income earners. While these moves have been criticised and it has been predicted that they will result in tax avoidance as people try to remain below the new 50% tax threshold, the proposal is clearly capitalising on the general belief that the ‘super-rich’ are not paying their share of taxes.

The OECD study⁵²⁸ identifies the extent to which the tax transfer system has been used in different jurisdictions, and the impact it has had on the growth in inequality: generally it dampened inequality between 1985 and 1995, but as benefits became less targeted on the poor between 1995 and 2005, inequality increased. The increasing inequality of market income can be significantly ameliorated by the redistributive effect of the tax transfer system, if it is appropriately targeted.⁵²⁹

Conclusion

Two of the major functions of tax transfer systems are to fund the direct expenditure of government, and to redistribute resources. Public policy in both of these areas will be influenced by the underlying philosophical perspective of policymakers. The trade-offs needed between efficiency and equity require public policymakers to strike a balance between free market, interventionist and redistributive policies — the current global financial crisis is attributed by many commentators to the lack of regulation in many industrialised countries that have adopted neoliberal free market based policies in relation to the financial sector.

However the purpose of this article is not to examine these trends empirically, but to review the literature on distributional justice, to identify the major theories; to identify the moral

⁵²⁸ OECD, above n 3.

⁵²⁹ OECD, above n 3, Figure 11.6, 293.

and ethical underpinnings and the role of redistribution within these theories. This analysis focused on the work of a number of philosophers and economists representing the major schools of economic thought.

The trend toward greater inequity in OECD countries has occurred over the past two decades, during which the predominant economic philosophy has been neoliberalism under which market forces are allowed to dominate. To the extent that the market is seen as efficient, this trend has been accepted as increasing productivity, which allows the creation of jobs and wealth throughout the whole of society. If this widens the gap by creating greater benefits for those with more wealth, then that is an acceptable outcome. Utilitarians would also respond that the overall increase in the wealth of society is an acceptable outcome: however, they would apply redistributive strategies to ensure that deserving groups within society are protected. Within the market philosophies adopted by the UK and Australia over the past two decades, there have also been tax transfer measures that have targeted families with children to maintain their welfare. This would also accord with Rawls' 'difference principle', which states that where there are inequalities they should be in favour of the least well-off. However, there are other groups in society that have fallen further behind, such as the single unemployed. The capability principle advocated by Sen would suggest that policies be targeted to identify why such groups are disadvantaged, and attempt to address that disadvantage; as recently endorsed by Dr Ken Henry⁵³⁰ in the context of the Australian tax transfer system.

While philosophers and economists have distilled the essential elements, views range across a broad spectrum. Ultimately there is no easy answer to what is fair because it depends on the moral and ethical underpinnings of the person making the decision or designing the policy, and how they see the relationship between the individual and society. Public policy may incorporate elements of all of the philosophies I have discussed: the issue then becomes one of the extent of the trade-offs that are acceptable.

⁵³⁰ Ken Henry, 'How Much Inequity Should We Allow?' (Paper presented at the Australian Council of Social Service National Conference, 3 April 2009),
<<http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/speeches/05.htm>>.

Exchange of Information Agreements with Tax Havens: How Will this Affect the Rights of Non-Resident Taxpayers and Investors?

John McLaren *

The Organisation for Economic Cooperation and Development (OECD) appears to have been successful in convincing tax havens and countries with strict bank secrecy laws to exchange information on non-resident taxpayers, investors and businesses using their financial services. As at 18 August 2010, the OECD have confirmed that more than 320 Tax Information Exchange Agreements (TIEAs) and 150 Double Taxation Conventions that incorporate the new transparency standards have been signed between OECD member countries and non-OECD member states since 2006.⁵³¹ While this situation may be good for tax administrators in the pursuit of their goal of maximising the collection of tax revenue, the main question examined in this paper is where does it leave the non-resident taxpayer and foreign investor in terms of their right to privacy and the right to maintain the confidentiality of their financial and banking details? The Australian Taxation Office (ATO) has statutory powers that provide an extensive right to access information about a taxpayer's dealings both within Australia and overseas. 'Operation Wickenby', a joint operation between the ATO, the Australian Crime Commission, the Australian Federal Police and a number of government agencies is trying to detect Australian taxpayer's operating foreign bank accounts and evading income tax through the use of tax havens.⁵³² One of the major concerns about the exchange of information agreements is that tax authorities may be able to access information about their resident taxpayers without restriction and without the taxpayer being given the right to intervene or be consulted. This paper will commence with a brief examination of the existing rights that the domestic taxpayer possesses to maintain the confidentiality of their financial affairs, as well as the powers of the ATO to obtain information from taxpayers and third parties. The paper will then assess whether the OECD's 'model exchange of information agreements' and the new Article 26 of the Double Taxation Agreements will adversely affect the rights that the taxpayer currently possesses.

1 INTRODUCTION

The OECD and the European Union (EU) are anxious to end the movement of capital to low or no tax jurisdictions that have strong bank secrecy laws. The OECD's harmful tax competition project has been successful in convincing tax havens and Offshore Financial Centres (OFCs) to exchange bank details with OECD member states by way of bi-lateral agreements. The OECD can claim to have had success with the Caribbean Community and Common Market (CARICOM) states of the Caribbean and more recently, with the assistance of the G20 nations, success with the European countries with strong bank

* Assistant Professor, Faculty of Law, University of Canberra.

⁵³¹ OECD, *Promoting Transparency and Exchange of Information for Tax Purposes*, 18 August 2010 <www.oecd.org>.

⁵³² 'Operation Wickenby' is discussed in more detail later in this paper. For more information see <<http://www.ato.gov.au/corporate/content.asp?doc=/content/00220075.htm&page=3&H3>>.

secrecy laws. It would appear that with the agreement by Switzerland, Austria and Luxembourg the days of tax havens not being prepared to exchange information on non-resident taxpayers is coming to an end. The G20 Ministers at the London conference announced that ‘the era of banking secrecy is over’.⁵³³ The harmful tax competition initiative generated by the OECD has been viewed as the destruction of privacy because it requires these sovereign states to breach confidentiality by disclosing bank account information.⁵³⁴

The Australian Commissioner of Taxation has appealed to tax agents in Australia to ‘dob’⁵³⁵ in tax scheme promoters and clients with undeclared overseas income. This statement was made as part of the offensive by the Australian Taxation Office (ATO) against tax havens which receive up to \$5.3 billion a year from Australia.⁵³⁶ The ATO encourages the public to report suspected tax cheats either by telephone or through the internet. However, tax agents now have a separate line to report suspect action of other tax agents or even their own clients.⁵³⁷ If this approach was to be accepted by tax agents in Australia, what are the implications for both the taxpayers and the tax adviser and accountants? It is contended in this paper that tax advisers and accountants owe a fiduciary duty to their clients who require them to maintain the confidentiality of their financial information. However, should they place their clients first or do they have a higher duty to the community and in turn the ATO, which requires them to report the conduct of their client if their client’s activities will result in not paying the correct amount of tax.

By way of contrast, the Internal Revenue Service in the USA pays a reward to tax informers and the Service has been doing this since 1867.⁵³⁸ More recently the Bush administration introduced the *Tax Relief and Health Care Act 2006* which amended the previous informant reward program and introduced a ‘whistleblower’ program with rewards of up to 30 per cent of the tax, penalties and interest collected.⁵³⁹ As a countervailing measure, US State parliaments have specifically enacted laws making it a crime for accountants and lawyers to disclose confidential information about their clients

⁵³³ G20 Declaration: *The Global Plan for Recovery and Reform London*, UK, 2 April 2009, para 15.

⁵³⁴ Terry Dwyer, “‘Harmful’ Tax Competition and the Future of Offshore Financial Centres” (2002) 5(4) *Journal of Money Laundering Control* 302, 308.

⁵³⁵ The term ‘to dob’ is Australian slang for to report or to inform someone in authority about a person’s behaviour.

⁵³⁶ Fleur Anderson, ‘ATO Urges Tax Agents to Dob in Cheats’, *Australian Financial Review* Sydney, 9 October 2007, 1.

⁵³⁷ However, according to Justin Dabner this may have been put on hold as a result of opposition from the accounting profession. See Justin Dabner, ‘Partner or Combatants: A Comment on the Australian Tax Office’s View of its Relationship with the Tax Advising Profession’ (2008) 3 *Journal of the Australasian Tax Teachers Association* 76.

⁵³⁸ Kneave Riggall, ‘Should Tax Informants Be Paid? The Law and Economics of a Government Monopsony’ (2008–2009) 28 *Virginia Tax Review* 237, 239.

⁵³⁹ *Ibid* 241.

in relation to taxation matters.⁵⁴⁰ Accountants and lawyers in Australia have a similar duty to maintain the privacy and confidentiality of their clients' details. It is contended that in most cases these duties are based on the fiduciary relationship they have with their client.

There are established mechanisms that enable tax administrators in one country to obtain financial information about the business and investment activities of their own taxpayers in another country. This is achieved through a Double Taxation Agreement (DTA). One of the main purposes of a DTA is to provide the contracting states with the right of the home state to obtain financial and banking information about their residents engaged in business or investment activities within the territory of the other contracting state. Therefore, within countries with DTAs the taxpayer has always been liable to have their foreign financial information disclosed to the tax administration in their home state. However, one of the main features of tax havens is that they have not actively entered into DTAs with other countries for this very reason.

It should also be noted that tax havens and OFCs generate substantial income from the provision of banking, financial, legal and accounting services. In effect the tax avoidance and tax evasion industry provides the income for tax havens and OFCs to survive and prosper, and in many cases this is the main generator of the country's revenue. It is understandable that tax havens have strong bank secrecy laws and an incentive to maintain the privacy of their non-resident taxpayers.

The second and third parts of this paper will discuss the rights to privacy that existing taxpayers have both from a domestic perspective and an international perspective. The fourth part of the paper will examine the likely impact the OECD initiated 'exchange of information agreements' will have on the rights of privacy and confidentiality of non-resident taxpayers and investors operating in the international arena.

2 THE RIGHTS OF THE TAXPAYER – THE AUSTRALIAN POSITION

Australia has a 'self-assessment' system of taxation in that all income tax returns as well as Fringe Benefit Tax returns, Goods and Services Tax and Business Activity Statements are accepted at face value and are not subject to immediate scrutiny. This means that the Commissioner of Taxation has certain powers to check the veracity of claims by taxpayers.⁵⁴¹ There is very little that the ATO does not know about the finances of the individual and with developments in exchanging information between Australia and other countries, even foreign finances will be part of the vast amount of information gathered by the ATO each year. Even when visiting accountants or lawyers stay in Australia their client lists, which may be stored on a data file on their laptop computer, can be seized by the police and used in the prosecution of Australian taxpayers.⁵⁴²

The crucial issue with the collection of taxes and administering the tax law is to balance the rights of the taxpayer with maximising the collection of revenue. The rights of the Australian taxpayer are discussed briefly in this part of the paper.

⁵⁴⁰ Ibid 274.

⁵⁴¹ Reynah Tang, 'The Commissioner's Power to Access Taxpayer Information from Third Parties and a Taxpayer's Right to Privacy – A Case for Reform?' (2005) 34 *Australian Tax Review* 20, 20.

⁵⁴² *Egglishaw v Australian Crime Commission* [2006] FCA 819.

2.1 The Taxpayers' Charter⁵⁴³

The Taxpayers' Charter outlines the relationship the ATO seeks with the community, and is stated to be one of mutual trust and respect. To this end, the Charter sets out the taxpayers' rights under the law; the service and other standards taxpayers can expect from the ATO; what taxpayers can do if they are dissatisfied with the ATO's decisions, actions or service, or if they wish to complain; and taxpayers' important tax obligations.

The Charter contains two specific rights relating to privacy and confidentiality. At point 5, the ATO assures taxpayers that they respect their privacy and that they are collecting the information in a fair and lawful way that is not unreasonably intrusive and furthermore will advise the taxpayer of the reason why the information is being collected, especially from third parties, and the purpose to which the information will be used. At point 6, the ATO assures taxpayers that all information collected will be kept confidential unless the disclosure is authorised by the law.

One main issue that is at odds with the right of the taxpayer to privacy, and is contrary to the concept of mutual trust and respect as contained in the Taxpayer's Charter, is the ease by which information about a taxpayer can be obtained from third parties.⁵⁴⁴ Taxpayers are not given notice of the ATO's intention to obtain information from third parties and third parties are placed in a position of possibly infringing their obligations under the *Privacy Act 1988* (Cth) by not informing the taxpayer of the situation and obtaining their consent. Tang argues that taxpayers should have the right to contest the release of information in what has been described as a 'reverse-FOI procedure'.⁵⁴⁵ This approach is in line with the Australian Law Reform Commission report on privacy in advocating that all personal information should be kept confidential and that a person affected by disclosure of that information by a third party should be subject to objection by the person so affected.⁵⁴⁶ However, the ATO would contend that in order to effectively collect revenue in some cases the taxpayer should not receive advance notice.

2.2 Duty of confidentiality

It is not proposed to discuss breach of confidence actions in detail or to examine the concept of information as 'property' in the context of an analysis of the rights of taxpayers. It is well established in the common law that trade secrets and commercial intellectual property are protected by breach of confidence actions. Similarly, certain private and public organisations are governed by the *Privacy Act 1988* (Cth) in order to protect the confidentiality of confidential information. This issue was discussed in some detail by Tang, as well as the fact that organisations breach their legal obligation to maintain the privacy of information of individuals when served with notices under s 263

⁵⁴³ Australian Taxation Office, 'Celebrating the 10th Anniversary of the Taxpayers' Charter' <www.ato.gov.au/print.asp?doc=/content/86369.htm>.

⁵⁴⁴ Tang, above n 11, 27.

⁵⁴⁵ Ibid 26.

⁵⁴⁶ Australian Law Reform Commission, Report No. 108, *For Your Information: Australian Privacy Law and Practice* (ALRC, 2008).

or s 264, *Income Tax Assessment Act 1936* (Cth) (ITAA 36).⁵⁴⁷ The protection of the public revenue is paramount, and rights provided by the privacy legislation are secondary. The coercive powers under s 263 and s 264 provide access powers beyond those provided to the police. The police require a search warrant to access information for criminal proceedings, but such warrants are not required by the ATO when the revenue is being threatened.⁵⁴⁸ However, the focus of this section is to examine what protection the law provides to a taxpayer in their confidential dealings with their tax adviser.

It is established law that certain people or institutions have a duty to keep information confidential.⁵⁴⁹ This duty is based on trade secrets; and the existence of a special relationship such as lawyer and their client; accountant and their client, or a director and the company.⁵⁵⁰ If a tax adviser or accountant were to take notice of the Commissioner of Taxation's advice and report their clients that have foreign undeclared income then they would breach their duty of confidentiality. If the adviser and client are in a fiduciary relationship, then the taxpayer can take legal action on the basis of the special relationship. However, if that special relationship does not exist, the taxpayer must then rely on the common law to provide the basis for legal action for breach of confidence.

2.3 Fiduciary relationship – accountants, tax agents and lawyers

It is contended in this paper that accountants, tax agents and tax advisers are in a fiduciary relationship with their clients, the taxpayer. Moreover, it is equally contended that book-keepers engaged in preparing Business Activity Statements (BAS) are also in a fiduciary relationship with their clients. The High Court in the case of *Hospital Products Limited v Unites States Surgical Corporation* (1984) 156 CLR 41, especially in the judgment of Mason J, summarised the essence of a fiduciary relationship.⁵⁵¹

In the case of *Pilmer v Duke Group Ltd (In Liq)* (2001) 207 CLR 165, Kirby J examined in detail the tests to be used in determining the existence of a fiduciary relationship.⁵⁵²

Applying the tests as enunciated by Kirby J, it can be strenuously argued that an accountant, registered tax agent, tax adviser and registered bookkeeper stand in a fiduciary relationship with their clients. As such, the duty to maintain the privacy and confidentiality of their clients' personal financial details is of paramount importance. If they fail to uphold this duty then they should face the prospect of being sued for damages and be investigated and sanctioned by the appropriate professional body for misconduct.

2.4 Information gathering powers of the ATO

Taxpayers in Australia have virtually no power to prevent the ATO from accessing information from them or third parties or to prevent evidence from being provided to the

⁵⁴⁷ Tang, above n 11, 22.

⁵⁴⁸ Ibid 23.

⁵⁴⁹ P D Finn, 'Confidentiality and the "Public Interest"' (1984) 58 *Australian Law Journal* 497, 508.

⁵⁵⁰ Ibid.

⁵⁵¹ (1984) 156 CLR 41, 96.

⁵⁵² *Pilmer v Duke Group Ltd (In Liq)* (2001) 207 CLR 165, 217.

ATO. Sections 263 and 264 of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36) provide the ATO with coercive power to obtain information from the taxpayer and third parties. Section 263 allows the Commissioner or his delegate to enter buildings and take copies of documents, records and data stored on computers, provided it is undertaken for the purpose of administering the *Income Tax Assessment Act* of 1936 or 1997. Section 264 requires the recipient of the notice, being either the taxpayer or a third party, to provide information to the Commissioner. Section 8C of the *Taxation Administration Act 1953* (Cth) (TAA) makes it an offence to refuse to comply with the notices. A taxpayer served with a notice pursuant to s 263 or s 264 has the right to claim legal professional privilege to maintain the confidentiality of certain documents.⁵⁵³ The privilege against self-incrimination is abrogated by virtue of s 8C. In fact, failure to comply with either a s 263 or s 264 notice is a strict liability offence under s 8C, TAA. The implications for claiming legal professional privilege or the privilege against self-incrimination and the way in which taxation law takes precedence over the rights of the taxpayer are discussed below.

Under these coercive powers, a taxpayer does not have the ability to remain silent or the ability to claim the privilege against self-incrimination. If a taxpayer fails to comply with either a s 263 or s 264 notice, they face prosecution under s 8C of the TAA.

2.5 Privilege against self-incrimination

The privilege against self-incrimination is different from the common law right to remain silent. The right to remain silent simply means that a person, in the absence of some legal compulsion to answer questions from persons in a position of authority, is free to remain silent and do nothing without fear of having an adverse inference drawn at any subsequent proceeding.⁵⁵⁴ The privilege against self-incrimination only arises where a person is compelled to answer questions or provide documents, as is the situation with s 263 and s 264, ITAA 36, and s 8C, TAA. The privilege is also contained in s 128 of the *Evidence Act 1977* (Cth).

The case of *Deputy Commissioner of Taxation v De Vonk* (1995) 31 ATR 481 concerned the issuing of a s 264 notice while the taxpayer, De Vonk, had been indicted for criminal offences relating to a dishonest representation to the ATO and conspiracy to defraud the Commonwealth. The taxpayer was prepared to comply with the notice once the criminal proceeding had been completed, but in the meantime argued that he had the right not to answer questions on the grounds that answers to those questions would tend to incriminate him. He further argued that the issue of the s 264 notice was an abuse of power by the ATO. In terms of whether a taxpayer has the right to refuse to comply with the s 264 notice on the grounds of self-incrimination, Hill and Lindgren JJ concluded that as a result of s 8C being inserted into the TAA in 1984, the privilege against self-incrimination had been abrogated.

⁵⁵³ Lisa West, 'The Commissioner's Access and Information Gathering Powers Under Sections 263 and 264 of the Income Tax Assessment Act 1936: Some Issues for Tax Advisers and Criminal Law Practitioners' (2001) 30 *Australian Tax Review* 188, 202.

⁵⁵⁴ Kenneth Arenson and Mirko Bagaric, *Rules of Evidence in Australia* (LexisNexus Butterworths, 2005) 48.

In view of the finding of the majority of the Full Bench of the Federal Court in the *De Vonk* case, the privilege against self-incrimination provides no safeguard for a taxpayer facing a s 264 notice due to the effect of s 8C of the TAA. However, Hill and Lindgren JJ did find that an examination under a s 264 notice could amount to a contempt of court and an interference in the administration of criminal justice.

The only benefit a taxpayer has in relation to the privilege against self-incrimination is that a s 264 notice should not be used to obtain information in any pending or subsequent criminal prosecution otherwise the conduct by the ATO may be construed as interfering with the administration of justice. However, Lisa West contends that any evidence gathered under a s 264 notice for audit purposes could be used as evidence if a prosecution is launched, but it may be excluded by a court on grounds of unfairness.⁵⁵⁵ West does concede that s 263 and s 264 notices should not be used for the dominant purpose of gathering information for criminal purposes. This view is supported by the decision of Hill and Lindgren JJ in the *De Vonk* case as stated above.⁵⁵⁶

2.6 Legal professional privilege

If the Commissioner of Taxation serves a notice pursuant to s 263 or s 264, ITAA 36 the only means available to an Australian taxpayer to prevent access by the ATO to certain documents and advice is to claim legal professional privilege. That privilege will prevent the disclosure of written communication between the taxpayer and their lawyer relating to certain legal advice and legal services in some instances. There are two exceptions to this privilege; the frauds and crime exception and a waiver of the privilege.

The concept underlying the justification for upholding legal professional privilege is explained by Professor Ligertwood⁵⁵⁷ as the right of all citizens to obtain legal advice, which is at the core of the rule of law and protection human rights. It is especially important as a bulwark against tyranny and oppression.⁵⁵⁸ If citizens are to fully understand their rights they must be encouraged to communicate with lawyers through open and frank discussions and this can only be achieved if the communications are protected from disclosure.⁵⁵⁹ Legal professional privilege is described as a 'substantive right which applies to prevent any compulsory access to client-lawyer communications'.⁵⁶⁰

The concept of legal professional privilege has been recognised by the *Evidence Act 1995* (Cth) as providing two privileges: an advice privilege, s 118, and a litigation privilege, s 119. The sections provide for the written communications between a legal adviser and their client to be kept confidential provided the communication was made or the written advice was prepared for the 'dominant purpose' of the lawyer in providing that advice. It

⁵⁵⁵ West, above n 23, 204.

⁵⁵⁶ Ibid 203.

⁵⁵⁷ Andrew Ligertwood, *Australian Evidence* (LexisNexus Butterworths, 4th ed, 2004).

⁵⁵⁸ Ibid 275, and the case of *Australian Federal Police v Propend Finance Pty Ltd* (1997) 188 CLR 501, 583 (Kirby J).

⁵⁵⁹ Ibid 274.

⁵⁶⁰ Ibid.

should be noted that all states and territories in Australia have similar provisions in their own Evidence Acts, commonly known as the ‘uniform Evidence Act’.

2.7 Exceptions to the privilege – crime and fraud

The legal professional privilege to protect written communication between a lawyer and their client is lost when the documents relate to an activity involving a crime or fraud. The privilege is also lost if the client of the lawyer waives their right to claim protection under the privilege. Both of these exceptions will be examined as they relate to the rights of taxpayers and the ATO.

In the case of *Clements, Dunne & Bell Pty Ltd v Commissioner of Australian Federal Police* (2001) 48 ATR 650, North J held that the crime and fraud exception prevented the legal professional privilege being used to protect certain documents between the lawyer and client from being disclosed to the Australian Federal Police even though the alleged fraud was committed by a third party.

From the perspective of the taxpayer and their right to maintain the confidentiality of certain written communications, the basis on which this exception has been applied would tend to suggest that the tax administrator has been granted an unfair advantage. This view is supported by Vincent Morfuni when he contends that the extension of the exemption of the privilege to third parties contradicts the widely held view that legal professional privilege is a fundamental right; Morfuni hopes that an appellate court will restore the exception to its traditional boundary.⁵⁶¹ Morfuni⁵⁶² advocates the restoration of the view taken by Deane J in *Attorney-General (NT) v Maurice* (1986) 161 CLR 475 where he stated that:

Its efficacy as a bulwark against tyranny and oppression depends upon the confidence of the community that it will in fact be enforced. That being so, it is not to be sacrificed, even to promote the search for justice or truth in the individual case or matter and extends to protect a citizen from compulsory disclosure of protected communications or materials to any court or to any tribunal or person with authority to require the giving of information or the production of documents or other materials.⁵⁶³

The Australian Crime Commission was not successful in arguing this exception in the Paul Hogan situation before Emmett J in the Federal Court.⁵⁶⁴

2.8 Exception to the privilege – waiver

The privilege belongs to the client and not the lawyer providing the advice.⁵⁶⁵ Therefore, unless the client expressly claims the privilege, there is a presumption that it has been waived.⁵⁶⁶ However, if the documents are already in the possession of the lawyer it is

⁵⁶¹ Vincent Morfuni, ‘Legal Professional Privilege and the Government’s Right to Access Information and Documents’ (2004) 33 *Australian Tax Review* 89, 112.

⁵⁶² *Ibid.*

⁵⁶³ (1986) 161 CLR 475, 491.

⁵⁶⁴ *A3 v Australian Crime Commission (No 2)* (2006) 63 ATR 348.

⁵⁶⁵ Ligertwood, above n 27, 294.

⁵⁶⁶ *Ibid* 295.

assumed that the privilege exists unless waived by the client.⁵⁶⁷ In this situation the lawyer needs to be in a position where they can contact their client for specific instructions on claiming the privilege. Section 122 of the *Evidence Act 1995* (Cth), the uniform evidence legislation, provides for the waiver of the privilege along the lines of the common law waiver.

In the case of *Federal Commissioner of Taxation v Pratt Holdings Pty Ltd* (2003) 51 ATR 593, the issue of whether the privilege was waived in a situation where written legal advice prepared by ABL was provided to a firm of accountants, PW, for further analysis. In the Federal Court of Australia Kenny J held that the client had not waived privilege in a situation where documents were provided to a firm of accountants.⁵⁶⁸

This decision is important because many taxpayers provide their accountants with copies of legal advice so that tax returns can be prepared on the basis of the legal advice provided. In such situations that legal advice retains the protection of the privilege and it would therefore not be available to the ATO. This would also apply to foreign legal advice provided to an Australian accountant for similar purposes.

2.9 Tax advisers and professional privilege

In June 2005 the New Zealand government introduced statutory law to extend the professional privilege to tax advisers.⁵⁶⁹ The USA had extended the privilege to tax advisers from as early as 1998.⁵⁷⁰ Keith Kendall contends that there is a logical argument to extend the privilege to tax advisers in Australia on the basis that registered tax agents are given a statutory right to provide advice on tax law and that many tax agents are not lawyers.⁵⁷¹ Section 251L(1), ITAA 36, provides a penalty for the provision of advice on taxation law by anyone other than a registered tax agent or a barrister or solicitor. Kendall is in favour of extending the privilege to non-lawyer tax advisers on the basis of their need to be registered tax agents before they can provide advice. The fact that both the USA and New Zealand have extended the privilege, coupled with the fact that the ATO recognises the role played by accountants in the taxation process, should be reason enough for the privilege to be extended in Australia. This view is also supported by the Australian Law Reform Commission as discussed in their report titled *Privilege in Perspective: Client Legal Privilege in Federal Investigations*.⁵⁷² It would appear that it is only a matter of time before the privilege will be extended to tax advisers in Australia.⁵⁷³

⁵⁶⁷ Ibid.

⁵⁶⁸ (2003) 51 ATR 593, 613.

⁵⁶⁹ Keith Kendall, 'Prospect for a Tax Advisers' Privilege in Australia' (2005) 1(3) *Journal of the Australasian Tax Teachers Association* 46, 47. The New Zealand provisions are found in the *Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005* (NZ).

⁵⁷⁰ Ibid.

⁵⁷¹ Ibid 52.

⁵⁷² Australian Law Reform Commission, Report 107
<<http://www.austlii.edu.au/au/other/alrc/publications/reports/107/>>.

⁵⁷³ For an extensive discussion on the New Zealand law see Andrew Maples, 'The Non-Disclosure Right in New Zealand – Lessons for Australia' (2008) 1 *Journal of the Australasian Law Teachers Association* 351.

2.10 Spousal privilege

According to Professor Ligertwood, the common law sought to protect the institution of marriage by forbidding spouses from testifying for or against each other in civil or criminal cases.⁵⁷⁴ Unfortunately the common law has been overruled by specific statutory provisions at the state and federal level, which makes the spouse a competent and compellable witness. The statutory law generally make the spouse a compellable witness for the defence, but the spouse can be exempted from being compelled to give evidence for the prosecution by the judge if the relationship may be harmed.⁵⁷⁵

2.11 Banker–customer relationship

Both resident and foreign taxpayers should be confident that their financial details will not be disclosed by their bank. The common law duty of confidence or secrecy⁵⁷⁶ that a bank owes to its customers was established in the case of *Tournier v National Provincial and Union Bank of England Ltd* [1924] 1 KB 461.⁵⁷⁷

There are two situations where s 263 and s 264 notices were served on banks seeking information about certain customers and the role of the bank in providing that information to the ATO created a concern for the bank in performing their duty to their customer. The first case highlighted the fact that the banker–customer duty of secrecy is overridden by statutory requirements to disclose customer information. In the case of *Smorgon v Federal Commissioner of Taxation* (1979) 9 ATR 483, the High Court of Australia held that the ANZ Bank must allow the ATO access to documents contained in a safe deposit box belonging to their customer and it did not matter that the ATO was on a ‘fishing’ expedition because they had no idea what information or documents might be found in the safe deposit boxes.

In the case of *Citibank v Federal Commissioner of Taxation* (1989) 20 ATR 292, a bank was placed in a difficult situation of not being in a position to claim legal professional privilege over documents being seized by the ATO pursuant to a s 263 notice. The ATO entered Citibank’s premises looking for documents relating to a preference share arrangement but copied other documents relating to tax minimisation. The bank’s employees were not given an opportunity to claim legal professional privilege before the copies were taken by the ATO. The Full Bench of the Federal Court, per Bowen CJ, Fisher and French JJ held that Citibank should have had an opportunity to claim privilege on behalf of their customers before copies of documents were taken and that the ATO needed to adopt guidelines in order to prevent this from happening in a similar situation in the future.⁵⁷⁸

⁵⁷⁴ Ligertwood, above n 27, 371.

⁵⁷⁵ Ibid 372.

⁵⁷⁶ W S Weerasooria, *Banking Law and the Financial System in Australia* (LexisNexus Butterworths, 5th ed, 2000) 474. It is important to note that the text refers to the fact that the duty of confidence is also referred to as a duty of secrecy.

⁵⁷⁷ Also [1923] ALL ER Rep 550.

⁵⁷⁸ French J, (1989) 20 ATR 292, 320.

One of the arguments in favour of using s 263 or s 264 notices is that they are quicker to obtain because they do not require the consent of a judicial officer, as is the case with obtaining a search warrant. In some situations a search warrant is used particularly when criminal activity is suspected and evidence needs to be collected for a prosecution. In that case a s 263 or s 264 notice is not appropriate.

2.12 Search warrants and appearances – criminal tax matters

The use of a search warrant clearly violates the privacy of the individual and therefore there must be checks on the powers of the police. The justification for the warrant system is that it represents a control device by requiring a judicial officer, the person who issues the warrant, being convinced of the reasonableness of both the suspicion of the police and the proposed investigative action in order to provide some protection for the individual.⁵⁷⁹

The case of *Egglishaw v Australian Crime Commission* [2006] FCA 819 concerned a challenge to a search warrant pursuant to the *Judiciary Act 1903* (Cth) on the basis that the warrant was unlawful and of no effect, and that the seizure of the laptop computer and other material was unlawful. The applicant was Philip Egglishaw, a banker from Switzerland, who while staying in a hotel in Australia had his laptop computer seized under a search warrant. The computer contained a list of Australian clients using the services of Strachans bank, a bank controlled by Egglishaw and situated in Switzerland. As a result of the personal records of the Australian clients using the tax haven bank being disclosed to the Australian authorities, Egglishaw, the applicant, challenged the validity of the search warrant in an attempt to protect his clients from the pending disclosure.

Sundberg J held that the Australian Crime Commission had discharged their burden of proof that their actions were lawful by obtaining a search warrant and that the applicant had the burden of showing that the warrant and actions of the officers executing the warrant was unlawful. Egglishaw was unable to convince the court that the obtaining of information contained in the laptop computer was unlawful.

2.13 Summons to appear – Australian Crime Commission Amendment Act 2007 (Cth)

Philip Egglishaw was compelled to provide evidence to the Australian Crime Commission (ACC) pursuant to s 28 of the *Australian Crime Commission Act 2002* (Cth) (ACC Act). From this, the ACC learnt that Egglishaw's bank, Strachans, administers various companies, trusts and bank accounts based in foreign countries on behalf of, and for the benefit of, a number of Australian residents and their families. The ACC believed that the services provided by Strachans enabled Australian residents to: accumulate substantial assets overseas in companies and trusts hidden behind an impenetrable veil of incorporation; create misleading documents which assist in defrauding the Commonwealth of Australia; and access their funds administered by Strachans from anywhere in the world by the use of debit or credit cards linked to bank accounts opened and operated for them by Strachans outside Australia, including at Corner Banca, SA in Lugarno, Switzerland. Based on the information obtained from Egglishaw, the ACC

⁵⁷⁹ Jill Hunter, Camille Cameron and Terese Henning, *Litigation II: Evidence and Criminal Process* (LexisNexus Butterworths, 2005) 525.

commenced criminal investigations into suspected fraud and money laundering by a number of Australian residents who have utilised the services provided by Strachans and Corner Banca.

Egglishaw challenged the validity of the summons to appear, s 28, and the notice to produce documents, s 29. The matter came before Besanko J of the Federal Court and is reported in *Egglishaw v Australian Crime Commission* [2009] FCA 1027, (2009) 71 ATR 570. Egglishaw failed on all grounds to have the proceedings by the ACC declared invalid.

2.14 Freedom of information

Taxpayers have a legal right to access information held by the ATO pursuant to the *Freedom of Information Act 1982* (Cth). However, there are a number of exemptions contained in ss 36, 37, 38, 40 and 42 that may prevent the taxpayer from being able to access all relevant information. Obviously, if the ATO has obtained legal advice from the Australian Government Solicitor (AGS) then legal professional privilege would apply. Similarly, if the Director of Public Prosecutions (DPP) provides legal advice to the ATO then the documents are privileged. This was the finding of the Administrative Appeals Tribunal (AAT) in the case of *Re Collie and Deputy Commissioner of Taxation* (1997) 35 ATR 1204. However, not only can the ATO claim an exemption from disclosing information, it can frustrate the process by charging for the retrieval of documents which in some cases can amount to tens of thousands of dollars.⁵⁸⁰ As Reynah Tang states, the taxpayer is precluded from being able to recoup the costs of complying with any ATO demands to provide information.⁵⁸¹

2.15 Human rights to protect taxpayers

The United Kingdom (UK) adopted the European Convention on Human Rights in 1953, but it was not until 1998 that the UK Parliament brought into existence statutory law to incorporate the Convention with the enactment of the *Human Rights Act 1998* (UK).⁵⁸² The effect of the European convention was to guarantee a number of basic human rights by allowing the individual to complain about the behaviour of their own government.⁵⁸³ Lee contends that there are three main principles for the operation of the UK *Human Rights Act 1998*: first, any statutory interpretation must find a meaning that will prevent the legislation from being incompatible with the Convention rights; second, no court is able to strike down or disregard legislation that conflicts with the Convention rights otherwise the primary or secondary legislation must be corrected; and third, the act requires all public authorities, including the Inland Revenue Service, to act in accordance with Convention rights.⁵⁸⁴ However, Lee is of the opinion that taxpayers in the UK will have a bleak future in trying to use the Convention rights as a weapon against statutory

⁵⁸⁰ Tang, above n 11, 24. *Re Collie and Federal Commissioner of Taxation* (2003) 54 ATR 1048.

⁵⁸¹ *Ibid.*

⁵⁸² Natalie Lee, 'The Effect of the Human Rights Act 1998 on Taxation Policy and Administration' (2004) 2(2) *eJournal of Tax Research* 155, 155.

⁵⁸³ *Ibid* 157.

⁵⁸⁴ *Ibid* 159–60.

provisions.⁵⁸⁵ The impact of human rights legislation in Australia in relation to taxation law was considered by Farrell as potentially providing a fertile ground for tax practitioners,⁵⁸⁶ and it has been raised by the Federal Court in the case of *Federal Commissioner of Taxation v Citibank Ltd* (1989) 20 ATR 292. In the judgment by French J, His Honour endorsed the need to adhere to the International Covenant on Civil and Political Rights in administering the taxation law by the ATO in Australia.⁵⁸⁷

2.16 Australian tax agents and tax advisers – duty to society

Tax advisers can never without the authority of their client voluntarily give information to the Commissioner no matter how inclined they may be to co-operate. The confidentiality implied in the relationship of lawyer and client or accountant and client ensures this. This confidentiality is, however, overborne by s 264.⁵⁸⁸ However, in the absence of any lawful obligation to disclose confidential and private information, it is submitted that a tax agent or tax adviser must not disclose any information belonging to their client to the ATO. The following statement by A J Myers QC on the duty owed by a tax adviser to their client provides the most appropriate answer to the conflict between a duty to society and a duty to the taxpayer:

A legal adviser in the field of taxation or anything else has two main duties: to advise his client to the best of his knowledge and ability, and to uphold the law. There is no conflict between those roles, properly understood. The adviser upholds the law by advising his client to the best of his knowledge and ability.⁵⁸⁹

2.17 Conclusion

From the above analysis of the rights that a taxpayer possesses to maintain the privacy and confidentiality of their financial information, the right to claim legal professional privilege over certain information provides the only form of protection for a taxpayer. However, the crime and fraud exception severely weakens this privilege. The crime and fraud exception was defeated by Paul Hogan who was successful in claiming the privilege in an action by the ACC to use materials they had seized as part of ‘Operation Wickenby’. The privilege was upheld by Emmett J in the Federal Court proceedings, *Hogan v Australian Crime Commission (No 4)* (2008) 72 ATR 107, and the ACC abandoned further action against the decision in the subsequent High Court proceedings instituted by Paul Hogan to prevent the disclosure of documents that had been produced in evidence: *Hogan v Australian Crime Commission & Ors* [2010] HCA 21.

⁵⁸⁵ Ibid 181.

⁵⁸⁶ James Farrell, ‘Strange Bedfellows? Tax Administration and Human Rights Brought Together’ (2009) 44(3) *Taxation in Australia* 147, 150.

⁵⁸⁷ (1989) 20 ATR 292, 316.

⁵⁸⁸ D G Hill, ‘The Role and Responsibility of the Tax Practitioner’ (1984) *Taxation in Australia* 298, 311.

⁵⁸⁹ A J Myers, ‘Tax Advice: The Lawyer’s Ethical Responsibility’ (1990) 19 *Australian Tax Review* 80, 87.

The coercive powers that the ATO has to obtain information and the powers that are available in criminal cases far outweigh the rights a taxpayer has to maintain the confidentiality of their financial information.

3 THE RIGHTS OF THE TAXPAYER – THE INTERNATIONAL POSITION

With the OECD being successful in having all OECD member states accepting the revised Article 26 of the Double Taxation Agreement on the exchange of information and having signed more than 320 tax information exchange agreements, what then are the chances of a non-resident taxpayer being able to maintain the confidentiality of their banking details? This is one of the main issues to be examined in this part of the paper. The international situation is further complicated by the fact that some countries are willing to disclose information on banking details if the request involves a criminal tax matter but refuse to co-operate if it is merely a civil tax matter. However, the emphasis of the Australian government on categorising all forms of tax minimising, tax avoidance and tax evasion as constituting a criminal act is designed to overcome this particular reservation and to succeed in obtaining information from other countries. This particular issue will not be discussed in this paper as it has been discussed in detail elsewhere.⁵⁹⁰

3.1 The OECD and a level playing field

In their recent report, *Tax Co-operation 2009: Towards a Level Playing Field*, the OECD highlighted the reason why transparency and exchange of information agreements were so important for the collection of revenue. The following statement illustrates this point:

International banking has become commonplace and it is no longer extraordinary for taxpayers to reside in one country, hold assets in another and have them managed from a third location. ... But regardless of why taxpayers situate their assets beyond the boundaries of their own residence country, the result is that tax administrations around the world face more and greater challenges to the proper enforcement of their tax laws than ever before. To meet these challenges, tax authorities must increasingly rely on international co-operation based on the implementation of international standards of transparency and effective exchange of information.⁵⁹¹

The OECD's standards for transparency and information exchange are contained in the progress report. The standards are supported by the European Union, the G8, the G20 and the UN. They require that: countries have a mechanism for exchanging information on request; the information will relate to domestic tax matters of a civil and criminal nature; there will be no restriction caused by the application of the dual criminality principle or domestic tax interest requirement; there will be respect given to safeguards and limitation; strict confidentiality rules will apply; and countries will make available

⁵⁹⁰ For a full discussion on the blurring of tax avoidance and tax evasion see: John McLaren, 'The Distinction Between Tax Avoidance and Tax Evasion Has Become Blurred in Australia: Why Has it Happened?' (2008) 3(2) *Journal of the Australasian Tax Teachers Association*, 141.

⁵⁹¹ OECD, *Tax Co-operation 2009: Towards a Level Playing Field* (OECD, 2009) 9.

reliable information such as ownership, identity and accounting information and powers to obtain and provide such information in response to a specific request.⁵⁹²

3.2 Double Taxation Agreements – Article 26

Double Taxation Agreements (DTAs) are entered into between two nations for the avoidance of double taxation and the prevention of fiscal evasion. The following article relating to the exchange of information is only relevant where there is in existence a DTA. Australia does not have a DTA with tax havens, although there is a DTA between Australia and Switzerland. However, in the case of tax havens other ‘exchange of information agreements’ are used to try to achieve a similar outcome. The new Article 26 for the exchange of information requires the contracting state to provide information when requested on financial and banking information even if held in a nominee capacity. Article 26 strengthens the ability of the requesting state to obtain banking information and the contracting state has no justification to deny the supply of that information to the requesting state.

What rights does a non-resident taxpayer or foreign investor have to be involved in the process whereby information has been requested from a contracting state by the country of residence and that information may be privileged or of no relevance to a taxation matter? According to Branson, some countries will provide the taxpayer with notification that their financial details are being requested by another state except in the case of fraud.⁵⁹³ The following countries provide some type of prescribed notification to taxpayers when a request for information has been made: Germany, Luxembourg, Portugal, The Netherlands, Sweden, Switzerland and the United States.⁵⁹⁴ Branson discusses the possibility of providing the taxpayer with a right to notification, a right of consultation or a right of intervention and concludes with the finding that at present Australian taxpayers have no right to participate in the process whereby information is made available under the DTA. Branson discusses the fact that in Germany, The Netherlands, Portugal and Switzerland the government has introduced regulations giving rights of participation and The Netherlands and Switzerland have provided laws to govern obtaining court orders to prevent or control the transfer of information.⁵⁹⁵ An Australian taxpayer or foreign investor would have no knowledge of the fact that their financial information was being requested from a foreign country under the DTA, nor would they have the ability to contest the validity of such a request. Branson examines the possible remedies available to a taxpayer including resorting to the various conventions on human rights as one possible way in which a taxpayer’s privacy may be maintained in the absence of rules providing a taxpayer with the right to participate in the information exchange process.⁵⁹⁶

⁵⁹² Ibid.

⁵⁹³ C C Branson, ‘The International Exchange of Information on Tax Matters and the Rights of Taxpayers’ (2004) 33 *Australian Tax Review* 71, 84.

⁵⁹⁴ Ibid.

⁵⁹⁵ Ibid 86.

⁵⁹⁶ Ibid 87.

3.3 Offshore Information Notice – Section 264A(1)

Section 264A took effect on 8 January 1991 and was part of the general anti-avoidance regime.⁵⁹⁷ This notice is designed to obtain information about the affairs of the taxpayer that is located outside Australia. The notice can be served on either the taxpayer or a third party. The taxpayer has 90 days in which to comply. If the documents or information are in the control or custody of a third party, they still must be produced. The information or materials required to be produced must relate to the assessment of the taxpayer.⁵⁹⁸ If the notice has been served on a trustee and the trustee is not in a position to pay income tax because there are beneficiaries presently entitled and not under a legal disability, then the notice will be invalid.⁵⁹⁹ The taxpayer liable to tax must be identified in the notice.⁶⁰⁰ This means that if the Commissioner is not sure about the actual taxpayer because of trusts being used, then a subsection 264A notice may not be appropriate. The taxpayer can refuse to provide documents and information if covered by legal professional privilege.

As stated above, subsection 264A(22) does not have the same effect as s 263 and s 264 in that it is not an offence if the taxpayer fails to comply with the offshore notice. The only sanction is that the taxpayer is unable to rely on offshore information or documentary evidence in contesting an assessment that would have been provided under the notice. However, the Commissioner may consent to allow the information.⁶⁰¹

3.4 Mutual assistance requests – *Mutual Assistance in Criminal Matters Act 1987 (Cth)*

The ACC and the DPP are able to obtain information relating to criminal activities that is located in a foreign country under the *Mutual Assistance in Criminal Matters Act 1987 (Cth)*. A number of treaties have been entered into by the Australian government and various foreign countries in order to put into effect mutual assistance in criminal matters. In the case of *Dunn v The Australian Crime Commission* [2008] FCA 424, the Federal Court was asked to declare that the request sent to the Swiss authorities pursuant to the *Mutual Assistance Act* was made without authority, outside jurisdiction and unlawful. The request for information was undertaken as part of ‘Operation Wickenby’ and followed on from information that had been obtained from the laptop computer belonging to Philip Egglshaw. Tracey J found that the request for information was valid. Thereafter similar arguments were heard by Tracey J in the case of *Strachans v Attorney-General* [2008] FCA 553, and once again the request for information was held to be valid. Dunn subsequently appealed the decision and in *Dunn v Australian Crime Commission* [2009] FCAFC 16, the Full Bench of the Federal Court, per Moore, Jessup and Gilmour JJ, dismissed the appeal and upheld the validity of the request for information that had been sent to the Swiss authorities.

⁵⁹⁷ *Taxation Laws Amendment (Foreign Income) Act 1990 (Cth)*.

⁵⁹⁸ For a detailed examination of this issue see *Commissioner of Taxation v ANZ Banking Group Ltd* (1979) 143 CLR 499, 535.

⁵⁹⁹ *Ibid.*

⁶⁰⁰ Morfuni, above n 31, 101.

⁶⁰¹ *Ibid.*

These cases illustrate the fact that information can be successfully obtained from foreign countries under the *Mutual Assistance in Criminal Matters Act* and that it is very difficult to challenge the validity of the request.

3.5 Legal professional privilege – foreign lawyer

What is the situation where an Australian taxpayer has obtained legal advice from a lawyer in a foreign country and they claim that the document is privileged? In the case of *Kennedy v Wallace* (2004) 208 ALR 424, Giles J of the Federal Court of Australia held that legal professional privilege is available, subject to limitations, to protect communication between the client and their foreign lawyer relating to advice on foreign law.

Unfortunately, Kennedy was unsuccessful in claiming that the documents were covered by the privilege. The fact that the documents related to the laws of a tax haven, namely Switzerland, appeared to weaken his claim for legal professional privilege. The view taken by Giles J to limit the application of the privilege to foreign legal advice has been severely criticised. James McComish is critical of the claim by Giles J that in order to benefit from the privilege, ‘foreign legal advice must have some connection to the administration of justice or the proper functioning of the legal system in Australia’.⁶⁰² Mr Kennedy appealed to the Full Bench of the Federal Court, per Black CJ, Emmett and Allsop JJ, where once again he was not successful in upholding his claim of privilege. However, the spurious restrictions placed on claiming privilege in relation to foreign legal advice as advanced by Giles J were rejected by the Full Bench.

While it is to the advantage of a taxpayer that they may be able to claim legal professional privilege when a foreign lawyer provides legal advice, what happens when documents are obtained under an exchange of information agreement with a foreign tax authority and the foreign taxpayer has no knowledge of the release of the communication in the first place and then has no opportunity to claim the privilege either in the foreign country or in Australia? Moreover, the staff at the foreign bank may not be experienced enough to claim the privilege on behalf of their customer.

3.6 OECD – exchange of information agreements

The main question raised in this chapter is what effect will the exchange of information agreements, as espoused by the OECD, have on non-resident taxpayers and investors with money in tax havens and OFCs? As discussed in the previous sections of this paper, taxpayers have very little protection in preventing their personal financial details from being disclosed to the tax administrators. In Australia the ATO has coercive powers of seizure under s 263 and s 264 notices, search warrants, and compulsory attendance before the ACC. In terms of information held overseas, the ATO can request the information from the taxpayer pursuant to subsection 264A, by use of the DTA, or under the *Mutual Assistance Act*. If this is the case and it is possible to access information through a range of legal means, why then do the OECD and the G20 nations require all states to enter into ‘exchange of information agreements’?

⁶⁰² James McComish, ‘Foreign Legal Professional Privilege: A New Problem for Australian Private International Law’ (2006) 28 *Sydney Law Review* 297, 317.

In its *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes* the OECD examines three approaches to exchanging information: first, 'exchange of information on request'; second, a 'spontaneous exchange'; and third, an 'automatic or routine exchange of information'.⁶⁰³ Article 26, as discussed above, only applies to the exchange of information on request. In situations where there is no DTA between Australia and the other state, a separate exchange of information agreement is entered into by the parties. The OECD advocates that states take the further step of agreeing to automatic or spontaneous exchanges of information. An automatic exchange of information requires the country of source to automatically report to the country of residence, information about non-residents receiving interest, dividends, royalties or pension payments. The country of residence does not need to request the information on a specific non-resident taxpayer. The spontaneous exchange of information takes the process a step further and involves a foreign tax administrator identifying additional non-resident taxpayers involved in taxation arrangements and the information can be passed on to the tax administrators in the country of residence. Both of these activities would arguably contravene non-residents' rights of privacy and confidentiality as contained in the charter of human rights. However, the OECD and the G20 would like to put an end to tax havens and OFCs.

The Australian government has entered into a number of exchange of information agreements with tax havens; in two examples, the agreement with Bermuda and the agreement with Jersey, the only requirement is to exchange information on request. What is of interest is the fact that in relation to the Bermuda agreement reference is made to 'serious tax evasion' whereas in the Jersey agreement reference is made to 'criminal tax matters'. The Australian government has been actively blurring the distinction between tax avoidance, a non-criminal activity, with tax evasion, a criminal activity. One of the main reasons for doing this has been to treat all arrangements that involve foreign bank accounts and financial arrangements with tax havens and OFCs as constituting a criminal tax matter so that other countries are pressured into providing information on Australian taxpayers utilising those financial services.⁶⁰⁴

From the perspective of the United States, Timothy Addison contends that Tax Information Exchange Agreements (TIEAs) are of very limited benefit.⁶⁰⁵ Addison contends that the US has to identify not only the taxpayer or investor to be investigated and information obtained from the foreign country, but also that evidence exists to prove the taxpayer has engaged in criminal or civil tax activities.⁶⁰⁶ The US must show that it is not engaged in a 'fishing expedition'. Moreover, Addison states that the TIEA will not overcome the domestic bank secrecy laws of the tax haven. This view is supported by the evidence given by Professor Reuven Avi-Yonah to the Senate Finance Committee on

⁶⁰³ OECD, *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes* (OECD, 2006) 7.

⁶⁰⁴ McLaren, above n 60.

⁶⁰⁵ Timothy Addison, 'Shooting Blanks: The War on Tax Havens' (2009) 16(2) *Indiana Journal of Global Legal Studies* 703, 717.

⁶⁰⁶ *Ibid* 718.

Offshore Tax Evasion, 110th Congress.⁶⁰⁷ Addison provides evidence to suggest that the Cayman Islands has continued to experience stable growth in its financial industry and is now ranked fourth in market share for international banking behind the United Kingdom, United States and France.⁶⁰⁸ While this may be comforting for non-resident taxpayers and foreign investors using tax havens, why then did the Union Bank of Switzerland disclose the details of their account holders to the Internal Revenue Service in the United States?

3.7 The United States and the Union Bank of Switzerland (UBS)

In November 2008, an official from UBS was indicted by a US federal grand jury for an alleged conspiracy to conceal thousands of US taxpayers' accounts from the Internal Revenue Service (IRS).⁶⁰⁹ In February 2009, UBS entered into a deferred prosecution agreement on the basis that the bank paid US\$780 million to provide details of about 4500 US account holders to the IRS. The US Justice Department alleged that there were about 52 000 accounts of US citizens with about 20 000 containing securities and 32 000 containing cash with a total value of US\$14.8 billion.⁶¹⁰ This may be seen as a great victory for the US government and the IRS. However, it must also be viewed as being a comprehensive disregard of the rights of the account holders to expect their bank to maintain the confidentiality of their financial details. It is not the behaviour of a first world democracy.

As a result of UBS providing the names of US citizens having bank accounts with their bank, no foreign investor or non-resident taxpayer can have any confidence that this situation will not be repeated around the world. It would appear that the right of confidentiality has come to an end as far as the US is concerned. The situation could just as easily be replicated in Australia. The only feature that may provide comfort for non-resident taxpayers and investors is that the US government did not require all foreign banks located in the US to disclose bank account details of their US citizens, nor did the US government target Switzerland as a whole.⁶¹¹ The agreement between the US and UBS did not violate the Swiss bank secrecy laws.⁶¹²

4 CONCLUSION

Australian taxpayers have very limited rights to privacy and confidentiality of their financial affairs. The ATO has strong coercive powers to obtain information pursuant to s 263 and s 264 notices and the only defence to prevent access to certain information by the ATO is to claim legal professional privilege. This right, which is fundamental to the administration of justice, has been weakened by the crime and fraud exemption.

⁶⁰⁷ Ibid.

⁶⁰⁸ Ibid 720.

⁶⁰⁹ 'Swiss Bank Settles U.S. Tax Charges, Mounting Pressure on Swiss Bank Secrecy' (2009) 103 *The American Journal of International Law* 338.

⁶¹⁰ Ibid 339.

⁶¹¹ 'Offshore Private Banking Lives On' *Euromoney*, London, September 2009.

⁶¹² Ibid.

Australian taxpayers have no right to remain silent when confronted with a s 264 notice. Similarly, a taxpayer cannot claim the privilege against self-incrimination when faced with a s 264 notice. The right of a spouse not to give evidence against their partner is of no effect when required to appear before the ACC. The banker–customer duty of confidentiality has been severely weakened by the coercive powers of the ATO and provides no protection to a s 264 notice whereby the ATO is able to go on a fishing expedition. A taxpayer has no defence against a search warrant or a summons to appear before the ACC as has been demonstrated by the Egglisshaw cases.

From a domestic law perspective, Australian taxpayers can only rely on legal professional privilege in order to maintain their right to privacy over legal advice.

The research shows that with the introduction of TIEAs between tax havens and OFCs and OECD member nations, the rights of a non-resident taxpayer to maintain the confidentiality of their financial affairs in a foreign country is under threat. It is also apparent that non-resident taxpayers are not in a position to know if their financial details are being disclosed by a foreign tax authority to the tax authority in their home country, and even if documents are protected by legal professional privilege there is no way of claiming that privilege if the taxpayer is unaware that the documents are being disclosed. The research into the protection provided by the declarations on human rights and a variety of statutory provisions incorporating human rights was found to be of limited use in the area of taxation law. It was found that the courts in the UK were reluctant to allow taxpayers to rely on the human rights provisions when it came to matters of taxation revenue. It is contended in this paper that while ‘fishing expeditions’ by the ATO might be allowed under Australian domestic law, they are not permitted under the laws of tax havens and OFCs. If the ATO wants information about certain tax arrangements involving a tax haven then they must provide details of specific taxpayers and specific transactions before information is exchanged.

Based on the research undertaken for this paper, it is possible to draw the conclusion that with the introduction of TIEAs, non-resident taxpayers and Multi National Enterprises (MNEs) face a greater possibility of having their financial details disclosed to the tax authorities in their country of residence. This directly impacts on the future of tax havens and OFCs because the greater the threat of disclosure, the less non-resident taxpayers will use tax havens to hide financial assets and income. This would appear to coincide with the main objective of ‘Operation Wickenby’: to deter and detect Australian residents who hide income in tax havens and OFCs.

**PERFORMANCE MANAGEMENT FOR A TAX
ADMINISTRATION: INTEGRATING ORGANISATIONAL
DIAGNOSIS TO ACHIEVE SYSTEMIC CONGRUENCE**

MUZAINAH MANSOR*

ABSTRACT

While there are various studies on tax administration performance, a study which holistically analyses a tax administration performance management system is lacking in the literature. This paper proposes a performance management framework for a tax administration that integrates the congruence model for organisational behaviour diagnosis. The central idea of the congruence model is that the effectiveness of an organisation in achieving its objectives depends on congruence between the different parts of the organisational components in the transformation process. It is emphasised that if a tax administration is to adopt a performance management system in an interactive way, it needs to be embraced at an operational as well as behavioural level.

* Muzainah Mansor is a PhD candidate at the Australian School of Taxation (Atax), Faculty of Law, University of New South Wales, Sydney, Australia. Email: z3259401@student.unsw.edu.au. The author wishes to thank her supervisors, Professor Neil Warren and Associate Professor Binh Tran-Nam, for their assistance and valuable comments on the earlier version of this paper. Appreciation also goes to the anonymous reviewer for JATTA and the participants of the ATTA PhD Colloquium 2010 for their constructive comments.

1.0 INTRODUCTION

The best tax policy in the world is worth little if it cannot be implemented effectively⁶¹³ and tax policy design must take into account the administrative dimension of taxation.⁶¹⁴ According to Bird,⁶¹⁵ tax policy and tax administration interact at three distinct levels: (1) the formation of policy and the drafting of legislation; (2) the administrative procedures and institutions needed to implement legislation; and (3) the actual implementation of the tax system. Bird⁶¹⁶ added that some key policy decisions do not seem to have taken adequate account of their administrative consequences, which could lead to limitations in implementing a good tax policy.

The importance of good tax administration has long been a concern of many parties. The subject of tax administration is extremely important both to those concerned with the key role increased tax yields can play in restoring macroeconomic balance and those concerned with tax policy and its effects on the economy in general.⁶¹⁷ The way a tax system is administered affects its yield, its incidence and its efficiency. According to Bird, tax administration is a difficult task, and the best tax administration is not simply that which collects the most revenues; facilitating tax compliance is not simply a matter of adequately penalising non-compliance; tax administration depends as much on private as on public actions (and reactions); and there is a complex interaction between various environmental factors, the specifics of substantive and procedural tax law, and the outcome of a given administrative effort.⁶¹⁸ Even though tax administration is complex,

⁶¹³ Richard Bird and Eric Zolt, 'Tax Policy in Emerging Countries' (2008) 26 *Environment and Planning C: Government and Policy*, 73–86.

⁶¹⁴ Richard Bird, 'Administrative Dimensions of Tax Reform' (2004) 10 *Asia-Pacific Tax Bulletin*, 134–50.

⁶¹⁵ Richard Bird, 'Administrative Dimensions of Tax Reform' (2003) *ITP Paper 0302*.

⁶¹⁶ *Ibid.*

⁶¹⁷ Richard Bird and Milka Casanegra de Jantscher (eds), *Improving Tax Administration in Developing Countries* (International Monetary Fund, 1992).

⁶¹⁸ Bird, above n 3.

its significant effects on tax policy and economy make it important to be understood because tax administration is tax policy.⁶¹⁹

Considering the important role of a tax administration, it is also essential to ensure that the system is working well and it achieves the objectives it has established. One way to find out whether a tax administration achieves its goals is by measuring the tax administration performance. The following section discusses the literature on tax administration performance.

2.0 TAX ADMINISTRATION PERFORMANCE

Tax administration has to perform in an efficient and effective manner in order to ensure an equitable and economically efficient taxation system exists.⁶²⁰ The importance of an efficient and effective tax administration is supported by Gill⁶²¹ who stated that ‘while the tax policy and tax laws create potential for raising tax revenues, the actual amount of taxes flowing into the government Treasury, to a large extent, depends on the efficiency and effectiveness of the revenue administration’. Gill⁶²² further added that weaknesses in revenue administration lead to inadequate tax collections, hence shrinking the budgetary resource envelope, and affecting the government’s ability to implement its policies and programs and provide public services.

Despite the importance of having a successful revenue administration, there are no general, agreed upon measures which provide for the comparative assessment of a tax administration’s performance.⁶²³ Klun⁶²⁴ also reflected that the literature does not offer a

⁶¹⁹ Milka Casanegra de Jantscher, ‘Administering the VAT’ in Malcolm Gillis, Carl Shoup and Gerardo P Sicat (eds), *Value Added Taxation in Developing Countries* (World Bank, 1990).

⁶²⁰ Maja Klun, ‘Performance Measurement for Tax Administrations: The Case of Slovenia’ (2004) 70(3) *International Review of Administrative Sciences*, 567–74.

⁶²¹ Jit B S Gill, ‘The Nuts and Bolts of Revenue Administration Reform’ (2003), <<http://www1.worldbank.org/publicsector/pe/tax/NutsBolts.pdf>>, 1.

⁶²² Ibid.

⁶²³ Margaret Levi, *Of Rule and Revenue* (University of California Press, 1988); Malcolm Gillis, ‘Tax Reform: Lessons from Postwar Experience in Developing Countries’ in Malcolm Gillis (ed), *Tax Reform in Developing Countries* (Duke University Press, 1989), 492–520; Robert Taliencio, ‘Designing Performance: The Semi-Autonomous Revenue Authority Model in Latin America and Africa’ (Policy Research Working Paper 3423, World Bank, 2004).

common definition for performance measurement of a tax administration system. In fact, there is no one set of widely accepted performance measures or indicators for measuring the revenue performance or the overall performance of a tax administration system.⁶²⁵

Due to the lack of standardised systems for performance measurement,⁶²⁶ previous literature has suggested various methods in measuring the performance of a tax administration system. Some authors have proposed measuring tax office performance based on productive efficiency.⁶²⁷ Other authors — Goode,⁶²⁸ Tanzi and Pellechio,⁶²⁹ Silvani and Baer,⁶³⁰ and Casanegra de Jantscher⁶³¹ — have grouped certain factors together within the single concept of tax administration performance in terms of efficiency and effectiveness. Frampton⁶³² considered the important components of tax administration to be efficiency, responsiveness and motivation. Silvani and Baer⁶³³ proposed that the tax administration system's efficiency and effectiveness are best measured by looking at the tax collection process and taxpayer's non-compliance or the tax gap. The OECD⁶³⁴ evaluated performance in tax administration of OECD countries by focusing on efficiency, service quality and effectiveness. In other words, the literature

⁶²⁴ Klun, above n 8.

⁶²⁵ Christian von Soest, 'Measuring the Capability to Raise Revenue Process and Output Dimension and their Application to the Zambia Revenue Authority' (GIGA Working Papers, No. 35, GIGA-WP-35/2006, 2006).

⁶²⁶ Klun, above n 8.

⁶²⁷ M J Farrell, 'The Measurement of Productive Efficiency' (1957) 120(3) *Journal of the Royal Statistical Society, Series A*, 253–90; Rolf Fare, Shawna Grosskopf and C A Knox Lovell, *The Measurement of Efficiency of Production* (Kluwer-Nijhoff Publishing, 1985); Xose Manuel Gonzalez and Daniel Miles, 'Eficiencia en la Inspeccion de Hacienda' (2000) 8(24) *Revista de Economia Aplicada*, 203–19; Wim Moesen and Annick Persoon, 'Measuring and Explaining the Productive Efficiency of Tax Offices: A Non-Parametric Best Practice Frontier Approach' (2002) 47(3) *Tijdschrift Voor Economie en Management*, 399–416.

⁶²⁸ Richard Goode, 'Some Aspects of Tax Administration' (IMF Staff Papers, 1981).

⁶²⁹ Vito Tanzi and Anthony Pellechio, 'The Reform of Tax Administration' (IMF Working Paper 95/22, 1995).

⁶³⁰ Carlos Silvani and Katherine Baer, 'Designing a Tax Administration Reform Strategy: Experiences and Guidelines' (IMF Working Paper, 97/30, 1997).

⁶³¹ Milka Casanegra de Jantscher, 'Providing Resources to the Tax Administration, in Necessary Attributes for a Sound and Effective Tax Administration' (CIAT, 3-22, 1997).

⁶³² Dennis Frampton, *Practical Tax Administration* (Fiscal Publications, 1993).

⁶³³ Silvani and Baer, above n 18.

⁶³⁴ OECD, 'Performance Measurement in Tax Administration — Practice Note' (Committee of Fiscal Affairs Forum on Strategic Management, OECD, 2001).

suggests that the scope of evaluation relates to input, output, productivity, quality, taxpayer satisfaction and the outcomes from revenue and compliance.

The World Bank⁶³⁵ proposed that tax administration performance should be evaluated with respect to the three requirements of effectiveness, efficiency and equity. Teera⁶³⁶ suggested that tax performance evaluation should focus on raising more tax revenue. According to Serra,⁶³⁷ an example of an output of a tax administration system is the number of audits carried out by each tax inspector; while the outcomes usually include taxpayer satisfaction, quality of services to the taxpayers and taxpayer compliance rate. The OECD⁶³⁸ stated that the outputs of a tax administration are, for example, the number of inquiries processed and the number of audits cases and debt cases settled; and the outcome could be in the form of changes in taxpayers' compliance.

In spite of the lack of standardised systems for tax administration performance measurement, researchers have been measuring performance of tax administration using various performance criteria, measures and indicators to try to gauge the problems concerning tax administration and to suggest ways to overcome those problems. A summary of empirical studies regarding the performance of the tax administration system is shown in Table 1.

Table 1: Summary of empirical studies on tax administration performance

Studies	Performance criteria	Performance measures /indicators
---------	----------------------	-------------------------------------

⁶³⁵ World Bank, 'Zambia — Public Expenditure Management and Financial Accountability Review' (Report No. 26162-ZA, World Bank, 2003).

⁶³⁶ Joweria M Teera, 'Could Do Better: An Appraisal of Uganda's Tax Performance Relative to Sub-Saharan Africa' (Working Paper, University of Bath, September 2003).

⁶³⁷ Pablo Serra, 'Measuring the Performance of Chile's Tax Administration' (2003) 56(2) *National Tax Journal*, 373–83.

⁶³⁸ OECD, 'Monitoring Taxpayers' Compliance: A Practical Guide Based on Revenue Body Experience' (Forum on Tax Administration: Compliance Sub-Group, Centre for Tax Policy and Administration, 22 June 2008).

Ishi ⁶³⁹ — Japan	Efficiency and productivity	Cost–revenue ratio and employee productivity ratio
Mustafa ⁶⁴⁰ — Malaysia	Efficiency and productivity	Cost–revenue ratio and employee productivity ratio
Tayib ⁶⁴¹ — Malaysia	Efficiency and productivity	Cost–revenue ratio and employee productivity ratio; tax employee organisational commitment and high-commitment work system
Gonzalez and Miles ⁶⁴² — Spain	Efficiency of tax office	Input: ratio of tax inspectors to tax personnel Outputs: number of actions performed to total taxpayer, and ratio of debt to gross added value
Moesen and Persoon ⁶⁴³ — Belgium	Efficiency of tax office	Input: number of tax personnel

⁶³⁹ Hiromitsu Ishi, *The Japanese Tax System* (Clarendon Press, 1993).

⁶⁴⁰ Hajah M H Mustafa, 'An Evaluation of the Malaysian Tax Administrative System, and Taxpayers' Perceptions Towards Assessment Systems, Tax Law Fairness, and Tax Law Complexity' (PhD Dissertation, Universiti Utara Malaysia, 1996).

⁶⁴¹ Mahamad Tayib, 'The Determinants of Assessment Tax Collection: The Malaysian Local Authority Experience' (PhD Dissertation, University of Glamorgan, 1998).

⁶⁴² Gonzalez and Miles, above n 15.

		Output: number of audits returns
Taliercio ⁶⁴⁴ — Africa and Latin America	Efficiency and effectiveness	Input: personnel management and collection costs Output and outcome: tax/GDP ratio, taxpayer registration, compliance, taxpayer services
Klun ⁶⁴⁵ — Slovenia	Efficiency and effectiveness	Simplicity, costs, voluntary compliance (taxpayer attitude, rights and service quality), tax audit, labour productivity
Barros ⁶⁴⁶ — Portugal	Efficiency of tax office	Inputs: cost of labour and cost of capital Outputs: tax collected, clear-up rates of contested cases for tax demands

⁶⁴³ Moesen and Persoon, above n 15.

⁶⁴⁴ Taliercio, above n 11.

⁶⁴⁵ Klun, above n 8.

⁶⁴⁶ Carlos P Barros, 'Performance Measurement in Tax Offices with Stochastic Frontier Model' (2005) 32(6) *Journal of Economic Studies*, 497–510.

Aizenman and Jinjarak ⁶⁴⁷ — various countries	Tax collection efficiency	VAT revenue/consumption, and annual VAT revenue/GDP
Serra ⁶⁴⁸ — Chile	Tax revenue collection	Customer satisfaction, tax revenue collection, compliance rate, enforcement
von Soest ⁶⁴⁹ — Zambia	Revenue raising capability	Information collection and processing, merit orientation, administrative accountability, and revenue performance
Tennant and Tennant ⁶⁵⁰ — Jamaica	Efficiency of revenue collections	Tax/GDP ratio, cost of administration, administrative procedures, technical staff, auxiliary input

⁶⁴⁷ Joshua Aizenman and Yothin Jinjarak, 'The Collection Efficiency of the Value Added Tax: Theory and International Evidence' (Working Paper 11 539, National Bureau of Economic Research, 2005).

⁶⁴⁸ Pablo Serra, 'Performance Measures in Tax Administration: Chile as a Case Study' (2005) 25 *Public Administration and Development*, 115–24.

⁶⁴⁹ von Soest, above n 13.

⁶⁵⁰ Sandria Tennant and David Tennant, 'The Efficiency of Tax Administration in Jamaica: An Introspective Assessment' (2007) 56(3) *Social and Economic Studies*, 71–100.

James, Svetalekth and Wright ⁶⁵¹ — Thailand	Tax collection performance	Productivity, good practice, tax employee attitudes and perceptions of collection process

Source: Author

Reflecting on the studies in Table 1, three main limitations are derived. First, most of the empirical studies concentrated on the performance measurement and ignored the importance of performance management to improve a tax administration. Although measurement is a critical component of performance management, measuring and reporting alone have rarely led to organisational learning and improved outcomes.⁶⁵² Silvani and Baer⁶⁵³ suggested that, in order to determine the performance of a tax administration, attention must be given to the design and implementation of standards for management evaluation and control. Performance management is an appropriate tool for management evaluation and control of a tax administration. Alley and Bentley⁶⁵⁴ suggested that performance management theories support the achievement of a good tax administration system through target setting, which is measured by selected key performance indicators.

Second, previous empirical studies disregarded the importance of diagnosing the problems faced by a tax administration when aiming to improve its performance. Silvani

⁶⁵¹ Simon James, Thamrongsak Svetalekth and Brian Wright, 'Tax Charters, Performance Indicators and the Case for a More Strategic Approach to Tax Administration' (Discussion Paper in Management, Paper No. 07/12, 2007), <http://business-school.exeter.ac.uk/documents/discussion_papers/management/2007/0712.pdf>.

⁶⁵² The US National Performance Management Advisory Commission, 'A Performance Management Framework for State and Local Government: From Measurement and Reporting to Management and Improving' (2009), <<http://www.gfoa.org/downloads/PMCommissionFrameworkPUBLIC-REVIEW-DRAFT.pdf>>.

⁶⁵³ Silvani and Baer, above n 18.

⁶⁵⁴ Clinton Alley and Duncan Bentley, 'The Increasing Imperative of Cross-Disciplinary Research in Tax Administration' (2008) 6 (2) *eJournal of Tax Research*, 122–44.

and Baer⁶⁵⁵ suggested that one of the first steps reformers need to take in initiating a tax administration reform is to diagnose existing problems and to develop an appropriate strategy for improvement. In addition, Radnor and McGuire⁶⁵⁶ stated that some of the problems in the performance management for public organisations arise because of the reasons behind its implementation, for example purely for measurement and evaluation rather than as a tool for improvement. Organisational behaviour diagnosis therefore could reveal the problems faced by a tax administration and identify key areas for improvement.

Third, empirical studies on tax administration performance focused on the quantitative part of the performance measures. Studies incorporating behavioural aspects of a tax administration are lacking in the literature. Radnor and McGuire⁶⁵⁷ suggested that if public sector organisations are going to use performance management systems in an interactive way and develop coherent sets of performance measures, they need to embrace the system on a behavioural instead of just operational level.

Even though performance management is important for a tax administration, there is neither a performance management study nor a performance management framework for a tax administration in the literature. There are general performance management frameworks for public sector organisations being proposed in the literature — see, for example, Australian Public Service Management Advisory Committee (APS);⁶⁵⁸ the US National Performance Management Advisory Commission;⁶⁵⁹ and Mackie⁶⁶⁰ for the Scottish Government. However, like approaches to quality, there is no single

⁶⁵⁵ Silvani and Baer, above n 18.

⁶⁵⁶ Zoe Radnor and Mary McGuire, 'Performance Management in the Public Sector: Fact or Fiction?' (2004) 53(3) *International Journal of Productivity and Performance Management*, 245–60.

⁶⁵⁷ Ibid.

⁶⁵⁸ Australian Public Service Management Advisory Committee (APS), 'Performance Management in the Australian Public Service: A Strategic Framework' (2001), <<http://www.apsc.gov.au/publications01/performancemanagement.htm>>.

⁶⁵⁹ The US National Performance Management Advisory Commission, above n 40.

⁶⁶⁰ Bobby Mackie, 'Organisational Performance Management in a Government Context: A Literature Review' (2008) Scottish Government Social Research, <<http://www.scotland.gov.uk/Resource/Doc/236340/0064768.pdf>>.

performance management framework that suits all organisations.⁶⁶¹ A performance management framework which considers the organisational behaviour aspect specifically for a tax administration should be developed. The following section discusses a proposed performance management framework for a tax administration.

3.0 A PROPOSED PERFORMANCE MANAGEMENT FRAMEWORK

A performance management framework for a tax administration is proposed as depicted in Figure 1. At the centre of the framework is the transformation process where the tax administration consumes inputs to produce outputs/outcomes. This framework utilises the Nadler and Tushman⁶⁶² congruence model for diagnosing the tax administration transformation process. The Nadler and Tushman model has a reasonably complete set of variables and presents them in a way that encourages straightforward organisational analysis.⁶⁶³ It also provides a useful classification of internal organisational components while showing the interaction among them.

The congruence model for analysing an organisation's performance is applicable in the context of a tax administration. In this case, the tax authority acted as the transformation process between the inputs and outputs of the organisational system. Gill⁶⁶⁴ suggested that the congruence model enables a step-by-step analysis of the input, strategy, transformation processes, outputs and feedback mechanisms of a revenue administration system, with a view to identifying systematic deficiencies that lead to inefficiency and ineffectiveness in its operations.

The congruence model puts its greatest emphasis on the transformation process and specifically reflects the critical system property of interdependence. It views an organisation as made up of components or parts; that is, task, formal organisation,

⁶⁶¹ Kit Fai Pun and Anthony S White, 'A Performance Measurement Paradigm for Integrating Strategy Formulation: A Review of Systems and Frameworks' (2005) 71(1) *International Journal of Management Reviews*, 49–71.

⁶⁶² David A Nadler and Michael L Tushman, 'A Model for Diagnosing Organizational Behavior' (1980) (Autumn) *Organizational Dynamics*.

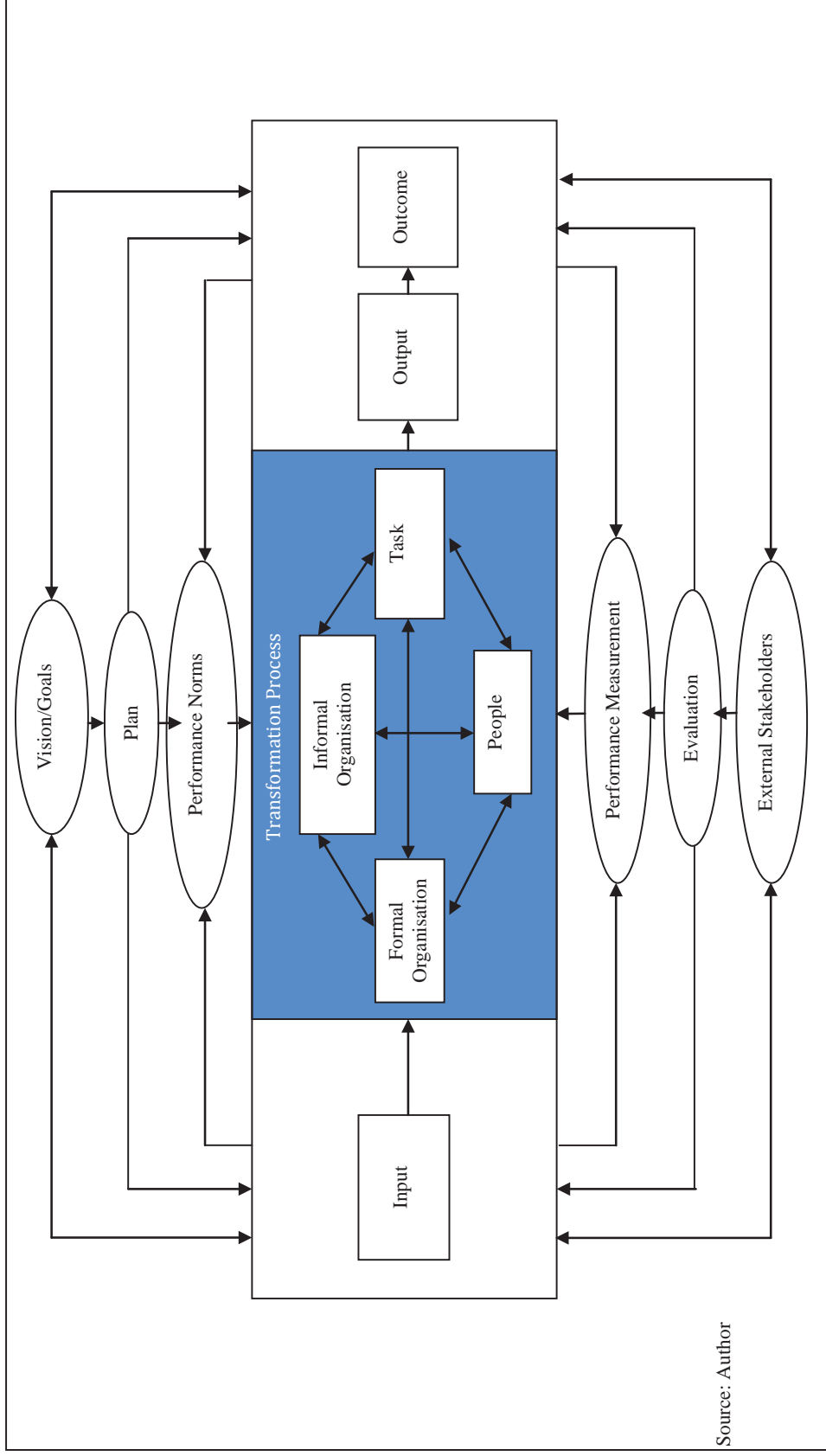
⁶⁶³ Tupper Cawsey and Gene Deszca, *Toolkit for Organizational Change* (Sage, 2007).

⁶⁶⁴ Jit B S Gill, 'A Diagnostic Framework for Revenue Administration' (World Bank Technical Paper No. 472, World Bank, 2000).

informal organisation and people that interact with each other. These components exist in states of relative balance, consistency, or 'fit' with each other. According to the model, the different parts of an organisation can fit well together and function effectively, or fit poorly and lead to problems, dysfunctions or performance below potential.

While the Nadler and Tushman congruence model provides a theory on how to diagnose the transformation process of an organisation, the model itself is a general model for the analysis of organisations. There is a need to include more specific methods to define high and low congruence among tax administration components. In addition, the congruence model only emphasises the transformation process and does not consist of other elements that make up the whole performance management system. This paper therefore provides a systematic approach to utilise the congruence model in the context of a performance management system for a tax administration. The following sections discuss the elements in the proposed performance management framework.

Figure 1: Performance management framework for a tax administration



Source: Author

3.1 TAX ADMINISTRATION TRANSFORMATION PROCESS

The tax administration transformation process has its major components: its tasks, its people, the formal organisational arrangements and the informal organisational arrangements. The real challenge of tax administration design is to select from the range of alternatives the most appropriate way to configure the tax administration components to create the output required by the strategy. In order to do this, it is essential to understand each tax administration component and its relationship to the others. The following sections discuss these tax administration components.

3.1.1 THE FORMAL ORGANISATIONAL ARRANGEMENTS

According to Wyman,⁶⁶⁵ the formal organisation is made up of the structures, systems and processes each organisation creates to group people and the work they do and to co-ordinate their activity in ways designed to achieve strategic objectives. It is proposed that an important aspect of formal organisational arrangement is the strategic planning system. Strategic planning has been defined as a disciplined effort to produce fundamental decisions and actions that shape and guide what an organisation is, what it does and why it does it.⁶⁶⁶ A strategic plan is essential for a tax administration. Given that the future is uncertain, management will always need to plan in order to develop the procedures and operations necessary to cope with the changing requirements. With a well-conceived strategic plan, tax managers will be more forward thinking in their approach in an era of uncertainty. A strategic plan is an important document to guide any tax department on the way forward. It provides a mechanism to pool ideas from each level of the organisation. Such collaboration and co-operation can only benefit the entire organisation. Adequate planning will help management to find the best way of achieving

⁶⁶⁵ Oliver Wyman, 'The Congruence Model: A Roadmap for Understanding Organizational Performance' (2003), http://www.oliverwyman.com/ow/pdf_files/Congruence_Model_INS.pdf.

⁶⁶⁶ John M Bryson, *Strategic Planning for Public and Non-profit Organizations: A Guide to Strengthening and Sustaining Organizational Achievement* (Jossey-Bass, revised ed, 1995).

a particular objective. In addition, it allows tax administration to examine areas that can be improved, including better use of available resources .⁶⁶⁷

Proper planning lends itself to more integration and synergies within the tax administration. Revenue collection is the main purpose of all tax departments. Therefore, any decision that will enhance that process should be examined. The strategic planning concerning performance objectives and operational strategies for a tax administration could be in the form of the desired outcomes.⁶⁶⁸ Dhillon and Bouwer⁶⁶⁹ suggested that these strategies include the desired outcomes of collecting more tax revenue, improving services to taxpayers, improving compliance and risk management and improving operational effectiveness. Bird⁶⁷⁰ added that a tax administration must also select strategies and set out administrative rules to counter each type of non-compliance by different groups of taxpayers.

The more important issue, however, concerns putting plans into action specifically for a tax administration. Strategic planning is an action-oriented type of planning that is useful only if it is carefully linked to implementation — and this is often where the process breaks down.⁶⁷¹ Tax administrators may fail to link their strategic planning efforts to other critical decision-making processes. Mintzberg⁶⁷² is one of the most vocal critics of strategic planning precisely because organisations' planning activities are too often completely divorced from performance measurement and resource allocation. Even though tax administrations around the world have embraced strategic planning, it is unlikely to produce the anticipated benefits unless they drive it through budgeting,

⁶⁶⁷ For example, it may be recognised that joint assignments by tax collection agencies may be a better utilisation of resources than for each organisation to carry out an assignment independently.

⁶⁶⁸ Australian Taxation Office (ATO), 'Guide for Researchers. Literature Review: Measuring Compliance Effectiveness' (2007),

<<http://www.ato.gov.au/corporate/content/00105122.htm&pc=001>>; OECD, above n 26.

⁶⁶⁹ Amardeep Dhillon and Jan G Bouwer, 'Reform of Tax Administration in Developing Nations' (2005) 1 *Accenture*.

⁶⁷⁰ Bird, above n 2.

⁶⁷¹ Theodore H Poister and Gregory Streib, 'Elements of Strategic Planning and Management in Municipal Government: Status after Two Decades' (2005) 65(1) *Public Administration Review*, 45–56.

⁶⁷² Henry Mintzberg, *The Rise and Fall of Strategic Planning: Reconceiving Roles for Planning, Plans, Planners* (Free Press, 1994).

measurement, and performance management processes. It is therefore important to ensure that the strategic plan of a tax administration is properly related to other critical strategic planning processes such as stakeholders' involvement, strategic management practices, allocation of resources, performance management and performance measurement processes.

In addition to the formal organisation arrangements, an organisation has informal organisational arrangements. While the strategic planning system is a formal arrangement, strategic planning processes and implementation can be in the form of informal organisational arrangements, which are any informal, unwritten guidelines that exert a powerful influence on people's collective and individual behaviour. It is important that informal organisational arrangements encompass the culture of an organisation. However, this issue is not given due attention in the tax administration context because of the dearth of literature on the topic. The following section discusses the importance of organisational culture in relation to organisational performance.

3.1.2 THE INFORMAL ORGANISATIONAL ARRANGEMENTS

Organisational culture has been defined as a complex set of values, beliefs, assumptions and symbols that define the way in which an organisation conducts its business.⁶⁷³ Flamholtz⁶⁷⁴ suggested that an organisation's culture is the set of values, beliefs and social norms which tend to be shared by its members and, in turn, tend to influence their thoughts and actions. Culture can also be broadly understood as a set of basic assumptions about how the world is and ought to be that a group of people share and that determines their perceptions, thoughts, feelings and, to some degree, their overt behaviour.⁶⁷⁵ According to Peterson and Smith,⁶⁷⁶ organisational culture reflects individuals' interpretations of events and situations in organisations.

⁶⁷³ Jay Barney, 'Organizational Culture: Can it be a Source of Sustained Competitive Advantage?' (1986) 11(3) *Academy of Management Review*, 656–65.

⁶⁷⁴ Eric G Flamholtz, 'Accounting, Budgeting and Control Systems in their Organizational Context: Theoretical and Empirical Perspectives' (1983) 8(2/3) *Accounting, Organizations and Society*, 153–69.

⁶⁷⁵ Edgar H Schein, 'Three Cultures of Management: The Key to Organizational Learning' (1996) 38(1) *Sloan Management Review*, 9–20.

The relationship between organisational culture and organisational performance has had sporadic but growing interest from a range of disciplines.⁶⁷⁷ In fact, general connections between an organisation's culture and its performance have been made since the early stages of management and organisation theory.⁶⁷⁸ One of the major reasons for the widespread popularity of and interest in organisational culture stems from the argument that certain organisational cultures lead to superior organisational performance.⁶⁷⁹ Academics and practitioners argue that the performance of an organisation is dependent on the degree to which the positive and strong values of the culture are widely shared.⁶⁸⁰

The claim that organisational culture is linked to performance is founded on the perceived role that culture can play in generating competitive advantage.⁶⁸¹ Krefting and Frost⁶⁸² suggested that organisational culture can create competitive advantage by defining the boundaries of the organisation in a manner that facilitates individual interaction by limiting the scope of information processing to appropriate levels. It is also argued that widely shared and strongly held values enable management to predict employee reactions to certain strategic options thereby minimising the scope for

⁶⁷⁶ Mark Peterson and Peter Smith, 'Sources of Organizations and Culture' in Neal M Ashkanasy et al (eds), *The Handbook of Organizational Culture and Climate* (Sage, 2000).

⁶⁷⁷ James L Garnett, Justin Marlowe and Sanjay K Pandey, 'Penetrating the Performance Predicament: Communication as a Mediator or Moderator of Organizational Culture's Impact on Public Organizational Performance' (2008) 68(2) *Public Administration Review*, 266–81.

⁶⁷⁸ Elton W Mayo, *The Human Problems of Industrial Civilization* (Macmillan, 1933); F W Taylor, *Principles of Scientific Management* (Harper & Brothers, 1911).

⁶⁷⁹ Emmanuel Ogbonna and Lloyd C Harris, 'Leadership Style, Organizational Culture and Performance: Empirical Evidence from UK Companies' (2000) 11(4) *The International Journal of Human Resource Management*, 766–88.

⁶⁸⁰ Terrence Deal and Allan Kennedy, *Corporate Cultures* (Addison-Wesley, 1982); Daniel R Denison, *Corporate Culture and Organisational Effectiveness* (Wiley, 1990); John P Kotter and James L Heskett, *Corporate Culture and Performance* (The Free Press, 1992); William Ouchi, *Theory Z* (Addison-Wesley, 1981); Richard T Pascale and Anthony G Athos, *The Art of Japanese Management: Applications for American Executives* (Simon & Schuster, 1981); Tom Peters and Robert Waterman, *In Search of Excellence: Lessons from America's Best-Run Companies* (Harper & Row, 1982).

⁶⁸¹ Christian Scholz, 'Corporate Culture and Strategy — The Problem of Strategic Fit' (1987) 25(Winter) *Long Range Planning*, 3–16.

⁶⁸² Linda A Krefting and Peter J Frost, 'Untangling Webs, Surfing Waves, and Wildcatting: A Multiple-Metaphor Perspective on Managing Culture' in Peter J Frost et al (eds), *Organization Culture* (Sage, 1985).

undesired consequences.⁶⁸³ Sustainable competitive advantage of an organisation which stems from a superior culture leads to superior organisational performance. Indeed, many commentators have advised organisations and researchers to exploit the multiple advantages that could be offered by culture rather than focusing on the more tangible side of the organisation.⁶⁸⁴ In the management and organisational research, culture is seen as providing a quick fix for managers seeking to improve productivity or organisational performance more generally.⁶⁸⁵ It is therefore interesting to see the type of organisational culture that exists in a tax authority and how this culture influences the way it conducts the tax administration tasks, hence influencing the overall tax administration performance.

3.1.3 TASKS

Task is the defining activity of any organisation; that is, the basic and inherent tasks to be performed by the organisation and its parts. The performance of this task is one of the primary reasons for the organisation's existence and any analysis from a design perspective has to start with an understanding of the nature of tasks to be performed, anticipated work flow patterns, and an assessment of the more complex characteristics of the work.⁶⁸⁶ Gill⁶⁸⁷ listed the main tasks of a tax administration that require analysis when assessing if a tax administration needs to be reformed (see Table 2). The tasks consist of organisation, management and operational tasks.

Table 2: Main tasks of revenue administration requiring analysis

Organisation and management tasks	Operational tasks
-----------------------------------	-------------------

⁶⁸³ Emmanuel Ogbonna, 'Managing Organizational Culture: Fantasy or Reality?' (1993) 3(2) *Human Resource Management Journal*, 42–54.

⁶⁸⁴ Gerry Johnson, 'Managing Strategic Change — Strategy, Culture and Action' (1992) 25(1) *Long Range Planning*, 28–36; Coimbatore K Prahalad and Richard A Bettis, 'The Dominant Logic: A New Linkage Between Diversity and Performance' (1986) 7 *Strategic Management Journal*, 485–501.

⁶⁸⁵ Rachel Parker and Lisa Bradley, 'Organisational Culture in the Public Sector: Evidence from Six Organisations' (2000) 13(2) *International Journal of Public Sector Management*, 125–41.

⁶⁸⁶ Wyman, above n 53.

⁶⁸⁷ Gill, above n 9.

Strategy and policy formulation	Registration of taxpayers
Planning, budgeting, resource allocation	Taxpayer services: <ul style="list-style-type: none"> • Taxpayer education • Taxpayer assistance • Facilitation of voluntary compliance
Monitoring and evaluation	Processing of declarations and payments
Co-ordination	Monitoring of tax withholders and collecting agents
Financial management	Collection of information about taxable transactions <ul style="list-style-type: none"> • Collection of information from third parties • Intelligence operations • Search and seizure and survey operations to obtain incriminating evidence
Personnel management	Risk analysis and selection of cases for audit and investigation
Information technology management	Audit and investigation
Asset management	Recovery of tax arrears
Internal control	Legal and judicial matters: <ul style="list-style-type: none"> • Legislation • Appeals • Prosecution
Anti-corruption	Code of ethics, disciplinary rules, vigilance and co-operation with external anti-corruption agencies
External relations	Effective interaction with important environmental factors to promote the tax administration objectives, meet external challenges and exploit emerging opportunities

	offered by the environment
--	----------------------------

Source: Gill⁶⁸⁸

Concerning the issue of tax administration tasks, Silvani and Baer⁶⁸⁹ suggested that, in order for a tax administration to be efficient, the general strategy of the tax authority should have an integrated approach to the tax collection process as a guiding principle, where each element in the tax collection process is essential to the tax administration strategy. Silvani and Baer⁶⁹⁰ also stated that to achieve a significant improvement in the overall performance of a tax administration, each element in the tax collection process needs to be improved. They elaborated that tax collection process involves: (1) taxpayer registration; (2) tax returns and payments processing; (3) computer operations; (4) detection of stop filers and collection of arrears; (5) delinquent taxpayers; (6) audit; (7) the sanctions and penalty system; (8) taxpayer services and publicity; (9) management and organisation; and (10) personnel.

Meanwhile, Baurer⁶⁹¹ suggested that all modern tax administrations perform common types of activities or business processes. Some of these activities (core business practices) directly relate to the mission of the tax administration, while other activities provide the support framework to properly carry out this mission. Core business processes are interrelated and ongoing communications and co-ordination between these processes is essential. For example, significantly increasing the number of audits in a given year will affect taxpayer services and enforced collection resource requirements. Similarly, increased attention to non-filers will affect audit and collection resource needs. Legislative changes will have similar impacts. The integration of all these factors into the development of an annual operating plan for a tax administration becomes a complex and demanding job. It is therefore important to evaluate the tax administration tasks as proposed in the performance management framework to ensure that the tasks are

⁶⁸⁸ Ibid 7.

⁶⁸⁹ Silvani and Baer, above n 18.

⁶⁹⁰ Ibid.

⁶⁹¹ Lewis I Baurer, 'Tax Administration and Small and Medium Enterprises (SMEs) in Developing Countries' (2005), <http://rru.worldbank.org/Documents/Toolkits/SME_Taxation_Toolkit.pdf>.

congruent with the rest of the components in the tax administration transformation process.

3.1.4 PEOPLE

Basically, a revenue collection system is an interactive structure of people, equipment, methods and controls, designed to create information flows and records that support the repetitive work routines of the revenue collection departments.⁶⁹² It is important to identify the salient characteristics of the people responsible for the range of tasks involved in the core work of an organisation. These characteristics include the knowledge and skills they bring to their work; their needs and preferences, in terms of the personal and financial rewards they expect to flow from their work; their perceptions and expectations about their relationship with the organisation; their demographics and how these factors relate to their work.⁶⁹³

The people who perform the core tasks are indeed an important element in tax administration. The importance of the tax employee in the tax administration environment was highlighted by Mikesell⁶⁹⁴ in his statement:

Whether any tax system achieves the goals set by society depends in large part on the success of the tax administrative procedure and tax administrators [or personnel] in carrying out the procedure. While some tax legislation can be so bad as to render it impossible to administer competently, incompetent administration can render any tax system bad.

The above view stressed that the tax employee is an important element since the employee performs tax administrative procedures such as tax collection to ensure that the tax administration system is performing in an efficient and effective manner. Revenue administration should focus on personnel rather than specific technical initiatives because what matters most is the combination of the institutional environment and the qualities of

⁶⁹² Ulric J Gelinus, Allan E Oram and William P Wiggins, *Accounting Information Systems* (PWS-KENT, 1990).

⁶⁹³ Nadler and Tushman, above n 50.

⁶⁹⁴ John L Mikesell, 'Administration and the Public Revenue System: A View of Tax Administration' (1974) 34 *Public Administration Review*, 618, 615–24.

the tax administration personnel. When the right experts are placed in settings conducive to training and skill transfer, they have a significant impact; and if these conditions are not met then the tax administration fails, no matter what the instrument is.

Schlemenson⁶⁹⁵ shares this view, proposing that the administration of human resources is a fundamental pillar of tax administration which will affect its efficiency and effectiveness. Bird and Zolt asserted that effective tax administration requires qualified tax officials.⁶⁹⁶ Silvani and Baer⁶⁹⁷ suggested the importance of tax personnel in tax administration reform when indicating that giving less attention to personnel matters as compared to technical matters may handicap other tax administration reforms. In addition, Jenkins, Kelly and Khadka⁶⁹⁸ suggested that the availability and retention of trained human resources are by far the most important factors in determining the efficiency of a tax administration.

In spite of the important role of tax employees, few studies have been performed on them especially regarding their attitudes and behaviours. Bird and Casanegra de Jantscher⁶⁹⁹ stated that there have been almost no studies in any country of tax officials, of why and how they do what they do; and governments in some developing countries have little day-to-day control over tax officials, little knowledge of what they do, and no easy way to obtain such knowledge. Most tax administration performance studies did not focus on the element of people involved in the tax collection process. For some of those studies which included tax employees, the measurements were limited to tangible aspects such as employee efficiency and productivity ratios. However, there is a limited study on tax employees' attitudes regarding their job and workplace.

⁶⁹⁵ Aldo Schlemenson, 'Organizational Structure and Human Resources in Tax Administration' in Richard Bird and Milka Casanegra de Jantscher (eds), *Improving Tax Administration in Developing Countries* (International Monetary Fund, 1992, 343–64).

⁶⁹⁶ Bird and Zolt, above n 1.

⁶⁹⁷ Silvani and Baer, above n 18.

⁶⁹⁸ Glenn Jenkins, Roy Kelly and Rup Khadka, 'Modernization of Tax Administration in Low-Income Countries: The Case of Nepal' (CAER II Discussion Paper 68, 2000).

⁶⁹⁹ Bird and Casanegra de Jantscher, above n 5.

Examining the attitudes of employees is important because they can affect customer satisfaction and therefore influence the performance of an organisation. According to Heskett, Sasser and Hart⁷⁰⁰ and Parasuraman, Zeithaml and Berry,⁷⁰¹ a major determinant of customer satisfaction within the service industry is the attitude of customer contact personnel. This relationship is succinctly summarised by John Smith, a former CEO of Marriott Corporation, in the phrase, 'you can't have happy customers served by unhappy employees'.⁷⁰² Schneider and Bowen⁷⁰³ and Marshall⁷⁰⁴ report that service cultures with the highest organisational commitment and lowest employee turnover consistently report the highest levels of customer satisfaction. Further, Bowen and Schneider⁷⁰⁵ noted that a high percentage of the time when customers report unfavourable views of service quality, they also report having served with bad attitudes or overhearing employees complain about their jobs and surroundings.

In a meta-analysis, Harter, Schmidt and Hayes⁷⁰⁶ found that overall employee attitudes at the business-unit level are positively correlated with several business-unit performance measures including customer satisfaction, productivity and profitability. Schneider, Parkington and Buxton;⁷⁰⁷ Schneider, White and Paul;⁷⁰⁸ and Schneider and Bowen⁷⁰⁹ used data from commercial banks to show that employee perceptions of the service

⁷⁰⁰ James L Heskett, W Earl Sasser and Christopher L Hart, *Service Breakthroughs* (The Free Press, 1990).

⁷⁰¹ A Parasuraman, Valarie A Zeithaml and Leonard L Berry, 'Understanding Customer Expectations of Service' (1991) Spring *Sloan Management Review*, 39–48.

⁷⁰² James L Heskett, W Earl Sasser and Leonard A Schlesinger, *The Service Profit Chain* (Free Press, 1997).

⁷⁰³ Benjamin Schneider and David Bowen, 'Employee and Customer Perceptions of Service in Banks: Replication and Extension' (1985) 70(3) *Journal of Applied Psychology*, 423–33.

⁷⁰⁴ John Marshall, 'Employee Retention Linked to Better Customer Service' (2001) 17(2) *Financial Executive*, 11–12.

⁷⁰⁵ David Bowen and Benjamin Schneider, 'Services Marketing and Management: Implications for Organizational Behavior' (1988) 10 *Research in Organizational Behavior*, 43–80.

⁷⁰⁶ James Harter, Frank Schmidt and Theodore Hayes, 'Business-Unit-Level Relationship between Employee Satisfaction, Employee Engagement, and Business Outcomes: A Meta-Analysis' (2002) 87 *Journal of Applied Psychology*, 268–79.

⁷⁰⁷ Benjamin Schneider, John Parkington and Virginia Buxton, 'Employee and Customer Perceptions of Service in Banks' (1980) 25 *Administrative Science Quarterly*, 252–67.

⁷⁰⁸ Benjamin Schneider, Susan White and Michelle Paul, 'Linking Service Quality and Customer Perceptions of Service Quality' (1998) 83 *Journal of Applied Psychology*, 150–63.

⁷⁰⁹ Benjamin Schneider and David Bowen, 'The Service Organization: Human Resources Management is Crucial' (1992) 21 *Organization Dynamics*, 39–53.

climate are significantly related to customer perceptions of service quality at the branch level. The findings are also supported by Johnson.⁷¹⁰

Liao and Chuang⁷¹¹ found that the service climate in a chain of restaurants is associated with employees' assessments of their own service performance. This view is supported by a study involving 200 retail stores conducted by Wiley⁷¹² on the relationships among employee attitudes, customer satisfaction and organisational performance. The study revealed that the stores most favourably rated by employees were rated equally favourably by customers. In fact, customer-satisfaction ratings were strongly and positively related to employees' descriptions of key aspects of their working environment, especially working conditions, minimum obstacles to accomplishing their work, and a strong sense that supervisors and co-workers emphasis customer service.

In the context of a tax administration, all the above findings could suggest that if the tax employees' attitudes towards the tax administration are positive, it could have favourable effects on taxpayer satisfaction and the overall tax authority performance. It is therefore proposed that the evaluation of tax employee attitudes is an important element in the performance management framework for a tax administration.

3.2 PERFORMANCE MEASUREMENT AND PERFORMANCE NORMS

The first cycle outside the transformation process in the performance management framework contains two elements — the performance measurement and the performance norms — where the tasks in the transformation process are compared against performance standards or performance norms. Performance measurement is also depicted as an essential prerequisite of the evaluation process, requiring not just information about

⁷¹⁰ Jeff Johnson, 'Linking Employee Perceptions of Service Climate to Customer Satisfaction' (1996) 49 *Personnel Psychology*, 831–51.

⁷¹¹ Hui Liao and Aichia Chuang, 'A Multilevel Investigation of Factors Influencing Employee Service Performance and Customer Outcomes' (2004) 47 *Academy of Management Journal*, 41–58.

⁷¹² Jack W Wiley, 'Customer Satisfaction: A Supportive Work Environment and its Financial Cost' (1991) 14(2) *Human Resource Planning*, 117–27.

the process but also contextual information.⁷¹³ This contextual information encompasses achievements in the form of outcomes/effectiveness. Outputs are not usually valued in themselves but more for the outcomes they provide, for example what the customer values as the result of the activity.⁷¹⁴ In the tax administration context, outcome or effectiveness is the degree to which institutional objectives of the tax authority are being achieved in the forms of taxpayer satisfaction, qualities of services to the taxpayers, and taxpayer compliance rate.⁷¹⁵ Tax authorities in the developed countries, such as the Australian Taxation Office (ATO)⁷¹⁶ and the US Internal Revenue Service (IRS),⁷¹⁷ have been measuring taxpayer satisfaction and quality of services to the taxpayers as their performance indicators for the outcome/effectiveness of the tax administration. Outcome/effectiveness can also be in the form of employee attitudes towards the tax administration. The IRS, for example, includes tax employee satisfaction as one of the measures in its performance assessment framework.

In establishing indicators for performance measurement and comparing them with performance norms, it is proposed that benchmarking is an appropriate tool for evaluating the performance of a tax administration. Gallagher⁷¹⁸ for example, uses performance indicators to assess a tax system of a country and then compare it with international benchmarks. Benchmarking is a means of comparing a set of specific indicators that capture the fundamental nature of almost any tax system to either international best or probably most relevant practices. It is used by some to refer to goals and outcome measures which are linked to a strategic plan or vision.⁷¹⁹

The benchmarking system also allows the tax authority to establish goals and specific targets for tax collection process improvement and modernisation. Specific benchmarks can be tracked over time and can show how reform or modernisation efforts are being implemented and even how they contribute to the tax administration's performance. The use of benchmarking is also proposed by the accounting profession when the American Institute of CPAs (AICPA)⁷²⁰ declared that benchmarking is the new performance measurement tool which compares costs, staffing, productivity, quality, service, value added, technology and organisational structure; identifies areas that offer the greatest opportunities for efficiency and effectiveness improvement; helps sell the need for change internally; and provides access to the best practices of world-class performers.

⁷¹³ Paul Rouse and Martin Putterill, 'An Integral Framework for Performance Measurement' (2003) 41(8) *Management Decision*, 791–805.

⁷¹⁴ Anthony A Atkinson et al, *Management Accounting*, (Prentice-Hall, 3rd ed, 2001).

⁷¹⁵ Serra, above n 25.

⁷¹⁶ <<http://www.ato.gov.au>>.

⁷¹⁷ <<http://www.irs.gov>>.

⁷¹⁸ Mark Gallagher, 'Benchmarking Tax Systems' (2005) 2 *Public Administration and Development*, 125–44.

⁷¹⁹ Michael Link and Robert Oldendick, 'The Role of Survey Research in the Benchmarking Process' (2000) 12(1) *Journal of Public Budgeting, Accounting & Financial Management*, 138–64.

⁷²⁰ AICPA, 'Benchmarking: The New Performance Measurement Tool' (*The CPA Letter*, Accounting & Tax Periodicals, 1998).

Benchmarking, therefore, can be used to evaluate the tasks performed by a tax administration.

3.3 ORGANISATIONAL PLAN AND EVALUATION

The second cycle in the performance management framework is the control model which interprets the two subsystems of planning and evaluation as suggested by Flamholtz.⁷²¹ Planning can be defined broadly as an attempt to influence the future by assessing the organisation and its environment, setting objectives and developing strategies for the achievement of these objectives.⁷²² Planning is believed to lead to positive organisational outcomes for a number of reasons.⁷²³ Rational planning forces leaders to clarify their goals and objectives, and thereby provides a framework for allocating resources in line with the purposes of the organisation. Furthermore, the goals and objectives of the organisation must be communicated to all staff who can then channel their efforts accordingly. The process of planning allows external events and internal changes to be identified and brought into alignment. Rational planning also allows decisions between alternative strategies to be taken on the basis of comprehensive information, rather than intuitively on the basis of hunches or guesswork. Finally, planning contributes to the integration of the diverse activities in an organisation. Separate functions can be combined and co-ordinated into a corporate whole, instead of working at cross-purposes.

It is therefore important for a tax administration to form a well-established organisational plan, systematically evaluate the achievement of the plan, and make appropriate reporting on the matter. The performance management framework proposed in this paper helps provide a reliable diagnostic tool for the evaluation of the transformation process in a tax administration, which would then aid in planning for the development of resources, tasks, procedures, services, people, output and outcome related to the tax administration system.

3.4 VISION/GOALS AND EXTERNAL STAKEHOLDERS

⁷²¹ Flamholtz, above n 62.

⁷²² Aaron Wildavsky, 'If Planning is Everything, Maybe it's Nothing' (1973) 4 *Policy Sciences*, 127–53; Steve Leach, 'In Defence of the Rational Model' in Steve Leach and Joseph Stewart (eds), *Approaches in Public Policy* (Allen & Unwin, 1982); Noel Capon, John Farley and James Hubert, *Corporate Strategic Planning* (Columbia University Press, 1987); Henry Mintzberg, 'The Strategy Concept II: Another Look at Why Organizations Need Strategies' (1987) 16(1) *California Management Review*, 25–32; Brian Boyd and Elke Reuning-Elliot, 'A Measurement Model of Strategic Planning' (1998) 19(2) *Strategic Management Journal*, 181–92.

⁷²³ John C Camillus, 'Evaluating the Benefits of Formal Planning Systems' (1975) 8(3) *Long Range Planning*, 33–40; George Boyne and Julian S Gould-Williams, 'Planning and Performance in Public Organizations: An Empirical Analysis' (2003) 5(1) *Public Management Review*, 115–32.

The outermost cycle completes the performance management framework where the interface between the tax administration and its external stakeholders⁷²⁴ takes place. According to Atkinson et al,⁷²⁵ stakeholders' requirements and expectations define the environment and general constraints that the organisation must recognise in its operations. Organisation goals embody the vision or mission, which are expressions of its response to stakeholder expectations and requirements. Outcomes reflect the impact of outputs on stakeholders' expectations. Recent work in performance measurement has argued that stakeholder expectations encompass both financial and non-financial dimensions of the organisation.⁷²⁶

Stakeholder expectation represents external reporting that includes benefits and outcomes of a tax administration. Inadequate delivery of benefits can lead to withdrawal of stakeholder contributions and subsequent failure of a tax administration. This is particularly important for a tax administration, where the government (through its Ministry of Finance) is a major stakeholder which can be expected to intervene if the tax administration does not pay sufficient attention to the needs of groups it wishes to target. External stakeholders of a tax administration are also the taxpayers who are affected by the tax administration objectives. In this case, it is important for a tax administration to consider the aspects of stakeholders' expectations and benefits in its performance management system and make appropriate external reporting regarding these matters to the relevant groups of stakeholders.

4.0 CONCLUSION

In this conceptual research paper, the focus of inquiry has been on identifying the knowledge gap in the previous literature and proposing new ways to look at the discipline of performance management for a tax administration. While there are various studies on tax administration performance, a study which holistically analyses a tax administration performance management system is lacking in the literature. Most of the tax administration performance studies concentrated on the small scope of performance measurement instead of examining performance management. These studies also disregarded the importance of diagnosing the problems faced by a tax administration in order to improve its performance. In addition, previous studies focused on the quantitative performance measures for a tax administration. Studies incorporating soft indicators or behavioural aspects of a tax administration — specifically tax administration culture, tax employee attitudes and taxpayer satisfaction in relation to the performance management system — are lacking in the literature. Hence, this paper proposes a holistic performance management framework, which incorporates the congruence model for organisational behaviour diagnosis, as a guide for a tax administration to evaluate, improve and manage its overall performance management system. However, further research is required to identify how this improved understanding of performance management and emerging approach of integrating

⁷²⁴ Stakeholders are any identifiable group or individual that can affect the organisation's objectives or who are affected by these objectives.

⁷²⁵ Atkinson et al, above n 102.

⁷²⁶ Rouse and Putterill, above n 101.

organisational behaviour diagnosis to achieve systemic congruence can be translated into better outcomes for a tax administration.

An Analysis of the Exemption from Income Tax of Canadian ‘Indians’ either as Individuals or ‘Bands’

Fiona Martin*

Introduction

Canadian law allows for the exemption from tax of the real and personal property of persons defined in the *Indian Act*, RSC 1985, c I-5 (the ‘*Indian Act*’) as ‘Indians’. Through the case law the concept of ‘personal property’ has been interpreted to include personal income, resulting in the advantage to Indians of enjoying tax free income in certain situations. The relevant provisions of the *Indian Act*, however, confine this exemption to income situated ‘on a reserve’. A further restriction is that the exemption is only available for individuals and Indian ‘bands’ (as defined in the *Indian Act*) so that the exemption is lost when a group of Indians incorporate. The results of these restrictions have serious financial consequences for many Indians and First Nations⁷²⁷ groups of peoples.

This article examines the jurisprudence that surrounds the exemption from taxation provisions of personal property income under the *Indian Act*. It analyses the case law development and highlights how the exemption has been consistently read down in recent cases, to the detriment of the taxpayer Indian. It also analyses the income tax exemption available to Indians and bands when acting as a public body performing a function of government.

This article is aimed at informing Australian tax academics and policymakers of an approach to tax exemption that has been developed for Canadian Indians and which does not exist for Australian indigenous peoples. It concludes, for reasons which are discussed in the paper, that the Canadian approach has serious limitations as a means of overcoming the past disadvantages of indigenous peoples.

The *Indian Act* 1876 and onwards

*Atax, University of New South Wales.

⁷²⁷ This term is often used to refer to Canadian Indians, for example section 87 *Indian Act*, RSC 1985, c I-5. Reference is sometimes made to First Nations because the word ‘Indian’ is viewed by many as colonialist and pejorative; however, there is no precise legal meaning for ‘First Nation’. In the United States of America the term used is ‘Native American’.

The first *Indian Act* was enacted in 1876. This Act was passed after the majority of Indians living on the Prairies either signed or were in the process of signing treaties with the Federal Government. The Act amended and consolidated previous laws regarding the Indians.⁷²⁸ The *Indian Act* was developed in accordance with the *Constitution Act* of 1867, which assigned to Parliament legislative authority over ‘Indians and Land reserved for Indians’.⁷²⁹ The *Indian Act* made Canadian Indians legal wards of the State⁷³⁰ and set out the conditions that needed to be met in order for them to be recognised as Indians and for the management of reserve land. There are strict requirements under the *Indian Act* for determination of whether or not a person is an Indian,⁷³¹ the term ‘band’ is defined,⁷³² a register of ‘Indians’ is required to be kept under the *Indian Act*,⁷³³ Indian reserves are defined⁷³⁴ and the Act establishes rules for the transfer of an Indian’s property on their death.⁷³⁵ The definition of Indians specifically excludes the Inuit people.⁷³⁶

⁷²⁸ L James Dempsey, ‘Status Indian: Who Defines You?’ in Duan Champagne, Karen Jo Torjesen and Susan Steiner (eds), *Indigenous Peoples and the Modern State* (Altamira Press, 2005) 33, 34.

⁷²⁹ *Constitution Act*, RSC 1867, s 91(24).

⁷³⁰ Dempsey, above n 2, 33 and 34.

⁷³¹ Section 2 of the *Indian Act*, RSC 1985, c I-5 defines an ‘Indian’ as a person who is registered as an Indian or is entitled to be registered as an Indian under the *Indian Act*. Scholars now argue that this definition and categorisation of ‘Indian’ for Canadian indigenous people negates their indigenous nationhood. Refer, for example Bonita Lawrence, *“Real” Indians and Others: Mixed -Blood Urban Native Peoples and Indigenous Nationhood* (University of British Columbia Press, 2004) 37.

⁷³² Section 2 defines a ‘band’ as a body of Indians: (a) for whose use and benefit in common, lands, the legal title to which is vested in Her Majesty, have been set apart before, on or after September 4, 1951, (b) for whose use and benefit in common, moneys are held by Her Majesty, or (c) declared by the Governor in Council to be a band for the purposes of this Act.

⁷³³ *Indian Act* s 5.

⁷³⁴ *Indian Act* s 2.

⁷³⁵ *Indian Act* s 42.

⁷³⁶ *Indian Act* s 4.

The *Indian Act* has been amended many times over the years with the most recent consolidation occurring in 1985, although there have been amendments since that date.

Taxation issues: the impact of the *Indian Act* and the treaty rights on taxation

Under the Canadian Constitution the Federal Government is the only entity with the power to enact legislation in respect of Canadian Indians and lands reserved for Indians.⁷³⁷ The Federal Parliament enacted the provisions of s 87 of the *Indian Act*, which exempts real and personal property situated on reserve land from taxation where the owners of the property are either individual Indians or the collective First Nation.⁷³⁸ This provision predates the first Federal income tax which was not enacted until 1917.⁷³⁹

In his book *Indians and Taxation in Canada*,⁷⁴⁰ Professor Richard Bartlett traces the origins of statutory tax exemptions for native Indians to an Act of the Province of Canada passed in 1850.⁷⁴¹ Professor Bartlett notes this exemption from taxation remained unchanged until the passage of Canada's first post-Confederation *Indian Act* in 1876,⁷⁴² which effected a comprehensive consolidation of laws respecting Indians.

⁷³⁷ *Constitution Act*, RSC 1867, s 91(24).

⁷³⁸ Section 87 states that (1) Notwithstanding any other Act of Parliament or any Act of the legislature of a province, but subject to section 83 and section 5 of the *First Nations Fiscal and Statistical Management Act*, the following property is exempt from taxation: (a) the interest of an Indian or a band in reserve lands or surrendered lands; and (b) the personal property of an Indian or a band situated on a reserve. (2) No Indian or band is subject to taxation in respect of the ownership, occupation, possession or use of any property mentioned in paragraph (1)(a) or (b) or is otherwise subject to taxation in respect of any such property. (3) No succession duty, inheritance tax or estate duty is payable on the death of any Indian in respect of any property mentioned in paragraphs (1)(a) or (b) or the succession thereto if the property passes to an Indian, nor shall any such property be taken into account in determining the duty payable under the *Dominion Succession Duty Act*, chapter 89 of the Revised Statutes of Canada, 1952, or the tax payable under the *Estate Tax Act*, chapter E-9 of the Revised Statutes of Canada, 1970, on or in respect of other property passing to an Indian.

⁷³⁹ The *Income Tax War Act 1917* (Ca) 7-8 Geo, c 28.

⁷⁴⁰ Richard H Bartlett, *Indians and Taxation in Canada* (University of Saskatchewan, Native Law Centre, 3rd ed, 1992) 1.

⁷⁴¹ Section 4 of this statute, entitled *An Act for the protection of the Indians in Upper Canada from imposition, and the property occupied or enjoyed by them from trespass and injury*, SC 1850, c 74.

⁷⁴² Bartlett, above n 14, 128.

In order to ensure that s 87 is effective for Federal income tax purposes,⁷⁴³ there is express provision in the *Income Tax Act* (the ITA) that a party exempt from taxation by an application of another statute is accordingly not subject to taxation under the ITA.⁷⁴⁴ Provinces and municipal governments are precluded from imposing taxes on property located on reserves by s 88 of the *Indian Act*.⁷⁴⁵

As part of the legislative suite of sections aimed at protecting Indian income and property, the legislature also enacted s 89 of the *Indian Act*, which prevents Indian property from being mortgaged to or charged by non-Indians.⁷⁴⁶ Section 90 provides that property acquired under treaty is deemed situated on a reserve and is consequently exempt under s 87.⁷⁴⁷

⁷⁴³ In Canada there is also provincial income tax legislation and sales tax.

⁷⁴⁴ ITA s 81 (1)(a).

⁷⁴⁵ Section 88 of the *Indian Act*: Subject to the terms of any treaty and any other Act of the Parliament of Canada, all laws of general application from time to time in force in any province are applicable to and in respect of Indians in the province, except to the extent that such laws are inconsistent with this Act or any order, rule, regulation or by-law made thereunder, and except to the extent that such laws make provision for any matter for which provision is made by or under the Act.

⁷⁴⁶ Section 89(1):

Subject to this Act, the real and personal property of an Indian or a band situated on a reserve is not subject to charge, pledge, mortgage, attachment, levy, seizure, distress or execution in favour or at the instance of any person other than an Indian or a band.

(1.1) Exception — Notwithstanding subsection (1), a leasehold interest in designated lands is subject to charge, pledge, mortgage, attachment, levy, seizure, distress and execution.

(2) Conditional sales — A person who sells to a band or a member of a band a chattel under an agreement whereby the right of property or right of possession thereto remains wholly or in part in the seller, may exercise his rights under the agreement notwithstanding that the chattel is situated on a reserve.

⁷⁴⁷ Section 90(1):

For the purposes of sections 87 and 89, personal property that was (a) purchased by Her Majesty with Indian moneys or moneys appropriated by Parliament for the use and benefit of Indians or bands, or (b) given to Indians or to a band under a treaty or agreement between a band and Her Majesty, shall be deemed always to be situated on a reserve.

(2) Every transaction purporting to pass title to any property that is by this section deemed to be situated on a reserve, or any interest in such property, is void unless the

Indian reserves

In order to understand the operation of the exemption under s 87 it is important to be clear on the meaning of the terms 'reserve' and 'band', which are defined in the *Indian Act*.

A reserve is an area of land set aside for the use of Canadian Indians. Section 2 of the *Indian Act* defines 'reserve' as '(a) ... a tract of land, the legal title to which is vested in Her Majesty, that has been set apart by Her Majesty for the use and benefit of a band, and ... includes designated lands'. A 'band' is also defined in this section and is essentially a body of Indians for whose use and benefit in common, lands have been set apart or for whose use and benefit in common moneys are held by Her Majesty the Queen.

Reserve lands are therefore Federal Crown lands held by Her Majesty the Queen in Right of Canada for the use and benefit of the Native Indian bands for which they have been set apart. There are more than 600 reserves across Canada.⁷⁴⁸ Although the *Indian Act* defines reserve, it is silent with respect to the procedures required to create reserves. Because of this, Federal policy has been developed with respect to the creation of new reserves.⁷⁴⁹

The *Indian Act* imposes certain limitations on the rights of non-Indians to occupy reserve lands. Where it is intended that the reserve property will be occupied by a corporation or other non-First Nation entity, provision is made for a process under which the First Nation band surrenders its rights in the land to the Federal Crown, subject to the terms and conditions set out in the surrender. The result is that the land is determined as

transaction is entered into with the consent of the Minister or is entered into between members of a band or between the band and a member thereof.

(3) Every person who enters into any transaction that is void by virtue of subsection (2) is guilty of an offence, and every person who, without the written consent of the Minister, destroys personal property that is by this section deemed to be situated on a reserve is guilty of an offence.

⁷⁴⁸ Richard M Bird 'The GST in Canada: *Plus Ca Change, Plus C'est La Meme Chose?*' (2009) 63 *Bulletin for International Taxation* 414, 415.

⁷⁴⁹ Department of Indian and Northern Affairs Canada, 'Additions to Reserves Policy', <<http://www.ainc-inac.gc.ca/ai/mr/is/urs-eng.asp>> 22 September 2009.

‘designated’ land and may then be leased by the Crown to the non-First Nation entity.⁷⁵⁰ These designated lands continue to hold the status of reserve lands for the purposes of the *Indian Act*.⁷⁵¹ As a result income sourced from this land may also be exempt from income tax under s 87.

The term ‘Urban Reserve’ is typically applied to lands acquired by First Nations which subsequently achieve reserve status. There is nothing inherently different about the legal status of an ‘Urban Reserve’ from that of other reserve lands located elsewhere in Canada.⁷⁵²

Taxation of income of Canadian Indians

Section 87 of the *Indian Act* has been interpreted by the courts to mean that all income of an Indian⁷⁵³ from the use of their property, both real and personal will be exempt from income tax provided that it has the necessary connection with a reserve. Personal property of a First Nation individual has been held to include income from personal services for the purposes of this exemption. The result is that the exemption can apply to salary and other income from personal services such as business income where the business is operated as a sole trader or in a partnership of Indians.⁷⁵⁴ In the case of *Nowegijick v R*⁷⁵⁵ the Court held that wages, salary or other income constitute personal property thereby ensuring that this type of income could be exempt from tax under the

⁷⁵⁰ Barbara M Shields, ‘Aboriginal Tax Issues/Urban Reserves’ (Paper presented at Prairie Provinces Tax Conference, 2004) 1–12.

⁷⁵¹ ‘Designated lands’ is defined in s 2 of the *Indian Act* as ‘a tract of land or any interest therein the legal title to which remains vested in Her Majesty and in which the band for whose use and benefit it was set apart as a reserve has, otherwise than absolutely, released or surrendered its rights or interests, whether before or after the coming into force of this definition’.

⁷⁵² Shields, above n 24.

⁷⁵³ As determined in accordance with the definition of Indian under s 2 of the *Indian Act* and the consequent provisions of the *Indian Act*.

⁷⁵⁴ *Nowegijick v R* [1983] CarswellNat 123 [29].

⁷⁵⁵ [1983] CarswellNat 123.

Indian Act and this exemption remains.⁷⁵⁶ In coming to this conclusion Dickson J took the broad view that ‘treaties and statutes relating to Indians should be liberally construed and doubtful expressions resolved in favour of the Indian’.⁷⁵⁷

In order to gain the exemption from income tax, however, the income must be ‘situated on a reserve’. This is straightforward where the income is from real property or other tangible personal property physically situated on reserve land.⁷⁵⁸ However, it is more problematic where the income is from an individual’s personal exertion either as an employee or as a business (sole trader or partnership of Indians).

Originally, court decisions on this issue applied the principles of conflicts of laws to determine this question based on the *situs* of the obligation to pay the income.⁷⁵⁹

As a result the salary of Indians was held to be from the reserve and exempt where payment was made by an entity located on a reserve even where the employment activity took place outside the reserve.⁷⁶⁰ In the 1992 decision of *Williams v R*⁷⁶¹ this test was replaced by the ‘connecting factors’ test.

The issue in the *Williams Case* was whether employment insurance benefits were taxable where the employment giving rise to the insurance benefits had occurred on a reserve. The Court was of the view that the complexities of determining the location of income were strong arguments against the use of the *situs* test relied upon in *Nowegijick v R*⁷⁶² and earlier decisions. In addition the Court had considered similar issues in their earlier decision of *Mitchell v Peguis Indian Band*,⁷⁶³ which involved the potential garnishment of First Nation funds. In this case the Court came to the conclusion that a *situs* test was

⁷⁵⁶ Although there is judicial comment to suggest that it is no longer good law; refer *Southwind v R* [1998] CanLII 7300 [16].

⁷⁵⁷ *Nowegijick v R* [1983] CarswellNat 123 [25].

⁷⁵⁸ As the income producing property is physically located on the reserve. Also refer Barbara M Shields, ‘Current Trends in Aboriginal Taxation’ (Paper presented at Prairie Provinces Tax Conference, 2008) 15.

⁷⁵⁹ *Nowegijick v R* [1983] CarswellNat 123 [17].

⁷⁶⁰ *Nowegijick v R* [1983] CarswellNat 123.

⁷⁶¹ *Williams v R* [1992] CarswellNat 232.

⁷⁶² *Nowegijick v R* [1983] CarswellNat 123 [17].

⁷⁶³ *Mitchell v Peguis Indian Band* [1990] CarswellMan 209.

inappropriate and that a test relying on connecting factors was more appropriate given the rationale behind the legislative protections of Indian property.

The connecting factors test arises out of the commentary of La Forest J in *Mitchell v Peguis Indian Band*⁷⁶⁴ with respect to the purpose of the statutory exemption. In this case La Forest J stated:

The exemptions from taxation and distraint have historically protected the ability of Indians to benefit from this property in two ways. First, they guard against the possibility that one branch of government, through the imposition of taxes, could erode the full measure of the benefits given by that branch of government entrusted with the supervision of Indian affairs. Secondly, the protection against attachment ensures that the enforcement of civil judgments by non-natives will not be allowed to hinder Indians in the untrammelled enjoyment of such advantages as they had retained or might acquire pursuant to the fulfilment by the Crown of its treaty obligations. In effect, these sections shield Indians from the imposition of the civil liabilities that could lead, albeit through an indirect route, to the alienation of the Indian land base through the medium of foreclosure sales and the like ...⁷⁶⁵

In the *Williams Case* the Court stated that in order to determine whether or not the income was situated on a reserve, the first step was to identify the various connecting factors which are potentially relevant to either connect the property at issue to a reserve location or away from the reserve. The weight to be attached to the individual factors will then depend on the nature of the property itself, in the context of the purpose of the exemption, as well as the nature of the taxation from which the exemption is sought.⁷⁶⁶ Examples of the factors which may play a role in the determination include the residence of the employee, location of the employer, nature of the services provided, business activity, where the services giving rise to the wages/business income are performed and where the transactions giving rise to the income occur.⁷⁶⁷

⁷⁶⁴ [1990] CarswellMan 209.

⁷⁶⁵ [1990] CarswellMan 209 [85].

⁷⁶⁶ *Williams v R* [1992] CarswellNat 232.

⁷⁶⁷ *Williams v R* [1992] CarswellNat 232.

Although the results in both the *Williams* and *Mitchell Cases* were in favour of the Indians, by applying a connecting factors test the outcome is that the exemption is confined to activities closely connected with reserve life. The Courts specifically stated that the exemption is only available to Indians in respect of Indian property,⁷⁶⁸ a clear indication that the exemption does not apply to income producing activities that cross the reserve boundaries.

The substitution of a 'connecting factor' test for the *situs* test has made it more difficult for an Indian to gain the tax exemption.⁷⁶⁹ In coming to his conclusion in *Mitchell's Case*, La Forest J strongly argued that Parliament did not intend to 'remedy the economically disadvantaged position of Indians' through the income tax exemption in the *Indian Act*.⁷⁷⁰

Business income of Indians

In *Southwind v R*⁷⁷¹ the Court held that the taxpayer Indian's business income was not from 'on the reserve' and therefore was not exempt from income tax. In coming to its conclusion the Court applied the connecting factors test outlined in the *Mitchell* and *Williams Cases*. Although the taxpayer lived on the reserve and the business had its office there, the only customer was off-reserve and the business activity (logging) was performed off-reserve. The Court therefore concluded that the resulting business income was off-reserve and not subject to the exemption.

The Canadian Federal Court warned in *Southwind* that s 87 does not exempt all Indians resident on a reserve from income taxation. The Court clearly distinguished between business and employment income that is situated on the reserve and which is integral to community life and which should therefore be tax exempt and 'income that is primarily derived in the commercial mainstream, working for and dealing with off-reserve people' which is not tax exempt.⁷⁷²

⁷⁶⁸ *Williams v R* [1992] CarswellNat 232; *Mitchell v Peguis Indian Band* [1990] CarswellMan 209.

⁷⁶⁹ Shields, above n 32.

⁷⁷⁰ *Mitchell v Peguis Indian Band* [1990] CarswellMan 209 [87].

⁷⁷¹ [1998] CanLII 7300.

⁷⁷² [1998] CanLII 7300 [17].

Investment income of Indians

The connecting factors approach established in *Mitchell's Case* and leading to a narrow application of s 87 was confirmed in the recent decision of *Dube v Canada*⁷⁷³ in the context of income from investments.

In this case the taxpayer was a member of the Obedjiwan First Nation. He used the services of the financial institution, the Caisse populaire Desjardins de Pointe-Bleue (the Caisse) situated on the Mashteuiatsh Reserve. There is no financial institution on the Obedjiwan Reserve, which is located approximately 300 kilometres from the Mashteuiatsh Reserve.

The Caisse has three main sources of revenue. Twenty-five per cent of the Caisse members' deposits are invested with the Fédération des caisses populaires Desjardins (the Federation), which makes investments in investment funds and liquidity funds that, in turn, are invested in the economic mainstream off the reserve. The remainder of the deposits, namely 75 per cent of the total, is lent to members of the Caisse residing on or off the reserve. Lastly, the Caisse receives income from other revenue sources, such as administrative fees, brokerage fees and so on.

The Court found that the majority of the Caisse members were Indians. The taxpayer also considered himself to be a resident of the Obedjiwan Reserve, even though, for a few years, he owned a residence in St-Félicien and then in Roberval.

Mr Dube used the services of the Caisse for personal purposes and for the purposes of his business. This business involved transportation services, including transportation from the Obedjiwan Reserve to Roberval, for reserve residents in need of medical care.

The taxpayer argued that the investment income, in other words the profit generated from the capital invested with the Caisse, was exempt from income tax under s 87. The case came down to a debate of whether or not this income was sourced from on the reserve.

⁷⁷³ [2009] FCA 109.

In concluding that the investment income was not exempt, the Court stated that the mere fact that the financial institution is situated on the reserve merited little weight. What mattered to the Court was whether the investment income was produced on or off the territory of the reserve.

The Court concluded that, since part of the funds were invested in the general mainstream of the economy, the exemption from taxation provided by s 87(1)(b) of the *Indian Act* could not apply.

In a concurring judgment Pelletier J pointed out that the capital market is a global market. His Honour went on to say:

While the sources of the capital put on the market are local and the projects in which that capital is invested are local, the fact remains that the market itself is global. Investors can access that market from their own communities, but the point of entry does not, in itself, limit the market in which investors make profits and incur losses. I therefore conclude that in the case of the investment of capital through a financial institution, including a *caisse populaire*, the weightiest factor in determining the *situs* of the investment income is the nature of the capital market itself, which is not limited to a reserve, a province or even a country.⁷⁷⁴

Dube's Case follows the leading case of *Recalma v Canada*⁷⁷⁵ which points out that investment income, being passive income, is not generated by the individual work of the taxpayer and therefore different factors come into play in determining the source of this income.⁷⁷⁶

The Court in *Recalma* stressed that the relevant factors to take into account in determining whether investment income is from on a reserve are the residence of the issuer of the security (the bank or other financial institution), the location of the issuer's income generating operations, and the location of the security issuer's property.⁷⁷⁷ However, the Court in *Dube* went one step further and clearly stated that in reality, where investment income is concerned it is really the location of the source of the investment income that is

⁷⁷⁴ [2009] FCA 109 [36].

⁷⁷⁵ *Recalma v Canada* (1998) 98 DTC 6238.

⁷⁷⁶ (1998) 98 DTC 6238 [11].

⁷⁷⁷ (1998) 98 DTC 6238 [11].

the most important factor and that the location of the financial institution on the reserve, as was the case here, has little importance.⁷⁷⁸ As the marketplace in modern banking situations is global, it is unlikely that there will be any situations where investment income is from inside the reserve.

The *Dube Case* was handed down at the same time as the decision of *Estate of Rolland Bastien v R*⁷⁷⁹. This case came to the same conclusion, placing little weight on where the investment bank is situated and making it clear that where the investments are made in the general economy the tax exemption will not apply.

Justice Nadon stated:

When an Indian invokes paragraph 87(1)(b) of the *Indian Act* to obtain a tax exemption on his or her investment income, and the income in question is generated off the reserve, the exemption cannot be granted. In such a context, the other connection factors are of little importance. In particular, the mere fact that the financial institution is situated on the reserve merits little weight. What matters is whether the investment income — that is, the profit generated from the capital invested in a financial institution — was produced on or off the territory of the reserve. In other words, if all or part of the funds were invested in the general mainstream of the economy, the taxation exemption provided at paragraph 87(1)(b) of the *Indian Act* cannot apply.⁷⁸⁰

Both *Dube* and *Bastien* are on appeal to the Supreme Court, however at the time of writing this article neither decision had been handed down.

The taxation of the income of entities formed by Indians or bands

Because an Indian is defined as an individual who is either registered or entitled to be registered pursuant to the *Indian Act*,⁷⁸¹ a corporation is not entitled to the benefit of the income tax and other taxes exemption under s 87 even where all of its shareholders are

⁷⁷⁸ *Dube v Canada* [2009] FCA 109 [36].

⁷⁷⁹ *Estate of Rolland Bastien v R* [2009] FCA 108.

⁷⁸⁰ [2009] FCA 108 [36].

⁷⁸¹ *Indian Act* s 2.

members of a First Nation.⁷⁸² Accordingly, where a business enterprise or other organisation is incorporated by an individual or group of individuals who themselves would be entitled to the exemption from income tax its net income will, at first glance, be subject to taxation under the ITA. This is, however, subject to the following discussion. The Canadian Revenue Agency (CRA) had originally considered, despite the lack of specific application of s 87 of the *Indian Act* to incorporated entities, that these entities were exempt from taxation as a 'public body performing a function of government in Canada' and therefore exempt from income tax under s 149(1)(c) of the ITA. The CRA also accepted the decision of *Otineka Development Corporation v R*⁷⁸³ that a band is a public body performing a function of government, and that a corporation owned by a band that earns at least 90 per cent of income on reserve is therefore also exempt. Although not binding on Federal income tax interpretation, the 2001 decision of *Tawich Development Corporation v Deputy Minister of Revenue of Quebec*⁷⁸⁴ cast doubt on the correctness of this approach. In this case the Quebec Court held that the Cree Nation of Wemindji was not a Canadian municipality for the purposes of the Quebec taxation legislation which contained a similar provision to the previous s 149(1)(c) of the ITA. The Court considered that even though the Cree Nation exercised powers of local self-government, it was not a municipality because it had not been expressly constituted by provincial statute as a Canadian municipality.

The Canadian Federal Government has proposed an amendment (although it has not been passed) that will apply retrospectively from 2000. This amendment will clarify that a corporation 90 per cent owned by a public body performing a function of government (and not just a corporation owned by a municipality) in Canada is exempt from tax. This exemption is, however, subject to the proviso that the corporation's income from activities carried on outside the geographical boundaries of the entity (band) which owns it does not exceed 10 per cent of its income for the period. The proposed new provision, s 149(1)(d.5) of the ITA provides that, at least to the extent of the Federal income tax

⁷⁸² *Kinookimaw Beach Association v R in Right of Saskatchewan* [1979] 6 WWR 84 (CA); *Re Stony Plain Indian Reserve No 135* [1982] 1 WWR 302 (Alta CA).

⁷⁸³ *Development Corporation v R* [1994] 2 CTC 2424.

⁷⁸⁴ [2001] DTC 5144 (Que CA).

legislation, corporations with a minimum 90 per cent share ownership by a municipal or public body performing a function of government in Canada are treated as tax exempt. Corporations whose shares are owned by a First Nation may therefore qualify for the exemption provided that the CRA has agreed to treat the First Nation as ‘a public body performing a function of government in Canada’.

As a result, band owned corporations may be exempt from Federal income tax, but not because of s 87 of the *Indian Act*. The exemption flows from s 149(1)(d.5) provided the criteria set out in that section are met. Importantly, at least 90 per cent of this corporation’s income must be from within the reserve. This brings the situation back to a similar limitation to the tax exemption under the *Indian Act*.

Taxation of First Nations trusts established as part of reserve development

As part of their move towards economic development and self-determination, it is common for First Nation bands of Indians to enter into what are called Impact Benefit Agreements (IBAs). These agreements are often entered into where a development project of some form is to take place on reserve land. The contracting company will usually consider social and cultural issues, and agree to provide training, education, employment and business opportunities, environmental management and financial compensation in return for the First Nation supporting the relevant project.⁷⁸⁵ As part of the IBA, and in order to receive and distribute the financial compensation, a trust is established. The trust money, which includes the compensation from the IBA as well as investment income from this money, may be used for a variety of purposes including band and community development and may also be distributed to individual band members.

The application of s 75(2) of the ITA to this trust income ensures that it is considered income of the members of the First Nation⁷⁸⁶ and, as this is personal income of the individuals who make up the First Nation band, it is exempt from tax under s 87. The income is consequently exempt from Federal income tax because of the operation of s 81

⁷⁸⁵ Refer CRA Ruling 2005 – 0126261R3 ‘Taxation of Indian Trust’ 2006.

⁷⁸⁶ Refer CRA Ruling 2005 – 0126261R3 ‘Taxation of Indian Trust’ 2006, A.

ITA, which specifically states that a party exempt from taxation by an application of another statute is not subject to taxation under the ITA.⁷⁸⁷

Furthermore, as stated earlier the CRA considers that the First Nation is a public body performing a function of government under s 149(1)(c) of the ITA and is therefore exempt from tax. It considers no tax is payable by the First Nation (as an entity in its own right) on the money received under the IBA.⁷⁸⁸

The range of services that the First Nation undertakes and which demonstrate that it is a public body performing a function of government include band administration; management of existing fire protection services on the reserve; management of the reserve housing program; and medical and health services.⁷⁸⁹

The variety and far-reaching benefits of these services demonstrate that these bands are operating at a significant administrative level. It certainly shows that they are performing many government and semi-government obligations and duties.

Conclusion

The tax exemptions under the *Indian Act* are significant financial and economic factors for many First Nation people. Without these exemptions there are potential negative impacts on their financial situation. This may pose immediate problems leading to a lack of funds to access services and infrastructure and could potentially harm their long-term financial future.

The discussion in this article indicates that there has been a consistent trend in the Canadian courts restricting the application of the s 87 exemption to income situations where there is a direct relationship between the earning of the income and a reserve community. Appeals to the CRA and ultimately to the courts seeking the application of the exemption from taxation to business, investment and employment income are being met with an increasingly narrow interpretation of s 87. This results in a correspondingly greater exclusion from the benefit of the exemption to Indians. Given the reference to the ownership of the property 'qua' Indian found in the comments of La Forest J in *Mitchell's Case*, there appears to be a growing intention that the exemption is limited to

⁷⁸⁷ ITA s 81 (1)(a).

⁷⁸⁸ Refer CRA Ruling 2005 – 0126261R3 'Taxation of Indian Trust' 2006, C.

⁷⁸⁹ CRA Ruling 2003 – 0035821R3 'Taxation of Indian Trust' 2004.

situations where the reserve community benefits from the property of the individual recipient of the income, or when the traditional aboriginal way of life is supported by the exemption.

The use of IBAs to fund economic and community development in a tax exempt manner is a clear example of a tax effective way that development can be funded; however, this is also clearly linked to the reserve and does not cross reserve boundaries. CRA approved IBAs cover such things as housing, service provision and medical centres, but they are all situated on a reserve.

Recent case law demonstrates the judicial view that the purpose of the *Indian Act* is not to overcome Indian disadvantage caused by previous colonial governments. The judicial narrative stresses that Indians and non-Indians must compete in the commercial world on a level playing field. An examination of the decisions bearing on these sections confirms that Indians who acquire and deal in property outside lands reserved for their use deal with it on the same basis as all other Canadians.⁷⁹⁰ Justice La Forest in *Mitchell's Case* warned that '... the purpose of the legislation is not to remedy the economically disadvantaged position of Indians by ensuring that Indians may acquire, hold, and deal with property in the commercial mainstream on different terms than their fellow citizens'.⁷⁹¹

The historical basis for this is explained by La Forest J:

In summary, the historical record makes it clear that ss. 87 and 89 of the Indian Act, the sections to which the deeming provision of s. 90 applies, constitute part of a legislative 'package' which bears the impress of an obligation to native peoples which the Crown has recognized at least since the signing of the Royal Proclamation of 1763. From that time on, the Crown has always acknowledged that it is honour-bound to shield Indians from any efforts by non-natives to dispossess Indians of the property which they hold qua Indians, i.e., their land base and the chattels on that land base.⁷⁹²

⁷⁹⁰ *Mitchell v Peguis Indian Band* [1990] CarswellMan 209 [87].

⁷⁹¹ *Mitchell v Peguis Indian Band* [1990] CarswellMan 209 [87].

⁷⁹² *Mitchell v Peguis Indian Band* [1990] CarswellMan 209 [86].

In arriving at his conclusion, La Forest J also points out that the specific wording of the sections as confirmed by modern legislatures indicates a current government approach of treating Indians on an equal footing with other Canadians when dealing in commercial matters.⁷⁹³

Barbara Shields argues that, because of the narrowing of the application of the s 87 exemption and its restriction to ‘on reserve’ activity, economic development from both the business and employment contexts should be strategically linked to on reserve development opportunities.⁷⁹⁴

On the other hand Chris Sprysak argues that, while the courts have on several occasions stated that it is both possible and acceptable for Indians and their tax advisors to structure their affairs in order to take advantage of the s 87 exemption, the reality is that such tax planning is very limited.⁷⁹⁵ This is highlighted by the above discussion of the recent case law and the way the courts have determined and prioritised the connecting factors necessary to determine whether income is sourced from the reserve.

Chris Sprysak concludes that Indians and bands appear to be relying less on s 87 to exempt their income from taxation and more on other opportunities to raise monies for reserve life in a tax efficient manner.

A further significant hurdle for First Nations is that the tax exemption is lost once an individual or group incorporates. The corporate structure is commonly used in the commercial world as a vehicle for business operations. It has the advantages of perpetuity (being a legal entity as opposed to an individual) and it is flexible in that shareholding can be bought or sold so that ownership and income streams can vary depending on the future direction of the company and the decisions of the board of directors. Financing organisations are familiar with the corporate structure so that borrowing money for commercial endeavours is relatively easy. By not continuing the exemption when Indians

⁷⁹³ [1990] CarswellMan 209 [87].

⁷⁹⁴ Shields, above n 32.

⁷⁹⁵ Chris Sprysak, ‘Aboriginal Taxation Update’ (Paper presented at Prairie Provinces Tax Conference, 2007) 1.

wish to incorporate the advantages of the exemption in a commercial setting are significantly restricted.

When the First Nation is considered a public body carrying out functions of government within the provisions of s 149(1)(c) of the ITA then its income is exempt from income tax. The proposed new s 149(1)(d.5) will allow this exemption to flow through to a corporation, although it is again very restricted because 90 per cent of the income must be generated within the reserve. The alternative of a trust structure where the income is distributed to the band members ensures the continuation of the exemption, but again this structure is limited to activities on reserve land and does not apply to other economic development.

In conclusion, the discussion of the case law surrounding s 87 indicates that the exemption from income tax has little relevance to modern day economic activities of Indians once these activities cross reserve boundaries. It is therefore argued that if the Canadian Government wishes to encourage economic development by Indians it will need to investigate a broader range of approaches than the tax exemptions currently available under the *Indian Act*.

THE SCIENCE OF TAXING THE ARTS

LISA MARRIOTT*

Most OECD countries support the arts with a broad range of tax incentives. The primary incentives provided in New Zealand are direct subsidies to traditional art forms, such as the ballet and the symphony orchestra; tax credits for donations to certain not-for-profit organisations, which may include arts organisations; and tax incentives for New Zealand production of films, digital and visual effects.

This paper investigates the economic, philosophical and sociological arguments raised for, and against, the provision of tax incentives for 'the arts'. A variety of direct and indirect instruments are discussed. A trans-Tasman comparison of arts related funding and incentives is undertaken and the suggestion made that New Zealand must engage in more effective targeting of scarce resources in order to maximise outcomes from tax incentives and increase economic efficiency.

I INTRODUCTION

Countries throughout the OECD provide tax based support for the arts. This may take the form of tax credits, tax deductions for charitable donations, direct grants or targeted support. Incentives are provided to a range of industries that include, but are not limited to, the performing arts, film, publishing, music, digital media, literature and television.

Typically, government support of the arts is justified with the assumption that the market for the arts does not work, or that the arts generate a social benefit that validates state support. There are a number of issues in quantifying and justifying state support for the arts. Of particular relevance are

* Lisa Marriott is a Senior Lecturer at the School of Accounting and Information Systems, University of Canterbury, Christchurch, New Zealand. Correspondence to Lisa.Marriott@canterbury.ac.nz. The author is grateful for the helpful comments provided by an anonymous reviewer in the preparation of this article.

the definitional issues around what qualifies as 'art'; the difficulties associated with measuring the potential economic contribution, if any, from the arts; and measuring the level of assistance provided to the arts community, particularly in relation to indirect assistance. As observed by Frey:

creativity is an elusive concept and most difficult to deal with in a way providing useful insights for the typical problems with which the economics of art is concerned. In particular, the effect of government intervention on artistic activity is complex, and does not lend itself to simple relationships and conclusions.⁷⁹⁶

In the current environment of constrained resources, it would appear timely to revisit the issue of tax incentives for the arts and ask the questions of who receives tax incentives, how much they get, who decides on the allocation, and the economic or social benefit gained from the subsidies provided. This paper explores the justification for tax incentives for the arts and offers some suggestions for their existence. In addition, it investigates the philosophical issues raised in providing tax incentives for the arts, including what qualifies as an 'art'.

The funding of arts activities is not questioned. However, it is suggested that greater transparency is required in New Zealand in relation to arts funding decisions. Moreover, an expectation of demonstrated economic or social benefit should be a prerequisite for state assistance.

The paper commences with a discussion on what is art. An outline of the literature follows, incorporating the economic, philosophical and sociological arguments for the provision of tax incentives for the arts. The different forms of incentives, and advantages and disadvantages of the incentives, are summarised. The current direct and indirect funding approaches in New Zealand and Australia are examined, followed by a discussion on the debates around the provision of incentives for arts activities. Conclusions are drawn in the final section.

II WHAT IS ART?

796 Bruno Frey, 'State Support and Creativity in the Arts: Some New Considerations' (1999) 23 *Journal of Cultural*

Economics 71, 75.

When exploring a topic such as this, perhaps the first issue to address is the question of ‘what is art’? Arts are typically ‘experience’ activities, providing economic value that is difficult to measure. Definitions of art range from the product of human creativity, to the popular Wikipedia definition: ‘the process or product of deliberately arranging elements in a way that appeals to the senses or emotions’.⁷⁹⁷

For the purposes of this paper, art is not confined to the traditional ‘high arts’. While the more conventional performing arts (eg, ballet, opera, and orchestral performances) are considered, other more modern arts, such as digital film production, are included in the discussion. Items that are cultural in nature and traditionally supported by the state, such as the provision of a national archive, national library or a national museum, are excluded from this discussion. Cultural activities tend to be broader in definition than the arts, including heritage items as well as more traditional forms of performing arts.⁷⁹⁸ The primary reason for exclusion of cultural activities in this analysis is that arguments surrounding justification of funding for culturally significant activities differ considerably from the debates around activities of a more conventional artistic nature.⁷⁹⁹ Instead, the focus is on those activities that have greater discretion for a country, are more likely to be supported by a small proportion of the population and are less likely to have cultural significance.

From a broader perspective, art may be included within the category of ‘creative industry’; a topic that has generated considerable research interest in recent times. A creative industry is defined by Barrowclough and Kozul-Wright as essentially dualistic, comprising an intangible and a tangible component and ‘underpinned by intangible creativity and ideas (symbolic cultural expressions,

797 Wikipedia, <<http://en.wikipedia.org/wiki/Art>>.

798 Victor A Ginsburgh and David Throsby, *Handbook of the Economics of Art and Culture*, Volume 1 (Elsevier, 2006) 5.

799 For example, individuals have different perspectives on the funding of cultural activities and the funding of more traditional art forms. In addition, cultural goods and services are more likely to adhere to the ‘public good’ definition that is used to support government funding, whereas more conventional arts do not easily fit within this boundary.

musical ideas, visual images, products of the intellect) as well as a tangible mode of delivery'.⁸⁰⁰ For the purposes of completeness, creative industries are also included in this analysis.

Among the statements defending state support for the arts are those such as the following: 'art is beyond calculation, and due to its uniqueness it may not be compared with anything else';⁸⁰¹ 'we have an interest in promoting beauty and excellence, which it is reasonable for us to fulfil in part through government activity';⁸⁰² and 'the arts are among the most desirable products of civilization – they are among the most worthy of the outputs of the economy'.⁸⁰³ However, despite this apparent worthiness, in many cases there is a gap between supply and demand of arts activities, which results in the need for financial support from other sources, such as the state.

III TAX AND THE ARTS

Tax incentives are typically provided to encourage or modify certain behaviours. These behaviours may be macro- or micro-economic in nature: for example, they may be provided to individuals to encourage saving for retirement, or they may be provided to large organisations to assist in maintaining competitiveness in a global environment. Typically, there is some economic benefit associated with their provision.

The behavioural effects resulting from tax incentives are well known, and include:

- increasing the attractiveness of the concessionally taxed activity;
- the need for increased tax revenue from other sources to supplement revenue foregone;

800 Diana Barrowclough and Zeljka Kozul-Wright, *Voice, Choice and Diversity Through Creative Industries: Towards a New Development Agenda* (Routledge, 2008) 5.

801 Bruno S Frey and Werner W Pommerehne, *Muses and Markets: Explorations in the Economics of the Arts* (Oxford University Press, 1989) 8.

802 Harry Brighouse, 'Neutrality, Publicity and State Funding of the Arts' (1995) 24 *Philosophy and Public Affairs* 35, 35.

803 William J Baumol, 'Applied Welfare Economics' in Ruth Towse (ed), *A Handbook of Cultural Economics* (Edward Elgar Publishing Ltd, 2003) 21.

- the possible impact on economic activity, with the altered allocation of scarce resources.⁸⁰⁴

Economics and art are a relatively recent addition to the academic literature, with the origin of the discipline now known as contemporary cultural economics in the mid 1960s, following the seminal research of Baumol and Bowen.⁸⁰⁵ Despite its recent addition to the academic community, tax incentives for the arts are not new; they have existed in some countries from the early twentieth century.⁸⁰⁶

A variety of economic and philosophical viewpoints have been raised for, and against, state involvement in funding the arts. The reasons outlined below from Towse,⁸⁰⁷ and Throsby and Withers,⁸⁰⁸ are used as a framework for investigation of the common arguments for government assistance to the arts.⁸⁰⁹

Towse⁸¹⁰ suggests that there are three primary benefits that flow from the arts to society, which provide an argument for state support:

- The economic spill over from the existence of the art (such as increased tourism);
- The creation of a legacy for future generations; and
- Their educational contribution.

Throsby and Withers⁸¹¹ add the following:

804 Commonwealth of Australia, Tax Expenditures Statement 2008, <<http://www.treasury.gov.au>> 23.

805 William J Baumol and William G Bowen, *Performing Arts — The Economic Dilemma: A Study of Problems Common to Theater, Opera, Music and Dance* (The Twentieth Century Fund, 1966).

806 Stephen E Weil, 'Tax Policy and Private Giving' in Stephen Benedict (ed), *Public Money and the Muse: Essays on Government Funding for the Arts* (W W Norton and Company, 1991) 168.

807 Ruth Towse, *Baumol's Cost Disease: The Arts and Other Victims* (Edward Elgar Publishing Ltd, 1997).

808 David Throsby and Glen Withers, *The Economics of the Performing Arts* (Edward Arnold (Australia) Pty Ltd, 1979).

809 This section focuses on the primary arguments for state support for the arts. It is acknowledged that other arguments exist, such as supporting infant industries, or increasing access to the population of a particular art form. For further discussion on justification of these forms of concession, refer to Brett Freudenberg, 'Tax: Contributing to a Sustainable Arts Sector in Australia — Lessons from Overseas' (2010) 15(2) *Media and Arts Law Review*, 169, 174.

810 Towse, above n 12, 256.

- Support for the arts ‘provides work for artists in their chosen profession, prevents loss of talent to other professions or to other countries and also attracts key non-artistic personnel to the country who require a cultured environment’;
- The option value associated with the arts that is held by individuals that do not attend arts performances;⁸¹²
- The high risks and uncertainties of artistic activity;
- The range of community benefits generated by the existence of the performing arts, as well as for those who do not attend the performances, including ‘the provision of public creative ideas and aesthetic standards; the development of national feeling, pride and identity; the provision of social comment and criticism; and the social improvement of the participants in the arts’.

Each of the points raised by Towse, and Throsby and Withers, is discussed in more detail in this section.

A National identity and national prestige

As observed by O’Hagan, ‘one of the arguments used most frequently in relation to subsidies to the arts relates to national identity’.⁸¹³ Throsby and Withers⁸¹⁴ define ‘national identity’ as ‘those elements of national life which characterise a country and distinguish its attitudes, institutions, behaviour and way of life from those of other countries’. Further suggestions are that the existence of arts institutions leads to an enhanced concept of society, which leads to greater social cohesion⁸¹⁵ and that individuals benefit from national or international recognition of achievement.⁸¹⁶ There is

811 Throsby and Withers, above n 13, 170.

812 An option value exists when individuals do not attend arts activities themselves; instead, they place value on their presence so that others may attend, or for possible self-attendance in the future.

813 John W O’Hagan, *The State and the Arts: An Analysis of Key Economic Policy Issues in Europe and the United States* (Edward Elgar Publishing Ltd, 1988) 23.

814 Throsby and Withers, above n 13, 177.

815 Steven Gliberman, *Culture, Governments and Markets: Public Policy and the Culture Industries* (The Fraser Institute, 1987) 30.

816 Throsby and Withers, above n 13, 177.

also the suggestion that art is a reflection of society; in which case it is reasonable that society as a whole supports it.

The ‘national pride’ argument is often used to justify the potential for inequity inherent in arts based funding; that is, ‘low income nonusers are compelled to pay taxes to finance the entertainment of high income and well educated theatre-goers’.⁸¹⁷ The opposing views can be seen in the following two claims: ‘screen productions are particularly significant for their impact on how New Zealanders see themselves’⁸¹⁸ and national identity arguments as support for the arts are ‘very dubious grounds on which to base a public subsidy argument’.⁸¹⁹

The issue of increased national identity or national pride relating to arts activities remains far from settled, with few recent empirical studies undertaken testing the claim. Research by Throsby and Withers finds that 66% of questionnaire respondents indicated that the community benefited from a publicly supported symphony orchestra, while only 19% of those respondents had attended a symphony performance in the last two to three years.⁸²⁰ However, the data supporting this claim is now 35 years old, thus it is an area that warrants further research attention.

B Externalities

One of the most common arguments for state support for the arts is that they provide externalities or spill over benefits. An externality exists when the benefits (or costs) of a good or service have a spill over effect to those not involved in the transaction.⁸²¹ In relation to the arts, positive externalities may exist for society in both production and consumption. For example, individuals travelling to experience an arts performance will potentially consume other goods and services, such as accommodation, meals and transport. This expenditure assists in job creation in a

817 William G Morrison and Edwin G West, ‘Subsidies for the Performing Arts: Evidence on Voter Preference’ (1986) 15 *Journal of Behavioral Economics*, 57.

818 Ministry for Culture and Heritage, *Review of Government Screen Funding Arrangements Discussion Paper*, <<http://www.mch.govt.nz>> (2004).

819 O’Hagan, above n 813, 25.

820 Throsby and Withers, above n 13, 183.

821 Globerman, above n 20, 16.

variety of industries in the location of the art provided. Thus, the externality argument is that if 'benefits exist to non-consumers as well as to consumers, society as a whole should be willing to pay more for a product than would the direct consumers of that product'.⁸²² However, it is also argued that most economic activities create some form of externality, thus the existence of an externality in isolation is unlikely to provide sufficient grounds to justify financial support from the state.

C Legacy for future generations/option value

Towse suggests the creation of a legacy for future generations as justification for state support.⁸²³ This is perhaps more frequently recognised in the literature as the option value associated with the arts, as suggested by Throsby and Withers.⁸²⁴ The literature suggests that some individuals who do not attend the performing arts nonetheless attach a value to their existence. For example, Throsby observes that:

the arts are socially beneficial when held by people who do not themselves consume the arts directly, or an acceptance by some individuals of the desirability of others' consumption, can be accounted for in this way. In such cases what appears at first sight to be "imposed choice" turns out to be ultimately consistent with the principle of consumer sovereignty.⁸²⁵

In the economic literature this has been explored as the 'willingness-to-pay' approach, which examines the value of a particular art to the population. Bille Hansen⁸²⁶ finds that in a situation of payment for the Royal Theatre in Copenhagen, the population was willing to pay an amount at least equal to the government subsidy. While visitor numbers to the theatre were around 7% of the total population, willingness to pay by non-users was also substantial. This effect is described by Throsby

822 Globerman, above n 20, 16.

823 Towse, above n 12.

824 Throsby and Withers, above n 13.

825 David Throsby, 'The Production and Consumption of the Arts: A View of Cultural Economics' (1994) 32(1) *Journal of Economic Literature*, 23.

826 Trine Bille Hansen, 'The Willingness-To-Pay for the Royal Theatre in Copenhagen as a Public Good' (1997) 21(1) *Journal of Cultural Economics*.

and Withers⁸²⁷ as an option value on the presence of the arts for non-users. The option value is not reflected in the market, as no demand is exerted.⁸²⁸ The value exists from the opportunity to attend performances, despite non-attendance in practice, together with a value that they can be utilised by others. The option value argument, to some extent, addresses the question of why it is that if benefit is generated by arts, those obtaining that direct benefit may not incur the full costs of it. Thus, state support may be warranted to allow this option demand to be met.

D Education

The educational potential from the arts may flow to both the producer and the consumer. Existence of arts organisations provides employment and skill enhancement opportunities for those engaged in all elements of the production. Similarly, it is argued those attending the arts also benefit from a component of learning from the experience. However, traditional forms of art are often charged with being the domain of the elite. While this is outside the scope of this paper, there is considerable support among the literature linking factors such as income and education to ‘high arts’ attendance. As observed by Baumol,⁸²⁹ ‘the difficulties of those who advocate public support for the arts is compounded by the well-documented fact that their audience is typically composed of individuals whose incomes, wealth and education are well above those of the population as a whole’.⁸³⁰

The relationship between attendance at arts performances, higher levels of education and higher consumer income is well established.⁸³¹ Blaug captures this point succinctly, stating that ‘audiences

827 Throsby and Withers, above n 13.

828 Frey and Pommerehne, above n 6, 10.

829 Baumol, above n 8, 21.

830 An example of this is provided by Towse who notes that in the United Kingdom, opera receives five times the amount of subsidy per attendance when compared to other Arts Council supported performing arts organisations, despite only being attended by 7% of the population. Ruth Towse, ‘Opera’ in R Towse (ed), *A Handbook of Cultural Economics* (Edward Elgar Publishing Ltd, 2003).

831 For example, Throsby, above n 30; Ginsburgh and Throsby, above n 3; J Mark Davidson Schuster, ‘Tax Incentives in Cultural Policy’ in V Ginsburgh and D Throsby (eds), *Handbook of the Economics of Arts and Culture*, Volume 1 (Elsevier, 2006) 1275.

for the arts are skewed to the right in income, age, occupation, and levels of education and indeed differ more markedly in years of schooling achieved than in any other personal characteristic'.⁸³² Thus, the argument in support of increased education may be valid as a spill over benefit, but is tempered by the over-utilisation of some arts activities by the wealthier, more educated proportion of society.

E Arts and economic growth

In recent years, considerable attention has been paid to the links between arts based industries and economic growth. This economic growth can be viewed as an externality from state support for the arts industries. There is some indication that the arts, as an industry, is growing at a faster pace than average and providing a greater contribution to society than many other industries. The United Kingdom publishes an annual *Creative Industries Economic Estimates*,⁸³³ outlining estimates of economic contribution provided by the creative industries.⁸³⁴ As at January 2009, the gross value added by creative industries was estimated at 6.4%. In addition, creative industries in the United Kingdom are demonstrating higher growth than the wider economy (at 4% over the 10 years from 1997 to 2006 compared to 3% for the economy as a whole).

Peacock observes that state support for the arts can provide a spill over benefit to other producer organisations.⁸³⁵ This is similar to Florida's argument of the existence of a 'creative class'.⁸³⁶ Florida's primary argument is that the presence of 'creative' individuals among a population can result in improved economic growth. Florida calls these people the 'creative class', explaining 'the

832 Mark Blaug, 'Where Are We Now on Cultural Economics?' (2001) 15 *Journal of Economic Surveys* 123, 125.

833 Department for Culture, Media and Sports, *Creative Industries Economic Estimates*, 2009, <<http://www.culture.gov.uk>>.

834 The estimates include the following industries: advertising; architecture; art and antiques; designer fashion; video, film and photography; music and the visual and performing arts; publishing; software, computer games and electronic publishing; and radio and television.

835 Alan Peacock, 'The Arts and Economic Policy' in V Ginsburgh and D Throsby (eds), *Handbook of the Economics of Arts and Culture*, Volume 1 (Elsevier, 2006) 1134.

836 Richard Florida, *The Rise of the Creative Class and How It's Transforming Work, Leisure, Community and Everyday Life* (2002); Richard Florida, *Cities and the Creative Class* (2005).

distinguishing characteristic of the Creative Class is that its members engage in work whose function is to create meaningful new forms'.⁸³⁷ Florida suggests that approximately 30% of the United States' population may qualify as comprising part of the creative class.⁸³⁸

Florida's research indicates that 'places that succeed in attracting and retaining creative class people prosper; those that fail don't'.⁸³⁹ This may perhaps be viewed as a multiplier effect where initial spending (ie, state funding) results in increased consumption (ie, spending), which results in increased national income. The question that is difficult to answer is whether the consumption would have existed in the absence of the state funding; in other words, is there a causal relationship between the state funding and increased national income. An alternative explanation may arise from the established link between education and arts attendance, whereby cities with highly educated populations create the demand for arts activities, rather than responding to a supply-driven service.

Florida is not the first to highlight the potential economic benefits from a thriving arts community. Throsby observes that 'the arts can be seen as a potentially leading sector in central city renewal and in urban economic development'⁸⁴⁰ and Globerman suggests that 'government intervention and support in the culture area has been increasingly justified on the basis that culture is "big business" that makes an important economic contribution to the entire community'.⁸⁴¹ Thus, the argument that state funding support may result in increased economic growth has some merit. However, the arts need to demonstrate that their funding assists in achieving this outcome and, in addition, that the benefit of the activity exceeds the cost of its provision.

F Risk, uncertainty and market failure

837 Richard Florida, *Cities and the Creative Class* (2005) 34.

838 Florida defines a 'creative class' as 'a fast growing, highly educated, and well-paid segment of the workforce on whose efforts corporate profits and economic growth increasingly depend. Members of the creative class do a wide variety of work in a wide variety of industries — from technology to entertainment, journalism to finance, high-end manufacturing to the arts. They do not consciously think of themselves as a class. Yet they share a common ethos that values creativity, individuality, difference, and merit'. Richard Florida, *The Rise of the Creative Class and How It's Transforming Work, Leisure, Community and Everyday Life* (Basic Books, 2002) 3.

839 *Ibid* 4.

840 Throsby, above n 30, 25.

841 Globerman, above n 20, 21.

The argument described by Throsby and Withers⁸⁴² as the risk and uncertainty of artistic activity is perhaps more readily recognised as the potential for market failure. Market failure is a common argument raised in support of state assistance to the arts and is the condition where ‘the market is “incapable” of producing the “socially efficient” output rate for a particular product’.⁸⁴³ The position is captured by Towse⁸⁴⁴ who suggests that:

failure to pass the market test does not necessarily mean that the goods in question are unwanted; it merely reflects the fact that they are not amenable to ordinary commercial standards of valuation. In these conditions public support may be entirely justified as the only available means to make demand effective.

The market failure argument appears warranted for many arts based activities. However, it is not applicable for all arts. As observed by Frey and Pommerehne, markets for the arts may work effectively.⁸⁴⁵ Frey and Pommerehne use the example of fine art to demonstrate this principle, noting that works by Lichtenstein and Warhol were commercially recognised and traded at high prices long before museums of modern art considered them suitable for display. This raises the question of whether the market for arts does not work effectively, or whether it has not been appropriately tested.

Historically, various art forms have benefited from individual or corporate benefactors that have assisted in funding the activity. While this continues today, it is often the ‘high profile’ arts that receive corporate sponsorship which also receive state funding.

G Community benefits and the merit good argument

Throsby and Withers⁸⁴⁶ suggest that society benefits from the provision of the arts. This is aligned with the economic perspective of the arts as a merit good. A merit good is one that, ideally,

842 Throsby and Withers, above n 13.

843 Globerman, above n 20, 13.

844 Towse, above n 12, 256.

845 Frey and Pommerehne, above n 6, 16.

846 Throsby and Withers, above n 13.

is maximised as it is deemed to be socially desirable. Education and health services can be examples of merit goods: where they are provided on the basis of need, rather than ability to pay.

Netzer suggests that:

the meritorious nature of the arts is the most general and perhaps the most widely espoused argument for public subsidy. It is a valid point of view but an inadequate guide for public policy; it tells us nothing except that more of what is good is better. It does not, for example, help fund-granting agencies to decide which activities and organizations are most deserving of additional subsidy.⁸⁴⁷

Thus, merit may be one deciding factor in where funding is distributed, but in isolation, the merit good argument is insufficient for funding allocation decision-making in an environment of scarce resources.

H Summary

What may be seen from the perspectives outlined above is that a number of arguments exist for why state support for the arts is desirable. However, the issue is not assisted by the complexity of demand and supply associated with the arts, combined with the elements of private goods providing public externalities. Perhaps the issue is best captured by Barrowclough and Kozul-Wright who suggest that creative enterprises ‘come with high risk, uncertainty, transaction costs, network externalities, spillovers and public good effects that imply that markets alone will not be sufficient to create an adequate resource base’.⁸⁴⁸

IV STATE SUPPORT FOR THE ARTS

Throughout the OECD, various forms of tax support for the arts exist, including exemptions from capital gains, estate or gift taxes; deductions for individual and company donations to art organisations; direct grants or subsidies; state provided support for arts based education and training;

847 Dick Netzer, *The Subsidised Muse: Public Support for the Arts in the United States* (Cambridge University Press, 1978) 16.

848 Barrowclough and Kozul-Wright, above n 6, 3.

and a variety of additional tax exemptions for arts institutions.⁸⁴⁹ A further way of subsidising the arts via the tax system is through reduced Value Added Taxes, such as those provided in the Netherlands.⁸⁵⁰ Additional state support mechanisms are suggested by Schuster: ‘tax policies, copyright laws, zoning, unemployment and employment programs, urban redevelopment programs, and social security legislation are among the ways that governments can affect the flow of money to the arts and the mix of artistic activities ultimately available to the public’.⁸⁵¹ Moreover, state support may take the form of assistance in relation to arts infrastructure. These are all important funding mechanisms, but the limitations associated with measuring the components of these various expenditures that may have an impact on the arts will be evident. Thus, the research limits itself to those subsidies that can be clearly linked to arts activities: both direct and indirect tax incentives.⁸⁵²

Subsidies reduce the ability of the market to provide an optimal price and quantity from the traditional supply and demand mechanism. However, as found by Schuster, ‘many countries are experimenting with a wide variety of tax-based incentives that go well beyond the realm of private individual or corporate philanthropy’.⁸⁵³

Historically, the provision of direct grants, which may be either public or private in nature, has been one of the most common methods of providing financial assistance to the arts.⁸⁵⁴ In addition to direct subsidies, governments frequently encourage taxpayer contributions to arts institutions, for

849 It is acknowledged that support may also be regulatory in nature, such as the requirement in New Zealand for locally generated programming to be broadcast for at least one-third of the hours between 6.00am and 10.00pm, in order to qualify for a Local FM Radio Broadcasting Licence. In many countries, program content is unregulated.

850 Value Added Tax incentives are the principal form of tax incentives for the arts in the Netherlands. Sigrid J C Hemels, ‘Tax Incentives for the Arts: The Case of the Netherlands’ (2006) 5(1) *Journal of Cultural Economics* 2.

851 J Mark Davidson Schuster, ‘Tax Incentives as Arts Policy in Western Europe’ in Paul J DiMaggio (ed), *NonProfit Enterprise in the Arts: Studies in Mission and Constraint* (Oxford University Press, 1986) 320.

852 For a comprehensive discussion on a range of international approaches to funding the arts, refer to Clare McAndrew, ‘Artists, Taxes and Benefits: An International Review’ (2002) Arts Council England Research Report 28; and Freudenberg, above n 14.

853 Above n 36, 1286.

854 Throsby and Withers, above n 13, 230.

example, through tax credits. In New Zealand a tax credit is available at 33.33 cents for each dollar donated to an approved organisation.⁸⁵⁵ The benefit from the tax credit is in the form of an overall reduction in the individual's tax liability.

Another form of indirect subsidy is a tax deduction for contributions to the arts (more commonly framed as a tax deduction to a not-for-profit organisation). Under a tax deduction, an amount is deducted from taxable income, which reduces the taxable amount. Tax deductions favour high income earners who pay tax at a high marginal tax rate. This point is illustrated in Table 1, which outlines the different tax outcomes under different tax conditions. The simple example assumes an individual with an income of \$10 000 making a \$1000 charitable donation, with two possible tax rates (45% and 20%) and two possible tax treatments: a tax credit at 33.33 cents per dollar donated or a tax deduction. Table 1 shows the greater tax benefit from a tax deduction for a higher rate taxpayer, with the greater tax benefit from a tax credit accruing to a lower rate taxpayer.

Table 1: Comparison of tax treatments: tax deductions and tax credits

Tax deduction			Tax credit at 33.33c/\$		
Tax rate	45% tax (\$)	20% tax (\$)		45% tax (\$)	20% tax (\$)
Income	10 000	10 000	Income	10 000	10 000
Donation (deduction)	1000	1000	Tax	4500	2000
Taxable income	9000	9000	Donation	1000	1000
Tax payable	4050	1800	Tax credit	330	330
Tax 'saving'	450	200	Tax payable (tax — tax credit)	4170	1670
Cost of donation to taxpayer	550	800	Tax 'saving'	330	330
			Cost of donation to taxpayer	670	670

While there has been some investigation as to which methods are preferable insofar as eliciting higher levels of donation, the issue remains unclear. Of further relevance is that there appears to be

⁸⁵⁵ It is acknowledged that some of the terminology may have a different interpretation in different jurisdictions. In New Zealand, tax rebates have been recently replaced by tax credits. In Australia this is now referred to as a tax offset.

little evidence that an individual's primary motivation for giving is for tax benefit.⁸⁵⁶ However, tax benefits may encourage higher levels of donation by the wealthy.

In countries that provide tax deductions for private contributions to arts organisations, Brooks suggests that this provides a significantly larger contribution than direct government subsidies.⁸⁵⁷ Brooks finds that in the United States, around \$14 in indirect contributions is made for every \$1 in direct subsidy.⁸⁵⁸

Another issue with tax deductions for any activity is their relative decline in recent years as marginal tax rates have reduced. This general decline in marginal tax rates has seen the balance of the contribution move from the state to the taxpayer. Thus, a donor wanting to make a contribution at a certain level has seen the government co-contribution reduce. As observed by Weil, 'in theory at least ... the value of the charitable deduction as an incentive for private giving has been substantially eroded simply by the ongoing reduction in the maximum marginal tax rate'.⁸⁵⁹

As a tax credit provides a higher benefit to lower income earners, an argument has been made that a tax credit system is preferable on improved equity grounds. However, as captured by Throsby and Withers:

since the rates struck under a tax credit system would probably be such as to reduce the financial incentive to rich donors as compared to a system involving deductibility of donations, and since this group is likely to be the major source of private finance, the overall flow of private funds to the performing arts could be expected to be lower under the more "equitable" tax credit arrangement than with a more discriminating scheme.⁸⁶⁰

856 Kym Madden and Cameron Newton, 'Is the Tide Turning? Professional Advisers' Willingness to Advise about Philanthropy' (Working Paper No CPNS 30, Centre of Philanthropy and Nonprofit Studies, Queensland University of Technology, 2006). Madden and Newton highlight a number of reasons, other than tax benefits, that motivate philanthropic giving (31–32).

857 Arthur C Brooks, 'In Search of True Public Arts Support' (2004) *Public Budgeting and Finance* 88, 89.

858 This may be compared to the Royal New Zealand Ballet, which received NZ\$3.5 million in state support (in the 2008/09 financial year), additional revenues of NZ\$2.5 million from other grants and sponsorship, and NZ\$2.7 million from all other income; indicating around 40% of revenue was in the form of a direct state subsidy.

859 Weil, above n 11, 169.

860 Throsby and Withers, above n 13, 240.

From the perspective of an individual, a tax incentive decreases the marginal cost of making a donation to an arts organisation. A question that has been explored in the literature is whether the existence of such an incentive increases the amount that is donated, as the cost of giving reduces. The literature is undecided on this effect. Early research found that the organisation receiving the donation receives more than the government reduction in tax revenue.⁸⁶¹ However, more recent research challenges this finding and indicates that donors will take advantage of the tax expenditure to reduce the private contribution.⁸⁶²

V NEW ZEALAND AND AUSTRALIA

This section outlines the tax incentives provided in New Zealand and Australia for the arts. New Zealand funding includes sources from both national and local governments, while Australian funding is obtained from both the national and the state governments.

A New Zealand

In 1963, the establishment of the Queen Elizabeth II Arts Council resulted in the provision of a number of objectives for the Arts Council; these are outlined below:

- (a) 'to encourage, foster and promote the practice and appreciation of the arts in New Zealand;
- (b) to make accessible to the public of New Zealand all forms of artistic or cultural work;
- (c) to improve standards of execution of the arts;
- (d) to foster and maintain public interest in the arts and culture in New Zealand; ...'.⁸⁶³

The aim of providing funding at the present time is outlined in the appropriations for the 'Vote Arts, Culture and Heritage' and is to 'help ensure that culture is visible and accessible, and deliver

⁸⁶¹ Schuster, above n 36, 1273.

⁸⁶² Ibid 1274.

⁸⁶³ Throsby and Withers, above n 13, 209.

cultural products and services to New Zealanders and international audiences'.⁸⁶⁴ The focus on culture, rather than arts, is apparent in this statement.

New Zealand's current position on funding for the arts is perhaps best seen in a recent announcement by Chris Finlayson, New Zealand Minister for Arts, Culture and Heritage, that the government intends to investigate overseas funding models to encourage a 'culture of philanthropy' in New Zealand, with the arts as a focus. A taskforce 'consisting of several of New Zealand's most high-profile supporters of the arts' will investigate ways to improve charitable giving in New Zealand.⁸⁶⁵ However, Mr Finlayson comments that the state has an ongoing responsibility for funding the arts. For many years in New Zealand there have been few generous tax incentives for this endeavour, with the exception of the film industry.

The film industry has benefited from government support in recent years, with the provision of a tax exempt Large Budget Screen Production Grant for New Zealand based production of films, digital, and visual effects.⁸⁶⁶ The objective of this grant is to increase economic growth by providing a financial incentive to attract large budget film and television productions to New Zealand. In addition, the grant has a secondary objective to accelerate skill development and technology transfer within the local screen production industry and to provide additional benefits for the economy via increased tourism and the promotion of New Zealand.⁸⁶⁷

The value of the Large Budget Screen Production Grant is 15% of qualifying production expenditures. The grant applies to screen productions in various formats (including feature films and television drama series). For these formats 'qualifying New Zealand production expenditure'⁸⁶⁸

864 New Zealand Treasury, 2009, Performance Information for Appropriations — Vote Arts, Culture and Heritage, <<http://www.treasury.govt.nz>>.

865 New Zealand Government, 2009, Review to Improve Arts Philanthropy, Press Release, <<http://www.beehive.govt.nz>>.

866 Income Tax Act 2007, ss DS 1, DS 2, EJ 4, EJ 5, EJ 7 and EJ 8.

867 Office of the Minister for Economic Development, Cabinet Policy Committee Business Committee, Large Budget Screen Production Grant Review of Bundling (Cabinet Paper, 2007).

868 This is 'the production expenditure incurred for, or attributable to: goods and services provided in New Zealand; the use of land located in New Zealand; and the use of a good that is located in New Zealand at the time that good is used in the making of the screen production'. Film New Zealand, Production Guide, 2007, <<http://www.filmnz.com/production-guide>>.

must be NZ\$15 million. The grant is also available for post, digital and visual effects, in which case the qualifying New Zealand production expenditure may be between NZ\$3 million and NZ\$15 million. The grant is available to New Zealand resident companies or foreign organisations operating with a fixed establishment in New Zealand for the purposes of lodging an income tax return. Audited information must be presented to the Inland Revenue Department for verification prior to grant payment.

Another key incentive is the Screen Production Incentive Fund (SPIF), announced in 2008.⁸⁶⁹ The SPIF provides a grant of 40% of New Zealand qualifying production expenditure for New Zealand feature films and 20% for television and other screen production expenditure. Funds allocated for this endeavour were NZ\$27.8 million over four years⁸⁷⁰ plus a further NZ\$26 million from existing funding to the New Zealand Film Commission (NZ\$53.8 million in total).⁸⁷¹ To qualify for these funds, the productions are required to have significant New Zealand content⁸⁷² and meet an eligibility threshold (eg, NZ\$5 million for feature films; NZ\$250 000 per hour of documentary production). The upper limit is NZ\$15 million for any individual production, resulting in a maximum grant of NZ\$6 million (at 40%) to any one project.

869 Taxation (International Taxation, Life Insurance and Remedial Matters) Act 2009, s DF5.

870 That is, NZ\$3 million in the 2008/09 year, and NZ\$8.250 million in each of the following four years.

871 Ministry for Culture and Heritage, New Zealand Screen Production Incentive Fund, 2008, <<http://www.mch.govt.nz>>.

872 A 'New Zealand Content Test' exists for this purpose, which has been designed to 'reflect the importance of on-screen New Zealand content — in terms of New Zealand characters, locations, stories, and historical and cultural elements'. However, the criteria also state that it is possible for a production to meet the content test 'while having no identifiable New Zealand setting, characters or other cultural elements. It is not the intention of the Test to restrict New Zealand film-makers' creativity by limiting them solely to New Zealand settings and situations.' Thus, high levels of New Zealand production activity could also assist in meeting the test. Ibid.

In New Zealand, government funding is provided to a number of sectors that fall within the broad definition of the arts. The government department that receives this funding is the Ministry of Arts, Culture and Heritage. Funding is provided in the following categories:⁸⁷³

- Music Industry Commission;
- New Zealand Film Archive;
- New Zealand Symphony Orchestra;
- Royal New Zealand Ballet;
- Film Production Fund;
- Christchurch Art Gallery;
- Te Papa Tongarewa;
- New Zealand Music Commission; and,
- Creative New Zealand.⁸⁷⁴

Expenditure in the 2009/10 budget (along with the previous year actual spend) is outlined in Table 2. Table 2 highlights the percentage of annual income that is provided by the state to a range of arts institutes in New Zealand. Funding appears to be primarily based on historic provision, with no additional justification provided in government budgets on how funding decisions are made.

Table 2: New Zealand expenditure on the arts: 2009/10⁸⁷⁵

	2008/09 actual (\$'000)	2009/10 budget	Per cent of annual income

⁸⁷³ A number of categories of funding, eg, management of historic places, public broadcasting (New Zealand on Air, TVNZ, Radio New Zealand International, Broadcasting Standards Authority) have been excluded from discussion in this paper.

⁸⁷⁴ This is the Arts Council of New Zealand. It is responsible for schemes such as the Creative Communities Scheme, which aims to increase participation in the arts at a local level, and increase the range and diversity of arts available to communities, <<http://www.creativenz.govt.nz>>.

⁸⁷⁵ New Zealand Treasury, The Estimates of Appropriations 2009/10 — Vote Arts, Culture and Heritage, B.5, <<http://www.treasury.govt.nz>>.

		(\$'000)	
Museum services	24 644	24 644	50%
<i>Performing arts services</i>			
New Zealand Symphony Orchestra	13 446	13 446	78%
Royal New Zealand Ballet	3534	4384	42%
New Zealand Music Commission	1378	1378	88%
Te Matatini ⁸⁷⁶	1248	1248	80%
<i>Promotion and support of the arts and film</i>			
Creative New Zealand	15 937	15 689	45%
New Zealand Film Commission	3611	3611	22%

These figures exclude capital expenditure. For example, Te Papa Tongarewa (the national museum) is allocated NZ\$9 million per annum for ongoing capital expenditure, exhibition research and development, and acquisition of items for the collection. In relation to economic factors, the primary output performance measures and standards are outlined in Table 3. What can be seen from Table 3 is that the performance measures provide for minimal accountability for funding provided. Reporting measures such as audience numbers, or performances provided, do little to increase efficiency or quality of provision.

Table 3: Primary performance measures in New Zealand

876 The national body for Maori Performing Arts for Aotearoa.

Museum services	Visitor numbers, new exhibitions
Performing arts services	Audiences, performances
Promotion and support of the arts and film	Arts development, access to arts experiences, projects funded, films financed

In addition to central government funding, in many New Zealand regions arts funding is supported by local government. For example, in Wellington (a city which considers itself to be the cultural capital of New Zealand), the Wellington City Annual Report discloses expenditure on the arts under the category of ‘Cultural Wellbeing’, as outlined in Table 4.⁸⁷⁷

Table 4: Expenditure on ‘Cultural Wellbeing’ in Wellington (2008/09)

	Total cost (\$'000)	Cost per resident
Arts partnerships	\$2620	\$13.61
Community arts and cultural support	\$3741	\$19.43
Galleries and museums	\$6376	\$33.12
Heritage	\$1226	\$6.37
Total ‘Cultural Wellbeing’	\$13 963	\$72.53

By way of comparison, expenditure on other environmental items that are typically considered as important to New Zealanders is outlined in Table 5:

⁸⁷⁷ Wellington City Council, Summary Annual Report 08/09, 2009, <<http://www.wcc.govt.nz>>.

Table 5: Selected environmental expenditure in Wellington (2008/09)

	Total cost (\$'000)	Cost per resident
Environmental conservation attractions	\$4260	\$22.13
Gardens and beaches	\$12 075	\$62.73
Green open spaces	\$14 014	\$72.80
Total selected environmental expenditure	\$30 349	\$157.66

Tables 4 and 5 highlight the different values appointed to each of these activities. Total expenditure (excluding finance expenses) for the Wellington City Council in the 2008/09 financial year was NZ\$331 million, indicating that 4.2% of expenditure was related to 'Cultural Wellbeing'. On the selected environmental issues, expenditure was 9.1%. As with spending at the national level, no justification for funding allocations to either of these activities is provided.

In 2007, the previous maximum limit on the tax credit available for donations made by individuals was removed and the amount became claimable at the value of one-third of the gifted amount.⁸⁷⁸ In addition, maximum deduction limits for corporate donations were removed. These tax concessions are available for donations made to 'registered charities'. To meet the requirements under the *Charities Act 2005* (NZ), a registered charity must have a charitable purpose; broadly providing services of benefit to the community. A number of arts organisations, including the Royal New Zealand Ballet, are listed as registered charities by the Charities Commission.

B Australia⁸⁷⁹

⁸⁷⁸ Income Tax Act 2007, ss DB 41, DV 12, LD.

⁸⁷⁹ For further discussion on Australia's tax treatment of the arts, refer to Freudenberg, above n 14.

The equivalent portfolio to New Zealand's Ministry of Culture and Heritage is the Australian Department of the Environment, Water, Heritage and the Arts. Under 'arts' portfolios, funding allocations for 2009/10 are:

- The Australia Council for the Arts⁸⁸⁰ — A\$181.9M
- Australian Film, Television and Radio School — A\$23.7M
- Australian National Maritime Museum — A\$23.2M
- National Film and Sound Archives — A\$25.2M
- National Gallery of Australia — A\$69.9M
- National Library of Australia — A\$69.8M
- National Museum of Australia — A\$46.2M
- Screen Australia — A\$102.1M

Of further, and perhaps greater, relevance is the *Tax Expenditures Statement*, which 'provides details of concessions, benefits, incentives and charges provided through the tax system ... to taxpayers by the Australian Government'.⁸⁸¹ A tax expenditure is 'a tax concession that provides a benefit to a specified activity or class of taxpayer'.⁸⁸² There are approximately 340 tax expenditures, which may be in the form of a tax deduction, tax offset, tax exemption, or a concessional tax rate. The *Tax Expenditures Statement* provides an outline of the financial revenue foregone due to the provision of the tax benefit. As noted in the *Tax Expenditures Statement*: 'tax expenditures are often an alternative to direct expenditures as a method of delivering government assistance or meeting government objectives'.⁸⁸³

In Australia, tax expenditures are significant. By way of example, superannuation tax concessions are one of the key components of the tax expenditures in Australia, attracting A\$22.3

880 The Australia Council is responsible for 'creation, presentation and appreciation of distinctive cultural works by providing assistance to Australian artists and making their works accessible to the public' Budget: Portfolio Budget Statements 2009–2010 (Budget Related Paper No 1.6 Environment, Water, Heritage and the Arts Portfolio, 13).

881 Commonwealth of Australia, Tax Expenditures Statement 2008, <<http://www.treasury.gov.au>>.

882 Ibid 6.

883 Ibid.

billion in the 2009/10 tax expenditure statement.⁸⁸⁴ Recreation and culture concessions are A\$240 million for 2009/10. Examples of tax concessions provided for the arts at the Commonwealth level are:

- The exemption of certain prizes (such as literary awards) from taxation;
- Income averaging for certain occupations, including authors, inventors, performing artists and production associates;
- Film Tax Offset payments (where film production companies incur expenses in relation to Australian productions, they may be eligible for tax offsets, including a location offset, a producer offset, and a post, digital and visual effects offset). These tax offsets are typically a 15% rebate;
- An exemption from income tax for the Australian Film Finance Corporation;
- Capital gains tax exemption for assets disposed of under the Cultural Gifts Program;⁸⁸⁵ and,
- Tax incentives for film investment (this is accelerated depreciation of capital expenditure incurred in purchasing an interest in the copyright of a new Australian film). The write-off may be either fully deducted in the year of acquisition or spread over two years.⁸⁸⁶

Similarly to New Zealand's Charities Register, Australia operates a Register of Cultural Organisations. Donors contributing to organisations on this register will attract a tax deduction for their donation. The purpose of the scheme is to strengthen public support for the arts.⁸⁸⁷ A number of conventional arts organisations are on the register, including state ballet companies and the

884 This figure is costs less offsets. The Treasury, Tax Expenditures Statement 2009, Appendix D, Aggregated Superannuation Tax Expenditure (2009) 240.

885 The Taxation Incentives for the Arts Scheme commenced operation in 1978. The purpose of the scheme was to encourage donations of gifts in kind to cultural institutions in Australia. Today, an indirect tax incentive remains under this scheme (now the Cultural Gifts Program), providing for a tax deduction and capital gains tax exemption for a gift of property that has cultural significance to a public art gallery, museum, library or archive.

886 The Treasury, 2010, Tax Expenditures Statement 2009, A50, A51, B29, B32, B72 and E7 respectively. This list is not intended to be exhaustive; a number of additional tax concessions for arts activities are provided.

887 Australian Government, Department of the Environment, Water, Heritage and the Arts, <<http://www.arts.gov.au>>.

Australian Ballet. In 2001, 'prescribed private funds' were implemented, which allowed individuals to form charitable trusts which benefited from attracting tax deductions for donations made. In 2009, these were replaced with 'private ancillary funds'. When certain conditions are met, private ancillary funds allow donors to claim tax deductions for charitable giving to that entity.⁸⁸⁸

Screen Australia provides direct funding for the film and television industry.⁸⁸⁹ For example, an Enterprise Program provides funding up to A\$500 000 per year for three years to support film production companies to develop their businesses. In addition, single-project development programs exist for individual projects of value up to A\$50 000. Targeted 'Talent Escalator Programs' exist to support skill development, expansion of market knowledge and production expertise, with funding up to A\$20 000. Furthermore, an Innovation Program funds up to A\$30 000 for digital media development purposes and A\$250 000 for production.

Over the period from 1994/95 to 2007/08 in Australia, more than three-quarters of film agency income was from the government. Over this period, A\$1.85 billion in appropriations was provided to federal film agencies and A\$481 million to the state film agencies.⁸⁹⁰ Funding is also provided through the Australia Council for the Arts. This organisation provides contestable funding of around A\$160 million per annum to arts organisations and individuals.

Funding to the arts is also provided by the states. For the purposes of comparison, the state of New South Wales is used for analysis. The New South Wales government provides support for the arts through Arts New South Wales. As well as fellowships, scholarships and awards, it also provides direct funding. The funding is provided with the aim of increasing access to arts and cultural activities across New South Wales. In addition, the New South Wales Film and Television Office provides financial and other forms of assistance to the film and television industry.

Adopting the state of New South Wales for comparison purposes permits inclusion of a unique Australian icon in this discussion: the Sydney Opera House. In 2009, the Sydney Opera House received A\$14.4 million in the form of a government endowment, together with A\$30.4 million in

⁸⁸⁸ The Treasury, above n 91, A66.

⁸⁸⁹ Screen Australia commenced in 2008 and brings together the functions of the Australian Film Commission, the Film Finance Corporation Australia and Film Australia Limited. Screen Australia is also responsible for the aforementioned producer offset.

⁸⁹⁰ Screen Australia, <<http://www.screenaustralia.gov.au/gtp/govtfundsummary.html>>.

the form of a maintenance grant. Operating revenues from the sale of goods and services were A\$50 million, with an overall reported loss of A\$8.7 million. The operating revenue and expenses provided in the financial statements for the organisation indicate that under the current arrangements, it is not possible to achieve an effective market based outcome. However, the significance of the Sydney Opera House is evident in the number of visitors it attracts (over 7 million per annum) and performances it holds (1600 per annum).⁸⁹¹ Moreover, the Sydney Opera House is generally considered important for Australian national identity.⁸⁹²

VI DISCUSSION

This discussion starts from the position that arts funding is necessary, and desirable, for a number of reasons. These reasons include economic benefit, together with more intangible benefits like contributing to national identity. The primary issue is the form that this funding should take, and how it should be allocated.

The fundamental economic argument is that we exist in a world of scarce resources and, accordingly, choices must be made in relation to how these resources are allocated. In an environment of limited resources, it would appear reasonable to suggest that funds are allocated to where they will provide the greatest return, or at the very least, an established return, either from a demonstrated social or positive economic benefit. Some of the issues discussed earlier are revisited in this section, together with some additional issues raised from the previous section on arts funding in New Zealand and Australia.

A National identity

While the national identity argument may have validity in certain countries, traditionally, in New Zealand, it has been sporting achievements that have created identification with the New Zealand national identity and raised the country's national prestige, rather than accomplishments in

891 Source: Sydney Opera House public relations material, <<http://www.sydneyoperahouse.com>>.

892 For example, the Chairman of the Sydney Opera House Trust is quoted as saying that the Sydney Opera House is 'core to our national cultural identity and a source of great pride to all Australians' (reported by the BBC News, 29 November 2008, Sydney Opera House Architect Dies).

the performing arts. There are few, if any, instances of traditional performing arts where New Zealand has raised its international profile due to the existence of a particular activity. However, the Sport and Recreation New Zealand budget for 2009/2010 to promote and encourage sport and recreation in New Zealand was NZ\$22 million,⁸⁹³ which is only slightly higher than the funding provided to the Royal New Zealand Ballet and the New Zealand Symphony Orchestra combined.

Conversely, while more of a cultural symbol than an arts institution, an important cultural reference point for Australia is the Sydney Opera House. This organisation appears to be unable to break even, even with the support of the state, thereby perhaps justifying state support for its continued existence. Thus, the national identity argument appears most relevant when assessed on a country specific case-by-case basis.

Moving away from the more traditional arts, New Zealand and Australia have both recently benefited from the national prestige, or increased national awareness, associated with a successful film industry.⁸⁹⁴ The considerable positive economic benefits and externalities from the *Lord of the Rings* trilogy, filmed in New Zealand, are outlined later in this section.

B Calculating economic benefit

One of the issues with tax incentives is their lack of transparency. New Zealand is one of few OECD countries to not produce a tax expenditures statement. The concept of tax expenditures was raised by Stanley Surrey in 1973, in the seminal work *Pathways to Tax Reform: The Concept of Tax Expenditures*.⁸⁹⁵ Surrey claimed that governments should account for tax expenditures in the same manner as other government expenditures. Since Surrey raised the issue, most countries have made some attempt to measure this foregone revenue and have published tax expenditure statements to report these amounts. Typically the production of a tax expenditure statement is to ensure transparency of policy and to facilitate debate and input into development of the tax system. The explanation provided for this non-disclosure in New Zealand is that the levels of revenue foregone are small. However, the impact of this non-disclosure is that it becomes difficult to analyse the

893 New Zealand Treasury, Estimates of Appropriations 2009/10 — Vote Sport and Recreation, B.5, 315.

894 For example, in Australia: Jindabyne, Samson and Delilah, and Rabbit Proof Fence.

895 Stanley Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Harvard University Press, 1973).

effectiveness and potential contribution to the economy of the tax based incentives. Moreover, this lack of visibility of state expenditure removes accountability for the funds invested. At the present time in New Zealand, the primary performance measures for arts activities are outputs such as performances and audiences (as outlined in Table 3), rather than demonstration of economic or social benefit.

C Who decides?

A criticism frequently attached to the provision of any tax incentive is the tendency to privilege one group above another. In a democratic environment, direct taxpayer funded subsidies may be accused of lacking transparency. Furthermore, when the state funds certain art forms and not others, it is influencing the arts activities that are likely to be provided. As captured by Feld, ‘centralized government grant-making creates the risk that a small number of decision makers will determine the kind and quality of art worthy of support, based on their particular judgments and tastes’.⁸⁹⁶

By way of comparison, the provision of a tax deduction, tax credit, or government matching co-contribution for a charitable donation, provides for individual preference to influence the organisations that receive state support. However, the use of deductions does not resolve the issue. Weil claims that ‘the bulk of giving to cultural organizations comes from a relatively small handful of affluent taxpayers’.⁸⁹⁷ When tax support is provided in the form of a tax deduction, Weil suggests that ‘this handful of taxpayers is in essence able to spend the public’s money without any of the administrative safeguards or democratic participation that would normally accompany such a public expenditure’. This view is shared by Schuster⁸⁹⁸ who claims that tax deductions ‘may exacerbate the tastes of relatively wealthy donors who use the tax incentive to leverage and help finance large donations to certain charitable sectors’. In addition, Schuster claims ‘not only do tax incentives affect the relative cost of artistic goods and services, they also affect the relative mix of artistic activities that public and private arts institutions, artists, and entrepreneurs ultimately choose to

896 Alan L Feld, ‘Revisiting Tax Subsidies for Cultural Institutions’ (2008) 32 *Journal of Cultural Economics* 275, 276.

897 Weil, above n 11, 173.

898 J Mark Davidson Schuster, ‘Issues in Supporting the Arts through Tax Incentives’ (1987) 16 *Management and Law* 31, 45.

provide'.⁸⁹⁹ What is apparent is that the privileged arts that receive government funding are likely to be those provided to the public.

As outlined in the previous section, vehicles such as 'prescribed ancillary funds' in Australia, allow individuals to create trusts to which tax deductible donations can be made, with the objective of future distributions to 'deductible gift recipients'. These instruments have proved popular, with 769 vehicles approved as at 2008, with a combined value of A\$2.1 billion in donations received.⁹⁰⁰ Approximately 20% of these donations (A\$447 million) has been distributed; A\$62 million, or 14%, of which was donated to 'cultural organisations'.⁹⁰¹ The issue of whether these vehicles have increased overall levels of giving to arts organisations has yet to be established.

D Costs

There are a number of financial issues associated with arts funding, particularly in New Zealand. The process for allocation of funds to the arts in New Zealand is unclear, appearing to be based primarily on historical practice, with little evaluation and analysis over time in relation to its continued provision. By way of illustration, arguably New Zealand's most well-known performer among the more traditional arts is the opera singer, Kiri Te Kanawa. However, opera in New Zealand receives no direct government support.⁹⁰² Conversely, and again arguably, New Zealand has not produced any internationally recognised ballet dancers, but this activity attracts significant government funding.

Schuster suggests that the problems associated with appropriately targeting tax incentives, and the difficulty with assessing the cost of the tax incentive, are that these incentives may 'prove to be

899 Schuster, above n 56, 321.

900 Australian Tax Office, 2010, Prescribed Private Funds Statistics, <<http://www.ato.gov.au/nonprofit>>.

901 Ibid.

902 However, New Zealand Opera does receive a grant of NZ\$2.3 million per annum from Creative New Zealand. This is a recurrent grant, despite coming from a contestable fund. In addition, New Zealand Opera receives funding from the local Auckland City Council. However, its primary funding source is from corporate donations.

particularly costly ways to support the arts'.⁹⁰³ There are well-established issues in measuring tax expenditures, both in terms of their cost and their effectiveness. Zee, Stotsky and Ley⁹⁰⁴ suggest that there are four costs associated with the provision of tax incentives:

- i. distortions between activities that receive incentives and those that do not;
- ii. foregone revenue;
- iii. administrative resources; and
- iv. the social costs of rent-seeking activities associated with the abuse of tax incentives.

All these points are relevant, and their existence supports an argument that state funding of any enterprise should require justification of social or economic benefit. As observed by Globerman:

conceptually, the cost to the public treasury is the foregone tax revenue associated with the tax write-off ... appropriately discounted to a present value. In fact the more relevant notion of social costs to employ when evaluating any public policy is the value of the resources used to produce the output in question, presuming the resource would not have otherwise been unemployed.⁹⁰⁵

This concept of the opportunity cost associated with arts funding is important, and one that is not frequently seen in the literature. In particular, opportunity cost applied to industries that have demonstrated an ability to contribute to economic growth would appear to be a valid, if perhaps contentious, measure.

When compared with expenditure on the arts in Australia, and in particular on the Australian film industry, New Zealand's tax incentives are meagre. There is an awareness of the importance of remaining internationally competitive in the film industry, as demonstrated in the Ministry of Economic Development Cabinet Paper in 2007, which outlines changes to the Large Budget Screen Production Grant, and observes that 'the proliferation of production subsidies around the globe has been one of the most significant factors affecting the choice of production venues for a significant volume of production. Therefore, in order to remain a preferred destination, New Zealand must

903 Schuster, above n 56, 354.

904 Howell H Zee, Janet G Stotsky and Eduardo Ley, 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries' (2002) 30 *World Development* 1497, 1501.

905 Globerman, above n 20, 11.

ensure that our incentive is globally competitive'.⁹⁰⁶ Despite this awareness, New Zealand does not provide incentives at a comparable level to many other OECD countries.

E Maximising economic benefit

The argument that a strong arts community can assist in job creation and other economic benefits is not without merit. However, this argument may be extended to almost every industry: most have the potential for economic growth, job creation and skill development.⁹⁰⁷ The issue is in deciding which of the arts are more equal than others when funding decisions are made. There may be the potential for the arts sector to be, or become, a high-growth market but, nonetheless, it would seem prudent to fund those activities that are most likely to produce this outcome.

There are some who consider that New Zealand is performing well in its support of the arts. For example, Barrowclough and Kozul-Wright suggest that New Zealand has 'a sophisticated menu of policy tools and regulations promoting production' in creative industries, and '[in New Zealand as well as in other] countries, the debate has moved on from whether the sector is a valuable one or not, to which policy tools are best adapted to participating in it or which are most acceptable given international policy commitments'.⁹⁰⁸ Furthermore, Florida⁹⁰⁹ suggests that New Zealand will be among a number of smaller countries 'that have built dynamic creative climates and are turning out creative products ranking from Nokia cell phones to the *Lord of the Rings* movies'. However, it is suggested that New Zealand has not capitalised on the success of the *Lord of the Rings* films and subsequently lost an opportunity to benefit from further economic gain as a result of expansion of this niche industry. By way of comparison, in 2009 Australia launched an A\$17 million Creative

906 Office of the Minister for Economic Development, above n 72.

907 The World Bank suggests that creative industries can add up to 7% to GDP, with associated growth rates of 10–20% per annum. Barrowclough and Kozul-Wright, above n 5, 6.

908 Barrowclough and Kozul-Wright, above n 5, 20.

909 Above n 44, xxiv.

Industries Innovation Centre to provide emerging creative organisations with access to business advisory and development networks.⁹¹⁰

There are numerous opportunities to provide arts funding. New Zealand, as a small country, needs to be particularly strategic about the provision of funding for enterprises that may or may not contribute to economic growth. In 2002, the New Zealand Institute of Economic Research produced a report on the economic impacts of the *Lord of the Rings*.⁹¹¹ While the film trilogy was not yet complete at the time of the report, it provides some indication of the transitory and lasting benefits gained from its New Zealand production. The primary benefits are outlined below:

- Financial benefits of New Zealand expenditure, including NZ\$353 million expenditure (to March 2002) and labour costs of \$188 million;
- Peak period employment of around 1500 people per week;
- The use of around 5000 vendors, primarily in New Zealand;
- Broadening of production skill base and capacity;
- Enhancing New Zealand's creative reputation, talent development and production capacity; and
- Lifting industry capability and ability to new levels.

The differences in approaches between funding the arts and encouraging business in the arts are vast. State provided funding for the arts implies that it should be both transparent and accountable: discretionary taxpayer funded support should come with strings attached. As noted by Bille Hansen, 'it is not enough to show that the arts generate income, employment and tax revenues, for all economic activity does that. Of course, the arts are not the only sector that contributes directly and indirectly to value growth and employment in society'.⁹¹² Thus, it may not be sufficient to consider certain forms of arts as necessary for society, particularly when they are not available to all for consumption.

910 Australian Government, Department of the Environment, Water, Heritage and the Arts, <<http://www.arts.gov.au>>.

911 New Zealand Institute of Economic Research, 2002, Scoping the Lasting Effects of the Lord of the Rings (Report to the New Zealand Film Commission, 6), <<http://www.nzier.org.nz>>.

912 Bille Hansen, above n 32, 310.

F Externalities

One of the potential greatest outcomes from expenditure on the arts is the potential for spill over benefits. The *Lord of the Rings* production in New Zealand provided significant externalities for the country, many of which are long-term in nature. Those estimated by the New Zealand Institute of Economic Research⁹¹³ include:

- Increased international profile of the New Zealand film industry;
- Increased skill base in the New Zealand screen production industry;
- Establishing a foundation for New Zealand creative entrepreneurship, centred on the film industry;
- Broadening film infrastructure;
- Enhancing Brand New Zealand; and
- The creation of spin off industries, such as merchandising.⁹¹⁴

When these benefits are compared to those of the more traditional art forms, such as ballet and the symphony orchestra in New Zealand, the traditional arts activities have not demonstrated the same capacity to generate positive externalities.

G Merit good argument

Following the economic argument of market failure and the potential demise of some areas of art, the associated question becomes whether this is likely to have a significant impact on society. It is well established⁹¹⁵ that the traditional arts are frequented to a greater extent by those with greater education and higher incomes, thus it may not be unreasonable to suggest that the majority of the population would not suffer a declining quality of life if art forms such as the ballet or symphony orchestra were no longer state funded. The question is succinctly captured by Peacock, who claims

913 New Zealand Institute of Economic Research, above n 116.

914 It is acknowledged that the report highlighted some negative externalities from the production of *Lord of the Rings* in New Zealand, including increased labour costs in some industries, the potential for adverse environmental effects in some filming locations, and increased house prices in the Wellington suburbs where much of the work was undertaken. However, these effects are mostly short-term in nature. *Ibid.*

915 For example, Globerman, above n 20, 40.

‘the interesting question is why such support, coupled with regulatory measures to control the provision and sale of historical artefacts, is found in the arts, whereas in other forms of productive activity, such support is increasingly reduced, as instanced in privatisation measures’.⁹¹⁶ This can be seen in New Zealand, with the removal of tax credits for research and development in November 2008. However, funding for traditional arts has either remained the same or, in some instances, increased.

Peacock⁹¹⁷ suggests that there is scepticism by governments about the ability of consumers to appropriately value the choice of arts that they wish to enjoy, thereby resulting in producer interest groups with the ability to influence the policy approach in this regard. However, there is an equally compelling argument that if these arts institutions were ‘good enough’ then they would not need state funding because they would attract sufficient private audiences to permit self-funding.

H Summary

Perhaps the two primary potential benefits from arts organisations are the potential for improved national identity and economic growth. Elements of the ‘high arts’ in New Zealand, such as the ballet and national orchestra, have shown they are unlikely to generate considerable economic activity or add significantly to New Zealand’s national identity. These national arts in New Zealand are unable to compete with the standards of their more well-known counterparts in larger countries (eg, England’s Royal Ballet and Royal Opera House) and thus are unlikely to attract the international audiences required to generate increased economic benefit. Conversely, New Zealand cultural activities, such as Te Papa Tongarewa, the national museum, have a demonstrated ability to attract a wider audience.⁹¹⁸

916 Peacock, above n 40, 1124.

917 Peacock, above n 40.

918 For example, an exhibition held at Te Papa Tongarewa in Wellington in early 2009 (Monet and the Impressionists) was estimated to bring NZ\$34.5 million in additional spending into the Wellington region. The total net economic benefit from the exhibition was estimated at NZ\$14.8 million. Of the 150 000 people attending the exhibition, 52% were from outside the Wellington region.

The Ministry for Culture and Heritage *Review of Government Screen Funding Arrangements Discussion Paper* in 2004⁹¹⁹ emphasises that government support should be based on ‘the screen sector’s ability to contribute to the government’s broad cultural and economic objectives; [and] the identification of gaps in the sector where government intervention is appropriate and effective and will be complementary to activities in the private sector’. While there appeared to be an attempt to take advantage of the immediate post-*Lord of the Rings* positive impact on the New Zealand film industry (eg, the large budget productions such as the *Chronicles of Narnia* and the *Hercules* mini-series filming in New Zealand⁹²⁰), this position appears to have been ineffectively capitalised, with few producers choosing New Zealand as a location in more recent times.⁹²¹

In a highly competitive, global marketplace, the need for all publicly funded organisations to be held accountable for the use of state funds, and provide a demonstrated return on investment, appears defensible. As a small country, New Zealand has to be strategic in all expenditure. Appropriate targeting of specific, highly skilled endeavours and providing incentives to encourage these activities in New Zealand, appears to be more likely to generate a positive return than continuing the funding of traditional art forms that appear less likely to do so.

In New Zealand, the art form that has demonstrated the greatest potential to make both an economic and social contribution is film production. New Zealand does not have the population base to attract the audiences demanded of an international standard ballet or opera company, or orchestra. However, the film industry has an established ability to compete at an international level, while providing significant social and economic benefits.

919 Ministry for Culture and Heritage Review of Government Screen Funding Arrangements Discussion Paper,

<<http://www.mch.govt.nz>>.

920 Suggested by Trevor Mallard, as Economic Development Minister in 2006, as providing a NZ\$363 million direct cash injection into the New Zealand economy, additional economic activity of NZ\$119–227 million and indirect benefits of between NZ\$10 and NZ\$34 million. Government Support for Films to Continue, Minister of Economic Development Media Statement, 6 March 2006, <<http://www.med.govt.nz>>.

921 It is acknowledged that potential tax benefits will not be the sole factor for decisions relating to the location of film production. New Zealand’s landscape also provides a wide range of opportunities for promotion as a niche production location.

VII CONCLUSION

One's view on the provision of tax incentives is likely to be influenced as much by one's perspective of the place of the arts in society, as much as by potential economic analysis. However, where economic analysis may assist is in the allocation of scarce resources. While there is an argument to be made that funding is best allocated on efficiency grounds, this must be tempered by the intangible, and desirable, benefits that the arts contribute to society.

Arts funding is necessary but, as with any scarce resource, must be allocated to the activity that will generate the greatest return. This return may be in the form of a contribution to national identity, generation of externalities, increased economic growth, improved educational opportunities or any of the other established potential benefits of the arts. Criteria such as these should be used in funding allocation decisions to ensure that the greatest benefit is gained from the limited funds available.