CRITIQUE AND COMMENT

A JUDICIAL PERSPECTIVE ON TAX REFORM

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[During the tax reform process which has taken place over the last 25 years, simplicity has invariably given way to equity or efficiency when these objectives have conflicted, resulting in an extremely complex and burdensome system. In this piece, it is argued that the solution to this problem is not to be found in periodic tax reviews; rather, 'architectural' or 'structural' reform is required, even if this means that the criteria of equity and efficiency are compromised. At its most ambitious, such reform could entail the assimilation of all capital gains and losses to gains and losses on revenue account. A more modest change would be to remove uncertainty by embarking upon a process whereby the capital/revenue dichotomy was written out of the tax legislation.]

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I INTRODUCTION

It must be a rare occasion when a judicial officer of the Commonwealth is given the opportunity to comment on a topic which is currently the subject of such high political profile and debate, the more so to be given that opportunity under the shelter of the portals of an academic institution such as The University of Melbourne.[1] Even my judgments are not so protected; they can be subjected to the rigours of intellectual scrutiny on the part of the members of the High Court. On the other hand, I suspect most readers will be sufficiently technically adept to critically, but fairly, evaluate the merit or otherwise of what I have to say. I certainly do not expect my views to be left unchallenged. And that's as it should be. The concept of 'tax reform' is so subjective in the perception it generates, that inevitably consensus on whether or not a proposal qualifies as tax reform is impossible to achieve. This has been the case for many years and

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1 An earlier version of this paper was presented by the author as 'Judicial Perspective on Tax Reform' (Speech delivered at the Annual Tax Lecture, The University of Melbourne, 17 August 2010). The style of the author's oral delivery has been preserved.

reflects the diversity of political backgrounds and economic interests of the participators in the tax reform process. In more recent times, the lack of consensus has been exacerbated by the politicisation of that process. In short, the process has been politically hijacked to the detriment of the community at large. The government of the day will put change up in the name of reform, whether or not the change qualifies as such by reference to the generally accepted objective criteria;[2] and the opposition of the day will just as quickly denigrate the change as 'another big tax which will leave everyone worse off', without regard to whether or not the change qualifies as tax reform by reference to those same criteria. It is little wonder that the Secretary to the Treasury recently said:

> It is difficult to find consensus views among academics, perhaps especially in the social sciences in which even the most abstract theoretical proposition will betray a normative position. And yet, in the domain of tax policy debates, achieving academic consensus is the easy part. It is much tougher to convince a wary public; tougher still cynical media. And it is virtually impossible — in Australia at least — to secure political consensus on any tax proposal other than a straightforward tax cut.[3]

I would respectfully observe that, based on more recent events, even a straightforward tax cut (albeit for companies) is likely to buy a fight with the other side of politics.[4]

I have to say that I find this state of affairs extremely disappointing because it will, if it continues, inevitably handicap tax reform in this country, to the detriment of the community at large. One would hope to find greater qualities of leadership in those who promote themselves as deserving of our electoral patronage. Be that as it may, recent history would suggest that real reform in this country takes time; rarely has it found legislative expression on the heels of the recommendations of the review committee in which its provenance is sourced. So much was recognised by the Taxation Review Committee ('Asprey Committee') in 1975:

> In matters of taxation, committees of inquiry are ill-advised to offer neat timetables and precise rates or quantities. Moreover, and above all, when a tax system becomes somewhat ossified and somewhat incoherent as has the Australian, and when rather sweeping reforms are under consideration, much public discussion and understanding are essential before large changes can be attempted. Structural reforms will inevitably take some years to implement, rate changes have to be made gradually as the circumstances of the day permit, and transitional problems of much intricacy have to be solved at every point. A

[2] These criteria — equity (or fairness), efficiency and simplicity — are discussed in Part V.

[3] Ken Henry, 'Tax Reform: Opportunities and Challenges' (Speech delivered at the ATAX Conference, Sydney, 21 June 2010) <http://treasury.gov.au/contentlist.asp?ContentID=515&classification=54&titl=Speeches>.

[4] In May 2010, the Commonwealth government proposed lowering the company tax rate to 28 per cent: Wayne Swan, Deputy Prime Minister and Treasurer, 'Stronger, Fairer, Simpler: A Tax Plan for Our Future' (Joint Media Release with Kevin Rudd, Prime Minister, No 028, 2 May 2010) <http://treasurer.gov.au/tsr/Main.aspx?PageID=089&min=wms>. This proposal was not supported by the Opposition: see Commonwealth, *Parliamentary Debates*, House of Representatives, 13 May 2010, 3597 (Tony Abbott, Leader of the Opposition).

> proper appreciation of the ultimate aims of what is being proposed requires a presentation that in the first place is in terms of general principles rather than legal or quantitative detail. Strategy comes before tactics.[5]

Indeed, the important recommendations of the Asprey Committee did not manifest themselves in legislative form for over 10 years after the release of the *Full Report* (‘*Asprey Report*’), for various reasons.[6] The Australia's Future Tax System Review (‘Henry Review’) made many recommendations in its recent report (‘*Henry Review Report*’)[7] which merit further public discussion and consideration, and one can only hope that the present politicisation of the debate will not impede or handicap that process. Only time will tell whether that hope is realised.

At the outset, I hasten to add that the views expressed are my own, not those of the Federal Court nor of any of my colleagues on that Court. They are borne out of my experience over 40 years, first as a solicitor and barrister practising in the tax area, and now as a Federal Court judge deciding tax disputations between the revenue and taxpayers, and are undoubtedly conditioned by that experience. I've seen a lot of changes. Many of the changes that have occurred in that time have been monumental, not only in terms of the change, but in their qualitative merit. I'll return to some of these shortly.

II A Brief Outline of Tax Reviews in Australia

Few, if any, would seek to argue that periodic review of the tax system is not a legitimate nor, indeed, a desirable policy of government in Australia today.[8] From the time the Commonwealth entered the field of income tax in competition with the states in 1915, there have been a number of external reviews of particular aspects of the Australian tax system, or of the laws within that system:[9] the Kerr Royal Commission (1920–23);[10] the Ferguson Royal Commission (1932–34);[11] the Spooner Committee (1950–54);[12] the Hulme Committee (1954–

5 Taxation Review Committee, *Full Report* (1975) 3 [1.12] (‘*Asprey Report*’).

6 See below Part II.

7 Review Panel, *Australia's Future Tax System: Report to the Treasurer — Part One: Overview* (2009).

8 As the Asprey Committee observed, ‘[e]ven if, as is not the case, the Australian system were generally agreed to be as satisfactory as any tax system is ever admitted to be, a periodic thorough inspection would be as wise a precaution in this area of affairs as in any other’: *Asprey Report*, above n 5, 1 [1.2].

9 For a more comprehensive outline and assessment of these reviews, see Chris Evans and Richard Krever, ‘Tax Reviews in Australia: A Short Primer’ in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 3.

10 See Commonwealth, Royal Commission on Taxation, *First Report, Together with Appendices* (1921); Commonwealth, Royal Commission on Taxation, *Second Report, Together with Appendices* (1922); Commonwealth, Royal Commission on Taxation, *Third Report* (1922); Commonwealth, Royal Commission on Taxation, *Fourth Report* (1923); Commonwealth, Royal Commission on Taxation, *Fifth and Final Report, Together with Appendices* (1923).

11 See Commonwealth, Royal Commission on Taxation, *First Report* (1933); Commonwealth, Royal Commission on Taxation, *Second Report* (1934); Commonwealth, Royal Commission on Taxation, *Third Report* (1934); Commonwealth, Royal Commission on Taxation, *Fourth and Final Report* (1934).

55);[13] the Ligertwood Committee (1959–61);[14] the Mathews Committee (1974–75);[15] the Campbell Committee (1979–83)[16] and the Ralph Review (1998–99);[17] and two external reviews of the overall tax system, which produced the *Asprey Report* (1972–75)[18] and the *Henry Review Report* (2008–09).[19]

In the last 25 years, particular aspects of the Australian tax system have also been the subject of three government-led reviews, conducted by Treasury, which yielded:

1 The June 1985 *Draft White Paper*[20] — the precursor to the 1985 Tax Summit — and changes, some of them attributable to the recommendations of the Asprey Committee, which emanated therefrom:
   - the extension of the income tax base to include capital gains;[21]
   - the enactment of a new tax on employers in respect of fringe benefits provided to employees;[22]
   - the adoption of an imputation system for the taxation of companies and their shareholders;[23] and
   - the adoption of a foreign tax credit system (in place of the exemption system) for giving unilateral relief from double taxation of foreign source income taxed in the country of source;[24]

12 The Commonwealth Committee on Taxation, chaired by E S Spooner, was a standing committee on income tax which the Treasurer referred certain matters to during the years 1950–54. Over 50 such referrals were made. See 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, 12–13.

13 See Commonwealth Committee on Rates of Depreciation, *Report* (1955).

14 See Commonwealth Committee on Taxation, *Report* (1961).

15 See Committee of Inquiry into Inflation and Taxation, *Inflation and Taxation: Report* (1975).

16 See Committee of Inquiry into the Australian Financial System, *Australian Financial System: Final Report* (1981).

17 See Review of Business Taxation, *Report — A Tax System Redesigned: More Certain, Equitable and Durable* (1999).

18 *Asprey Report*, above n 5.

19 *Henry Review Report*, above n 7. The Henry Review was not totally external, as it was chaired by the Secretary to the Treasury.

20 Commonwealth, *Reform of the Australian Tax System: Draft White Paper* (1985).

21 *Income Tax Assessment Act 1936* (Cth) pt IIIA ('*ITAA 36*'), as inserted by *Income Tax Assessment Amendment (Capital Gains) Act 1986* (Cth). This regime is now contained in the *Income Tax Assessment Act 1997* (Cth) pts 3-1, 3-3 ('*ITAA 97*'). Subsequent to the preparation of the Asprey Committee's preliminary report, the government announced proposals for a capital gains tax to operate with respect to assets disposed of after 17 September 1974. The Committee recommended deferring the introduction of a capital gains tax and that the government's proposals be abandoned to enable public discussion and critical examination of the proposals to take place. Two days before the Committee furnished the *Asprey Report*, the government announced that its plans for the introduction of a capital gains tax had been postponed.

22 *Fringe Benefits Tax Assessment Act 1986* (Cth).

23 *ITAA 36* pt IIIAA, as inserted by *Taxation Laws Amendment (Company Distributions) Act 1987* (Cth). This regime is now contained in *ITAA 97* pt 3-6.

24 *ITAA 36* pt III div 18, as inserted by *Taxation Laws Amendment (Foreign Tax Credits) Act 1986* (Cth). This regime is now contained in *ITAA 97* div 770.

2 The April 1989 *Information Paper*[25] — the precursor to the accrual and taxation on a current basis of the income of controlled foreign companies,[26] certain non-resident trusts[27] and foreign investment funds;[28] and

3 The 1998 'A New Tax System' package[29] — the precursor to the goods and services tax[30] and the Ralph Review into the taxation of business entities and investments[31] — and changes emanating therefrom:

- the adoption of a regime to allow company groups to be taxed on a consolidated basis;[32]
- lower taxes on capital gains;[33]
- a lower headline tax rate for companies;[34] and
- scrip for scrip roll-overs.[35]

III THE ROLE OF JUDGES IN TAX REVIEWS

As a general rule, judges have not actively participated in the review side of the tax reform process. There have been some exceptions, such as the late Ken Asprey, the Chairman of the Asprey Committee, who at the time of his appointment was a Judge of Appeal of the Supreme Court of New South Wales, and the late Sir Gordon Wallace, who replaced Mr J P Hannan on the Spooner Committee when the latter died. Sir Gordon subsequently became the first President of the New South Wales Court of Appeal.

I'd suggest that this limited judicial participation in tax reviews has more to do with the boundaries of judicial experience than anything else. Judicial experience is confined to the way in which the existing system, or taxes within that system, operates. It does not extend to the identification and development of tax policy or the drafting of legislation to give effect to that policy. No judge in the course of his or her curial duties is going to suggest or propose that a new tax be introduced, although he or she may well advocate the introduction of a provision to

25 Commonwealth, *Taxation of Foreign Source Income: An Information Paper* (1989).

26 *ITAA 36* pt X, s 47A, as inserted by *Taxation Laws Amendment (Foreign Income) Act 1990* (Cth).

27 *ITAA 36* pt III div 6AAA, as inserted by *Taxation Laws Amendment (Foreign Income) Act 1990* (Cth).

28 *ITAA 36* pt XI, as inserted by *Income Tax Assessment Amendment (Foreign Investment) Act 1992* (Cth). This regime is now contained in *ITAA 97* pt 3-90 div 717 sub-divs 717-D–717-E.

29 Outlined in the document circulated by Peter Costello, Treasurer (Cth), *Tax Reform: Not a New Tax, a New Tax System — The Howard Government's Plan for a New Tax System* (1998).

30 *A New Tax System (Goods and Services Tax) Act 1999* (Cth). This tax replaced the antiquated wholesale sales tax which had hitherto plagued the system.

31 Review of Business Taxation, above n 17.

32 *ITAA 97* pt 3-90, as inserted by *New Business Tax System (Consolidation) Act (No 1) 2002* (Cth).

33 *ITAA 97* pt 3-1 div 114, as inserted by *Tax Law Improvement Act (No 1) 1998* (Cth); *ITAA 97* pt 3-1 div 15, as inserted by *New Business Tax System (Integrity and Other Measures) Act 1999* (Cth).

34 *New Business Tax System (Income Tax Rates) Act (No 1) 1999* (Cth), amending *Income Tax Rates Act 1986* (Cth).

35 *ITAA 97* pt 3-3 div 124 sub-div 124-M, as inserted by *New Business Tax System (Capital Gains Tax) Act 1999* (Cth).

replace an existing provision which has failed to give effect to intended policy. For example, the substitution of pt IVA for s 260 of the *Income Tax Assessment Act 1936* (‘*ITAA 36*’) illustrates the way in which the comments and observations of judges can provide the catalyst, even if only a slow-burning one, and the parameters for change.[36] Nearly 25 years before the substitution of pt IVA for s 260 took place, Kitto J said: ‘Section 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper.’[37] Over 20 years later, Mason J said:

> the very restricted operation conceded to s 260 by the course of judicial decision … is now settled. It is therefore a source of some surprise that it continues to be relied upon when its defects and deficiencies have been apparent for so long.[38]

After referring to what Kitto J said in the passage quoted above, his Honour stated: ‘This message, despite its clarity, seems not to have reached its intended destination.’[39] It took another four years before anything was done.[40]

The late Graham Hill suggested that there may be another reason why judges of ch III courts should not get involved in such inquiries or reviews, namely, that ‘judicial participation would raise a constitutional question as to whether participation in the legislative process is compatible with the conferral of Commonwealth judicial power in Ch III of the *Constitution*’.[41] Constitutional issues aside, I don’t know that judges are best equipped to set the policy directives that guide the tax reform process in so far as that process is to be served by the introduction of a new tax. On the other hand, judges may well have a valuable contribution to make where what is involved is a major change in the design features of an existing tax, having seen it operate, and having had to determine that operation, in the real world.

IV The Reforms of the Late 20th Century

There were more real reforms to the Australian tax system in the last 15 years of the 20th century than there were in the previous 70 years. As discussed above, many of these reforms have their provenance in the recommendations of the Asprey Committee.[42]

36 Section 260 was a general anti-avoidance provision which was intended to make void as against the Commissioner of Taxation every contract, agreement or arrangement made or entered into for certain purposes or effects. For a succinct outline of the difficulties with s 260, see G T Pagone, ‘Part IVA: The General Anti-Avoidance Provisions in Australian Taxation Law’ (2003) 27 *Melbourne University Law Review* 770, 771–6.

37 *Federal Commissioner of Taxation v Newton* (1957) 96 CLR 577, 596.

38 *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330, 337.

39 Ibid 337–8.

40 See *Income Tax Laws Amendment Act (No 2) 1981* (Cth) s 7.

41 Hill, above n 12, 6.

42 See above Part II.

Other reforms followed in the form of the controlled foreign company legislation,[43] the non-resident transferor trust legislation[44] and the foreign investment fund legislation.[45] These reforms were all designed to overcome the deferral of tax on income derived and accumulated by such entities, by taxing it on a current basis to the ultimate economic Australian resident owners or controllers. Finally, with the goods and services tax and other business-related measures, came the consolidation regime for the taxation of companies.[46]

These were significant reforms. The fact that the *Henry Review Report* did not recommend that their role in the system be abandoned or changed is testimony to their qualification as such. For example, while the *Henry Review Report* stated that 'consideration should be given to alternatives [to dividend imputation] as part of a further consideration of company income tax arrangements' in the longer term, it recommended that '[d]ividend imputation should be retained in the short to medium term'.[47]

There was only one major change to the Australian tax system in the latter part of the 20th century which did not qualify as reform, and there are no prizes for guessing what that was: the fringe benefits tax.[48] As an exercise in reform, this tax was, and still is, an absolute disgrace. A tax on a benefit where the tax falls on the provider of the benefit rather than on the recipient of the benefit does not meet any of the criteria by reference to which tax change is to be measured as reform,[49] and I include in that the hallmark of efficiency. Such a tax certainly did not have its provenance in the *Asprey Report*; rather, it was born, I believe, in New Zealand, and 'let loose' by Treasury with a passion akin to that displayed by the All Blacks on the rugby playing park.[50]

That the fringe benefits tax fell outside the tax reform criteria is manifest in the recommendation of the Henry Review that '[f]ringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees through the PAYG system.'[51]

Two observations should be made. First, all fringe benefits must be attributable to individual employees, otherwise they are not fringe benefits.[52] Second, all fringe benefits can be readily valued, if not by reference to accepted principles of valuation, then by reference to statutory formulae;[53] if they can be valued from

43 *ITAA 36* pt X, s 47A, as inserted by *Taxation Laws Amendment (Foreign Income) Act 1990* (Cth).
44 *ITAA 36* pt III div 6AAA, as inserted by *Taxation Laws Amendment (Foreign Income) Act 1990* (Cth).
45 *ITAA 36* pt XI, as inserted by *Income Tax Assessment Amendment (Foreign Investment) Act 1992* (Cth).
46 *ITAA 97* pt 3-90, as inserted by *New Business Tax System (Consolidation) Act (No 1) 2002* (Cth).
47 *Henry Review Report*, above n 7, 88.
48 *Fringe Benefits Tax Assessment Act 1986* (Cth).
49 See below n 54 and accompanying text.
50 New Zealand introduced a fringe benefits tax imposed on employers, rather than employees, in 1985: *Income Tax Amendment Act (No 2) 1985* (NZ), inserting *Income Tax Act 1976* (NZ) pt XB.
51 *Henry Review Report*, above n 7, 82.
52 *Federal Commissioner of Taxation v Indooroopilly Children Services (Qld) Pty Ltd* (2007) 158 FCR 325, 344–5 (Edmonds J).
53 See *Fringe Benefits Tax Assessment Act 1986* (Cth) pt III.

the point of view of the employer, they can certainly be valued from the point of view of the employee. The sooner this tax is fully written back so that as an impost it falls on the employee receiving the benefit, the better. Hopefully, the Henry Review recommendation will be but a first step in that direction.

V Tax Reform through a Judge's Eyes

Australia's taxation system (whatever its composition of taxes) and its transfer system (under which the government makes payments or provides concessions to support those in the community who are perceived as requiring such support) are creatures of statute in the sense that statutes provide the medium by which the taxes are levied and the transfers are made. Statutes are also intended to be the medium by which government policy underlying the tax or transfer is given effect, although they do not always succeed in that task. There can be a number of reasons for this, but one that judges have to deal with, perhaps not frequently but too often, is where the textual drafting of the statute does not accommodate judicial construction that can give effect to that policy, even with the assistance of modern principles of interpretation.

It is generally accepted that the fundamental criteria for assessing tax systems as a whole, or individual taxes within those systems, are equity (or fairness), efficiency and simplicity.[54] As a judge fixed with responsibility for determining taxation disputes between the revenue and taxpayers and, in the course of doing so, applying the law (both statute and general underlying law) to the facts of a given case, you will not find it surprising to see me argue that it is the criterion of simplicity with which I have the greatest affinity. On the other hand, in the tax reform process that has gone on in this country over the last 25 years, it is simplicity that has invariably given way to equity or efficiency when there is conflict among these aspirational objectives. The result is that the tax system today, and the specific taxes within that system, are far more complex than they were in January 1975 when the Asprey Committee handed down its report.[55] Nonetheless, it is instructive to recall what the Asprey Committee had to say on the subject:

> After equity, simplicity is perhaps the next most universally sought after of qualities in individual taxes and tax systems as a whole: like fairness it is a word that, in this context, points to a complex of ideas. …
>
> A tax will be called simple, relatively to others, if for each dollar raised by it the cost of official administration is small, and if the 'compliance costs', the costs in money and effort of all kinds to the taxpayer, are also small. These two ideas are of course connected, and add up to much the same as the ancient canon of certainty. Both costs will be the less if assessor and assessed can each establish with certainty what is due: uncertainty entails the costs of consultation with experts and sometimes the yet greater costs of litigation. Both kinds of cost are increased, and certainty is endangered, when a tax, whether in the in-

54 See, eg, *Asprey Report*, above n 5, 12–17 [3.7]–[3.26]; *Henry Review Report*, above n 7, 17; *Draft White Paper*, above n 20, 14–15.

55 *Asprey Report*, above n 5.

> terests of equity or of efficiency, requires the drawing of fine distinctions between what is and what is not liable, and when these distinctions involve such uncertain ideas as 'purpose' or 'value to the recipient'. Then the legal definitions get longer and longer and beyond the comprehension of those untrained in the law, and the relevant facts in particular cases become more and more disputable.
>
> Two further aspects of simplicity require specific mention here. First, when (as is often unavoidable) a quite complex operation is needed before the administrators can make the assessment or the taxpayer can ascertain his liability, it is desirable that the tax be such that the taxpayer, for private purposes unconnected with tax, already needs to perform such operations. A tax on company income may be fairly regarded as a simple tax if the company already calculates its income or profits on the same or very similar basis. A tax on personal income is not a simple tax if it be so structured that many taxpayers who would not otherwise wish (or without hired help be able) to keep accounts at all, have to preserve many records and learn sophisticated accounting. The point, though obvious, is often forgotten.
>
> A second observation is perhaps even more obvious and even more frequently forgotten. The fewer, per million dollars raised, are the individuals or organisations from whom tax is collected the simpler is a taxation system. The sheikdom that can raise all the revenue it requires (and maybe much more) from a single tax on a single oil company has what is unquestionably the simplest tax system of all.[56]

The Asprey Committee recognised the potential for conflict between these aspirational goals:

> In general it does not appear that, in practice, the conflict between simplicity and efficiency need be very great. Certainly when the latter can be interpreted as mainly requiring neutrality, reliance upon a very simple tax, a broad-based tax at uniform rates on all goods and services used in consumption, would produce a taxation system that was simple and efficient. Though efficiency may undoubtedly require additional special taxes for special purposes it need not require many if policy instruments other than taxation are also being actively directed to this aim.
>
> The potential conflict between the ideals of simplicity and equity, by contrast, is apparently very great indeed. The taxes most obviously adapted to the requirements of equity, those technically capable of being adapted to vary the levy upon individuals in accordance with a multitude of differences in their situations considered relevant to equity, are the most complex of taxes: income tax, capital gains tax, gift and estate duties, wealth tax. Hence it appears that a country may have a simple and efficient taxation system or an equitable one but not both.[57]

Post-*Asprey Report* reviews paid lip service to simplicity, but were prepared to throw it on the scrapheap of compromise where it conflicted with the goal of equity. The *Draft White Paper* of June 1985 exemplifies the point:

[56] Ibid 15 [3.19]–[3.22].

[57] Ibid 20–1 [3.47]–[3.48].

> A good tax system should be as simple as possible. A complex tax system makes it difficult for people to understand the law and apply it to their circumstances. The present law has become so complex that it is difficult to convey its meaning simply and adequately on tax return forms and in other printed matter. Complexity imposes high compliance costs on the community and high administrative costs on the tax authorities. Complex tax laws also result in socially unproductive and costly tax litigation. These considerations suggest that, where possible, tax reform measures capable of ready comprehension and application should be preferred over more complex alternatives.
>
> This review affords an opportunity to see what can be done to reduce the burden of record-keeping on ordinary taxpayers, to increase the certainty of what is or is not taxable, and to increase the clarity of the tax system.
>
> The objectives of equity, efficiency and simplicity sometimes conflict. Measures to make the system more equitable, for example, might require complex legislative provisions and may also cause economic distortions. Inevitably, compromises have to be struck among these criteria.[58]

That the tax system and various taxes within the system are more complex today than they have ever been in the past, despite the alleged pursuit of simplicity as an aspirational goal by the various tax reviews that have occurred, was recognised by the Henry Review:

> The complexity of the tax system and the costs of complying with it are perennial concerns, particularly of the business community. Recent research suggests a range of costs associated with this complexity. It reduces transparency, impeding optimal decision making by businesses and individuals and their ability to respond to intended policy signals. It can cause people inadvertently to pay the wrong amount of tax or claim more or less than they are entitled in transfer payments. It is regressive in its impact, affecting mostly those people with the least capacity to deal with complexity and the least access to professional help.
>
> Significant among the causes of complexity are the pursuit of finely calibrated equity and efficiency outcomes, instability in policy settings and people's incentives to maximise their after-tax and transfer incomes or after-tax business profits. The provision of choice in determining a tax liability can increase complexity and result in higher compliance costs where taxpayers seek to discover the best tax outcome. Complexity may also be compounded where policy settings within the system do not draw on 'natural' taxpayer systems or are inconsistent with broader policy objectives of government.
>
> Related to the issue of complexity are the costs of administering and complying with the tax and transfer system. These costs represent a net loss to the economy, because the resources engaged in these activities could otherwise be put to more highly valued uses. Recent research suggests there is an optimal level of system complexity and operating costs, one that balances administration and compliance costs with improved efficiency and distributional outcomes.[59]

So what is to be done to simplify a system the complexity of which is conceded even by those who have reviewed it and made recommendations as to its improvement, albeit on grounds that gains to equity and efficiency outweigh the

[58] *Draft White Paper*, above n 20, 15.
[59] *Henry Review Report*, above n 7, 21.

loss to simplicity? Something will have to be done, because if nothing is done then by the middle of this century we will have a tax system so complex that administrators will not be able to properly administer it, taxpayers will not be able to properly comply with it and judges will not be able to properly adjudicate upon it. The stand-alone attributes of equity and efficiency will be so infected with its complexity that, to use the words of the late Ross Parsons, it will be a system which can only be described as an 'institution in decay'.[60] The more cynical among us would say that that time has already arrived. But even if it has not, the time has come when the pendulum has to swing back towards giving preference to simplicity, even if it is at the expense of equity and efficiency. It is the balance that is adopted amongst these aspirational goals which will determine whether the tax system we have in the middle of this century is capable of serving the community and the country in a way which meets the demands that will surely come upon us between now and then.

There are, in my view, a number of recommendations of the Henry Review which are directed or pointed towards this swing of the pendulum. Without intending to be exhaustive, they include:

> Recommendation 2: Progressivity in the tax and transfer system should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity.[61]
>
> Recommendation 6: To remove complexity and ensure government assistance is properly targeted, concessional offsets should be removed, rationalised, or replaced by outlays.[62]
>
> Recommendation 8: All forms of wages and salary for Australian resident taxpayers should be taxable on an equivalent basis and without exemptions.[63]
>
> Recommendation 9: Fringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees through the PAYG system.[64]
>
> Recommendation 11: A standard deduction should be introduced to cover work-related expenses and the cost of managing tax affairs to simplify personal tax for most taxpayers.[65]
>
> Recommendation 17: The capital gains tax regime should be simplified …[66]
>
> Recommendation 36: The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application.[67]

60 Ross Parsons, 'Income Taxation — An Institution in Decay?' (1986) 12 *Monash University Law Review* 77.
61 *Henry Review Report*, above n 7, 80.
62 Ibid 81.
63 Ibid 82.
64 Ibid.
65 Ibid 83.
66 Ibid 84.
67 Ibid 87.

> Recommendation 38: A flow-through entity regime for closely held companies and fixed trusts should not be adopted for now, but would merit further consideration if there is a move away from dividend imputation in the long run.[68]
>
> Recommendation 111: The government should establish a more transparent means of dealing with community ideas about the tax system by extending the Tax Issues Entry System website and further developing its use.[69]
>
> Recommendation 112: The government should commit to a principles-based approach to tax law design as a way of addressing the growing volume and complexity of tax legislation, and as a way of helping those laws to be interpreted consistently with their policy objectives.[70]

On the other hand, any attempt to reduce the complexity of the tax system, or particular taxes within that system, is going to fail if the attempt is confined to a redrafting of the text of the legislation without addressing the fundamental cause of the complexity. The *ITAA 97* exemplifies this failure, and new drafting techniques, such as principles-based drafting, cannot remove what I call 'architectural' or 'structural' complexity. The only way such complexity can be removed is by altering the architecture of the tax. This will involve fundamental change, but that is not a reason for a proposal for such change to be dismissed out of hand. On the contrary, it is a reason to ensure that facilities are provided to enable public discussion and understanding of the change and what it involves, as well as to provide sufficient time for that process to take place. As the *Asprey Report* recognised, structural reforms will inevitably take some years to implement.[71]

Architectural complexity can manifest itself in a variety of forms. For example, distinctions, carve-outs and even exceptions to carve-outs which are designed to give effect to policy can be so dependent on findings of fact that their application or non-application to a prospective transaction is infected with uncertainty from the very outset. Take the distinction between capital and income, which the Asprey Committee recognised as problematic:

> If the Committee's recommendations with regard to the introduction of a capital gains tax were to be adopted, the recurrent disputes between the Revenue and the taxpayer attendant upon the realisation of various forms of property would be diminished in number. The present conflict in the rival contentions, on the one hand, that the profit is a taxable income-profit and, on the other, that the profit is a non-taxable capital profit, should be reduced for the reason that the difference in the amount of tax exigible in any transaction will be considerably less than under the 'all-or-nothing' approach which must result under the legislation in its present form. The problem of distinguishing between capital and income will continue to exist since, with the presence in the system of a capital gains tax, a capital-profit and an income-profit will be brought to tax in ways producing different monetary consequences. That problem is one which has always defied easy solution because the criteria for distinguishing between the

[68] Ibid 88.
[69] Ibid 102.
[70] Ibid.
[71] *Asprey Report*, above n 5, 3 [1.12].

> two types of profit can, according to circumstances, encompass such a wide variety of matters which may be relevant to its determination that no universally infallible touchstone is possible.[72]

In the absence of any legislative guidance as to the distinction between income (revenue) and capital, the courts, over the years, have adopted their own hallmarks of distinction; in this country, at least until recently, hallmarks borrowed from those that had been adopted by the Courts of Chancery in relation to trusts. The late Ross Parsons considered that this was exemplified by the majority decision of the House of Lords in *Commissioners of Inland Revenue v Blott* ('*Blott*').[73] In *Blott*, the House of Lords held that a bonus issue of shares was not income of the shareholder for purposes of income tax. Their Lordships relied on *Bouch v Sproule*,[74] in which it was found that 'in the absence of a different intention evident in the trust instrument, the remainderman was entitled to bonus shares, not the life tenant.'[75] Parsons noted that *Blott* was accepted by Dixon CJ in *Federal Commissioner of Taxation v W E Fuller Pty Ltd* as expressing the 'natural legal meaning' of income.[76] This meaning became, 'in the context of its development in the interpretation of income tax legislation', the 'ordinary usage meaning', although Parsons preferred to call it the 'judicial concept'.[77]

As well as Parsons,[78] other commentators have criticised Australian courts for, among other things, their reliance on the metaphorical language of Pitney J in the United States Supreme Court in *Eisner v Macomber*.[79] In that case, Pitney J likened '[t]he fundamental relation of "capital" to "income"' to the relation between 'the tree or the land' and 'the fruit or the crop'. His Honour characterised capital as 'a reservoir supplied from springs', and income as 'the outlet stream, to be measured by its flow during a period of time.'[80] The criticism of the Australian reliance on *Eisner v Macomber* was best expressed by Rick Krever 20 years ago:

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

72 Ibid 430 [23.73].
73 [1921] AC 171.
74 (1887) 12 App Cas 385.
75 Parsons, above n 60, 82.
76 (1959) 101 CLR 403, 413.
77 Parsons, above n 60, 82.
78 Parsons clearly preferred the economists' notion of 'income' as a base, principally by reference to the work of Henry Simons, which rejected the trust law concept of income built on flows and embraced the element of 'gains'. See Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) 50–1. Simons did concede that no workable scheme which required annual reporting could extend the concept beyond realised gains: at 207.
79 22 US 189 (1920).
80 Ibid 206 (Pitney J for White CJ, McKenna, Devanter, Pitney and McReynolds JJ).

> Court's ruling is carefully dissected and the extracted parts quoted out of context.
>
> It is exactly this course that Australian tax lawyers, judges and scholars followed. Their acts were deeds of misuse and not abuse, resulting from ignorance and inaccuracy rather than malevolence or deceit. The resulting peculiar Australian legacy of *Eisner v Macomber* serves as a useful reminder of the narrow and parochial origins of Australian tax jurisprudence and the slowness of its evolution.[81]

More recently, in *Federal Commissioner of Taxation v Montgomery* ('*Montgomery*'), the High Court has not sought to hide from the fact that Pitney J made it clear that, at least in the United States, 'income' for 'income tax' purposes includes 'profit gained through a sale or conversion of capital assets'[82] — in other words, capital gains as well as income gains. However, in *Montgomery* the majority also made it clear that this was not the position in Australia:

> As was noted in *Federal Commissioner of Taxation v Myer Emporium Ltd*, both the 'ordinary usage meaning' of income and the 'flow' concept of income derived from trust law have been criticised. But both the ordinary usage meaning and the flow concept of income are deeply entrenched in Australian taxation law and it was not suggested by either party that there should be any reconsideration of them. Nor was it suggested that they should be replaced by concepts of gain or realised gain, concepts that some economists consider preferable.[83]

In consequence, the application of the criteria distinguishing between capital and income to the facts of any particular case produces an uncertain outcome. This is exemplified by the decisions of the High Court in *Montgomery*[84] and *Federal Commissioner of Taxation v McNeil*[85] on the income side, and the decisions of the Full Federal Court in *Macquarie Finance Ltd v Federal Commissioner of Taxation*[86] and *St George Bank Ltd v Federal Commissioner of Taxation*[87] on the outgoings side.

When an issue as to the character of a receipt or receivable comes before a court, the Commissioner of Taxation is invariably contending that it is 'income' and the taxpayer is contending that it is not; save where the taxpayer relies on some exemption or other relief (for example, double tax treaty relief), it is implicit in the taxpayer's contentions that the receipt or receivable is 'capital'. There does not appear to be any room for a third category within the area

[81] Rick Krever, 'The Ironic Australian Legacy of *Eisner v Macomber*' (1990) 7 *Australian Tax Forum* 191, 192.

[82] *Federal Commissioner of Taxation v Montgomery* (1999) 198 CLR 639, 662 (Gaudron, Gummow, Kirby and Hayne JJ).

[83] (1999) 198 CLR 639, 662 (Gaudron, Gummow, Kirby and Hayne JJ) (citations omitted).

[84] In this case, the High Court held that a lease incentive paid to a law firm was assessable as ordinary income.

[85] (2007) 229 CLR 656. Here, the Court held that the grant of 'put options', or 'sell-back rights', as part of a share buy-back was assessable as ordinary income.

[86] (2005) 146 FCR 77. The Court held in this case, after considering the benefit obtained by the corporate group to which the taxpayer belonged, that interest paid by the taxpayer on perpetual notes was not deductible.

[87] (2009) 176 FCR 424. In this case, it was held that interest payments made under a debenture by the taxpayer to its subsidiary were capital outgoings, and therefore not allowable deductions.

covered by the two concepts as they have been subsumed into the tax base. In other words, on the income side, they cover the field.

When an issue of the deductibility of an outgoing comes before a court, the Commissioner may contend that it is an outgoing of capital or of a capital nature, and therefore not deductible. In response to such a contention, the taxpayer will contend that it is not, but before that argument is ventilated, the taxpayer must succeed in persuading the court that the outgoing satisfies one of the two limbs of *ITAA 97* s 8-1(1).[88]

It is important to a reading and understanding of the jurisprudence in this area that the differences illustrated in the above two paragraphs be kept in mind.

VI Some Reform Suggestions

In the income tax arena, the capital/income distinction is an architectural complexity which no amount of rewriting or principles-based drafting will remove. My view on the way forward has a number of possible levels. I only propose to mention two. At the highest level, I think the time has come for serious consideration to be given to, and equally serious discussion to take place on, what may presently be perceived as a giant step but which, with the benefit of hindsight, may be seen as consistent with an evolutionary process — namely, the assimilation of all capital gains and losses to gains and losses on revenue account. Obviously, there would have to be design rules developed to accommodate the assimilation, but I have no doubt that the ingenuity and creativity of those charged with the task would ensure they could overcome whatever hurdles are encountered in the assimilation process or under the ensuing regime. It may be thought desirable to stage the assimilation process so that in the first place it is confined to entities, including individuals, carrying on an enterprise or business; it would then be extended, under a subsequent stage, to all taxpayers. The design rules and any staging of the kind suggested would, of necessity, introduce a level of complexity, but that would be insignificant compared to the simplicity and certainty that would flow from the assimilation. The assimilation would also introduce efficiencies in administration and compliance, and ultimately contribute to horizontal equity by broadening the tax base from the hybrid base we have at the present time. With this would come the potential for a consequential lowering of the tax rate.

If assimilation is perceived to be a level too high to aim for, either now or in the future, a first or alternative step would be to embark upon a process whereby the capital/revenue dichotomy, for distinguishing gains on the one hand and outgoings and losses on the other, is written out of our tax legislation, or replaced by a dichotomy far more certain in its application to a prospective transaction. Where that is not appropriate, specific deeming rules as to what and when gains, or outgoings and losses, are on revenue account and what and when gains, or

[88] Section 8-1(1) states that you cannot deduct from your assessable income any loss or outgoing to the extent that: (a) it is incurred in gaining or producing your assessable income; or (b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

outgoings and losses, are on capital account, could be adopted. A replacement dichotomy might be based on the length of time an asset has been held, without regard to whether it was acquired for the purpose of profit-making by the means giving rise to the profit. Deeming provisions provide the potential for even greater flexibility, but at the same time greater certainty, in their application to a prospective transaction.

Other architectural or structural complexities can arise for reasons such as the failure of the legislature to define a fundamental term or phrase. It is then left to the courts to fill the gap on a case-by-case basis — hardly a recipe for certainty. Phrases such as 'presently entitled', 'share of' and 'income of the trust estate' in *ITAA 36* pt III div 6 have cried out for definitional assistance for years, as indeed has the whole structure of div 6, but it has only been in recent times that those cries seem to have been heard.[89]

Changes to the tax system, or to taxes within the system, designed to remove architectural complexity — what I call 'micro changes' — are as important to the tax reform process as changes involving the introduction of a new tax — what I call 'macro changes'. And yet to date, proposals for micro change have not received the focus of attention that proposals for macro changes have. Of course, this has a lot to do with the politicisation of the tax reform debate that I referred to earlier; until recently it has been far easier to sell a new tax in the name of reform by pointing to the failings of the tax it replaces, or by broadcasting the rate reductions it will facilitate in other taxes. But if we allow that process to continue without addressing the architectural and structural complexity that is being built up in the system, we will eventually reach a point where the whole system grinds to a halt.

VII Conclusion

In short, I am strongly of the view that reform must be directed at simplifying the system and the taxes within the system; that is, at removing architectural or structural complexity, even if this involves compromising on the criteria of equity and efficiency. How is this best done? Not by establishing tax reviews every 10 to 15 years because, based on recent experience, that only exacerbates the problem. Perhaps a standing committee could be established, as a forum through which such complexities are identified and articulated with a view to formulating various possible solutions for further consideration and discussion.[90] That would be a start, because at the moment we are not even on the starting line.

89 See, eg, Tax Laws Amendment (2011 Measures No 5) Bill 2011.

90 The UK Office of Tax Simplification, established in July 2010 as an independent Office of the Treasury intended to provide advice about the simplification of the tax system, is an example of such an alternative to periodic tax reviews: see its website at <http://www.hm-treasury.gov.uk/ots>.