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An Examination of the Influence of Inheritance Tax upon Business Succession - Lessons for Germany

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Abstract

Family enterprises form the backbone running right through the economy of nations; therefore the business environment and business succession are subjects which are currently receiving widespread attention in most European countries. In Germany there are about 350,000 enterprises - most of them are family-owned - which will have to carry out business succession during the next five years. One major factor influencing business succession is taxation. Many business successions are completed within the family without financial compensation, so there is a strong connection between business succession and inheritance tax as a major fiscal threat. In Germany over the past years there has been intensive discussion about the liquidity burden created by inheritance tax liability endangering the continuation of family enterprises. The inheritance tax rules for business property under discussion in Germany are somewhat similar to the UK ones. Moreover, the UK legal system is more favourable to business succession than most European countries. Therefore the prospective reform in Germany will be

succession. The research methodology involved an empirical examination of the impact of the inheritance tax on business succession including personal interviews and written questionnaires with UK tax professionals.

1. Inheritance Tax and the Planning of Business Succession

1.1 Background of research question

In the second half of the 20th century economic growth and political stability allowed the accumulation of private and business wealth in Germany. Those assets are now and in the next years to be given to the following generation.[1] Accordingly, business succession will be an important task to be handled. Following recent statistics, about 350,000 companies with approximately 3,400,000 employees in Germany have to be transferred in the next five years.[2] From this point of view, business succession can be seen as a major task for the German economy.[3]

Many factors have an influence on business succession. Management, legal and psychological questions have to be considered, but taxation also plays an important

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[1] See Kohli, M./Künemund, H./Schäfer, A. et al. (2006), p. 58.

[2] See Institut für Mittelstandsforschung (ed.) (2005).

[3] See Spiegelberger, S. (2007), p. 354.

role.[4] The inherent complexity leads to specific challenges for the senior generation as for the successor.[5] The general aim of a business succession – not only from the successor's personal point of view, but also from a German constitutional perspective,[6] is to guarantee the survival of the company and its jobs as well as the economic existence of the successor in the long run.[7] For closely held companies, especially if held by a family, the going concern of the company under family supervision can be an aim itself.[8]

Almost 95% of all companies existing in Germany are managed by families. Each year nearly 71,000 companies are to be transferred,[9] and in the past approximately 44% were succeeded by a relative.[10] Intra-family business succession is generally not on a (100%) for-money-basis, so gift and inheritance taxes have a major influence on structure and timing of business succession. Accordingly, tax optimisation is seen as an important task in the process of planning such kind of succession.[11]

Inheritance tax has to be paid out of the successor's property and thus can lead to an extraordinary reduction of liquidity.[12] As business succession is not normally planned under liquidity aspects, the successor has to liquidate his private property and may even be forced to extract liquidity from the business.[13] This can lead to a lack of liquidity at the company level and may even threaten its going concern.[14] To resolve such problems, the German tax system provides a tax deferral in such cases,[15] but as it is subject to strong restrictions, it is of low importance for the praxis of succession planning.[16] Additionally, these regulations only shift the tax burden in time without abolishing it, so they lead to a mere time effect.[17]

The European Communities see causality between the failure of business succession and the connected tax burden[18] and are regularly confirmed in their opinion by scientific literature.[19] Even as there has not been any empirical proof for this assumption, it can be seen as a major reason for the ongoing discussion of inheritance tax reforms in Germany.[20]

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[4] See Friedrich, K./Steidle, B./Gunzelmann, U. (2006), p. 19.

[5] This can be seen easily by counting the amount of information brochures and practical guidelines of chambers of commerce and professional associations. See e.g. Industrie- und Handelskammer Baden-Württemberg (ed.) (2005); Deutscher Industrie- und Handelskammertag (ed.) (2004); Bundessteuerberaterkammer (ed.) (2007).

[6] See Art. 14 Abs. 2 GG.

[7] See Steuerberaterkammer Stuttgart (ed.) (2006), p. 6.

[8] See Watrin, C. (1997), p. 18.

[9] See Bundesminid(te)ugm6.155 T2ism Tc0 Tw,3 Tc0 T Bun[wS--5.3(a)-52 23r4(nes).4(t)10.24 2258026 T8.46751((2)-mf(.)0.5(5.8

On 11th December 2007, the German government once again published a new version of an inheritance tax reform that still gives space for discussion in several details.[21] An be determined first.[31] In a second step it will be possible to design goal-oriented and long-lasting gift and inheritance tax reform.

There is little knowledge about evaluation of primary empirical data in the field of tax research, especially in Germany. Thus, the research project underlying this paper had two different aims to fulfil:

- The first **aim with regards to the content** of the research is empirical research on decision effects of inheritance tax that will provide causality information between tax principles on one side and intra-family business succession on the other. Based on this, an evaluation of tax reform alternatives is possible. In a further step, political advice for tax legislation are deduced in an "if then"-format for tax legislation.

- The second **aim with regard to method** is an improvement of empirical tax research in Germany, which has been underrepresented in the past. Using different instruments developed by empirical social researchers will give broad information about pros and cons of these methods in tax research.

In this paper, chapter 2 describes the theoretical framework for the research project. The role of the British tax system as a blueprint for the German inheritance tax reform (chapter 3) and the design of the study (chapter 4) are then explained. Chapter 5 contains the results of a first survey and is split up into evidence of the general influence of inheritance tax on business succession decisions on one hand and in analysis of special regulations in the British Inheritance Act on the other. A summary and an appraisal (chapter 6) lead to the additional questions that are worthy of further research (chapter 7).

2. METHODOLOGY

2.1 Foreign tax systems as blueprint for national tax reforms

Using the British inheritance tax system as a blueprint has been suggested several times in the past by the European Commission[35] as well as in literature[36] and was topic of general discussions. [37] The Commission even directly recommended the British model for tax system reorganisations in the EU member states,[38] and as recently as European Autumn 2007 the International Fiscal Association (IFA) discussed the advantages for Germany in learning from Great Britain in the field of taxation of

In empiric socio-economic research, interrogation is seen as the most used and most developed method for data evaluation.[46] Behavioural research in the field of decision effects of taxation can be done solely in this manner, as motives for the taxpayers' decisions have to be evaluated verbally.[47] Despite methodological and practical limitations, interrogations are seen as the single proper method for field research with the aim of determining tax mentalities.[48]

Empirical research is in most cases based on only one or few evaluation instruments and thus can lead to instrument-specific distortions.[49] By the parallel use of several methods, such problems can be avoided or at least be under better control. Additionally, research based on more than one method uses more than one strategy of operationalisation and thus leads to more reliable results. For this reason, empirical research might use written questionnaires as well as oral interviews for data evaluation.

Standardised written or oral interrogations allow a generalised measurement, mostly with the questioned person being the party whose reactions are to be measured. But, in an expert-interrogation, the questioned person has only informational status, informing the interrogator about the person concerned, its characteristics and economic decisions.[50] So expert-interrogation is an indirect method of evaluation and is as far accepted for empiric, socio-economic research.[51] For this research project, it seems to be appropriate because of the following reasons:

(1) High complexity of research topic. Practical experience shows that business decision-makers usually rely on experts for analysis of tax aspects, caused by the high complexity of this legal area.[52] Due to this, experts have a deeper insight into tax effects in detail.

(2) Objectivity of tax advisors. As entrepreneurs are personally affected by tax systems, their judgements will often be influenced by individual settings. To exclude subjectivism, experts can be used as a more neutral source of information.[53]

(3) Status of a multiple. Tax experts usually concentrate on specific areas of advisory and thus have accumulated practical knowledge. As an entrepreneur can give information only about his own decisions, well-experienced experts can answer the research questionnaire based on multi-annual experience in a broad range of situations. Thus, they can be used as multiples in the process of data evaluation.[54]

In the following chapters, experts will be defined as tax advisors that complete advisory work for business successions under the British inheritance tax system.

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[46] See Diekmann, A. (2006), p. 371; Kromrey, H. (2006), p. 358.
[47] See Hüsing, S. (2007), p. 3.
[48] See Hosing, S. (2007), p. 24 f.; as an example for empiric research about "felt" tax burden using written questionnaires see Dietrich, M./Kiesewetter, D./Moosmann (2006).
[49] See Kromrey, H. (2006), p. 535.
[50] See Kromrey, H. (2006), p. 257 ff., p. 391 f.
[51] E.g. see Felden, B. (2007), p. 475 ff.
[52] An empirical survey shows for example that about 78% of the polled Swiss entrepreneurs included their tax advisors and chartered accountants in the process of succession; see PricewaterhouseCoopers (ed.) (2005), p. 28 f.
[53] See Kromrey, H. (2006), p. 107.
[54] An example can be seen at Felden, B. (2007), p. 475 ff.

The results of a first survey described in chapter 5 are based on information of 20 participants. The tax professionals that have been interviewed are divided into three categories of experience (CE). The categorisation has been done particularly with regard to the number of business successions that have been advised (see table 1). The criterion "cases per professional" corresponded largely with the temporal and professional work experience of the participants that has also been requested in the survey.

As illustrated in table 1 the evaluation that is given by all of the participants is based on at least 666 business successions.

TABLE 1: DATABASE OF THE SURVEY

CE	Cases per professional		

Additionally, the written questionnaire was sent out with support of the Society's of

5. RESULTS OF THE SURVEY

5.1 Preliminary remarks

In the following we describe the results of the survey among British tax professionals concerning the general effects of the inheritance tax on business succession as well as effects of specific regulations of the British Inheritance Tax Act.

The figures show the results over all of the three categories of experience and additionally the evaluation of the participants with the most experience (CE 3). One participant represents 5% (over all CE) respectively 7,7% (CE 3). The percentage values in brackets that are mentioned under the figures show the evaluation that has been given by participants with most of experience (CE 3).

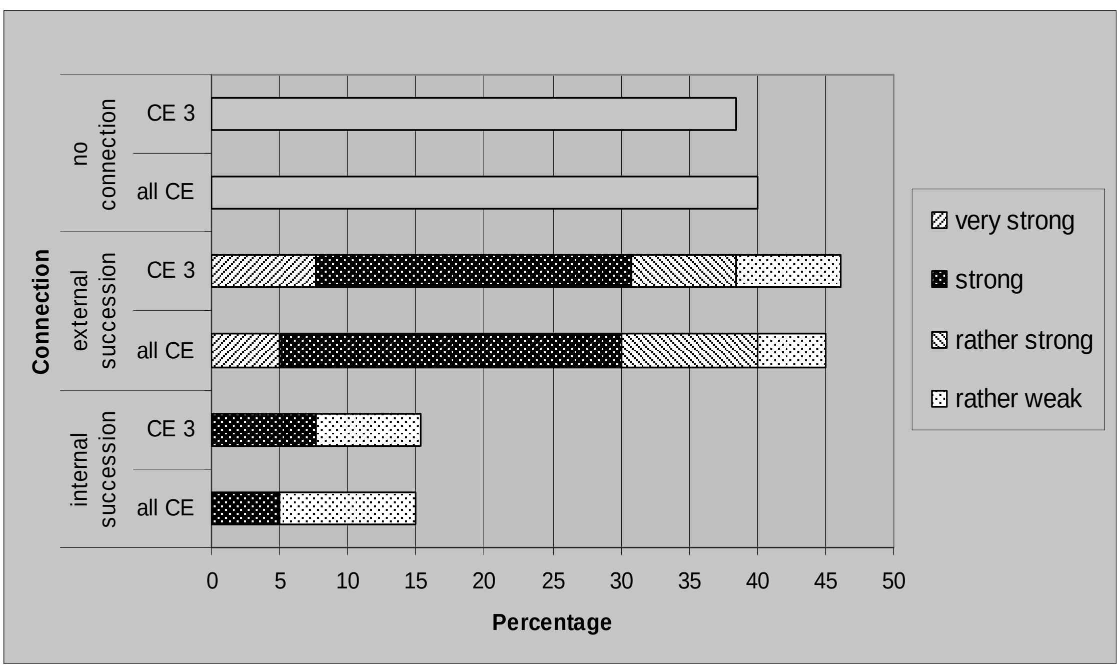
The categories of answers consist of "very strong", "strong", "rather strong", "rather weak", "weak" and "very weak". If one of these categories does not exist in the evaluations, it is not shown in the respective figure.

5.2 General effects of the inheritance tax on business succession

5.2.1 Liquidity burden and way of succession

Figure 2 shows if there is a connection between the liquidity burden due to taxation and whether the business succession occurs within the family (internal succession) or by external succession, typically by selling the enterprise. If there is a connection from experience, the figure illustrates also the strength of this connection.

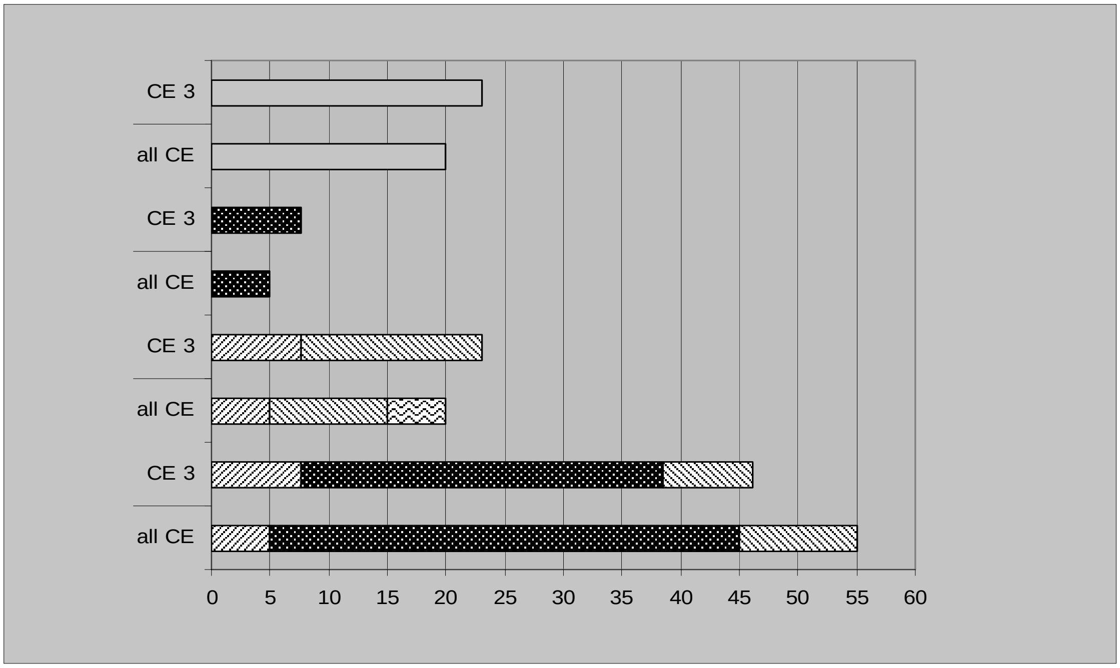
FIGURE 2: LIQUIDITY BURDEN AND WAY OF SUCCESSION



A connection between the liquidity burden due to inheritance tax and the way of succession is confirmed by 60% (61,6%) of the interviewed tax professionals. 45% (46,2%) of them evaluate the connection as "very strong", "strong" and "rather strong", and can be summarised as an overall strong connection.

connection between the level of the tax burden and the volume of the transferred assets and how strong this possible connection is.

FIGURE 4: TAX BURDEN AND VOLUME OF THE TRANSFERRED ASSETS



60% (61,5%) declare that the composition of the assets has the aim of realising the lowest possible tax burden. 20% (30,8%) confirm that the composition is tax driven but follows also economic aspects. No one of the interviewed tax professionals confirms solely economic aspects as relevant for the composition of the transferred assets. According to 20% (7,7%) of the participants there is no influence.

FIGURE 5: TAX BURDEN AND COMPOSITION OF THE TRANSFERRED ASSETS

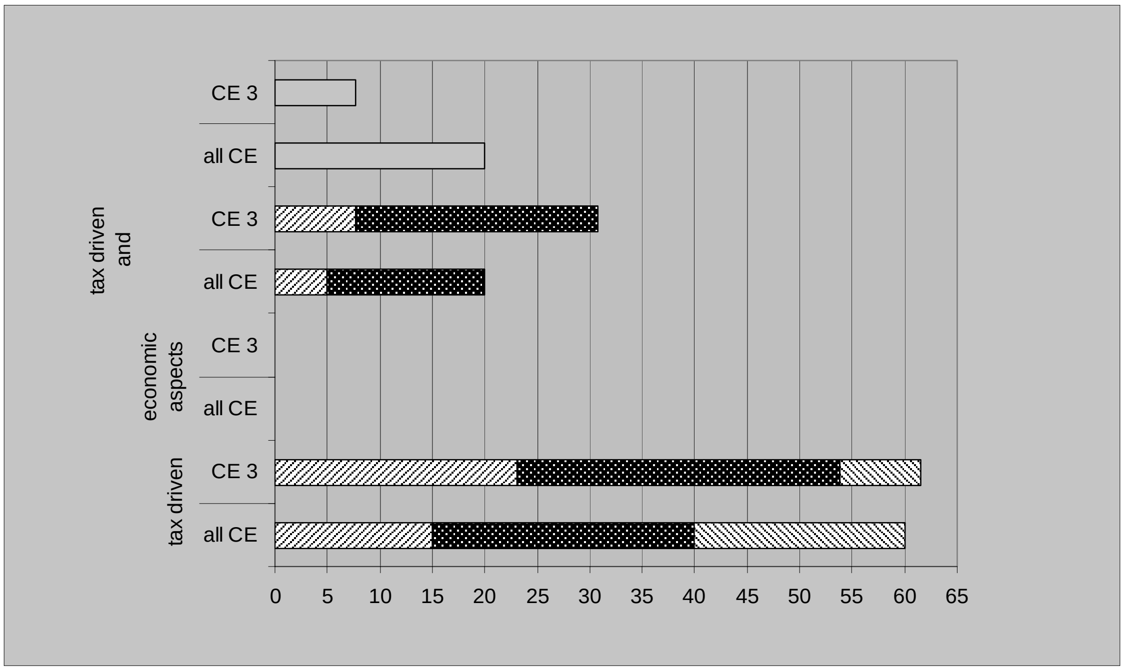
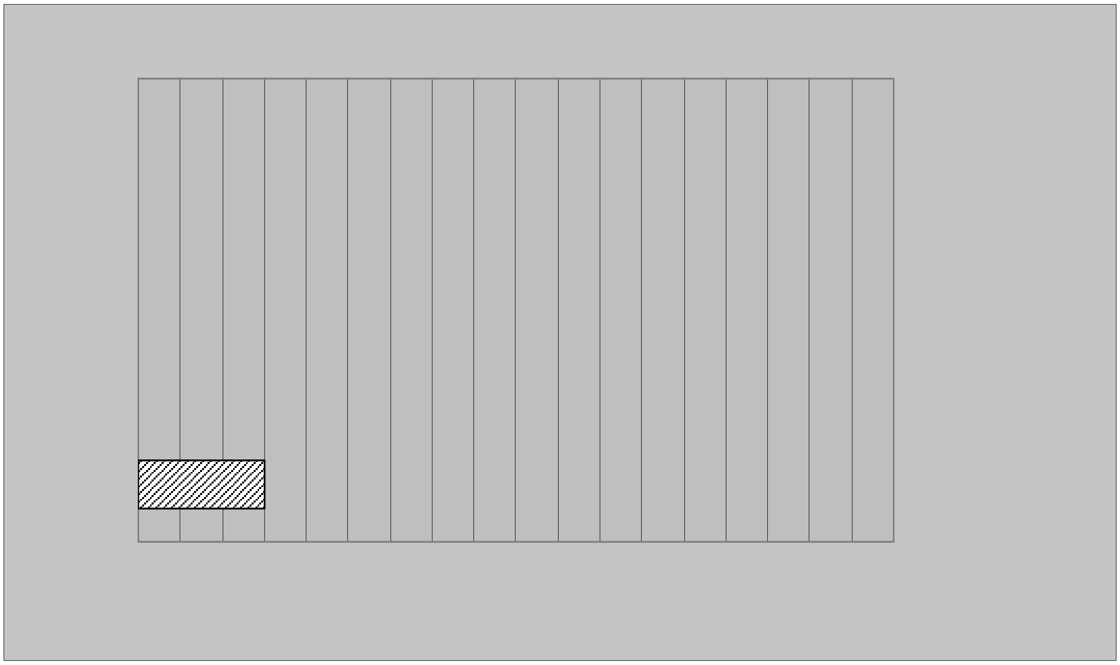


FIGURE 6: TAX BURDEN AND WILLINGNESS TO MOVE ABROAD



5.2.6 Preferential treatment of business property to ensure business succession within the family

Figure 8 shows the personal opinion of the participants concerning the question if the preferential tax treatment on the transfer of business property is necessary to ensure the business succession within the family.

The preferential tax treatment on the transfer of business property to ensure the business succession within the family is confirmed by 90% (100%) of the interviewed tax professionals as a necessary measure. They evaluate the preferential tax treatment as "absolutely necessary", "necessary" or "rather necessary", and can be summarised as necessary overall. Only 10%, (solely participants who are categorised in CE 1 and 2), negate this necessity.

FIGURE 8: NECESSITY OF THE PREFERENTIAL TAX TREATMENT OF BUSINESS PROPERTY

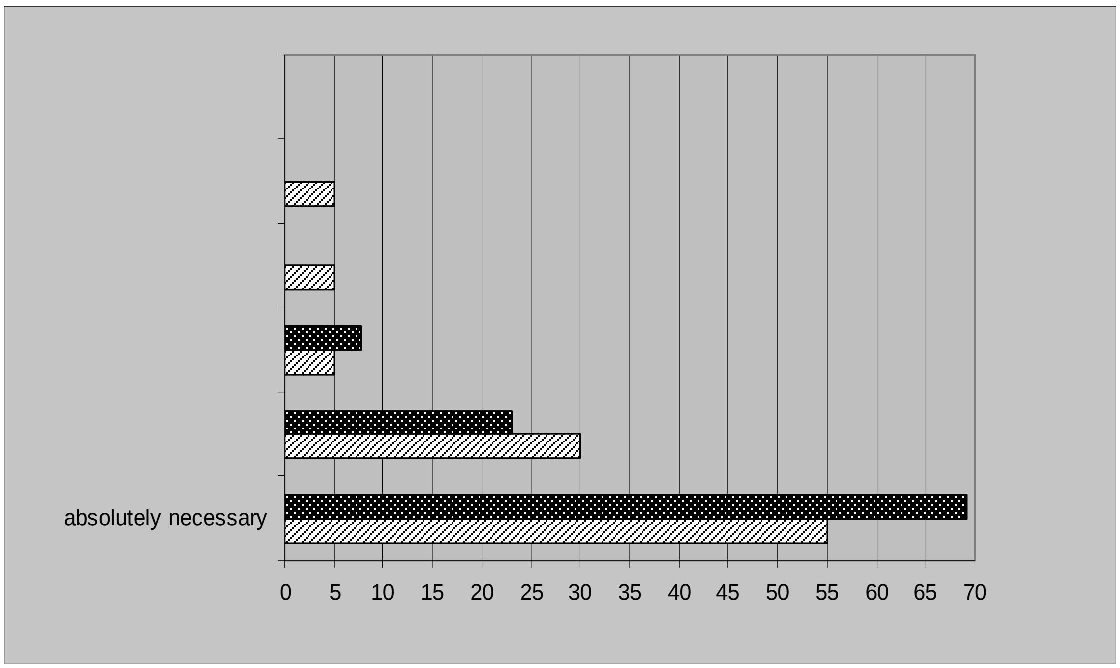


FIGURE 9: REASONS AND IMPORTANCE OF A PREFERENTIAL TAX TREATMENT

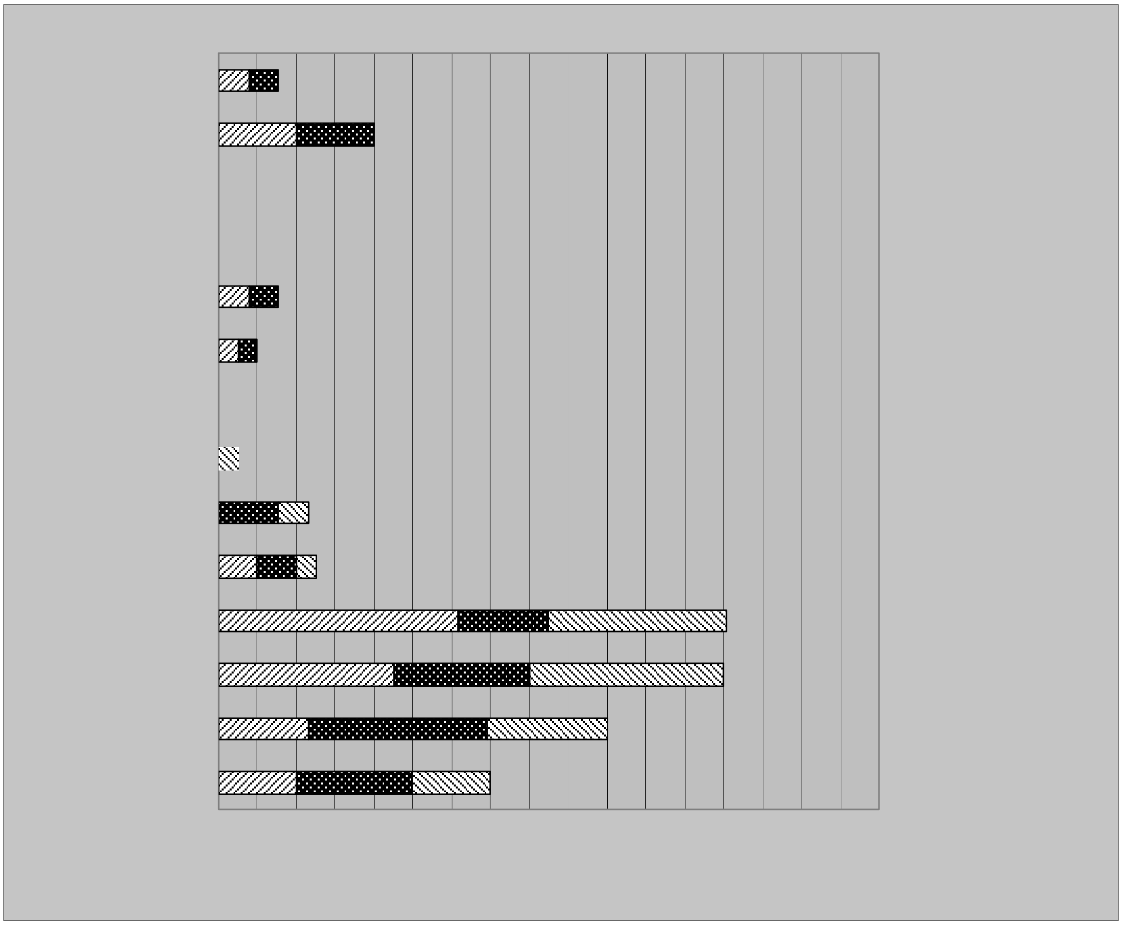


FIGURE 10: CONNECTION BETWEEN PET AND THE TIMING OF A TRANSFER

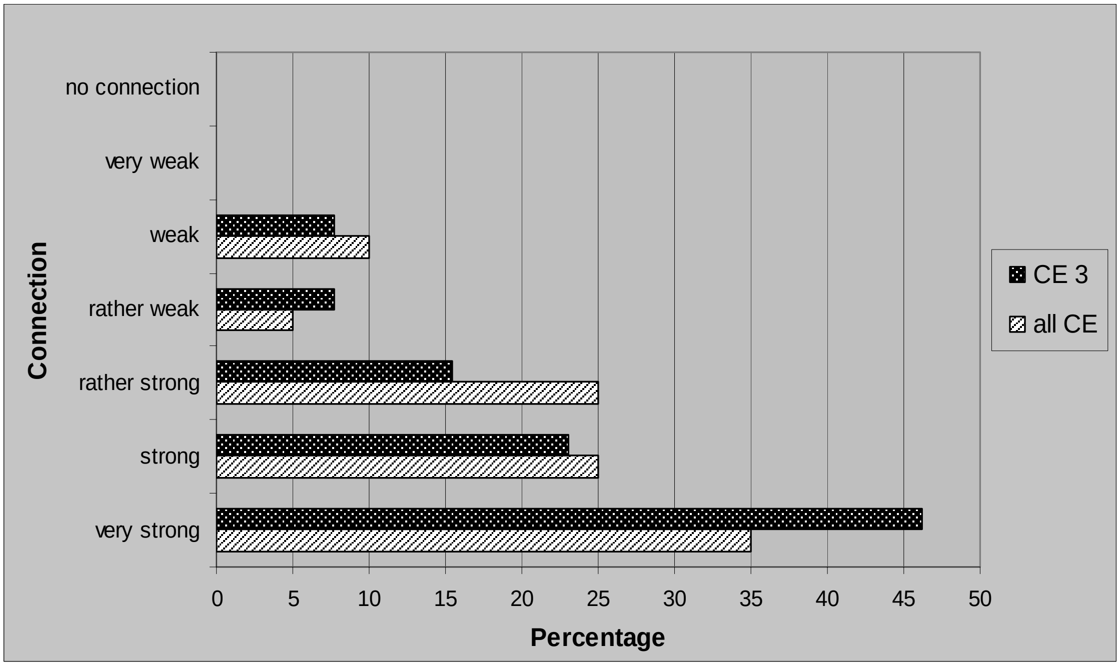
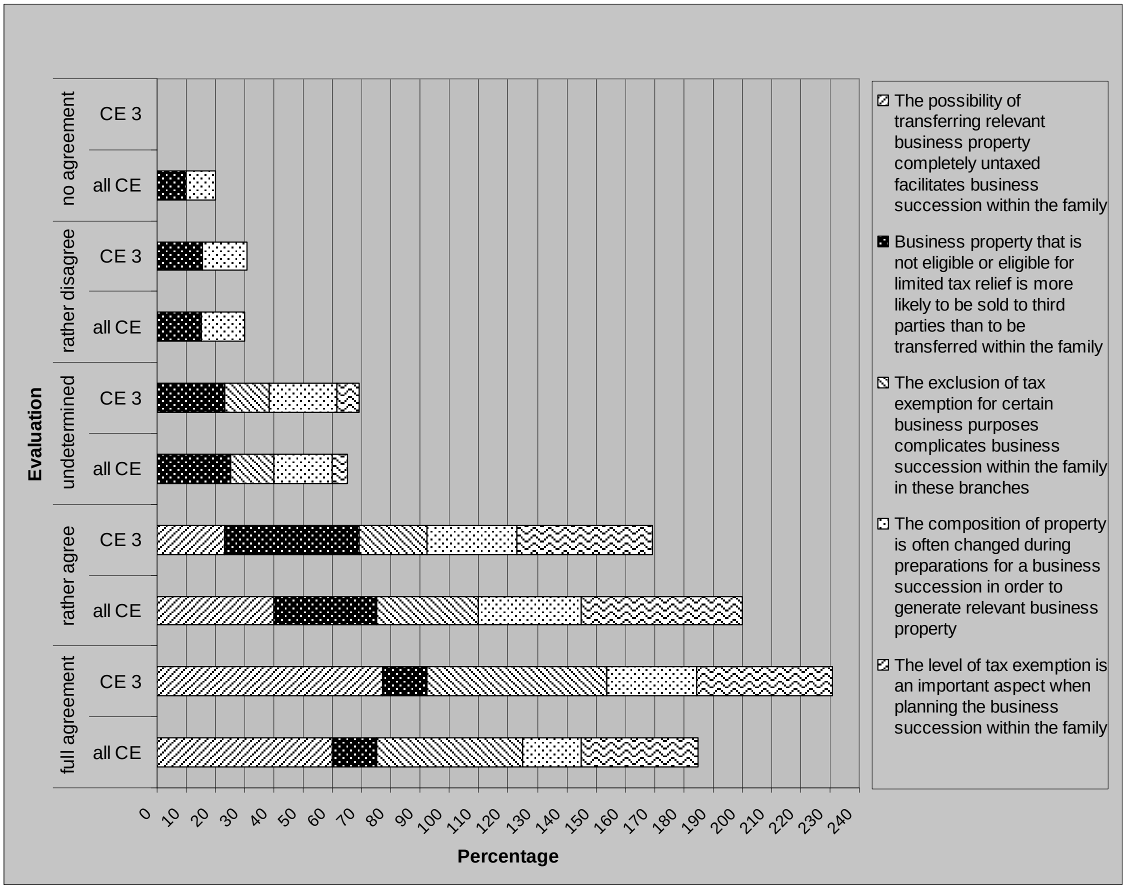


Figure 11 shows 3N.16 7184 N4 57g

FIGURE 13: CONNECTIONS BETWEEN BPR AND BUSINESS SUCCESSION



The statement, "that the possibility of transferring relevant business property completely untaxed facilitates the business succession within the family", is fully or rather agreed by all of the participants.

50% (61,5%) of the respondents fully or rather agreed to the statement, "business property that is not eligible or eligible for limited tax relief is more likely to be sold to third parties than to be transferred within the family". 25% (23,1%) are undetermined and 25% do not agree (15,4%).

85% (84,6%) of the respondents fully or rather agreed that "the exclusion of tax exemption for certain business purposes (dealing in securities, stocks or shares, land or buildings; making or holding investments) is fully or rather seen as complication for business succession within the family in these branches" . 15% (15,4%) were undetermined, but there was no disagreement with the statement.

55% (61,5%) fully or rather agreed with the statement, "that the composition of business property is often changed during preparations for a business succession in order to generate non-taxable or partly taxable property". 20% (23,1%) were undetermined, while 25% (15,4%) did not agree to this statement.

The level of tax exemption was evaluated as an important aspect by 95% (92,3%) of the interviewed tax professionals when planning the business succession within the family. The remaining 5% (7,7%) were undetermined, there was no disagreement.

5.3.3 Level of tax exemption of business property

The following figure shows the influence of the general level of tax exemption on business succession and the strength of this possible influence. “General level” means the division of business property into non-taxable or partially taxable (see BPR) and professionals, this possibility facilitates business succession within the family. 35% (23,1%) were undetermined, while 15% (23,1%) did not agree.

The British preferential tax treatment of busin

5.3.4 Restriction of Potentially Exempt Transfers

When the transfer of business property is treated as PET, the tax exemption (BPR) lapses retroactively if the property is sold within seven years after the transfer and the donor died after the sale and within these seven years. Figure 16 shows the existence and the strength of a possible influence of this restriction to the willingness of a potential successor to assume the business succession.

FIGURE 16: RESTRICTION AND WILLINGNESS TO ASSUME A BUSINESS SUCCESSION

FIGURE 17: INFLUENCE OF THE LOSS OF TAX EXEMPTION TO THE CONTINUATION OF AN ENTERPRISE

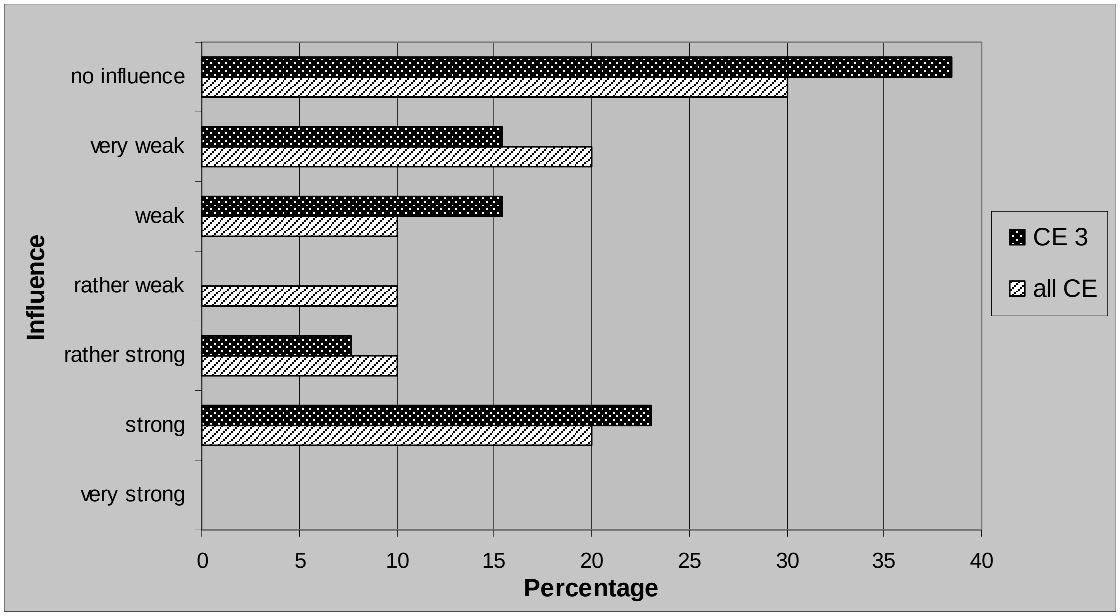


Figure 18 shows the evaluation of predetermined connections between the possible implications mentioned above and business succession. The level of agreement is used as a standard of evaluation.

The statement, that the seven-year restriction period is a reason that a business succession is not assumed by the potential successor, was “rather agreed” by 15% of the respondents (but only participants who are categorised in CE 1 and 2). 15% (7,7%) were undetermined while 70% (92,3%) did not agree.

35% (23,1%) of the participants agreed that the seven-year restriction period limits the successor in his entrepreneurial decisions. 15% (7,7%) were undetermined and 50% (69,2%) did not agree.

The statement, “the seven-year restriction period can result in competitive

5) There is a strong connection between the willingness to move abroad to a country with lower taxes. However, the option to move abroad is rarely used.

6) Preferential tax treatment on the transfer of business property is absolutely necessary to ensure the business succession within the family, particularly to safeguard employment, investment activity, and capital base of the transferred enterprise.

As effects of specific regulations of the British Inheritance Tax Act on business succession it has been identified that:

1) The option of Potentially Exempt Transfers (IHTA 1984 s 3 A; 7 (4)) is an important incentive for the transfer of an enterprise during lifetime with the result that most business successions taking place during lifetime does not create any tax burden.

2) The Business Property Relief (IHTA 1984 s 104; 105) is very important to facilitate business succession within the family.

3) The risk that business property might be considered as non-tax exempt (IHTA 1984 s 112 (2)) hinders the business succession within the family.

4) The differentiation between relevant business property and property without a preferential tax treatment can be difficult.

5) The seven-year restriction period (IHTA 1984 s 113 A) influences neither the willingness to agree to a business succession nor the continuation of the enterprise.

These results are based on information of 20 participants respectively with the experience of at least 666 business successions. On this basis the results of the survey should be understood as first findings that have to be validated by further research. The existing database is currently improved by additional personal and written interviews with British tax professionals. However these first results can be used to investigate the effects of the British inheritance tax system on business succession that are expected during the hypothetical discussion (summarised in table 2) as one theoretical part of our research. The evaluation of the expected effects by using the first results mentioned above is shown in table 2. By using the first results most of the expected effects concerning inheritance tax and business succession can be confirmed.

It could be criticised that most of the expected effects are based on announcements that are perceptive. However to date there is no scientific knowledge concerning empirical effects of the inheritance tax on business succession. Further it has to be distinguished between simple awareness and scientific knowledge.[76]

[76] See Kromrey, H. (2006), S. 17.

6.2 Methodological results

The results discussed in this paper are based on information of tax professionals who have participated in personal interviews.[77] To date the willingness of tax professionals to participate in the survey has been very low. One reason is that tax advisors and solicitors presently have large workloads because the legislator has announced further essential changes of the British tax law. This means that in many cases advisers would have required a form of financial compensation in order to participate in a survey. A further reason is the regional concentration of professionals who are working in the area of business succession consulting; most of them in cities like London, Manchester or Leeds. Other practitioners are often experienced only with private or agricultural property. This concentration of experience concerning business property requires a large amount of travelling to perform the personal interviews which means high travelling costs and a time gap between the8(Othj7 0 TDi0.00dalf5.6(st2i 00da c)u)-0cnc wha.3([(high

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1. INTRODUCTION

The Australian Financial Reporting Council (FRC) announced on 3 July 2002 that Australia would formerly adopt the International Financial Reporting Standards (IFRS) for reporting periods commencing on or after 1 January 2005. The FRC advanced the argument that the adoption of IFRS by Australian companies would facilitate cross-border comparisons by improving comparability and transparency in financial reporting thereby leading to more efficient contracting between various capital market participants, a lower cost of capital and an increased ability to raise finance or list overseas (FRC, 2005). Adoption of the International Financial Reporting Standards (IFRS) in Australia has had a profound impact on the recognition, measurement and disclosure of assets, liabilities, equity and profitability (Jubb, 2005; Jubb, 2006). The Australian Accounting Standards Board issued the Australian equivalents to the International Financial Reporting Standards to incorporate requirements that are specific to Australian entities. The conversion to IFRS has a fundamental impact on a number of important areas of financial reporting income tax consolidation and the thin capitalisation provisions. Consequently, accounting standard setters need to be mindful of the potential Australian income tax implications of IFRS adoption, particularly in the case of large multinational firms that operate between Australia and several other tax jurisdictions. The tax value of assets, liabilities and equity capital under the thin capitalisation rules are determined by reference to accounting standards and compliance of entities with these rules potentially may change as a direct consequence of IFRS adoption itself (Nethercott and Hanlon, 2004). This research will describe and quantify the impact of the introduction of IFRS on compliance with the Australian thin capitalisation provisions.

The Australian thin capitalisation provisions are designed to ensure that Australian and foreign owned multinational entities do not allocate an excessive amount of debt to their Australian operations or investments (Division 820 of the ITAA, 1997). This Division does this by limiting the debt deductions (interest payments and loan fees) an entity can claim against Australian assessable income when debt deductions are in excess of a 'maximum allowable debt' amount (ATO, 2006). These provisions apply to Australian entities and their associate entities investing overseas through an overseas permanent establishment or Australian controlled foreign entity, and foreign entities investing directly in Australia or through foreign controlled Australian entities (ATO, 2005)[1].

The next section outlines the significance of the study and significance of the study. Section 3 covers the research questions and issues while section 4 discusses the research approach. Section 5 provides the results of the empirical analysis while section 6 concludes the study.

2. SIGNIFICANCE OF THE STUDY

This study examines the impact of the Australian equivalents to the International Financial Reporting Standards on the thin capitalisation position of Australian listed companies. The objective of this project is twofold: to determine how and why the key IFRS could impact the thin capitalisation compliance of Australian companies and secondly to quantify these impacts and relate them back to accounting and taxation policy initiatives. Leading up to formal adoption of IFRS in Australia, several parties expressed concern over the impact of IFRS on compliance of Australian entities with the thin capitalisation provisions (The Group of 100, 2006; The Institute of Chartered Accountants in Australia, 2006), but there has been no in-depth research that quantifies the potential impact.

The adoption of IFRS in Australia on 1 January 2005 has the major consequences of impacting on a firm's dividend and franking policy, its thin capitalisation position, application of Australian withholding taxes and income tax consolidation (Leyden and Croft, 2004; Joseph, 2005). The Group of 100 (G100) and The Institute of Chartered Accountants in Australia clearly voice the view that the adoption of IFRS could have unintended negative and inappropriate tax consequences, particularly in respect to the thin capitalisation position of companies. Changes in the recognition and valuation of

[1] Potentially, the thin capitalisation provisions can apply to inward investing entities and outward

a decline in equity for a sample of 1386 Australian listed firms on transition to IFRS relating largely to the recognition of new assets and liabilities, reclassifications and changes in measurement of these balance sheet elements. They concluded that the two most common adjustments to equity are income tax and goodwill with mean total equity declining from $308.72 million under GAAP to $274.55 million under IFRS. The leverage ratio (total liabilities/total assets) increased under IFRS leading to Ahmed and Godwin (2006) suggesting that debt covenants and lending criteria may need to be re-examined in light of these changes.

For some Australian companies, a key concern is that the debt to capital ratio could increase under IFRS to the extent that they exceed the safe harbour debt limit of 75%, particularly if they had debt to capital ratios in the order of 60% to 75% prior to the introduction of IFRS. The safe harbour debt limit is 75% of the average asset value of Australian operations net of non-interest bearing liabilities and investments in associates. The consequence is that debt deductions[2] (e.g. interest payments, loan fees) can be disallowed when that entity's debt used to fund Australian assets exceeds the safe harbour debt amount[3]. Larger multinational companies commonly undertake

institution[6]) Australian companies including the key accounting standards causing the impact?

2. How do these adjustments influence Australian accounting and taxation policy initiatives in relation to thin capitalisation?

4. RESEARCH METHOD

Data was collected from the annual financial reports of 150 top Australian listed companies by market capitalisation (Australian Financial Review, 2007[7]) in the year immediately pre-IFRS adoption and in the year in which companies had to prepare their first full year annual report under IFRS. The top 150 companies were chosen as these are more likely to be subject to the Australian thin capitalisation regime and also are potentially more likely to have their thin capitalisation position change as a direct consequence of IFRS adoption. Determination of whether an entity was subject to the thin capitalisation provisions was made based on segment assets and liabilities and source of borrowings. Finance, ADI and insurance companies were excluded from the sample set as the thin capitalisation calculation fundamentally differs for these entities. Consequently, data was only collected in respect of general, non-financial, non-ADI companies. Companies that did not provide their annual report online for both the immediate pre-IFRS and post-IFRS years were also excluded from the sample set. This resulted in a final sample size of 105 companies.

AASB 1047 *Disclosing the Impacts of Adopting the Australian Equivalents to the International Financial Reporting Standards*[8] requires an entity to restate comparatives and provide reconciliation of GAAP to IFRS (AASB, 2004[f]). These reconciled financial statement notes show the changes in assets, liabilities, equity and profit on transition from GAAP to IFRS. Further AASB 1 *First-Time Adoption of Australian Equivalents to International Financial Reporting Standards* allows an entity to make choices when first applying IFRS which may in turn impact on the thin capitalisation position of a company.

Reconciliation data[9] relating to the most recent balance sheet date where tdat9 e ce

SHDA. An entity subject to the thin capitalisation provisions that has an average debt amount below the safe harbour debt amount of 75% of the average value of Australian assets is in compliance with those provisions. However, negative consequences occur if the average debt amount exceeds the SHDA as interest payments and loan fees may be denied as an allowable deduction against assessable income if that entity is subject

5. RESULTS

Descriptive statistics provided as Table 1 show the mean assets, liabilities, equity, safe harbour debt amount (SHDA) and maximum allowable debt (MAD) for all sample firms under GAAP. The mean MAD is 37.98%. The range in MAD values from 0.00 to 131.00 indicates diversity in quantum of assets, debt and non-debt liabilities and therefore potential compliance with the thin capitalisation provisions. For companies with MAD values in excess of 100%, interest payments and loan fees in excess of that amount could be disallowed as tax deductions. Under GAAP, there are two companies that have exceeded 80% post-IFRS and another three companies with MAD values less than 60% pre-IFRS that have exceeded 60% post-IFRS. These changes are the result of the changes in existing accounting standards and the introduction of new accounting standards on IFRS adoption in Australia.

TABLE 2: AUSTRALIAN COMPANIES' THIN CAPITALISATION POSITION ON TRANSITION TO IFRS ADOPTION

Descriptive statistics of the top Australian listed firms (by market capitalisation) sample firms immediately following IFRS adoption. All data was obtained from reconciliation tables of GAAP-IFRS financial statement

TABLE 4: AUSTRALIAN COMPANIES' IMPACT OF KEY IFRSS ON EQUITY

Impact of IFRSs on Equity (millions)	*AASB 2 Share Based Payments*	*AASB 3 Business Comb-inations*	

Table 5 provides the results of a paired t-test for the 105 sample companies. The introduction of IFRS itself has increased th

Overall, the introduction of the new IFRS rules in Australia does not present a major thin capitalisation compliance risk to listed firms.

Nethercott and Hanlon (2004) highlighted that the introduction of IFRS and convergence of tax and accounting standards in Australia would likely to lead to a reduction in thin capitalisation compliance costs. For those companies whose thin capitalisation position changed significantly as a consequence of IFRS adoption, the government may be required to legislate to remove the change relating to IFRS adoption. However, to modify the existing thin capitalisation provisions relating to a small group of companies may introduce unwarranted complexity into these provisions and associated increased administration costs. The Institute of Chartered Accountants (p. 7) has stipulated that their preferred option would be to allow these impacted companies to "recognise and/or establish their own valuation of certain assets or liabilities for thin capitalisation purposes, where those assets and liabilities would not be recognised or would be given a different value under AIFRS". They further indicate that the IFRS impacts are not necessarily restricted to a limited number of special interest companies and should therefore be available to all companies and other entities on an optional elective basis. New tests relating to valuation and revaluations for thin capitalisation purposes are required based on the results. For instance, the ICAA highlight that internally generated intangibles could be provided with a particular asset value for thin capitalisation purposes even though they may not be recognised as assets in the balance sheet under IFRS. Integrity of valuations and revaluations would also be required. The results of this study indicate that the suggested policy initiatives of the ICAA could be implemented in respect of the small number of companies that do not or are in danger of not complying with the thin capitalisation provisions following the introduction of IFRS. Application of the ICAA policy initiatives would not unduly increase compliance costs or reduce consistency in application of the thin capitalisation rules. An alternative is to extend the existing grandfathering rules (i.e. GAAP) for thin capitalisation purposes as suggested by The G100 although this option was not supported by the ICAA. The findings of this study indicate that an extension of the previous accounting GAAP treatment of financial statement elements specially used to calculate the thin capitalisation position of firms could also be undertaken. These factors need to be considered by relevant stakeholders including the AASB, ATO, Treasury, auditors, lenders and company management.

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Tax Advantages for Bungling Trustees

Monica Bhandari[1]

Abstract
Where property is transferred and the manner in which the transaction is carried out results in an unforeseen or unwanted tax liability, what can be done? For individuals, there are some remedies, but for the main part, where the only error was as to the tax liability, claims cannot be brought to undo the transaction or the tax liability. Trustees on the other hand seem to have an alternative avenue, using the principle in *Hastings-Bass*. This article considers the

This article first considers the *Hastings-Bass* principle, which stems from case law, and the way in which it is evolving as a tool for trustees to escape from transactions where there are unwelcome tax consequences. Then it will explore the extent to which this goes further than the remedies available to individuals. Finally, it will consider for whose benefit the *Hastings-Bass* principle operates and whether there can be any justification for the diff

2. THE *HASTINGS-BASS* PRINCIPLE

Whilst the decision in *Hastings-Bass* itself was made in 1975, the principle has, even recently, been described as “emerging” and “developing”.[9] In fact, the principle in its current form was not even applied in *Hastings-Bass*, rather it is the principle as explained in *Mettoy Pension Trustees v Evans*[10] that is used in later cases.[11] It is interesting to note that *Hastings-Bass* concerned the Revenue seeking to have a transaction set aside but it did not succeed. Yet in the more recent cases, the principle has been used successfully to avoid tax liabilities and so the Revenue contributed to creating the very principle which has come to haunt them.[12]

Re Hastings-Bass[13] related to a tax avoidance scheme. On the death of the beneficiary of the trust, Captain Hastings Bass, his interest was to pass to his son, which would trigger estate duty. In order to minimise this tax charge, in 1958 the trustees of the settlement advanced a fund valued at £50,000 to another trust set up in 1957 by Captain Hastings-Bass’ sister, under which the son had a life interest. This would have the effect of removing the funds from his estate before his death and so they would not be subject to estate duty. The scheme would have been successful were it not for the Revenue’s appeal of *Re: Pilkington's Will Trusts*[14] in relation to the rule against perpetuities. The decision of the House of Lords[15] in that case mean]TJ6.6040.3303ean]TJe.T.2(-B21.63n.0

> (b) had he not failed to take into account considerations which he ought to have taken into account."[17]

This is the quotation which has proved fundamental to the development of the principle.[18] The basis is that where the trustee has acted properly within his power, there is no reason for the court to interfere. The court set out clearly in its summary that unless the provisions of its condition were satisfied, a decision taken by a trustee could not be set aside. However, the quotation has often been described as being in a negative form,[19] and it was in the case of *Mettoy* that it was put in the positive form that:

> "where a trustee acts under a discretion given to him by the terms of the trust, the court will interfere with his action if it is clear that he would not have acted as he did had he not failed to take into account considerations which he ought to have taken into account."[20]

Whilst many commentators and the case law have seen this to be a mere positive form of what was said in *Hastings-Bass* it is submitted that this is in fact a development of the principle. In *Hastings-Bass* the court merely set out when it would not interfere. It certainly did not state that where the conditions were satisfied there was an obligation for the court to step in, nor that the court *should* step in.[21] Thus, *Mettoy* was the first development of and move away from the original statement in *Hastings-Bass*

The will trust and the A&M trusts were treated as one single settlement for CGT purposes. In order to prevent tax from being paid in the UK, the trust had to be non-resident in the UK. In order achieve this, a sufficient number of the trustees had to be non-resident. On setting up the will trust and the A&M trusts, this requirement was satisfied. Some of the trustees were non-resident by virtue of the rule at the time in s69(2) of the Taxation of Chargeable Gains Act 1992 (UK) (TCGA) which set out that if a trustee carried on the business of managing trusts, and was the trustee of a will trust, he was treated as non-resident wherever he actually resided.[39]

whether this is actually a deserving case. As will be seen below, outside the context of a trust, if you regret arranging your affairs in a certain way so as to attract an unwanted tax liability, it is unlikely the affairs can be changed or the transactions enacted set aside. Jonathan Parker J. suggested that if the declaration were effective, the CGT effects would be "catastrophic."[42] Whilst it is true that a substantial tax liability would have ensued, this description of a tax liability on a £35million gain is questionable.[43] What is clear from the application of the *Hastings-Bass* principle in this case is that where an error is made in relation to the tax consequences of a transaction by a trustee, it can be set aside.

5.

consequences of the mistake. Whilst, this distinction is not without its critics,[51] it is still the key test used in the case law.

Second, and more importantly for the current purposes, it has only been in cases where rescission for mistake and rectification are *not* interest in possession and create two new trusts. The shares mentioned previously were transferred into a discretionary trust. Although the shares were eligible for business property relief, which relieves a lifetime charge to IHT on entry into the trust, the shares had to be owned for two years before the transfer to attract the relief.[56] The interest in the shares for IHT purposes only vested in the son when he gained an interest in possession of the trust,[57] which was at the age of 18. The transfer took place when he was 19 and so he had not owned the shares for the requisite period. Thus the transfer into the trust attracted an IHT liability of up to £1.47million. Mann J. suggested that this would be "a very serious loss to the trust estate."[58] Mann J. stated that trustees must consider the tax consequences of their decisions and that failure to do so can trigger the *Hastings-Bass* principle.[59] The trustees had tax consequences in their mind, but they did not give them proper attention.[60]

However, another way of looking at this is way to minimise this charge in future. One option given by the advisers was to transfer the property from the original settlement to Lord Howland, the primary beneficiary, contingent on his being alive on a future date. At that time, Lord Howland would resettle the property in a more flexible trus itself.[76] The transaction itself has ac cases. This is because setting aside the transaction will either alleviate a tax burden on the beneficiary himself or on the trust. If the beneficiary's own tax burden is relieved, the benefit to the beneficiary is easy to see. If the trust is relieved of a tax burden, the beneficiary still benefits because there will be more assets in the trust in which they have an interest.[81] However, whilst on the face of it the beneficiary benefits in these cases, in fact it is the trustee who benefits. This is because in overlooking a relevant consideration, the trustee has generally acted either in breach of trust[82] or negligently. Therefore, usually there is a remedy for the beneficiary against the trustee, which would give them compensation for the lost tax.[83] Therefore, whilst the law gives protection to the beneficiary through other action, the *Hastings-Bass* principle in fact protects the trustee from an action being brought against them. In cases where the trustee has simply not recognised that there is a tax liability, he has not fulfilled his obligation to consider all aspects of the transaction. Where the trustee obtains legal advice but does not follow it, again the trustee has made the error and so the remedy sought should be against the trustee. Where the trustee has obtained legal advice but the advice has been given negligently, then the action should lie against the professional adviser and no one else. As stated by Wu,[84] it is a burden on society to undo the transaction where there are other remedies available.[85]

Hilliard has argued that the trustee is not in fact protected by the principle. One reason he gives is that trustees will be protected by a wealth of exemption clauses in the trust documents and so it will be very difficult for beneficiaries to pursue them.[86] However, as Wu points out[87] this is an issue better dealt with by considering the rules relating to exemption clauses. If exemption clauses are available in such a wide range of situations that beneficiaries have no protection as against trustees, perhaps the rules for exemption clauses need to be reconsidered – this is not a reason to provide another legal remedy depriving a different person.[88] On the other hand, if there is a sound basis for the exemption clause rules then the trustees receive protection for sound reasons and the beneficiary should have no claim. The settlor has granted the right to the trustee to be protected against such claims from the beneficiary. Equally, the settlor acknowledges that if the trustee acts in a manner which is outside the bounds of his duty, the beneficiary will receive no protection. Thus, if exemption clauses protect the trustee from liability, the beneficiary has no remedy and this is the extent of the right the settlor has given the beneficiary and which the law allows. No further remedy need be available to protect the beneficiary, yet the *Hastings-Bass* principle means that the

[81] cf. *NSPCC*, above, fn.24 where the undoing the transaction would result in the removal of a gift to a charity but this was not contested by the charity and nor was it by the Attorney General on behalf of the charity, who was invited to make representations in the case.

[82] In *Barr*, above, fn.24, it was said that the *Hastings-Bass* principle could only be used where there was a breach of trust in place. However later cases have said such a limitation is not necessary, e.g. *Sieff*, above, fn.9, although it is usually present. See also R. Nolan and M. Conaglen "Trustee (in)discretion" [2006] CLJ 15 at pp.16-17; M Thomas and B Dowrick "The Odd Couple? *Hastings Bass* and mistake" [2006] Conveyancer and Property Lawyer 91 at p.95.

[83] See I. Ferrier "When trustees err" [2002] Conveyancer and Property Lawyer 199 at p.200 who argues the *Hastings-Bass* principle needs revisiting by the House of Lords, for policy reasons.

[84] Above, fn.75 at p.76.

[85] See also I. Dawson "The effect of an unthinking trustees' action" [2002] Conveyancer and Property Lawyer 67at pp.71-72; R. Nolan and M. Conaglen "*Hastings-Bass* and third parties" [2006] CLJ 499; *Donaldson v Smith* [2006] EWHC 1290 (Ch).

[86] See Hilliard, above, fn.51 at p. 212. See also *Breadner*, above, fn.9 at [57].

[87] Wu, above, fn.75 at pp.69-70 and fn.45.

[88] In the current discussion, that is the Revenue.

burden of the trustee's error moves to th

8. DIFFERENCE IN TREATMENT BETWEEN AN INDIVIDUAL AND A TRUSTEE

It is clear that trustees are protected from tax errors in a way that individuals are not protected. Furthermore, a professional adviser giving advice to a trustee has more protection than one advising an individual because if they give negligent advice, in the former case the transaction can be overturned, but in the latter case a negligence claim may be possible.[97] The question is then whether there is any justification for this beneficial treatment of trustees. One possible reason why this issue has not been explored in detail in the past (alongside other issues stemming from the *Hastings-Bass* case) could be that it is mainly trust lawyers who have contributed to the discussion in this area, whose whole concern is the relationship between the trustee and beneficiary. From a tax point of view, on the other hand, equity as between taxpayers is a cornerstone of tax policy which should be maintained.[98] This is a very different aim and when considered, a serious unfairness can be seen.

In *Sieff v Fox* Lloyd L.J. recognised the difference in treatment between individuals and trustees[99] and said that such a difference was justified for two reasons: first trusts in order to avoid tax.[102] In this context the parties have chosen a more struck down,[108] the courts are wary of tax avoidance and recognise the need to separate transactions with a true commercial nature from those with the sole aim of avoiding tax.[109] Here we see a contrast with the approach in the *Hastings-Bass* cases, where the courts turn a blind eye to the fact that the transaction is related to tax avoidance and allowed trustees to escape from the tax consequences flowing from a tax avoidance scheme which has been improperly implemented. This is in particular contrast to the tax avoidance cases where the transaction entered into is extremely artificial.[110] In fact, had the Revenue participated in such cases it would be surprising if it did not try to prevent the transaction from being set aside on the basis of tax avoidance. If courts can ignore artificial transactions where they have a tax avoidance purpose, then there is no reason to set aside a transaction which does not achieve its avoidance purpose. This is because, even if the transaction were put in place in the proper manner, the courts would be able to see through the transaction.

The courts need not strike down every tax avoidance scheme, but there is a vast difference between this and aiding taxpayers in their desire to escape tax by helping them to set aside the unwanted consequences of the transaction. Even though tax than the trustee would have to pay,[112] although it is unlikely that the trustees would seek to have the transaction set aside in these circumstances. In *Hastings-Bass* itself, the court pointed out that the income tax consequences of setting the transaction aside would be difficult, as the previous income tax and CGT consequences would have been different if the transaction were not effective.[113] The point is that there are many tax issues to consider even when setting aside just one transaction, particularly after some considerable time period has elapsed. Whilst this is not a strong reason to deny the relief on its own, this is of course a factor and added to the more forceful arguments, provides an extra incentive to deny a remedy where the issue pertains to tax consequences.

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

Nicole Wilson-Rogers[*] and Dale Pinto[**]

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

Abstract
In the 2008 Australian Federal Budget, Treasurer Wayne Swan announced a comprehensive ‘root and branch’ review of the Australian tax system to help create the foundation for Australia’s future tax system. This Review is now underway. This article argues that a pivotal part of the review is clarifying and outlining ***how***

%20Australia's%20Future%20tax%20System.pdf at 15 July 2008.
[2] Ibid.

not impossible, to satisfy all of these criteria simultaneously. Thus, while previous reviews such as Asprey (1975), the Tax Summit (1985) and the Review of Business Taxation (1999) have all made significant contributions to tax reform in Australia, arguably none of these reviews has managed

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

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

1. Defining the Criteria for Assessing what is an Effective Tax

1.1 Defining the Criteria

The Consultation Paper outlines several design principles that submissions have identified which can be used to critique the "effectivene

> that the law which it has made is not a law with respect to taxation… (emphasis added)[14]

In utilising these principles as potential measures against which to base an evaluation, one of the initial and fundamental difficulties faced by the AFTS Review is to clearly define what is meant by each of the criteria. A review of the literature in this area illustrates that the definitions attributed to these criteria can differ significantly and a discussion of these definitions is therefore instructive and will be undertaken later in the article.[15]

1.2 Equity

Uncontroversially, most would agree that a tax should be equitable. A tax that is perceived as fair or equitable should promote voluntary compliance.[16] In this regard, Allan states:

> It is clearly a desired characteristic of taxes that they be fair. Apart from the ethical desirability of equity, there is the practical need for taxes to be acceptable to the tax-paying public. If taxes are generally believed to be inequitable the consequences may range from widespread evasion to revolution.'[17]

The Consultation Paper recognises that whilst equity is an important design principle for the review of a tax there is: 'no consensus about exactly what equity is or how to measure it.'[18] The Consultation Paper discusses various perspectives on equity as advanced in the submissions including:

- That: 'all individuals should have the opportunity to participate in society and achieve the things that they value';[19]
- That those with greater economic means should pay more (vertical equity). It is noted however that there is little agreement about how economic means should be measured and what degree of progressivity in a tax system is appropriate;
-

It is suggested that for the purposes of the AFTS Review equity should be defined as encompassing a reference to horizontal, administrative, vertical and inter-nation equity. However, further work on refining the meaning to be attributed to equity should be undertaken by the Review in establishing the evaluation framework.

Horizontal equity is said to occur when people in the same situation are treated in the same manner by the tax. For example, people with the same income should be taxed the same amount. Allan states:

> …horizontal equity, describes the equal treatment of equal people. This principle is unchallengeable as an ideal and is not impracticable of operation. People of equal incomes, for example, might be required to pay the same income taxes. All people who smoke twenty cigarettes per day would be required to pay the same in specific tobacco taxes.[20]

Another attribute of horizontal equity is that the tax should apply equivalent treatment to transactions that achieve the same economic result. That is the tax should not apply differently to two transactions that although different in form (e.g. conducted through a company or trust) are economically equivalent.

Vertical equity refers to the proposition that people in different situations should be taxed differently. Thus, the concept of vertical equity requires a progressive tax system where those in a better position or

- *Sex Discrimination Act 1984.*

In conclusion on this point it is recognised that it can be problematic determining what is "fair" or equitable and that further detailed work is required in refining the definition of equity. The Asprey Report recognised these difficulties when it stated that that equity is: 'an ideal exceedingly difficult to determine and harder still to measure.'[21] The difficulty lies in determining the basis on which individuals should be compared. For example, when defining horizontal equity when will two taxpayers be in the same position? Should a comparison for the purposes of horizontal equity be undertaken on an individual or family unit basis? It is generally accepted that the "income" of the individual is a relevant measure to use for comparative purposes. However, there is some debate as to whether income should be th.7729 09(mpare2di)-7.5(y)-15.79uor co

> Complexity and simplicity…are concepts lacking simple definitions. It may be anecdotally convenient, and not unduly misleading, to equate complexity to some index of the growth in volume of tax legislation ... Nevertheless, it is clear that short provisions of legislation may not be simple and long provisions may not be simple and long provisions may not be complex.[31]

1.5 Sustainability

The Review suggests that sustainability can be viewed from three perspectives: environmental, institutional and fiscal sustainability.

Environmental sustainability demands that a taxation reform measure should be compatible with environmental policies. The Report states that:

> An important theme in submissions from environmental groups is that, given its central importance to economic decision making, the tax transfer system needs to be consistent with achieving sustainable economic growth...
>
> Many submissions argue that tax transfer setting should be consistent with the objective of

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

The attainment of certainty, used for the purposes of this article, alters the traditional definition of certainty. The traditional definition (as outlined by Smith above) requires that the taxpayer is able to apply the tax law with certainty. In this article, it will be assumed that, certainty will be obtained where the taxpayer or ***their adviser*** is able to there are difficulties also for taxpayers and their advisors and the potential for disputation increases.[42]

2. RELATIONSHIPS BETWEEN THE CRITERIA

A tax or tax reform measure that exhibited all of the above attributes could only be achievable in 'Fiscal Utopia', as many of the criteria discussed above are conflicting or mutually exclusive. The corollary of this is that trade offs between the attainment of individual criterion are inevitable. Accordingly, part three of this article discusses the priorities to be assigned to the eht 5(.3(neaSt)78of)]TJ-11 6.c-11tscul-6.68.0. e6.8(of)7TT (of)7T1

A certain tax measure should not contain broad discretions. Broad discretions may compromise equity by vesting in the administrator the discretion to determine the treatment of individual taxpayers

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

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

2.8 Efficiency and Policy Consistency

Efficiency and Policy Consistency have a largely complementary relationship.

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

To ensure environmental sustainability a revenue act may need to embrace non-

> These two ideals 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 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 interests of equity or 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.[59]

Furthermore, another complementary aspect of the relationship with simplicity involves the use of discretions. Broad discretions are the antithesis of the Rule of Law. Thee 0a192h5.8(disceT2o)7.(Th)8.8dTJT*-vetdsdsnToataally compel a taay

from 1986/1987 in relation to income tax. Under this system the onus is upon the taxpayer to calculate their tax liability. The ATO will usually accept the tax return upon lodgement; however, they retain specific rights of amendment for errors of calculation and mistakes of fact or law.[63] The self assessment system is supported by a rigorous penalty regime imposed on taxpayers for errors and non-compliance. Indeed, this system places an onerous burden on taxpayers to digest and apply accurately the voluminous and complicated body of income tax legislation apparent in Australia. As Dirkis and Payne Mulcahy observed:

> The introduction of self assessment fundamentally altered the balance of power and focus of responsibilities between taxpayers and the Australian Taxation Office. It has also impacted dramatically on the triangular relationship between the ATO, taxpayers and their tax advisers creating an often fractious relationship.[64]

> Ministers when formulating policy, should at all times be asking themselves and asking parliamentary counsel 'Is this concept too refined to be expressed in basic English? If so, is there some way in which we can modify the policy so it can be expressed?[67]

Uncertainty will inevitably flow through to the drafting stage and will make it

3.2.2 Equity

The importance of the policy underlying a tax being equitable cannot be overstated. Equity is pivotal because it encourages the perception of fairness by taxpayers, which supports voluntary compliance with the taxation law.[74] The Review of Business Taxation states: 'Multifaceted though it is, no acceptable system of taxation can proceed without due weight being given to equity considerations — the history of democracy has many object lessons in that regard.'[75] Furthermore, in order to achieve the AFTS Review's aim of enhancing international competitiveness any taxation policy should maintain inter-nation equity, by ensuring Australia is only claiming its share of profits from multinational entities.

3.2.3 Efficiency

In order to maximise the revenue raised by the government, a tax should not impede economic growth.[76] A tax which adversely effects economic growth by unintentionally distorting economic activity will diminish the revenue base as a whole. Therefore, in critiquing a tax or tax reform measure, one must determine: will the tax protect or raise revenue or will it have unintended economic effects that will impede economic growth and, therefore, diminish the revenue base?

Where a tax is not neutral the unintended economic distortions may compromise the

3.2.5 Policy Consistency

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

3.2.6 Summary of the Criteria Relevant for Evaluating Taxation Policy

It is important, at the policy stage, that a taxation measure adheres to the requirements of the Rule of Law and is equitable, efficient, has policy consistency and is sustainable. Whilst there may not necessarily be a trade off between these criteria for certain taxation measures, if trade offs do occur it is suggested that priority should be given to the design principles of adherence to the Rule of Law, equity, efficiency and sustainability. As a subsidiary goal it is desirable that the taxation policy should be policy consistent. Policy consistency is made a subsidiary goal as sometimes trying to utilise the tax system to pursue non-revenue raising goals and achieve external policy consistency, can jeopardise the efficiency and certainty of the Act and given the primacy of these goals (as discussed above) arguably this criteria should be given a subsidiary ranking.

FIGURE 2: STAGE ONE - POLICY

3.3 Stage Two – Evaluating Drafting

The second stage of the evaluation framework, critiques the legislative words or the "drafting" of a taxation measure. When critiquing drafting, the Rule of Law, equity and simplicity should be considered.[77]

3.3.1 Rule of Law

There is mixed opinion on the importance of the Rule of Law in the context of the self assessment system. Professor Cooper observed:

> …the Rule of Law might be a value that should be given absolute primacy in cases where the curtailment of personal freedoms or the expropriation of property without some attempts at lawful justification is threatened. But might be appropriate to modify or

[77] Note the composition of these can also differ. See for example the differing formulations of what constitutes a good tax by Adam Smith and Joseph Stiglitz.

In more recent times, however, the judiciary has been more amenable to give effect to legislation by interpreting it in a purposive manner.[81]

In short, simplicity is not always desirable or possible. In some cases simplicity may

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

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

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

It is also imperative that the tax has been administered in a manner to minimise compliance costs and so that economic activity is impacted as little as possible. This will involve a consideration of many of the factors listed under 3.4.1 in deciding whether the ATO acted in a transparent and timely manner or whether there has there been a considerable delay in providing advice to taxpayers. One particularly important aspect of efficient administration is the timeliness in which the ATO provides private rulings. Report 410 comments on the pivotal role that rulings play in the self-assessment system. Therefore an assessment on how quickly private rulings that concern the operation of a particular taxation measure have been issued will be relevant in determining administrative efficiency.

3.4.4 Criteria Relevant for critiquing the administration of a taxation measure at Stage Three

Under stage three, it is very important that a tax is able to be administered equitably, in compliance with the Rule of Law. The goal of administrative simplicity is of secondary importance. This is because, arguably, administrative costs are already minimised significantly under a self assessment system and, therefore, it is more important in such a system to pursue the goals of certainty and equity. However, where the tax is certain it is likely to also be capable of being administered cost effectively and therefore, where certainty is pursued it is likely that administrative costs will be minimised.

FIGURE 4: STAGE 3 - ADMINISTRATION

4. CONCLUSIONS

In order for the AFTS Review to be effective, this article has argued a comprehensive and more appropriate evaluative framework for the review of Australia's existing taxes than currently exists must be constructed. The Review Panel needs to be transparent in defining the criteria it will use in its evaluation for the AFTS Review, detail the priorities given to each of these objectives and the structure of the framework that it plans to use. This article advocates a three staged evaluation framework and suggests an essential/desirable ranking that should be attributed to these criteria.

The first stage evaluates the policy underlying the tax. At this stage, five criteria are relevant. The policy of the tax should comply with the Rule of Law, be equitable, efficient, and sustainable and it is also desirable that it is policy consistent.

The second stage evaluates the drafting of the tax. Three criteria are used to evaluate drafting and should be given the following ranking. It is crucial that the tax does not detract from the Rule of Law and is equitable. Optimally the tax will also be simple. However, in some circumstances simplicity will conflict with equity and the Rule of Law and to the extent of any conflict this criteria should be treated as a merely desirable, subsidiary criterion.

The final stage critiques the ability of the tax to be administered effectively. Four criteria are relevant at this stage and should be assigned the following ranking. At this stage (as at the policy level) it is most important that the tax can be administered in a certain, efficient and equitable manner. It is also desirable that the administrative costs of the tax acrite(at th)Tc0.1796ipp ia.2(a)2et tative(ia)5x o(ed)li circu.9(licy)-1w[(Th)6ao-6.4(h)017.563

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

It is accepted that further work could usefully be undertaken on the suggested integrated evaluation framework put forward in this article. For example, significant

APPENDIX 1: STRUCTURE OF THE PROPOSED THREE STAGE EVALUATION FRAMEWORK

APPENDIX 2: REPORT CARD FORMAT FOR THE INTEGRATED EVALUATION FRAMEWORK

Stage One – Policy	
Criteria	Relevant Considerations