

eJournal of Tax Research

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eJournal of Tax Research

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The Effect of the Human Rights Act 1998 on Taxation Policy and Administration

Natalie Lee*

Abstract

In her paper, Natalie Lee considers the implications for UK taxation of the European Convention for the Protection of Human Rights and Fundamental Freedoms, incorporated into UK law by the Human Rights Act 1998. The paper reviews the history of the Convention and the context in which it was framed. It examines what its effect on taxation has been thus far and it goes on to speculate as to its likely future impact, specifically in the context of the UK taxpayer. It concludes that although European Community law has applied in the UK for over thirty years it, and its implications, are only now coming to be understood. It is clear that taxpayers are perfectly prepared to mount an attack on the application of a tax law on grounds of breach of rights under the Convention and this will have implications for tax administration in future. The paper considers the likelihood of success of such challenges and notes that taxpayers mounting such challenges have, to date, had less success than citizens mounting challenges to more serious and fundamental infringements. This may continue to be the case in future, and indeed such an outcome may be justifiable in light of the need to balance "...the interests of the whole community and the protection of individual fundamental rights".

INTRODUCTION

In October 2000, the Human Rights Act 1998 incorporated into the law of the United Kingdom the European Convention on Human Rights. The European Convention for the Protection of Human Rights and Fundamental Freedoms (to give it its full title) is a treaty of the Council of Europe. The Council of Europe was itself established on May 5, 1949 by ten founding western European states,¹ with thirteen others joining a short while after. Since the dismantling of Communism, a number of eastern and central European states have been admitted, bringing the Council's current membership to some forty-five.² The Council has generated over 150 international agreements, treaties and conventions, replacing numerous bilateral treaties between European states. Among the most important of its agreements is the European Convention on Human Rights (the Convention) which first saw the light of day in Rome in 1950. The Council, which comprises a Committee of Ministers³ and a Parliamentary Assembly, also established the European Commission of Human Rights⁴ and the European Court of Human Rights, both in Strasbourg, to which people from countries that had signed up to the Convention could take their complaints and have them judicially determined.

The Council of Europe was really the first step along the road to a type of federated Europe, culminating in 1958 in the formation of the European Economic Community. But the Council was borne of motives other than just economic ones. The idea of

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¹ Including the UK and France.

² As of January 2004, 44 of those 45 states have ratified the Convention.

³ A separate body from the Council of Ministers of the European Union.

⁴ Abolished in November 1998.

uniting Europe, which had been promoted from the 1920s onwards, was revived at the onset of the Second World War. Indeed, in 1939, Clement Attlee, then leader of the British Labour Party, declared, “Europe must federate or perish.”⁵

That the Council of Europe and the Convention were both aimed at securing the most fundamental of values can be concluded from surrounding circumstances, the Preamble to the Convention itself and modern-day pronouncements. Thus, the Council was established, and the Convention came into being, four and five years respectively after the end of the Second World War, and one and two years respectively after the adoption and proclamation by the General Assembly of the United Nations of the Universal Declaration of Human Rights⁶. The Preamble to the Convention specifically reaffirms the “profound belief” of the members of the Council “in those fundamental freedoms which are the foundation of justice and peace in the world” The first four of the Convention rights and freedoms are the right to life, the prohibition of torture, the prohibition of slavery and forced labour and the right to liberty and security. More recently, it was said:

The Europe we foresee in our Presidency priorities is one which is anchored in the values of the Council of Europe and the European Convention on Human Rights. ... We will give a focus to issues such as fair wages, good job opportunities, civil and political rights, greater security and better co-operation between Governments in Europe and beyond.⁷

The aim of this paper is to determine the effect to date of, and any likely future impact from, the incorporation of Convention rights into UK law by the Human Rights Act 1998 (HRA) on the formation of tax policy and tax administration. This will, however, necessitate the consideration of three preliminary issues. First, since UK citizens have enjoyed the right to take a case to Strasbourg since 1953⁸ and, more recently, the protection by the common law through judicial review against interference with a fundamental right through the exercise by a public body of a very wide discretion conferred by statute,⁹ why should the HRA make any significant difference? Secondly, what are the main principles of the HRA? Finally, given the fundamental values behind both the Council of Europe and the Convention, what have the Convention and the HRA to do with taxation at all?

COMPARING RIGHTS BEFORE AND AFTER INCORPORATION

The effect of the Convention is to guarantee a number of basic human rights by allowing an individual to complain about the behaviour of his own government.¹⁰

⁵ In a speech, later circulated in pamphlet form, on November 8, 1939 that sought to define the Labour Party’s war objectives, in Cole, GDH, *A History of the Labour Party from 1914* (Routledge & Kegan Paul Ltd, London 1948) at p 379.

⁶ On 10 December 1948.

⁷ Dick Roche, Irish Minister of State for European Affairs in a presentation to the Committee of Ministers of the Council of Europe of the priorities of the Irish Presidency of the European Union, January 2004.

⁸ Although the UK was the first state to ratify the Convention in 1951, it only came into force in 1953.

⁹ See, for example, *R v Ministry of Defence, ex p. Smith* [1996] QB 517; *R v Secretary of State for the Home Department, ex p. McQuillan* [1995] 4 All ER 400.

¹⁰ Before the adoption of the Convention in 1953 by the UK, individuals enjoyed few opportunities to assert rights under international law.

Prior to October 2000,¹¹ any person within the jurisdiction of the UK could submit a petition to the European Commission of Human Rights if they felt aggrieved about the effect of an existing law or an action of the executive, provided that they had exhausted all the possible means of challenge within the UK system. If a friendly settlement between the Commission and the applicant could not be secured, then the Commission would send to the Committee of Ministers of the Council of Europe a report, including its opinion on whether or not there had been a violation of a Convention right. The Committee itself could make a decision, thereby concluding the matter, or the case could have been referred to the European Court of Human Rights for consideration. Then, as now, if the Court found that there had been a violation, it could either make a simple formal finding to that effect, or it could make an award of damages or of costs and expenses to the injured party. For its part, the country concerned would be expected to amend the relevant law or procedure so as to bring it into line with the Convention.

At the time of ratification by the UK, it was believed that the rights guaranteed by the Convention were already protected by British law, and that there was no pressing need for their actual incorporation. This appears to stem from the fact that the “easy assumption, and source of pride, that our unwritten constitution is the best in the world has long been part of our national consciousness.”¹² With a deal of conviction, the commentator added that the “time had come when an examination of that assumption is acceptable and necessary.”¹³ In practice, the Convention had very limited effect upon UK law since, apart from changes made to domestic law through public and political pressure following a Strasbourg decision, it was used only as an aid to interpretation of statute or common law. And even here the Convention could only be considered where it was necessary to resolve an ambiguity in a statute or there was some uncertainty in the common law.¹⁴ Moreover, one commentator was critical of Strasbourg’s approach to commercial issues, and went as far as to say that:

the Court at Strasbourg, quite understandably, is preoccupied with the task of broadening the geographical reach of the simpler sort of human rights, those issues of life, limb and liberty with which it began. It shows signs of being overwhelmed even by this task and it lacks the resources to develop the potential of its jurisdiction in the ways that would be interesting to those .. who practise commercial law. Worst of all, it lacks any real capacity for establishing matters of fact, particularly on complex or judgmental issues, and in consequence is excessively deferential to the factual assertions of signatory States.¹⁵

By 1997 it had become clear that non-incorporation had two further serious repercussions. First, Convention rights, developed with major help from the UK

¹¹ Although the HRA received the Royal Assent in 1998, most of its provisions did not come into effect until October 2000. It was believed that a period of no less than two years was required to educate those, including senior members of the judiciary, who would be required to apply the Act.

¹² Richard Wilmot-Smith, *Incorporation and the Loss of Illusion in Human Rights in the United Kingdom* Richard Gordon & Richard Wilmot-Smith, eds (Oxford University Press, 1996) at p 92.

¹³ *Ibid.*

¹⁴ *Derbyshire County Council v Times Newspapers* [1993] 1 All ER 1011.

¹⁵ Nicholas Jordan, *The Implications for Commercial Lawyers in Practice in The Impact of the Human Rights Bill on English Law* Basil S Markesinis, ed (Oxford, Clarendon Press, 1998) at p133.

Government, were no longer perceived as British rights.¹⁶ Indeed, it was pointed out with some force that the United Kingdom lagged some way behind the international human rights movement, with Britain remaining “in a slightly insular condition of satisfaction with its own legal institutions.”¹⁷ Secondly, the cost of taking a case to Strasbourg was enormous, and the time involved too great.¹⁸ Furthermore, whilst there is no doubt that the common law was developing to protect rights that were coming to be regarded as fundamental against excessive use of discretion by public bodies,¹⁹ the source of those rights was a matter of conjecture; in other words, how was a judge to decide what rights were fundamental, and from where were the judges deriving their authority?²⁰ Moreover, although there are some who would disagree,²¹ it has been argued with some force²² that the protection afforded to such rights through the doctrine of ‘Wednesbury unreasonableness’²³ is not as great as it might otherwise be, requiring a lesser degree of scrutiny of actions by public bodies than that exercised under the doctrine of proportionality.²⁴

That these problems would be overcome by “bringing home” fundamental rights and freedoms was made clear by the 1997 White Paper, in which it was said that incorporation of such rights into domestic law would mean that:

... British people will be able to argue for their rights in the British courts – without ... inordinate delay and cost. It will also mean that the rights will be brought much more fully into the jurisprudence of the courts throughout the United Kingdom, and their interpretation will thus be far more subtly and powerfully woven into our law. And there will be another distinct benefit. British judges will be enabled to make a distinctively British contribution to the development of the jurisprudence of human rights in Europe.²⁵

Accordingly, since October 2000, individuals in the UK have been able to bring human rights issues directly before the British courts, whilst remaining entitled to petition Strasbourg after all possible domestic remedies have been exhausted. Since that time, there has been a steady stream of cases before the courts in which, inter alia, questions of human rights have had to be determined, giving credence to the belief of Lord Cooke of Thorndon that human rights law would “take off in the United

¹⁶ *Rights Brought Home: The Human Rights Bill*, Cm 3782 (October 1997), para 1.14. As Rabinder Singh points out in *The Future of Human Rights in the United Kingdom* (Hart, 1997) at pp 5-6, the relative silence during the 20th century on the matter of the protection of liberty in the UK belied the contribution made by Britain to the development of human rights around the world.

¹⁷ Lord Cooke of Thorndon, *The British Embracement of Human Rights*, (1999) EHRLR, 3, 243-260, at p 246.

¹⁸ *Op. cit.* n 16. It was estimated that it took an average time of five years to get an action into the European Court of Human Rights, at an average cost of £30,000.

¹⁹ See, in particular, the judgment of Bingham MR in *R v Ministry of Defence, ex p. Smith* [1996] QB 517 at 554E-F.

²⁰ Rabinder Singh, *The Future of Human Rights in the United Kingdom* (Hart, 1997), pp 13, 16.

²¹ See, for example, Nicholas Blake, *Importing Proportionality: Clarification or Confusion* (2002) EHRLR, 1, 19-27 at p19.

²² Rabinder Singh, *The Future of Human Rights in the United Kingdom*, at pp 40-42.

²³ So called after the case of *Associated Provincial Picture Houses v Wednesbury Corporation* [1948] 1 KB 223, in which reasonableness was first propounded as a judicial device designed to preserve the exercise of statutory discretion by a public body free from inappropriate interference from the judges.

²⁴ Discussed later.

²⁵ *Rights Brought Home: The Human Rights Bill*, Cm 3782 (October 1997), at para 1.14.

Kingdom” in the same way that administrative law had grown exponentially in the latter half of the twentieth century.²⁶

THE MAIN PRINCIPLES OF THE HUMAN RIGHTS ACT 1998

Three Main Principles

Convention rights have been incorporated into UK law by the HRA only insofar as this is consistent with parliamentary sovereignty. So, the Act, which itself can be repealed, does not give the courts a power to strike down primary legislation that is inconsistent with Convention rights, and Parliament may, if it chooses, maintain in force such legislation. Subject to that overriding caveat, the Act operates on three main principles. First, and of supreme importance, courts and tribunals are required to construe both primary and secondary legislation in a way that is, as far as possible, compatible with Convention rights.²⁷ In practical terms, this section introduces a new and different approach to statutory interpretation by UK courts, going beyond the common law rules. Thus, rather than searching for the true meaning of words or phrases in the traditional manner, courts will now seek to find a meaning that will prevent legislation from being incompatible with Convention rights.²⁸ The former Lord Chancellor, Lord Irvine stated:

The Act will require the courts to read and give effect to the legislation in a way compatible with the Convention rights ‘so far as it is possible to do so’. This ... goes far beyond the present rule. It will not be necessary to find an ambiguity. On the contrary the courts will be required to interpret legislation so as to uphold the Convention rights unless the legislation itself is so clearly incompatible with the Convention that it is impossible to do so. Whilst this particular approach is innovative, there are some precedents which will assist the courts. In cases involving European Community law, decisions of our courts already show that interpretative techniques may be used to make the domestic legislation comply with the community law, even where this requires straining the meaning of words or reading in words which are not there.²⁹

Whilst Lord Irvine did not repeat this view in Parliament, it was nonetheless seen at the time as an indication of the quantum leap that the courts would now be taking towards statutory interpretation in the light of the HRA and, indeed, his words now appear to have full judicial force. In *R v A (No. 2)*, Lord Steyn said:

In accordance with the will of Parliament as reflected in Section 3, it will sometimes be necessary to adopt an interpretation which linguistically may appear strained. The techniques to be used will not only involve the reading down of express language in the statute, but also the implication of the provisions.³⁰

This pronouncement seems to give credence to the belief, formed during the passage through Parliament of the Human Rights Bill, that the new legislation would give excessive power to an unelected judiciary to strike down legislation enacted by

²⁶ *The British Embracement of Human Rights* (1999) EHRLR 3, 243-260, at pp247-248.

²⁷ Human Rights Act 1998, s 3(1).

²⁸ Lord Cooke of Thorndon, H.L. Debs., Vol. 582, cols. 1272-1273

²⁹ [1998] PL 221, at pp 228-229.

³⁰ [2001] 2 WLR 1546 at p1563.

Parliament. However, as Lord Hope has observed, section 3(1) must be read so as to preserve the sovereignty of Parliament:

... the interpretation of the statute by reading words in to give effect to the presumed intention should always be distinguished carefully from amendment. Amendment is a legislative act. It is an exercise which must be reserved to Parliament.³¹

Secondly, although it has already been stated that no court is able to strike down or disregard legislation that conflicts with Convention rights, the High Court and above³² may make a ‘declaration of incompatibility’,³³ which may be viewed as a first step towards correcting the primary or secondary legislation. However, a declaration of incompatibility has been described as a “measure of last resort” and one that “must be avoided unless it is plainly impossible to do so.”³⁴ Such legislation will continue in force until the relevant Minister chooses to exercise his power to amend it by way of remedial order, which can have retrospective effect.³⁵ Moreover, a Minister responsible for the introduction of a Bill in either the House of Commons or the House of Lords must now make a written statement prior to the Second Reading of such Bill to the effect that either it is compatible with Convention rights or, if this cannot be done, that the Government has nonetheless decided to proceed with the Bill.³⁶ This ensures that every new piece of legislation must be considered in the light of the HRA and, although the Government is still able to proceed with legislation that does not necessarily have the ‘stamp of approval’, the force of public opinion may make such an attempt very difficult.

Finally, the Act requires all public authorities (and this would include the Inland Revenue and Customs and Excise) to act in accordance with Convention rights.³⁷ This is subject to the all-important doctrine of the ‘margin of appreciation’, which refers to the ability of public authorities to make discretionary decisions with which courts should not unduly interfere, and requires the court to consider not only whether the relevant authority acted reasonably, carefully and in good faith but, in addition, whether the authority’s action was proportionate to the aim pursued. Certain of the Convention rights are specifically subject to what may loosely be called restrictions. Thus, for example, the right in Article 8 to respect for private and family life is subject to the caveat that there may be interference in accordance with the law to achieve a legitimate aim in light of a pressing social need. So also in Article 1 of the First Protocol, the peaceful enjoyment of possessions by a person, is limited by the right of a state to enforce laws that it deems to be necessary for the control of the use of property or ‘to secure the payment of taxes or other contributions or penalties’ in ‘accordance with the general interest.’ The words of the Convention itself provide for

³¹ *R v Lambert* [2001] 3 WLR 206.

³² But not tribunals.

³³ Human Rights Act 1998, s 4(2).

³⁴ *R v A (No. 2)* [2001] 2 WLR 1546 at p 1563.

³⁵ *Ibid*, s 10(2)(3).

³⁶ *Ibid*, s 19.

³⁷ *Ibid*, s 6(1). Public authorities include courts and tribunals, but not the Houses of Parliament or any individual person (such as a Minister) exercising functions in connection with proceedings in Parliament. In holding that a parochial church council was not a ‘public authority’ for these purposes, the House of Lords in *Aston Cantlow & Wilmcote with Billesley PCC v Wallbank & Wallbank* [2003] UKHL 37; [2003] 3 WLR 283 drew a distinction between persons who, in Convention terms, are governmental organisations on the one hand, and those who are non-governmental on the other.

the purposes for which these restrictions may be made and, although they also give an indication of the width of a discretionary area of judgment enjoyed by public authorities in actually deciding whether to introduce measures restrictive of fundamental rights, they do not “spell out ... a doctrine of proportionality.”³⁸ Rather, the question of whether the action of a public body, which has the effect of restricting fundamental rights, is proportionate to the needs of a democratic society has, in the past, been left to the Strasbourg Court to decide.

The European Court of Human Rights has explained fully the principles that it, in its supervisory role, should apply with respect to taxation. First, although the margin of appreciation available to the national legislature, particularly under Article 1 of Protocol No 1 is a wide one, the measure imposed must have a legitimate aim in the sense of not being ‘manifestly without reasonable foundation’; secondly, where the measure has a legitimate aim, there must be a reasonable relationship of proportionality between the means employed and the aim sought to be realised; and finally, a fair balance must be struck between the demands of the general interests of the community and the protection of the individual’s fundamental rights, the balance failing to be struck if the measure results in an individual or section of the public carrying an excessive burden.³⁹ In summary, these principles require the court to consider not only whether the relevant authority acted reasonably, carefully and in good faith but, in addition, whether the authority’s action was proportionate to the aim pursued. Importantly, incorporation of Convention rights by the HRA has “brought the concept of proportionality directly into force in the law of the United Kingdom”,⁴⁰ and that concept is now “at the heart of the HRA case law.”⁴¹ What this actually means in practice is that, rather than questioning whether a public authority reasonably believed that their decision was proportionate and not therefore irrational, it has to be asked whether the decision was *in fact* proportionate.

CONVENTION RIGHTS, THE HUMAN RIGHTS ACT 1998 AND TAXATION

Given the circumstances that gave rise to the Convention in post-war Europe, not to mention the origins of human rights themselves which, it has been argued, lie in the “Enlightenment belief in inalienable rights ... incompatible with Parliamentary absolutism, which is a residue ... of many centuries of despotism,”⁴² it has to be asked whether human rights apply, or were ever meant to apply, to taxpayers, bearing in mind particularly that a number of them are corporate bodies whose property interests could not have been uppermost in the minds of those who drafted the Convention. One commentator certainly believed that the enactment of the HRA was a prelude to change. He wrote:

Until now, this was a jurisprudence mainly developed by men whose motives were ethical or political, or urgently personal, but the potential for

³⁸ *Ibid* at p 51.

³⁹ *Wasa Liv v Sweden* (1988) 58 DR 163 at pp177-178.

⁴⁰ Nicholas Blake, *Importing Proportionality: Clarification or Confusion* EHRLR 2002, 1,19-27 at p19.

⁴¹ *Ibid* at p 20.

⁴² Andrew Marr, *Rights and Rites for a New Britain* in *Human Rights in the United Kingdom* (ed Richard Gordon & Richard Wilmot-Smith, Oxford University Press, 1996) at p15.

applying many of the Convention rights to business life has been dawning upon lawyers in the UK for some years now.⁴³

Taxation was mentioned for the first time in the Convention only when Protocol No 1 was adopted a few years after the original Convention, and only then to permit contracting states to limit the right of an individual's enjoyment to property in order to secure the payment of taxes.⁴⁴ Nonetheless, whilst individuals cannot maintain that an ordinary assessment to tax or the imposition of very high rates of tax is a breach of Article 1 of Protocol No 1, it does mean that cases can be brought on the basis that a certain tax measure was not proportionate to society's needs. Moreover, it has to be accepted that a large number of tax cases have come before the Human Rights Commission⁴⁵ and the Strasbourg court, a few of these being cases brought by UK taxpayers against the Government even before the Act had come into force.⁴⁶ That Convention rights should apply to taxpayers has been explained on the basis that taxpayers have as much right to protection as do criminals whose right, for example, to a fair trial is guaranteed by Article 6, and that the "system of human rights is, after all, a matter of protecting the individual human being and not especially protecting governments."⁴⁷

As far as corporate taxpayers are concerned, it is the view of one leading human rights lawyer that, despite "the irritation which many people feel at the prospect of incorporation being "hijacked" by the rich and powerful to protect their interests against progressive action by the state," human rights protection should not be denied to companies.⁴⁸ Indeed, it is argued that to do so would itself be a violation of Convention rights insofar as it would be inconsistent with Article 1 of Protocol No 1 and could be said to be discriminatory against companies on the ground of their status in breach of Article 14.⁴⁹ And it is undoubtedly the case that, despite the fact that companies have been petitioning the Strasbourg court for many years, the results do not indicate that "the Convention has become a boardroom charter."⁵⁰

This point is well illustrated by the decision in *National and Provincial Building Society and Others v United Kingdom*.⁵¹ In that case, three building societies challenged retrospective legislation introduced by the Government to prevent a windfall benefit to the applicants that would otherwise have occurred due to technical defects in the regulations governing the taxation of interest paid to investors, and to frustrate any attempts to challenge the validity of the regulations. For their part, the applicants claimed that the legislation would result in double taxation, that it was

⁴³ Nicholas Jordan, *The Implications for Commercial Lawyers in Practice in The Impact of the Human Rights Bill on English Law* (ed Basil S Markesinis, Oxford, Clarendon Press, 1998) at p133.

⁴⁴ Article 1 of Protocol No 1 guarantees, subject to conditions, the right to property.

⁴⁵ When it was still in existence.

⁴⁶ For example, *National and Provincial Building Society and Others v United Kingdom* (1998) 25 EHRR 127; [1997] STC 1466; *A, B, C & D v UK* (1981) 23 DR 203; *Nap Holdings UK Ltd v UK* (1996) 22 EHRR 114. All of these cases concerned the issue of retrospective legislation.

⁴⁷ Isi Foighel, *Do human rights apply to taxpayers?* in *Protecting Human Rights: The European Perspective* (Koln: Heymanns, 2000) 535-543 at p 543.

⁴⁸ Rabinder Singh, *The Future of Human Rights in the United Kingdom* (Oxford, Hart Publishing, 1997) at p 25.

⁴⁹ *Ibid* at p 24. For Article 14, see *infra*.

⁵⁰ Michael Smyth, *The United Kingdom's Incorporation of the European Convention and its Implications for Business* (1998) EHRLR 3, 273-291 at p 273.

⁵¹ (1998) 25 EHRR 127; [1997] STC 1466.

invalid and that it sought specifically to limit their access to justice. The European Court of Human Rights rejected the argument that there had been double taxation, and concluded that, despite the fact that the legislation did constitute an interference with the applicants' rights of possession to property under Article 1 of Protocol No 1, the interference was justified in the public interest in that it secured the payment of taxes. The Court rejected the applicants' further claim that the retrospective legislation restricted their right of access to a court and that there was therefore a breach of Article 6(1),⁵² on the grounds that it was in the public interest that legislation should intervene to prevent litigation that was aimed at frustrating the intention of Parliament and, in any event, the dispute concerned matters of taxation, where recourse to retrospective legislation is not confined to the UK.

Whilst this case demonstrates the hurdles faced by all applicants, not just commercial ones, it should not be thought that the decision places doubt on whether applicants in tax matters will ever be successful. As has been pointed out, the case was lost on its merits⁵³; the court took the view that there was no double taxation in any real sense, and that all the retrospective legislation was intended to do was to cure technical defects in earlier legislation. The suggestion is that where there are issues of real double taxation, or cases where legislation is introduced with the sole aim of depriving taxpayers of the fruits of successful litigation, then such actions may well be open to a successful challenge.

The precise circumstances in which Convention rights might be invoked in tax matters still remains a matter of some speculation, although the comment has been made that "there is every reason to believe that tax and VAT cases will bulk large in post-incorporation litigation,"⁵⁴ and this prophecy seems to have been borne out over the last couple of years. That cases will be brought in ever greater numbers is recognised by the fact that public funding (formerly legal aid) is now available for cases before both the General and Special Commissioners of Income Tax where the proceedings concern penalties which the courts have declared to be criminal in the terms specified by the Convention, or where an applicant seeks to argue that issue *and* it is in the interests of justice for an applicant to be legally represented.⁵⁵

TAXATION AND CONVENTION RIGHTS POST-OCTOBER 2000

In monitoring compliance with Convention rights, a domestic court or, indeed, the Strasbourg court as a final court of appeal on matters of human rights, is concerned with two principles: first, it must ensure that a given piece of legislation is compatible with Convention rights and, secondly, it must be satisfied that the rules legislated for are being administered in such a way as to ensure that the rights of individuals are secure. As far as taxation is concerned, the first of these two principles clearly relates

⁵² Right to a fair trial.

⁵³ Michael Smyth, *The United Kingdom's Incorporation of the European Convention and its Implications for Business* (1998) EHRLR 3, 273-291 at p 285.

⁵⁴ *Ibid* at p 273.

⁵⁵ *Public Funding for Legal Advice and Representation Before the General and Special Commissioners of Income Tax*, Legal Services Commission in *Guidance to Inland Revenue Staff on Human Rights and Penalties*, guidance issued to Inland Revenue staff on 11 September 2002. Funding is available for both legal advice prior to any hearing and for legal representation at the tribunal. This is subject to the applicant being financially eligible, with applicants on income support and income-based jobseekers allowance being automatically eligible.

to tax policy, whilst the second deals with the administration of the tax system. Accordingly, it is proposed that the particular Convention rights affecting tax matters will be discussed under the two headings of 'tax policy' and 'tax administration.'

Tax Policy

The fact that the relevant Minister has to state in writing that a Bill introduced into Parliament complies with Convention rights suggests that, since the passing of the HRA, all legislation will be so compliant. However, it has already been seen that the Government may nevertheless proceed with a Bill without this positive statement. Whilst it is unlikely that this would ever be the case with fundamental issues relating to life and liberty, it is highly probable that it could be where matters of taxation are concerned. Thus, where legislation similar to that at issue in the case of *National & Provincial Building Society & Others v United Kingdom*⁵⁶ is sought to be introduced, although it may well result in an interference with a claimant's rights to property, the Government may yet continue with it and argue successfully against any challenge on the ground of securing the payment of tax in the public interest and the margin of appreciation.

It is interesting to debate whether such an argument would apply in the case of any possible future windfall tax. Soon after taking office in 1997, the new Labour Government imposed a windfall tax⁵⁷ on the excess profits of the privatised utilities⁵⁸ in order to fund its 'Welfare to Work' programme, which was aimed at encouraging people to move away from relying on state benefits and into work.⁵⁹ It should be noted that the profits that were to be taxed were profits previously made and upon which tax had already been levied. The Government's argument for raising the money in this way was based on the belief that the previously publicly-owned utilities had been sold by former Conservative Governments at far less than their market value, resulting in a windfall to the shareholders of the companies concerned. Of course, by the time the windfall tax was imposed, many of the original shareholdings had been sold, although it is highly likely that the company executives with their lucrative share-options remained the same and would, accordingly, suffer some financial loss as a result of the measure. Since the HRA had not been enacted at the relevant time, there was no question of a challenge before the domestic courts. However, legal opinions were canvassed on the likely success of a challenge before the Strasbourg Court on the basis that the tax was contrary to Article 1 of Protocol No 1, which (as already mentioned) guarantees, in substance, the right to property, and comprises three elements. The first contains the general principle of peaceful enjoyment of property; the second deals with deprivation of property and subjects that to certain conditions; the third recognises that contracting states are entitled to control the use of property, expressly reserving their right to pass laws that they deem necessary to secure the payment of taxes.

⁵⁶ *Op. cit.* n 51.

⁵⁷ Sections 1-5 and Schedule 1, Finance (No 2) Act 1997. The amount by reference to which tax was charged was the difference between a notional flotation value established by looking at average post-tax profits over four years following privatization, and an actual flotation value equal to the flotation price at which the shares were offered multiplied by the ordinary share capital of the company at flotation.

⁵⁸ For example, the water, electricity and telecommunication companies.

⁵⁹ This programme has since been bolstered by the Working Families' Tax Credit (now repealed) and, more recently, the Working Tax Credit, both measures providing tax credits for lower paid workers in an attempt to reduce or alleviate the poverty trap arising on a move from benefits to work.

The question that needed to be answered in the case of the windfall tax was not whether it interfered with the taxpayers' enjoyment of their property (for it obviously did since they would have rather less after the imposition of the tax than before) but, rather, whether it was disproportionate to the needs of the society for whose benefit it was being levied. Opinions on the matter differed and, in the event, no challenge was ever made, possibly for the reason that the directors of the companies' concerned could not justify to their shareholders the expense of a petition to Strasbourg when compared with the actual tax owed. As a matter of conjecture, it is submitted that a challenge would not have been successful. Although in *Wasa Liv v Omsesidigt v Sweden* the Strasbourg Court held that the protection afforded by Article 1 of Protocol No 1 and other relevant provisions of the Convention is not excluded by the fact that a legislative provision involved the payment of tax, so theoretically a challenge *could* be successful,⁶⁰ the facts surrounding the windfall tax are materially different from those of the *Building Societies* case.⁶¹ Whilst both involve the imposition of tax retrospectively, there was here undoubtedly a question of double taxation, and the legislation was not seeking to correct any previous errors. Moreover, the findings of the Strasbourg Court have to be applied in forty-four states, all having very different cultures and politics and, accordingly, it would not be surprising for it to act in a conservative fashion and apply a particularly wide margin of appreciation under Article 1 of Protocol No 1 in favour of the Government.

Of course, the question of whether a domestic court would come to the same conclusion is a totally separate one and, given that it would not be subject to the same political constraints as the Strasbourg Court, the answer cannot be assumed to be in the affirmative. Moreover, as for the *Wasa Liv* case, whilst domestic courts and tribunals will take into consideration the jurisprudence of the Strasbourg Court, indeed they are obliged to do so under the HRA,⁶² just like the European Court of Human Rights itself, they are not bound by any of its previous decisions. This was spelt out by Potter LJ in the following terms:

Since s. 2(1) of the HRA requires the court or tribunal to take into account the Strasbourg case law of the European Court of Human Rights (the Strasbourg Court) when determining a question which has arisen in connection with a Convention right, that case law provides a starting point for the domestic court or tribunal's deliberations and the court or tribunal has a duty to consider such case law for the purpose of making its adjudication. It is not bound to follow such case law (which itself has no doctrine of precedent) but, if study reveals some clear principle, test or autonomous meaning consistently applied by the Strasbourg Court and applicable to a convention question arising before the English courts, then the court should not depart from it without strong reason.⁶³

On balance, it is submitted that, like the Strasbourg Court, domestic courts will be reluctant for political reasons to reach a finding that a particular piece of tax legislation, even retrospective legislation such as a windfall tax, is in breach of

⁶⁰ (1988) 58 DR 163. In this case, which involved a challenge to a windfall tax on Swedish insurance companies, the Strasbourg Court dismissed the complaint as inadmissible.

⁶¹ Discussed earlier.

⁶² Section 2(1).

⁶³ *Han (t/a Murdishaw Supper Bar) v Customs and Excise Commissioners* [2001] EWCA Civ 1040, [2001] 1 WLR 2253 at p 2260.

Convention rights. It is likely that their unexpressed view would be that it should not be left to the courts to arbitrate on matters of tax policy, and an expressed conclusion could easily be reached on the grounds of the margin of appreciation and proportionality.⁶⁴

Indeed, this was exactly the position in *R (on the application of Professional Contractors Group Ltd v IRC)*,⁶⁵ a high-profile judicial review case arising in respect of the imposition of the notorious IR35 legislation relating to personal service companies. Companies subject to the IR35 regime are primarily one-man companies, which charge out the services of the owner ('the service contractor') to a client for fees paid by the client to the service company in circumstances under which the service contractor would be an employee of the client if he had provided the services directly to it. Out of this remuneration, the service contractor is paid a small salary, from which income tax and employers' national insurance contributions (NICs) are deducted, and the service company pays employers' NICs. From the balance will be deducted allowable expenses, and a substantial dividend out of the profit may eventually be paid to the service contractor which will not attract NICs, and in respect of which income tax will only be payable as and when the dividend is declared. Any retained profit will be assessable to corporation tax, but usually at the special low rate applicable to small companies. The aim of IR35 is to treat the fees as income from employment, with income tax and NICs being deductible.

The claimants' case was that a right to enjoy the benefit of a shareholding in a service company is a right of property and, by virtue of the IR35 legislation, there was an interference with the enjoyment of that right contrary to Article 1 of Protocol No 1 for two reasons. First, the imposition of income tax and NICs on the notional remuneration together with the way in which expenses are treated, meant that the 'right' was rendered more expensive. Secondly, the uncertainty as to whether a particular service contractor would be classified as an employee if he had rendered his services directly to the client, would result either in a loss of enjoyment of the shareholding or it put the very existence of service companies in jeopardy.

In holding the impact of IR35 was insufficient to amount to a breach of Article 1 of Protocol No 1, Burton J considered the Strasbourg jurisprudence in relation to the claimant's first argument, and, cited the conclusion of the Commission in *Svenska Managementgruppen AB v Sweden*⁶⁶ that:

A financial liability arising out of the raising of taxes or contributions may adversely affect the guarantee of ownership if it places an excessive burden on the person concerned or fundamentally interferes with his financial position. However, it is in the first place for the national authorities to decide what kind of taxes or contributions are to be collected. Furthermore the decisions in this area will commonly involve the appreciation of political, economic and social questions which the Convention leaves within the

⁶⁴ It is submitted that any challenge to the rumoured withdrawal of the capital gains tax exemption on principal private residences would fail on this ground.

⁶⁵ [2001] EWHC Admin 236; [2001] STC 629. A later appeal by the taxpayers did not concern the issue of human rights.

⁶⁶ (1985) 45 DR 211 at pp 222-223..

competence of the Contracting States. The power of appreciation of the Contracting States is therefore a wide one.⁶⁷

Accordingly, he concluded that even if the full amount of a service company's earnings (without any allowance for expenses) in a given year were treated as the remuneration of the service contractor, this would not amount to a confiscation of property, nor to a fundamental interference with the claimants' financial position, and nor would it amount to an abuse of the UK's rights to levy taxes.

As to the second argument relating to uncertainty, Burton J concluded that the effect of IR35 was to submit service companies to the same common law test of employment with respect to each engagement to which they would have been subject but for the interposition of the service company, and thus it could not offend against the concept of certainty for the common law of employment to apply to a service contractor. Bearing in mind the amount of publicity given to the IR35 legislation, and the furore with which it was met, the decision of Burton J, coupled with the fact that the claimants' chose not to appeal on the human right issue, demonstrates quite clearly how difficult it is likely to be to challenge successfully any particular aspect of tax policy, with the exception, perhaps, of legislation that could be said to be discriminatory.

Perhaps more so than any of the others, Article 14 has the greatest potential to cause a change in Government policy. Whilst there is no general prohibition on discrimination in the Convention, Article 14 requires that the enjoyment of Convention rights is to be secured without discrimination. In practice, this means that a claimant must plead a substantive right alongside discrimination. In the area of taxation, the substantive right that will most often be alleged to have been violated is Article 1 of Protocol No 1,⁶⁸ and although the connection between some substantive rights and Article 14 may be somewhat tenuous, the European Court of Human Rights has confirmed that the second paragraph of Article 1 of Protocol No 1 establishes that the duty to pay tax falls within its field of application.⁶⁹

In the spirit of legislation such as the Sex Discrimination Act 1975 and the Equal Pay Act 1970, it is difficult to understand how discrimination on the grounds of gender could possibly be justified in any circumstances. Since the beginning of the 1990s, successful attempts have been made to weed out such discrimination from the UK tax system. So, gone is the system whereby a married woman's income was treated as that of her husband's (and along with it has disappeared the wife's earned income allowance and the married man's allowance – so too the married couple's allowance that replaced it), and in its stead there is a single person's allowance. Nonetheless, a provision⁷⁰ (now also abolished with respect to deaths occurring after 5 April 2000⁷¹) that allowed for a widow, but not a widower, to claim a bereavement allowance, has

⁶⁷ [2001] STC 629 at p 648.

⁶⁸ See, for example, *R (on the application of Wilkinson) v IRC* [2002] EWCA Civ 814; [2003] 1 WLR 2683.

⁶⁹ *Derby v Sweden* 13 EHRR 774. This has since been followed in the domestic courts by *R (on the application of Wilkinson) v IRC* [2002] EWCH 182 (Admin); [2002] STC 347. The point was conceded before the Court of Appeal: [2003] EWCA 814.

⁷⁰ Section 262(1) ICTA 1988.

⁷¹ Section 34 FA 1999. The Welfare Reform and Pensions Act 1999 now provides for social security benefits which are available to both widows and widowers alike.

been the subject of two challenges under the Convention. In the first case, in order to avoid setting a precedent, the UK Government conceded the point and reached a 'friendly settlement' whereby the same amount was paid to Mr Crossland, the claimant widower, as would have been given to a widow.⁷² The second challenge arose in the wake of the Revenue's refusal to provide the same treatment for other widowers in the same position as Mr Crossland. In the High Court, Moses J held that it was clear that the difference between widows and widowers in relation to the widow's bereavement allowance constituted discrimination under Article 14 read with Article 1 of Protocol No 1 *in the absence of any objective justification advanced for such discrimination*.⁷³

The important issue of the margin of discretion (or appreciation) was discussed fully in another case concerning challenges in respect of certain types of widow's benefit and raising similar issues in relation to discrimination.⁷⁴ In that case, Moses J. sought to strike a balance between, on the one hand, the principle of equality between the sexes from which there should be departure only when there exist compelling reasons and the adoption of alternative measures that cause minimum interference to the right to non-discrimination and, on the other, the need to defer to Parliament in matters of social and economic policy. The weight of authority seems clearly to favour deference to Parliament, and was explained by Lord Woolf when, in relation to housing policy, he stated:

The economic and other implications of any policy in this area are extremely complex and far-reaching. This is an area where, in our judgment, the courts must treat the decisions of Parliament as to what is in the public interest with particular deference The correctness of this decision is more appropriate for Parliament than the courts and the Human Rights Act 1998 does not require the courts to disregard the decisions of Parliament in relation to situations of this sort when deciding whether there has been a breach of the Convention.⁷⁵

Moreover, the Strasbourg Court has also accepted the need to afford a wide margin of appreciation to contracting states in cases concerning social policy. Again in relation to housing policy, the Court has said:

In order to implement such policies, the legislature must have a wide margin of appreciation both with regard to the existence of a problem of public concern warranting measures of control and as to the choice of the detailed rules for the implementation of such measures. The court will respect the

⁷² *Crossland v United Kingdom*, 9 November 1999 (unreported). A similar set of events occurred in *Fielding v United Kingdom*, 29 January 2002 (unreported). Historically, this provision was introduced to compensate for the fact that if a husband died early in the tax year, his widow would only be entitled to a single person's allowance, whereas a husband would continue to receive the higher married man's allowance in the year of his wife's death. Moreover, it was extended in 1983 to the year of assessment following the year of death because, if a husband died towards the end of a tax year, a wife would often not have sufficient income in the remainder of the year to use the allowance in full.

⁷³ *R (on the application of Wilkinson) v IRC* [2002] EWHC 182 (Admin); [2002] STC 347.

⁷⁴ *R (on the application of Hooper & Ors) v Secretary of State for Work & Pensions* [2002] EWHC 191 (Admin); [2003] EWCA Civ 813; [2003] 1 WLR 2623.

⁷⁵ *Poplar Housing and Regeneration Community Association Ltd v Donoghue* [2001] 3 WLR 183 at p 202.

legislator's judgment as to what is in the general interest unless that judgment be manifestly without reasonable foundation.⁷⁶

Moses J also drew attention to the decision in *Petrovich v Austria*,⁷⁷ a case concerning parental leave payments to a man, where it was explained that a factor relevant to the scope of the margin of appreciation is the existence of common ground between the laws of the contracting states. Thus, the greater the disparity that exists between such states, the broader is the margin of appreciation.⁷⁸ In the end, however, Moses J concluded that:

it is neither possible nor productive to determine with any precision the degree of deference to be paid to the legislature when the issues concern social and economic policy and the constitutionally important right not to be discriminated against on the ground of gender⁷⁹

and felt that his task was simply the ordinary judicial one of subjecting to scrutiny the reasons advanced by the Government for the discrimination. He continued:

If the reasons advanced by the Defendant are insubstantial or, even if they are substantial, they do not persuade me, I shall decline to find any objective justification.⁸⁰

Using that reasoning, Moses J found that there was no objective justification for the discrimination resulting from the widow's bereavement allowance, and made a declaration of incompatibility, seemingly ignoring the fact that the legislation concerned could be justified on an historical basis⁸¹ and, moreover, had already been repealed. The point was not at issue in the Court of Appeal, where it was common ground that the offending provision was discriminatory, and the Revenue conceded that this discrimination fell within the ambit of Article 1 of Protocol No.1.⁸² Whilst this sounds hopeful for future claimants, the point should be made that, despite the finding by the judge, the taxpayer failed in his claim to be paid a sum of money equivalent to the allowance, on the basis that the Revenue had no power to make such a payment. This will be discussed below when considering tax administration. In the meantime, however, all that can really be said is that, whilst challenges to discriminatory tax legislation may be successful in terms of the willingness of the courts to accept that there has been a breach of a convention right, the real benefits may only be felt *in the future* by those similarly placed if the judgment weighs heavily on the conscience of the Government and Parliament agrees to amend the offending legislation.

⁷⁶ *Mellacher v Austria* [1989] 12 EHRR 391 at para 45.

⁷⁷ [1998] 4 BHRC 232.

⁷⁸ [2002] EWHC 182 (Admin) at para 105.

⁷⁹ *Ibid* at para 106.

⁸⁰ *Ibid*.

⁸¹ This provision was introduced to compensate for the fact that if a husband died early in the tax year, his widow would only be entitled to a single person's allowance, whereas a husband would continue to receive the higher married man's allowance in the year of his wife's death. Moreover, it was extended in 1983 to the year of assessment following the year of death because, if a husband died towards the end of a tax year, a wife would often not have sufficient income in the remainder of the year to use the allowance in full.

⁸² *R (on the application of Wilkinson) v IRC* [2003] EWCA Civ 814; [2003] 1 WLR 2683.

As to the scope of Article 14 as it might affect tax policy, it is possible that challenges could also be made on the grounds of the favourable tax treatment afforded to married couples, discrimination between similarly situated taxpayers and discrimination between employees and self-employed persons. As far as marriage is concerned, whilst UK legislation that provided for allowances discriminating between single and married people has been held not to be an infringement of the Convention on the grounds that it was within the discretion allowed to contracting states and that the distinction was objectively justifiable,⁸³ it remains to be seen whether the distinction will remain justifiable with the changing attitudes of society to marriage.

The issue has been recently tested in the context of Inheritance Tax (IHT), which allows for an exemption between spouses.⁸⁴ In *Holland v IRC*,⁸⁵ the Revenue accepted that marriage was a question of status within Article 14, and that the facts of the appeal fell within both Article 1 of Protocol No. 1 and Article 8 (right to respect for family and private life, discussed below), but the Special Commissioner dismissed the claimant's argument that, although she and the deceased were not legally married, they had lived together as husband and wife for thirty-one years before his death and so she should be treated as his spouse for IHT purposes. He held (*obiter*, since the HRA was not in force at the time of death) that it was permissible for Parliament to legislate for different tax provisions to apply to married persons, since this reflected the fact that marriage is accompanied by mutual rights and obligations between the spouses relating to maintenance both during their lives and after their deaths. That the claimant and her partner chose not to marry was entirely their decision; having made that decision, they had to accept the consequences.

It is, of course, quite possible that a single sex couple, living as though married, may seek to challenge the same legislation and may be successful since, in the UK in such a case, they would have no choice in the matter of marrying. Other legislation that could be the subject of a similar challenge is the Tax Credits Act 2002 which, whilst drawing no distinction between those who are married and those who are not, does not recognise single sex partnerships. It was to be hoped that this particular form of discrimination might soon be removed if the proposals which aim to permit the civil registration of single sex partnerships are carried into fruition.⁸⁶ Under these proposals, once a couple has registered its partnership, then certain rights that are currently afforded only to married couples, will also be available to single sex couples. Unfortunately, despite the fact that exemption from IHT is a key issue for many same-sex couples, the consultation document failed to address it (or, indeed, the further issue of tax credits). In its response, the Government merely paid lip-service to the problem, saying that the Budget process would take full account of the comments that had been received as part of the consultation process and their implications for the tax system.

It is possible that discrimination between similarly placed taxpayers could be the basis of a further challenge in respect of a windfall tax (already considered above in the

⁸³ *Lindsay v United Kingdom* (1997) 23 EHRR 199

⁸⁴ Inheritance Tax Act (IHTA) 1984, s 18.

⁸⁵ (2003) Sp C 350; (2003) Simons Tax Intelligence 62.

⁸⁶ The proposals were published in a consultation document, *Civil Partnership: a framework for the legal recognition of same-sex couples* DTI, June 2003. The Government's response to the proposals was published in November 2003.

context of Article 1 of Protocol No 1). If such a tax fell on one, or only some, of a number of companies in the same sector, it could be argued that it draws an arbitrary distinction between a similar group of taxpayers. It would, of course, be necessary for the claimant to prove such a similarity.

It is unlikely that the different tax provisions that apply to the employed⁸⁷ and to the self-employed⁸⁸ will ever be successfully challenged. One such provision permits employers to obtain a deduction for childcare expenses for employers as the provision of a benefit to its employees. Subject to certain conditions, an employee is not taxed on that benefit.⁸⁹ In contrast, self-employed persons can make no deduction for expenses incurred in respect of childcare. The taxpayer, a self-employed person, argued in *Carney v Nathan*⁹⁰ that the disallowance of such expenditure constituted discrimination within Article 14 in relation to Article 1 of Protocol No 1. Her argument was dismissed by the Special Commissioner, whose brief view was that the taxpayer, as a self-employed person paying childcare expenses for herself, was not in a similar situation to an employer paying for the employee. Given that the rules allowing for deduction of expenditure are generally more generous to the self-employed than to the employed, this must be seen as a pragmatic decision.

Although, in the context of taxation, Article 8 is inextricably linked with issues of compliance, and much of the case law concerns challenges against revenue authorities in respect of oppressive demands for information, it could well be that the future may also see challenges in respect of the legislation itself. The primary protection in Article 8 is that everyone is entitled to respect for his private and family life, his home and his correspondence. This does not provide a comprehensive privacy provision, and the right that is granted is subject to the strict limitations that any interference must be in accordance with the law, and necessary in a democratic society in the interests of national security, public safety, the economic well-being of the country, the prevention of crime, the protection of health and morals and the protection of the rights and freedoms of others. Accordingly, legislation that gives authority to the Revenue, within limits, to secure information necessary for investigations into taxpayers' affairs, will generally be held inviolable on the ground of being in the interests of the economic well-being of the country.

Nevertheless, in one recent case concerning legal professional privilege,⁹¹ comments made by Lord Hoffman give an indication that that view may be changing. The issue in that case was whether the taxpayer was protected against a notice under section 20(1) of the Taxes Management Act 1970 requiring production of documents covered by legal professional privilege. The appeal to the House of Lords was concerned solely with the construction of the Act. However, in the event that the court should reach a finding unfavourable to the appellants, they put forward an alternative submission that the provision should be declared incompatible with Article 8. In the

⁸⁷ Income Tax (Earnings & Pensions) Act (ITEPA) 2003.

⁸⁸ Income and Corporation Taxes Act 1988, s 18.

⁸⁹ Income Tax (Earnings and Pensions) Act 2003, s 318.

⁹⁰ (2003) Sp C 347; (2003) Simons Tax Intelligence 33. In *X v Austria* (Application No 6163/73), the Austrian tax system allowed certain deductions only to employed persons and not to the self-employed. The European Commission rejected the admissibility of the complaint on the grounds that the difference in treatment was justified.

⁹¹ *R (on the application of Morgan Grenfell & Co Ltd) v Special Comr of Income Tax* [2002] UKHL 21; [2002] STC 786.

event, this proved unnecessary, but Lord Hoffman took the opportunity to pronounce on the human rights issue. Citing the European Court of Human Rights case of *Foxley v UK*,⁹² he confirmed that legal professional privilege is a fundamental human right, which can be derogated from only in exceptional circumstances, and he doubted that these exceptional circumstances would include the public interest in the collection of financial information by the Revenue. He concluded by saying that if new information-gathering legislation were to be passed, then any interference with privilege would have to be shown to have a legitimate aim which is necessary in a democratic society.⁹³ It should be noted that Lord Hoffman's words of caution are limited to an 'interference with privilege' and, as vitally important as that may be, would not have a more general effect of curtailing Revenue powers in the future.

Tax Administration

Even though a piece of tax legislation may be Convention-compliant, it does not necessarily follow that the rules administered thereunder are similarly compliant. It is submitted that it is in this area where the HRA will have its biggest impact but, as the decision in *R (on the application of Wilkinson) v IRC*⁹⁴ demonstrates, this is more likely to be the case where the issue concerns proceedings in tax fraud cases and penalties, rather than with discretionary decisions by either the Inland Revenue or Customs and Excise. In that case, having ascertained that the legislation in question was indeed incompatible with Article 14, the taxpayer argued that, first, the Revenue had the power to make an extra-statutory concession in his favour by way of an income tax deduction equivalent to the allowance in question⁹⁵ and, secondly, they were *obliged* to grant such a concession to the taxpayer pursuant to section 6(1) of the Human Rights Act 1998. This section provides that it is unlawful for a public authority to act in a way that is incompatible with a Convention right. In respect of the first argument, the Court of Appeal reviewed the authorities dealing with both the extent of the Revenue's powers to care for, manage and collect, the various taxes,⁹⁶ and their ability to make extra-statutory concessions. Despite the fact that the Revenue proceed on the basis that they are vested with a wide managerial discretion to refrain from recovering taxes which are payable under a strict application of the relevant legislation,⁹⁷ there has for many years been some considerable debate about the basis upon which extra-statutory concessions are made,⁹⁸ the nature of that debate being summarised in the words of Scott LJ when he said:

⁹² [2001] 31 EHRR 637 at p 647.

⁹³ *Op. cit.* n 91 at p 796.

⁹⁴ [2003] EWCA 814; [2003] 1 WLR 2683 (discussed above in relation to legislation concerning the widow's bereavement allowance).

⁹⁵ The list of extra-statutory concessions published by the Revenue is introduced by an explanation of the term as "a relaxation which gives taxpayers a reduction in tax liability to which they would not be entitled under the strict letter of the law. Most concessions are made to deal with what are, on the whole, minor or transitory anomalies under the legislation and to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter." It should also be noted that, in addition to published concessions, *ad hoc* concessions are also given to individual taxpayers. .

⁹⁶ Section 1(1) Taxes Management Act 1970.

⁹⁷ *Op. cit.* n 94 at pp 2692-2697.

⁹⁸ See, in particular, the judgment of Walton J in *Vestey v Inland Revenue Commissioners (No 2)* [1979] Ch 198; David Williams, *Extra Statutory Concessions* [1979] BTR 137; John Booth, *The Inland Revenue: saint or sinner* (Lyminster: Coracle, 2002) pp17-19.

No judicial countenance can or ought to be given in matters of taxation to any system of extra-legal concessions.⁹⁹

Although there has been a move to incorporate some of the published concessions into the legislation,¹⁰⁰ a huge number remain and form an important part of the tax system. One writer commented that “[O]ne day the court may have to decide whether it is theoretically possible to order the department to give the taxpayer the benefit of a concession, i.e. to make an assessment which is not in accordance with the law.”¹⁰¹ That was exactly the issue before the Court of Appeal in the *Wilkinson* case, and it reached the conclusion that it was not; the Revenue were not authorised to grant the taxpayer an extra-statutory allowance in the form of a tax reduction. Lord Phillips MR, on behalf of the whole court, said:

we do not see how section 1 of the TMA can authorise the Commissioners to announce that they will deliberately refrain from collecting taxes that Parliament has unequivocally decreed shall be paid ... because the Commissioners take the view that it is objectionable that the taxpayer should have to pay the taxes in question.¹⁰²

Although the conclusion reached in respect of the taxpayer’s first argument made the second argument untenable, the court nevertheless decided to deal with it briefly, and took the view that, had the Revenue the power to grant extra-statutory allowances to widowers to match the Widow’s Bereavement Allowance, then, since the HRA, they would have been *obliged* to exercise that power in order to avoid a breach of Convention rights.¹⁰³ In the event, they had no such power and, although the result was a breach of the HRA, the Revenue had a defence to that breach.¹⁰⁴

Moreover, the Court of Appeal was unable to accept the taxpayer’s final argument that, in the light of the friendly settlement of the *Crossland* case,¹⁰⁵ the Revenue’s refusal to make a settlement in similar terms had caused Mr Wilkinson to suffer a pecuniary loss that should be compensated by payment of damages. An award of damages is permissible under the HRA, but only if it is necessary to afford the claimant “just satisfaction.”¹⁰⁶ Lord Phillips MR opined that the widow’s bereavement allowance was “an anachronistic relic”¹⁰⁷ of a previous tax regime, which was no longer sustainable with the advent of independent taxation because it gave widows an unjustified advantage over widowers and, indeed, over all other taxpayers. Since the allowance had been abolished prospectively by the time the HRA had come into force, there was no reason to increase further the numbers of those to whom anomalous payments were being made. He therefore concluded that the principle of “just satisfaction” did not entitle Mr Wilkinson to compensation.

⁹⁹ *Absolom v Talbot* [1943] 1 All ER 589 at p 598.

¹⁰⁰ For example, a number were incorporated into the Income Tax (Earnings & Pensions) Act 2003.

¹⁰¹ John Tiley, *Revenue Law* (Oxford, Hart Publishing, 4th ed., 2000) at p 59.

¹⁰² [2003] 1 WLR 2683 at p 2697.

¹⁰³ This, in fact was the decision reached in *R (on the application of Hooper & Ors) v Secretary of State for Work and Pensions* [2003] EWCA Civ 813, where, despite the statutory provision of certain widow’s benefits, there also existed a common law power that enabled the Secretary of State to make benefits payments to widowers.

¹⁰⁴ Human Rights Act 1998, s 6(2)(b).

¹⁰⁵ *Op. cit.* n 72.

¹⁰⁶ Human Rights Act 1998, s 8(3).

¹⁰⁷ *Op. cit.* n 102 at p 2700.

It is quite clear that despite the elation from commentators following the decision of the Strasbourg Court in *Willis v The United Kingdom*,¹⁰⁸ decided after the *Wilkinson* case, in which it was held that the difference in treatment between men and women regarding entitlement to the Widow's Payment and Widowed Mother's Allowance (both social security payments) was not based on any objective and reasonable justification, and was therefore in violation of Article 14 of the Convention taken in conjunction with Article 1 of Protocol No 1, this case will have little bearing on the issue under discussion. Whilst it is necessary to take the decision into account,¹⁰⁹ it carries little weight because it did not concern a tax allowance and, further, the UK did not deny its obligation to pay pecuniary compensation in that case, so that the principle of just satisfaction was not in issue.¹¹⁰ These differences will surely also be taken into account by the House of Lords when it eventually hears the *Wilkinson* appeal. It is submitted that the reasoning of the Court of Appeal was sound, and that the HRA cannot be a panacea for ill-founded claims against actions that can be historically justified.

This decision, albeit made in a particular context, must cause the whole question of the general operation of extra-statutory concessions to be re-opened, as the following example attempts to demonstrate. Taxpayer A, aggrieved that the Revenue have refused to grant him a concession previously granted to taxpayer B in similar circumstances, will either have no opportunity to challenge this discriminatory action, or will be unsuccessful in such a challenge. It now appears quite clear that no court will sanction the granting of an extra-statutory concession *in favour* of a taxpayer. Moreover, to maintain a successful challenge under Article 14, it has first to be decided if the claimant has been treated less favourably than others in relation to the enjoyment of a Convention right and, if he has, the grounds upon which he suffered discrimination have then to be determined. What has to be demonstrated is:

that the claimant is one of a class or group who share a distinguishing characteristic and that this characteristic is the ground upon which the State distinguishes against the members of the class or group.¹¹¹

This means that, unless an individual taxpayer can identify himself with a group being singled out for separate treatment, he will be unable to maintain a challenge under Article 14. Accordingly, any challenge by A will have to be made on the basis of requiring the Revenue to withdraw the concession granted to B, but this would be unsuccessful for two reasons. First, A cannot bring an action for judicial review because he has no sufficient interest or *locus standi* in the affairs of another taxpayer.¹¹² Secondly, section 7(1) of the HRA provides that a person who claims that

¹⁰⁸ 2002. The TaxZone Digest incorrectly reported that "the Inland Revenue was put to shame for its dreadful behaviour over not giving men and women equal treatment under the tax system," and commented that "there is expected to be a number of cases appearing in the European Court soon on the widow's allowance issue. Their chances of success were already great, but will have been bolstered by the *Willis* case." See TaxZone Digest, Issue 124 (17 June 2002) www.taxzone.co.uk and www.accountingweb.co.uk.

¹⁰⁹ Under the Human Rights Act, s 2.

¹¹⁰ See *R (on the application of Hooper & Ors) v Secretary of State for Work and Pensions* [2003] EWCA Civ 813; [2003] 1 WLR 2623 at p 2678.

¹¹¹ *R (on the application of Hooper & Ors) v Secretary of State for Work and Pensions* [2003] 1 WLR 2623 at p 2658..

¹¹² One taxpayer has no sufficient interest to ask a court to investigate the tax affairs of another: *IRC v National Federation of Small Businesses Ltd* [1981] 2 All ER 93.

a public authority has acted in a way which is incompatible with a Convention right must be a *victim* of that unlawful act. It is suggested that this requirement is even stricter than that of *locus standi*, and that it would be difficult for A to argue that he was a 'victim' because the Revenue had exercised an extra-statutory concession in favour of B. In effect, this leaves the Revenue with a considerable amount of unchecked discretionary power.

In the future, taxpayers may have more success with challenges under Article 6, one of the cornerstones of the Convention, which entitles everyone in civil cases to a 'fair and public hearing within a reasonable time by an independent and impartial tribunal established by law' and, in criminal cases, to more generous rights such as a presumption of innocence, a right to be informed of the nature and cause of the charges (and to have the assistance of an interpreter if necessary), adequate time to prepare a defence and the right to secure the attendance of witnesses.

One of the main issues to arise is the extent to which tax-related obligations are within Article 6(1), which requires either that the 'civil rights and obligations' of the claimant must have been affected, or that he is the subject of a criminal charge. As far as 'civil' rights are concerned, Strasbourg jurisprudence indicates that a taxpayer's obligations are outside the scope of Article 6(1) because they are public in nature. Thus it would appear that public law rights and obligations are not civil rights and obligations, whereas private law rights and obligations are. So, the obligations to make social security payments and to pay taxes are 'public' obligations since they derive from the citizen's normal civic duties in a democratic society¹¹³ and any procedural dispute, for example, concerning the restriction of a right of appeal¹¹⁴ in respect of the payment of such taxes, will not fall within the scope of Article 6(1).

It should be noted that, in contrast, restitution proceedings for tax paid under regulations later declared invalid do involve the determination of the applicant's civil rights because the action concerns a private law claim against the Revenue based on unjust enrichment.¹¹⁵ In such a case, where a taxpayer is given no right of appeal against a particular decision, or the right of appeal is so restricted that it is impossible to exercise, then Article 6(1) may be invoked. In *Ferrazzini v Italy*,¹¹⁶ a case in which the claimant alleged a violation of Article 6 on account of the length of tax proceedings to which he was a party, the majority of the European Court of Human Rights (sitting as the Grand Chamber of 17 judges, thus giving an indication of the importance of the issue) rejected the notion that the pecuniary nature of the claim was in itself sufficient to attract the applicability of Article 6(1) under the 'civil' head. Their view was that:

tax matters still form part of the hard core of public-authority prerogatives, with the public nature of the relationship between the taxpayer and the tax authority remaining predominant.¹¹⁷

¹¹³ *Schouten and Meldrum v Netherlands* (1994) 19 EHRR 432.

¹¹⁴ *Eagerpath v Edwards* [2001] STC 26.

¹¹⁵ *National Provincial Building Society & Ors v United Kingdom* (1998) 25 EHRR 127; [1997] STC 1466 at p 1490.

¹¹⁶ [2001] STC 1314.

¹¹⁷ *Ibid* at p1320.

Nonetheless, there was a strong dissenting opinion from six members of the Grand Chamber, and an indication that the majority view might not hold sway in the future. The view was put that:

as long as a dividing line between “civil” and “non-civil” rights and obligations is maintained in respect of proceedings between individuals and governments, it is important to ensure that the relevant criteria for determining what is “civil” are applied in a logical and reasonable manner – and that may make it necessary from time to time to adjust the case law in order to make it consistent in the light of recent developments.¹¹⁸

Whilst the majority considered that there had been no major developments in the field of taxation concerning the nature of the obligations of individuals and companies since the time of the drafting of the Convention, in the opinion of Judge Lorenzen, whose dissenting judgment represented the views of all the dissenters, this was far from reality. Whilst it was clear from the travaux préparatoires relating to Article 6 that disputes between governments and individuals generally were intended to be excluded from its scope, the lack of any specific reference to tax matters resting on the perception at the time that they were based on strict legal rules rather than on the exercise of discretion, it was also evident that administrative disputes were not intended to be excluded forever from the scope of Article 6(1). The major development to have occurred since 1953 is the recognition in the majority of contracting states that fiscal matters can be decided in ordinary proceedings by a court or tribunal. The fact of development, together with the caveat in Article 1 of Protocol No 1 that permits states to take measures for the purpose of collecting taxes, it would be wholly unfounded to deny to applicants procedural protection in disputes on tax matters. For these reasons, the minority was of the opinion that there were no convincing arguments in favour of the proposition that proceedings concerning tax do not determine ‘civil rights and obligations.’ The fact that UK taxpayers are now referred to as ‘customers,’ perhaps signifying a change in the nature of the relationship between the taxpayer and the Revenue from a public to a private one, may add further fuel to the flame.

Whether the Strasbourg court would accept such an argument is doubtful, bearing in mind the breadth of jurisdictions it must serve. The real question is whether it would find favour with the domestic courts, and whether the HRA has, in any event, caused them to adopt a different approach to the Strasbourg jurisprudence. The signs have not been promising. Prior to the *Ferrazini* case, the Court of Appeal had indicated in an *obiter dictum* that a challenge to a restriction with respect to an appeal seeking recovery of overpaid tax¹¹⁹ did not concern civil proceedings for the purposes of Article 6(1).¹²⁰ More recently, a Special Commissioner applied the *Ferrazinni* decision in two cases before him. In one, he dismissed a claim by a personal representative that an appeal against a notice of determination to inheritance tax was not within a reasonable time of the death of the testator in 1993¹²¹ and, in the other, he held that the imposition of a non-criminal tax penalty relating to the late payment of tax was so closely related to tax itself that it was not within the taxpayer’s ‘civil rights

¹¹⁸ *Ibid* at p 1324.

¹¹⁹ Pursuant to the Taxes Management Act 1970, s 33.

¹²⁰ *Eagerpath v Edwards* [2001] STC 26..

¹²¹ *Taylor (personal representative of Sosnowski, deceased) v IRC* (2003) Sp C 363; (2003) Simons Tax Intelligence 948.

and obligations.¹²² Furthermore, one commentator has expressed the view that *Ferrazzini* “makes it very unlikely that article 6 will be held to apply to most proceedings before the Special or General Commissioners or the VAT and Duties Tribunal.”¹²³

However, it is submitted that in these instances, no consideration at all was given to the dissenting minority opinion in *Ferrazzini*; that it was so strong and so well reasoned is surely an indication of a possible shift in direction, and it is argued that it should form the basis of an argument in the domestic courts, particularly in the higher courts, in future cases. Indeed, *Ferrazzini* has been rejected in one case by the VAT and Duties Tribunal. In *N Ali & S Begum & Ors v Customs & Excise Commissioners*,¹²⁴ the tribunal had to consider the preliminary issue of the extent the human rights of a taxable or potentially taxable person under Article 6, prior to deciding whether the tribunal and its procedures afforded that person a fair and independent hearing by an independent tribunal. Recognising that it was required to take into account decisions of the Strasbourg Court, but that it was not bound by them, the tribunal held that the majority decision in *Ferrazzini* was not applicable since:

there is no place in the laws of any part of the United Kingdom for a “public law” relationship, distinct from civil law rights and obligations, between taxpayer (sic) and the tax authorities.¹²⁵

Preferring the view of the minority in that case, the tribunal therefore held that the obligations imposed by the VAT assessments, default surcharge assessments, misdeclaration, late registration and civil penalty notices and notices of requirement for security were within the scope of Article 6(1) although, in the event, it was decided that the tribunal was sufficiently independent and impartial to satisfy the requirement set out therein. Although this decision should be hailed as representing a sea change in approach since the HRA, whether it will be followed in cases before the Special Commissioners remains questionable, bearing in mind that the decision was emphatically limited to VAT. As the tribunal pointed out:

The rights and obligations under the VAT code, a product of EC law, were not within the contemplation of those who drafted the Convention.¹²⁶

Different considerations apply to penalty proceedings which, if they can be classified as ‘criminal proceedings,’ are subject to the more generous protection mentioned before. Thus, Article 6(2) confirms the principle of innocence until proven guilty, whilst Article 6(3) guarantees certain minimum rights to everyone charged with a criminal offence. A spate of relatively recent decisions has been concerned with the question of whether certain tax, and ostensibly civil, penalties give rise to criminal charges within the meaning of Article 6(1).

¹²² *Bancroft & v Crutchfield* (2002) Sp C 322; (2002) Simons Tax Intelligence 1153. Interestingly, the Special Commissioner was of the further view that, if he was wrong on the point, and that Article 6(1) was engaged, judicial review alone of the Revenue’s decision was a sufficient remedy to satisfy the HRA.

¹²³ Jeremy Woolf, *Human Rights One Year On* (2001) The Tax Journal, Issue 617, 7 at p 8.

¹²⁴ (2002) VAT Trib 176851; (2002) Simons Tax Intelligence 1675.

¹²⁵ (2002) STC 1675 at p 1676.

¹²⁶ *Ibid.*

That such a penalty could be criminal in nature was confirmed by the Strasbourg Court in *Georgiou v United Kingdom*,¹²⁷ and was applied in the High Court in *King v Walden*¹²⁸ where it was held that the system for imposing penalties for fraudulent or negligent delivery of incorrect tax returns was criminal for the purpose of Article 6(1) because the system was punitive. In *Han v Customs and Excise Commissioners*,¹²⁹ the Court of Appeal, in deciding that appeals against civil evasion penalties¹³⁰ were criminal proceedings for the purpose of the Convention, agreed that the concept of a 'criminal charge' within the meaning of Article 6 is an autonomous one, and applied three criteria previously enunciated by the Strasbourg Court for determining whether a criminal charge has been imposed.¹³¹ These are, first, the classification of the proceedings in domestic law, secondly, the nature of the offence and, thirdly, the nature and degree of severity of the penalty that the person concerned risked incurring. In applying these criteria, Potter LJ said that they should not be considered separately, but as factors weighed together to decide whether, taken cumulatively, the relevant measures should be treated as criminal, and he concluded that, when coming to such a decision the second and third factors should weigh heavier than the first.¹³²

In slight distinction, two more recent decisions of the Strasbourg Court have treated the three criteria as alternatives and not cumulative, unless an analysis of each did not make it possible to reach a conclusion as to the existence of a 'criminal charge'.¹³³ In any event, our own courts are of the view that categorisation of the proceedings in domestic law is not decisive of their nature, and provides only a starting point for the classification. Applying the criteria to the facts before them, the Court of Appeal was of the opinion that the national classification of the penalties as 'civil',¹³⁴ did not represent a decision on the part of the legislature to de-criminalise dishonest evasion of VAT. The relevant provisions applied in principle to all taxpayers and sought to punish, rather than compensate, Customs and Excise. Finally, it was sufficient that the penalty was substantial and its purpose was punitive and deterrent, and there was no requirement that it should involve imprisonment. Accordingly, looking at the substance rather than merely the form of the penalty, it was evident that it amounted to a criminal charge to which Article 6 applied. For its part, the Strasbourg Court has also taken the view that so-called 'civil' surcharges amounting to 20% and 40% of the increased tax liability were criminal for the purposes of Article 6.¹³⁵

It has already been noted that the importance of the question at issue in cases such as *Han* lies in the protection afforded to taxpayers by the various minimum rights provided for by Article 6(2) and (3). It is critical, then, to have some certainty on the matter, and yet there is none. In *N Ali and S Begum & Ors v Customs and Excise*¹³⁶

¹²⁷ [2001] STC 80. The penalty in question was for dishonest evasion in respect of undeclared output VAT, but it was decided that there had been no infringement of Article 6 rights.

¹²⁸ [2001] STC 822.

¹²⁹ [2001] STC 1188.

¹³⁰ Imposed pursuant to the Value Added Tax Act 1994, s 60(1).

¹³¹ In *Engel v The Netherlands* (1976) 1 EHRR 647.

¹³² *Op. cit.* n 129 at pp 1208-1209.

¹³³ See *Vastberga Taxi Aktiebolag and Vulic v Sweden* (application no 36985/97) (final decision, 21.5.2003) and *Janosevic v Sweden* (application no 34619/97) (final decision, 23.5.2003).

¹³⁴ The classification came about through the implementation of the report of the Keith Committee, *Enforcement of Powers of Revenue Departments*, Cmnd 8822 (1983) and Cmnd 9120 (1984).

¹³⁵ *Op. cit.* n 139.

¹³⁶ *Op. cit.* n 130.

the VAT Tribunal concluded that serious misdeclaration penalties, default surcharges and late registration penalties were not criminal for the purposes of Article 6, a decision seemingly at odds with both the Strasbourg jurisprudence and the Court of Appeal. The Tribunal said that the penalties and surcharges in question had none of the characteristics of a criminal penalty, despite the fact that the 15% default surcharge appeared severe where the delay on payment was small,¹³⁷ and that the operation of the penalty regime under UK law adequately protected the rights of alleged defaulters, with no need for further safeguards.¹³⁸ What is not clear is whether the decision rests on the fact that the penalty was lower than in other cases, or on the fact that the Tribunal considered that the VAT system had inbuilt safeguards. If it is the former, then there needs to be spelt out with some precision how severe a penalty has to be before it metamorphosises into a ‘criminal charge;’ if it is the latter, then it is submitted that such a view may not withstand a review by the Court of Appeal.

The question that has to be asked is how are any future cases concerning penalties for misdeclaration, belated VAT registration, default surcharges, demand for security and refusal to restore seized excise, together with any future cases involving direct tax civil penalties, likely to be decided? This is surely one area where the HRA should have the greatest impact and yet, as both Potter LJ and Mance LJ said in *Han v Customs And Excise Commissioners*, there is unlikely to be any great change in existing procedures, provided all the necessary steps are taken to explain to the taxpayer his rights under the Convention and he is afforded his minimum rights under Article 6(3) (considered previously).¹³⁹ Certainly as far as Customs and Excise are concerned, this has proved to be the case, having amended their explanation to taxpayers involved in ‘civil’ investigations simply to confirm and explain the nature of a civil penalty.¹⁴⁰ In contrast, the Inland Revenue seems more aware of the possible impact of the HRA, and have issued guidance to their staff so as to avoid the possibility of infringing the taxpayer’s right of non-incrimination and right to silence.¹⁴¹ These particular issues will be discussed below, but it should be noted that the Revenue did not concede that their civil penalties were criminal in nature, but said that “it is not clear.”

The question of whether evidence obtained during interview or by way of disclosure breached the taxpayer’s right to silence and the right of self-incrimination were not resolved in the *Han* case, which the Court of Appeal recognised could only be dealt with by individual rulings by the VAT and Duties Tribunal in the light of the decision in *Han*. The issues concerning the invitation to cooperate with Customs and Excise, and subsequent disclosure of information, are at the heart of the civil evasion penalty regime, and similar considerations apply to the Revenue’s Hansard interview procedure. This procedure is adopted by the Revenue in cases of serious tax fraud, and permits the Board to accept a money settlement in lieu of instituting criminal proceedings in respect of the alleged fraud. Prior to recent changes made to the

¹³⁷ See also *Bancroft & Another v Crutchfield* (2002) Sp C 322; (2002) Simons Tax Intelligence 1153, where the late payment surcharge of 5% of unpaid tax under the Taxes Management Act 1970, s 59C was thought not to be sufficiently severe to constitute a criminal charge.

¹³⁸ *Ibid* at p 1677.

¹³⁹ *Op. cit.* n 129 at pp 1214, 1214-1215.

¹⁴⁰ HM Customs and Excise, *Civil Penalties: Fixed, geared and daily*, Notice 209 (December 2002).

¹⁴¹ Inland Revenue, *Guidance to Inland Revenue Staff on Human Rights and Penalties*, issued to Inland Revenue staff on 11 September 2002.

procedure, no undertaking was given that such a settlement would be accepted even if the taxpayer had made a full confession, and the Revenue's decision to exercise its discretion in favour of the taxpayer would have been influenced by the amount of co-operation given by him. In these circumstances, the taxpayer may well argue that his right to a fair trial has been breached because, by providing sensitive information under threat of a penalty, he has been forced to incriminate himself.

In *R v Allen*,¹⁴² a taxpayer charged with cheating the Revenue sought to have certain evidence, provided during a Hansard interview, excluded by relying on the privilege against self-incrimination. Although the House of Lords held that it was not necessary to consider the alleged breach of Article 6 because the HRA was not in force at the relevant time and it did not have retrospective effect, it nonetheless considered the issue. Confirming that the right to silence and the right to not incriminate oneself are "generally recognised international standards which lie at the heart of a notion of a fair procedure under Article 6," in Lord Hutton's opinion, to the extent that there was inducement to provide information contained in the Hansard procedure, it was to give true and accurate information to the Revenue. In *Allen*, the defendant failed to respond to the inducement and gave false information. Accordingly, his argument that he was induced to provide certain information to the Revenue by hope of non-institution of criminal proceedings by them, and that its provision was therefore involuntary and a breach of Article 6(1) was rejected. However, Lord Hutton concluded that, if true and accurate information is disclosed during the Hansard procedure, a taxpayer would have a strong argument that the criminal proceedings were unfair.¹⁴³

In the light of Lord Hutton's concluding words, changes have now been made to the Hansard procedure. As a consequence, a taxpayer making a full confession under this procedure is now assured that the Revenue will not pursue a criminal prosecution; the discretion previously enjoyed by the Revenue as to the course of action it would take following such a confession has effectively been removed. However, in addition to giving both a full and complete confession, the taxpayer must also offer full co-operation during the investigation, including the giving of full facilities for investigation into his affairs, and for the examination of such books, papers, documents or information as the board may consider necessary. Without such co-operation, the taxpayer remains at risk of prosecution. In addition, to avoid any further possibilities of infringing the taxpayer's rights under Article 6, as previously mentioned, the Revenue have also issued guidance to their staff,¹⁴⁴ a clear indication that the Revenue is taking the HRA seriously.

Just as the changes to the Hansard procedure were a direct result of the HRA, so also is the fact that taxpayers suspected of fraud must now be interviewed under caution. The Revenue had always maintained that the Hansard interview was part of a civil

¹⁴² [2002] 1 AC 509.

¹⁴³ *Ibid* at p 546.

¹⁴⁴ *Op. cit.* n 55. Under these guidelines, Revenue staff must make the taxpayer fully aware of (i) the need to provide information; (ii) the penalties that may attach if this is not done; (iii) the formal powers that can be used to obtain the necessary information should the taxpayer be unwilling to answer questions directed to him; (iv) the fact that the extent to which the taxpayer has freely and fully offered information may be taken into account in calculating the penalty; and (v) the fact that, in the event that the Revenue are unable to agree with the taxpayer, information or documents provided during the enquiry may be used in any appeal proceedings.

process, designed to gather in money, and was not a criminal investigation. However, in *R v Gill and Gill*,¹⁴⁵ taxpayers charged with cheating the Revenue challenged the use made of answers given by them during the Hansard opening interview. The Court of Appeal held that tax fraud involves the commission of a criminal offence or offences, with the result that the investigating of tax fraud must involve the investigation of a criminal offence. Accordingly, the provisions of the Police and Criminal Evidence Act 1984 applied to the Hansard interview, which involves the need to caution the taxpayer and to make a tape-recording of the interview.¹⁴⁶ Despite this, the court held further that, on the facts of the case, the admission of the evidence provided during the Hansard investigation would not have had such an adverse effect on the fairness of the proceedings that the court ought not to have admitted it. Although it was thus possible that the Revenue could have continued as normal using the new Hansard procedure introduced as a result of *R v Allen*¹⁴⁷ with the hope of surviving any subsequent challenge on the lines of *Gill and Gill*, the Revenue have now started to interview under caution, and to tape those interviews. Whilst this must be seen as a positive step towards the 'fairness' that is implicit in Article 6, the result must mean that taxpayers will need to be legally represented at all stages of a Hansard investigation, thereby increasing the taxpayer's costs even further.

CONCLUSION

European Community law has applied in the UK for three decades, but it is only relatively recently that its implications for income tax and corporation tax have begun to be understood.¹⁴⁸ The Human Rights Act 1998 has been in force for only three and a half years, and it is still too early to predict what future courts, particularly the House of Lords, will make of challenges by taxpayers. Since October 2000, there have been a sufficient number of tax cases before the domestic courts in which a breach of Convention rights has been alleged, for there to be no doubt that taxpayers are just as able to mount challenges under the HRA as, say, a person claiming wrongful imprisonment. The difference is, however, that taxpayers have enjoyed far fewer successes than other types of claimants, particularly when the challenge is in respect of a statutory provision. In this context, then, the future looks bleak for taxpayers. Thus, there has been much media speculation that the UK Labour Government is to abolish the CGT relief afforded to gains arising from the disposal of "the principal private residence."¹⁴⁹ This measure could theoretically be challenged as a breach of Article 1 of Protocol No 1, on the basis that the property was bought in the belief that, when it was sold, no CGT would be chargeable; any CGT eventually charged would, in effect, amount to retrospective taxation. The important question is whether, on the principles discussed in this paper, such a challenge would be successful. The discussion surrounding the proposed windfall tax suggests that, just like the Strasbourg Court, any domestic court will be reluctant to arbitrate on matters of tax policy and, in finding no breach, will formulate their decision on the basis of the wide

¹⁴⁵ [2003] EWCA Crim 2256;

¹⁴⁶ This is in contrast to the views of Potter LJ and Mance LJ in *Han v Customs and Excise* [2001] STC 1188 at pp1213,1214.

¹⁴⁷ *Op. cit.* n 142.

¹⁴⁸ See, for example, *ICI v Colmer* [1999] 1 WLR 2035.

¹⁴⁹ First reported in May 2003, Jennifer Adams, www.taxationweb.co.uk. Further reports followed, for example, see Robert Watts and Francis Elliott, *Chancellor looks at 40 per cent tax on all home sales*, The Sunday Telegraph, October 20 October, 2003, and Robert Watts, *Brown ponders plans to tax all house sales*, The Daily Telegraph, 20 October, 2003.

margin of appreciation afforded to the Government, and argue that the measure is in proportion to the needs of a democratic society. Only in very exceptional cases will the courts be willing to hold that a measure is not proportionate.¹⁵⁰

Challenging discretionary actions taken by the Revenue may also prove to be either difficult or impossible as an analysis of *R (on the application of Wilkinson) v IRC*¹⁵¹ has revealed. And perhaps that is all justifiable for, in the end, what is trying to be secured is a balance between the interests of the whole community and the protection of individual fundamental rights. It is all too easy to support the 'little' taxpayer against the might of the Revenue and Customs and Excise, departments universally loathed and vilified, sometimes without justification. The courts and tribunals, on the other hand, can look at the matter with dispassion, and can identify with relative ease those cases in which the taxpayer is simply jumping upon the 'human rights bandwagon.' However, when it comes to matters that are more in line with the original aims of the European Convention on Human Rights, for example, the presumption of innocence and the right to a fair trial, it has been shown that the domestic courts are more willing to consider holding both the Revenue and Customs and Excise to account, even to the extent of departing from the Strasbourg jurisprudence in holding that tax matters are not purely 'public' but are 'civil' for the purposes of Article 6(1). It is to be hoped that the courts will be rigorous in continuing to ensure that a taxpayer is treated as fairly as an ordinary criminal when being investigated in relation to serious fraud, and that any further attempt to infringe professional privilege will be held to be totally incompatible with Convention rights.

¹⁵⁰ As did the Strasbourg Court in *Darby v Sweden* (1991) 13 EHRR 774.

¹⁵¹ [2003] EWCA Civ 814; [2003] 1 WLR 2683.

Towards Community Ownership of the Tax System: The taxation Ombudsman's perspective

Philip Moss*

Abstract

Philip Moss reviews the various "controls" over the exercise of his powers of administration by the Commissioner of Taxation in Australia. He considers the terms of the legislation under which the Commissioner operates, the reporting requirements and the compliance with audit guidelines that affect the Commissioner. He describes the various Parliamentary committees that scrutinise tax administration and comments on them. He does the same for the Board of Taxation and the Treasury. The roles of the Administrative Appeals Tribunal and of the courts are also considered. More importantly, the author considers the purpose and powers of the Inspector General of Taxation, and the Special Tax Adviser to the Commonwealth Ombudsman. These two roles appear to overlap and even compete but, as the paper shows, they are complementary. The latter is concerned with individual taxpayers' circumstances whereas the former has a wider, more general policy ambit and is concerned with tax administration generally.

THE HISTORICAL BACKGROUND

In the early days of taxation in England, it was the exclusive prerogative of the Monarch to make executive decisions about taxation. However, to have all decisions going up to the pre-eminent person in the land would be a very cumbersome model, one unlikely to long survive. Indeed, about 150 years ago it was recognised that

“... as matters now stand, the Government of the country could not be carried on without the aid of an efficient body of permanent officers, occupying a position duly subordinate to that of Ministers who are directly responsible to the Crown and to Parliament, yet possessing sufficient independence, character, ability, and experience to be able to advise, and to some extent influence those who are from time to time set over them ...”¹

Those of you who enjoyed the “Yes Minister” TV series no doubt can imagine Sir Humphrey Appleby comfortably working within this model.

In Australia, section 61 of the Constitution provides for the exercise of the executive power of the Commonwealth. It “enables the Crown to undertake all executive action which is appropriate to the position of the Commonwealth under the Constitution ...” *Barton v Commonwealth* (1974) 131 CLR 477 at 498, per Mason J. This power may be abrogated by statute; no doubt the various taxation acts abrogate the executive power of the Commonwealth to take action otherwise than under those taxation acts in relation to the specific topics they cover. Those taxation acts also confer a general power on the Commissioner of Taxation to make decisions and take the actions that are necessary to administer those acts, eg, section 8 of the *Income Tax Assessment Act*

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¹ Report on the Organisation of the Permanent Civil Service (1854), The Northcote-Trevelyan Report.

1936, which states that the Commissioner shall have the general administration of this Act.

The Constitution in Chapter two anticipates that there will be an executive arm of Government responsible for the administration of Government policy and legislation. The tax system has always been grounded in legislation, which confers powers on the Commissioner of Taxation. The result is now a heavily legislated area. The Government has retained the right to determine tax policy, but it will choose legislation to implement that policy. The reality inevitably is that the tax system as we know it in Australia is established in legislation.

I understand that for many years it has been the practice for the Government of the day, when dealing with complaints about day-to-day decisions of the ATO, to assert that it is the Commissioner of Taxation who is responsible for the administration of the taxation law. In other words, freedom of the Commissioner from political interference in routine decision-making, and conversely non-accountability of the Minister in respect of routine decisions, and consequent freedom to concentrate on policy issues, would seem to have been a key value in our taxation system.

Of course, the Commissioner of Taxation has never been at large to do as he pleased. For example, he is controlled by the terms of the legislation he administers, he must report to Parliament and the Government, he is subject to audit, and his decisions may be subjected to judicial scrutiny. Other Government agencies, particularly the Treasury, contribute tax policy advice to the Government.

From the early days of taxation in Australia, it was possible for taxpayers to object to taxation assessments and, if the objection were disallowed, to seek review of the decision by a Taxation Board of Review. (In many respects, this arrangement was a pioneer model for administrative review, akin to the current Administrative Appeals Tribunal). The Boards were empowered, for the purpose of reviewing decisions, effectively to stand in the shoes of the Commissioner and exercise his powers (including discretions), and make decisions on the merits. This mix of external scrutiny for the tax office may have been adequate for the time, for it survived relatively unscathed, and apparently without undue disquiet, through much of the 20th century until the mid 1970's. However, during this time the ATO was evolving from "...a relatively small organisation with limited responsibilities to a relatively large bureaucracy with numerous social, political and economic objectives..."² The ATO continues to acquire responsibility for administering programs that are not directly related to revenue collection, such as superannuation guarantee, the baby bonus and the family tax benefit.

INCREASING ACCOUNTABILITY

Administrative Law at the Federal level was revolutionised during the 1970s. First came the Administrative Appeals Tribunal³ (although this had little initial application to the ATO, because of the continued operation of the Taxation Boards of Review) and the creation of the Administrative Review Council.

² Report 326, *An Assessment of Tax* (November 1993) Joint Committee of Public Accounts, Commonwealth Parliament, at page 27.

³ *The Administrative Appeals Tribunal Act 1975*

Then came the *Ombudsman Act 1976*. From that time, taxpayers with a complaint had an important additional avenue to seek a remedy, the right to seek an impartial review of ATO decisions by the Commonwealth Ombudsman. Taxpayers were quick to make use of this facility:

In 1977-78, the first year of operation, the Ombudsman received 333 tax complaints. Numbers have fluctuated considerably over the years, reaching a peak of 3354 during 2000-2001.

The law on judicial review was reformed, with the enactment of the *Administrative Decisions (Judicial Review) Act 1977*. As a result, it became easier to seek judicial review of a wide range of decisions of the ATO.

The reform continued into the 1980s, with the enactment of the *Freedom of Information Act 1982*, helping to underwrite democratic ideals by creating rights of access to information and documents, and helping to prevent improper practice and corruption.

The Taxation Boards of Review were subsumed into the Administrative Appeals Tribunal in 1986, bringing to bear the greater capacity and resources of that Tribunal (including Presidential members) on review of decisions on objections to taxation assessments.

No doubt picking up on the mood of the times the ATO, apparently largely on its own initiative, began to consult more widely with the community. This included establishment in 1985 of National and State Taxation Liaison Groups (with representation from professional associations and the Treasury) and the Commissioner's Advisory Panel (CAP) from 1989 (including various business and community associations).⁴ The ATO also established better internal complaint handling mechanisms, responding to an increasingly educated public, more conscious of their rights, including the right to complain.

One particular example of the ATO becoming more involved with the community was its sponsorship of the development of Atax here at the University of New South Wales (from around 1990). This initiative would have assisted the growth of external centres of excellence in taxation, and independent study, comment, and dialogue on taxation issues. This series of conferences is perhaps but one example of that process in operation.

MORE RECENT DEVELOPMENTS

Parliamentary Scrutiny

An interesting feature of the last decade or so has been the influence of the Federal Parliamentary committee system. The deliberations of committees can include the taking of evidence from the public as well as from tax officers and other public officials, such as the Ombudsman. Importantly, there can be input from the Opposition, minor parties and independents, so the reports do not necessarily represent Government policy, and can reflect a much wider community influence.

⁴ Report 326, *An Assessment of Tax* (November 1993), Joint Committee of Public Accounts, Commonwealth Parliament.

I have already referred to the November 1993 report of the Joint Committee of Public Accounts. This document made 148 recommendations that covered a wide range of tax administrative issues. Among them were recommendations to enhance the independence of the Commissioner of Taxation by requiring the tabling of any directions given by the responsible Minister to the Commissioner (recommendations 6 to 9). Other recommendations included formalising the role of Liaison Committees, facilitation of access of the public to private and public rulings and the establishment of a Taxpayers' Charter, a Commonwealth Taxation Ombudsman and a Small Taxation Claims Tribunal. Many of the recommendations seem directed at providing greater transparency, scrutiny and accountability for ATO operations. Not all of them were adopted.

More recently, problems have arisen due to the participation of many thousands of taxpayers in mass-marketed schemes. When the ATO acted to disallow tax advantages sought via the schemes, many of the taxpayers were unable or unwilling to pay the relevant tax or the accruing general interest charge. The Taxation Ombudsman investigated two of the arrangements, Budplan and Main Camp, and reports were duly published⁵. Yet another report dealt with film schemes. In the Main Camp report, the Taxation Ombudsman expressed the view that the ATO should "...bear some responsibility for the delays which have contributed to large interest bills..." It was recommended that all interest prior to 1 January 1998 be remitted, this being the date when the ATO made known its views on the particular arrangement under examination. Implicit in that recommendation is the notion that delay by the ATO in making known its views contributed to difficulties that taxpayers had in making payment of any tax properly due.

The problem then came under examination by the Senate Economics References Committee (SERC). The recommendations of that Committee, and the subsequent settlement offer by the Commissioner of Taxation, went further than the Taxation Ombudsman had been prepared to recommend. Eligible investors who were prepared to settle were granted nil penalties, nil interest, and conditional two years interest-free debt repayment. As I am sure you will appreciate, this is a much better deal than ordinary compliant taxpayers could expect to receive should they be unable to pay tax by the due date.

Another Parliamentary Committee, the Senate Standing Committee for the Scrutiny of Bills, in its report *Entry and Search Provisions in Commonwealth Legislation* (6 April 2000), recommended that the Ombudsman should undertake a regular, random "sample audit" of the exercise by the ATO of its entry and search powers to ensure that those powers have been exercised appropriately. The ATO has more intrusive powers than almost any other government agency. The Taxation Ombudsman is undertaking those audits.

The Information and Communication Revolution

We hear a lot about the effect of Globalisation and the increasing power of the people to access information and new ideas, shift funds, and co-ordinate tax planning across jurisdictions. There is certainly clear evidence of this in the cases we see, although we are not well placed to gauge the full extent of this development.

⁵ *The ATO and Budplan* (June 1999) and *The ATO and Main Camp* (January 2001), Reports under section 35A of the *Ombudsman Act 1976*.

Conversely, as will be seen from the foregoing discussion, there has been increasing pressure on the tax administration to disseminate quickly its views, provide electronic access to rulings, policies and practice statements, and provide early warnings to taxpayers. I have to say that in recent years the ATO appears to have made very effective use of modern communications to disseminate information to taxpayers. (Eg ATO website re tax avoidance, the public education program mounted for GST and the new tax system, the recent ATO publication on Tax Havens and tax administration).⁶

One factor underpinning the capacity of administrators to respond quickly to new developments must be new technology, and the power to analyse vast amounts of data and extract intelligence. For example, I note recent discussion in the media about global standards for dealing with and reporting suspected money-laundering arrangements.

There is also increased capacity for people to come together via the internet, gather support and apply co-ordinated political and administrative pressure. This capacity to establish and maintain contact is well illustrated by the remarkable phenomenon of mass-marketed schemes, already referred to. Here, a group of people some of whom, on one view, unambiguously set out to avoid tax⁷ were able to win concessions that would not have been achievable if they had not acted concertedly.

As an election approaches, we may again see media reports of pressure being applied to extend those concessions to participants in other tax avoidance arrangements. Also, the Inspector-General of Taxation has been asked by the Government to examine the consistency and appropriateness of ATO practices concerning remission of the general interest charge for groups in dispute with the ATO, including participants in employee benefit and other similar arrangements.⁸

Official Watch Dogs & Recent Administrative Changes

The Inspector-General of Taxation is an independent office created by the *Inspector-General of Taxation Act 2003*. The key function of the Inspector-General is to review systemic tax administration issues and to report to the Government with recommendations for improving tax administration. The sole focus for the Inspector-General is on tax systems rather than individual taxpayer matters since the Taxation Ombudsman deals with individual taxpayer disputes. The Inspector-General does not have the power to give directions or make recommendations to the Commissioner of Taxation. The review of the general interest charge, mentioned above, is a clear example of the role that the Inspector-General will perform.

Another recent creation is the Board of Taxation. The Board is a non-statutory body established to advise the Government on the development and implementation of taxation legislation and the ongoing operation of the tax system. A key objective of the Board is to ensure that there is full and effective community consultation in the design and implementation of tax legislation. This function includes monitoring and advising on the consultative and educative processes for the development of tax law.

⁶ Tax havens and tax administration, (2004) ATO

⁷ Mackenzie J., *Borg & others v Northern Rivers Finance Pty Ltd* (2003), Supreme Court of Queensland, commenting on "a conjunction of eager sellers and eager purchasers".

⁸ Media release dated 21 November 2003 by the Minister for Revenue and Assistant Treasurer, Senator the Hon. Helen Coonan,

The Board is also tasked with advising the Government on improving the general integrity and functioning of the taxation system and commissioning research and other studies on tax matters approved or referred to it by the Treasurer.

On 24 November 2003, the Treasurer announced the Government's decision to review the self-assessment system. This review was undertaken by the Department of the Treasury, and again involves extensive public consultation. A discussion paper was released in March 2004. That Department is also now responsible for the development of legislation to implement Government decisions on taxation, a function previously performed by the ATO.

The Role of the Ombudsman

At this stage, you may be wondering what role remains for the Ombudsman, first to be created among the independent watchdogs. It has to be acknowledged that there is some potential for overlap and confusion. For example, the Taxation Ombudsman currently has many complaints that raise issues related to groups of taxpayers and the general interest charge (the subject of review by the Inspector-General of Taxation), others that raise self-assessment issues (the Treasury review). One partial answer is that the Taxation Ombudsman will be working co-operatively with the newer players and will contribute our views and any insights gained from our cases. However, I should take this opportunity to reiterate the distinctive role that the Ombudsman plays in the taxation system.

The Taxation Ombudsman continues to be the only agency external to the ATO that can handle individual complaints about tax administration and resolve individual disputes. Hence, the obvious proposition is that the Taxation Ombudsman will focus primarily on individual complaints leaving the Inspector-General to conduct reviews of systemic issues.

The Ombudsman's Tax Team approaches the work of investigating and resolving complaints about tax administration from the perspective of administrative law rather than as tax law specialists. This statement should not be seen as discounting our knowledge of tax law. Rather our focus is on examining tax administration issues through the perspective of the Ombudsman Act.

Investigations by the Taxation Ombudsman are guided by the criteria spelt out in the Ombudsman Act. Our principal concern is whether an action of the ATO was contrary to law, unreasonable, unjust, oppressive, improperly discriminatory or based on a mistake of law or fact. The Taxation Ombudsman can also examine whether a legislative provision applied by the ATO, or an administrative practice followed by it, was unreasonable, unjust, oppressive or improperly discriminatory. The Taxation Ombudsman is limited to making a recommendation as to appropriate corrective action.

In working with the ATO, the Taxation Ombudsman has the advantage of his investigative experience in administrative matters over the breadth of the Federal bureaucracy, and indeed, the advantage of the corporate knowledge held in an office that has existed for over 26 years.

It is to be noted, however, that the Taxation Ombudsman's power to conduct own motion investigations remains. Again, clearly, there is some potential for overlap here. However, by appropriate liaison between agencies each will be able to

complement the work of the other and cooperate closely and consistently with our respective legislation.

We envisage that we would do fewer ATO-specific own motion investigations in future. These investigations would seem to fall more logically in the Inspector-General of Taxation's area of responsibility. However, the Ombudsman often undertakes own motion investigations into matters of more general administration such as FOI, record keeping, compensation and oral advice that cover many agencies. The ATO is a significant part of the federal bureaucracy and as such would naturally be included in such studies.

The establishment of the Inspector-General of Taxation has allowed the Taxation Ombudsman to refocus on achieving systemic remedies that arise from investigation of individual complaints. Some individual complaints indicate the presence of broader problems that can be redressed by the relatively efficient and informal processes of an Ombudsman inquiry.

This sort of approach would keep the Taxation Ombudsman's main focus on individual complaints and systemic remedies.

The Ombudsman provides an independent and informal avenue for taxpayers to raise their individual concerns. The Taxation Ombudsman follows a practical approach to complaint handling – identifying issues, setting the complaint on the path to resolution, and explaining the process to the taxpayer in a clear and open way. This serves the interests both of the individual taxpayer and of the tax system generally. The objective of our office, to achieve practical solutions to tax problems, remains vitally important.

INTERNATIONAL COMPARISONS

The facility for a citizen to be able to complain about taxation decisions to an official with an Ombudsman type function is by no means unique to Australia.

In the United Kingdom, the Ombudsman is an officer of the House of Commons, appointed by the Queen, and is able to consider a wide range of complaints (including those related to access to official information). Since 1993, there has also been the Adjudicator,⁹ specifically to investigate complaints about the way the Inland Revenue and the Valuation Office Agency handle taxpayers' affairs.

South Africa has a Service Monitoring Office to enable taxpayers to lodge complaints about the Revenue Service.¹⁰

New Zealand has interesting parallels with Australia. An Ombudsmen's office was established in 1962. The 1982 Official Information Act enables access to official information held by a Government agency, including the Inland Revenue Department. This Act also enables requesters to seek and obtain reasons for decisions. The New Zealand Government has indicated that it is committed to a generic tax policy process, a key feature of which is public consultation wherever practicable prior to the decision

⁹ The Adjudicator is Dame Barbara Mills DBE QC.

¹⁰ The Chief Executive Officer of the South African Revenue Service (SARS) Service Monitoring Office is Prof. Lynette Olivier.

to proceed. Otherwise, there is to be consultation about the shape of the changes, after an announcement of the policy change.

In the USA, disquiet about the functioning of the Internal Revenue Service (IRS) led to the enactment of the *Internal Revenue Service Restructuring and Reform Act 1998*. The Service was required by that statute to place a greater emphasis on servicing the public and meeting taxpayer needs. The Act considerably strengthened the office of the National Taxpayer Advocate¹¹ and defined it as an independent organisation, but within the IRS. The Advocate has some 2200 employees, or about 2 percent of IRS staff.

One of the functions of the Advocate is to assist taxpayers in resolving their problems with the IRS, called the case advocacy function. The statute also authorises the Advocate to identify and propose both administrative and legislative recommendations that will mitigate taxpayer problems. Given that Australia has a Taxpayers' Charter, it is interesting to read the USA Taxpayer Advocate calling in her 2003 paper for the tax system to "...respect taxpayer rights, broadly defined to include both access and customer service. Customer service must rise to the level of a taxpayer right..."¹² Her rhetorical questions would seem to be universal: "... what about...the right to courteous treatment, prompt and accurate answers, willingness to listen and keep an open mind, helpfulness, and the technical ability of the tax administrator? Is it too much to ask of the tax administrator that he [or she] will occasionally put himself [or herself] in the shoes of the taxpayer and think about what the taxpayer is experiencing as the tax system plows on..."¹³

One of the main themes of the Advocate's report to Congress for the year ended 31 December 2003 is the need to achieve proper balance between IRS enforcement activity on one hand and customer service and taxpayer rights on the other.

...Clearly, the IRS needs to maintain an active and vigorous presence in enforcing this country's tax laws. But these enforcement initiatives must be balanced with an equally vigorous protection of taxpayer rights, including the delivery of outstanding service..."¹⁴

Again, we daily face problems arising from this very same balancing trick.

The USA also has an IRS Oversight Board and a Treasury Inspector General for Tax Administration.

CONCLUSION

In the TV series, Sir Humphrey generally managed to keep the Minister on a very tight rein, and did not lightly suffer any meddling in his administration. Clearly, Sir Humphrey would not have made a good tax commissioner under modern conditions.

Intuitively, given the pervasive impact of taxation legislation, it seems appropriate that there be wide community input and acceptance of responsibility for design and management of the tax system.

¹¹ The National Taxpayer Advocate is Ms Nina E. Olson.

¹² "Taxpayer Rights, Customer Service, and Compliance: A Three-Legged Stool", Nina E. Olson, Kansas Law Review 2003 Symposium.

¹³ Nina E. Olson, *op cit*, p. 4.

¹⁴ National Taxpayer Advocate, *2003 Annual Report to Congress*, 31 December 2003.

Existence of multifaceted arrangements for consultation and review does present some problems for taxpayers and their professional advisers. When a remedy is needed, what is the most appropriate course to pursue: complaint to the ATO, complaint to a Member of Parliament or the Government, objection to an assessment and subsequent review or litigation, judicial review, complaint to the Ombudsman, or seek to involve the Inspector-General or the Board of Taxation? Or press all the buttons at once?

The answer depends largely on the nature of the problem. Is the issue one of interpretation of the law, does it raise a general systemic issue or affect large numbers of taxpayers, is a change in government policy required, or is the decision under question perceived to be contrary to law, unreasonable, unjust, oppressive or improperly discriminatory? The course to be adopted will remain one requiring some judgement, as well as an appreciation of the roles of the various agencies that might be able to assist and is as much a challenge to the tax administrators, and those overseeing the system, as for taxpayers and their advisers.

Trusts and Double Taxation Agreements⁺

John Prebble*

Abstract

This paper considers the correct interpretation of double tax agreements in the context of locally resident accumulation trusts established in New Zealand or Australia, that have foreign settlors and foreign-source income. The author explores the relevance and application of double tax agreements intended to minimise double taxation between New Zealand or Australia on the one hand and the source country on the other hand. In the process he identifies a difference in approach in Australia compared to New Zealand as they accord different treatment to accumulation trusts that have foreign settlors and foreign source income. The paper explores the reasons for, and the implications of, the different outcomes highlighting some key issues in tax administration where international tax is concerned.

INTRODUCTION

This paper deals with trusts that are established in New Zealand or Australia, with locally resident trustees, but having foreign settlors and foreign-source income. For purposes of source country tax, it may be relevant whether there is an agreement to minimise double taxation between New Zealand or Australia on one hand and the source country on the other hand. This question can arise in two contexts. First, if by a double tax agreement a source country grants privileges to taxpayers who are “resident” in terms of the treaty in the destination country, will the source country treat a trustee who is resident in the destination country as so “resident” for purposes of the source country’s taxation rules? Secondly, where a country agrees to reduce or eliminate withholding tax on outward-flowing passive income that is received by beneficial owners if they are resident in the jurisdiction of the treaty partner, will the source country treat a trustee for foreign beneficiaries as a “beneficial owner” in terms of the treaty?

These questions relate particularly to accumulation trusts, the subject of this paper. Where trusts do not accumulate, but distribute income as it arises, most jurisdictions that recognize the concept of the trust treat the beneficiary as the taxpayer, not the trustee. That is so in respect of both fixed and discretionary trusts.¹ As a result, in the context of distributing trusts, because the beneficiary is the taxpayer it is the residence of the beneficiary that matters, not the residence of the trustee.

DIFFERENCES BETWEEN AUSTRALIAN AND NEW ZEALAND REGIMES

In principle, the questions set out in the first paragraph of this paper raise the same issues and are answered in the same way in both New Zealand and Australia. In

⁺ This paper is a revised and expanded edition of John Prebble, “Accumulation Trusts and Double Tax Conventions” [2001] *British Tax Review* 69. It takes into account amendments to the Commentary the Model Tax Convention, published as OECD Committee on Fiscal Affairs, *OECD Model Convention on Income and on Capital*, Condensed Version, Paris, 2003.

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¹ See generally, J.F. Avery Jones et al “The Treatment of Trusts under the OECD Model Convention—I” [1989] *British Tax Review* 41, 50 ff.

practice, although the answers to the questions are the same in both countries there are significant second-order differences. The reason is that New Zealand and Australia accord different treatment to accumulation trusts that have foreign settlors and foreign source income.

Trusts with foreign settlors and foreign source income will often have foreign beneficiaries also. Such trusts are particularly likely to have foreign beneficiaries if they were established pursuant to a plan that is designed to take advantage of the New Zealand tax regime in respect of such trusts, which is described in the next paragraph.

In New Zealand, where New Zealand resident trustees accumulate income in respect of trusts with foreign settlors and foreign source income there is generally speaking no New Zealand tax. The rule is in section HH 4(3B) of the New Zealand Income Tax Act 1994. In contrast, Australia generally, and for practical purposes invariably, taxes accumulations to trustees of such trusts if they are resident in Australia. One result of this difference is that it is fairly common for foreign settlors to appoint New Zealand resident trustees to administer trusts of foreign property that they settle, whereas it is rare for foreign settlors to appoint Australian trustees, at least where there are no Australian beneficiaries or property.

Because there are a good many New Zealand resident trustees who administer trusts that are in other respects foreign, the issue arises as to how other countries that have tax treaties with New Zealand tax outward-flowing income that is bound for New Zealand resident trustees. This general issue gives rise to the specific questions set out in the first paragraph of this paper. As mentioned, readers should bear in mind that the answers to these questions are generally the same in respect of countries that have treaties with Australia as in respect of countries that have treaties with New Zealand, though in Australia the issue is generally less likely to arise in practice.

Positive answers to the questions are not crucial to all plans to employ New Zealand-resident trustees to receive foreign source income, but positive answers can significantly add to the attractiveness of that strategy. This paper addresses the subject from the point of view of New Zealand double tax agreements, of which there are twenty-seven.²

RESIDENCE CLAUSES IN DOUBLE TAX AGREEMENTS

Suppose that a trustee of foreign-source income is clearly resident in New Zealand for purposes of the Income Tax Act 1994. Does it follow that New Zealand's treaty partners must treat that trustee as resident in New Zealand for tax purposes and for purposes of the provisions of their several treaties? In most New Zealand treaties, the residence clause is based on Article 4(1) of the 1977 OECD model convention, which reads:

For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. [It is convenient

² In April 2004 New Zealand was party to three additional double tax agreements that were signed but not in force.

for purposes of this paper to call the clause beginning “But this term ...” the “proviso” to Article 4(1).]

Most of New Zealand’s treaties follow Article 4(1) of the OECD Model or a simplified version of it: Belgium, China, Denmark, Finland, France, Germany, India, Ireland, Italy, the Netherlands, Norway, the Philippines, and Switzerland. The treaty with Indonesia omits the proviso or any counterpart of it. The Swedish treaty and most treaties with British Commonwealth countries have a much simpler format, but a format that, like the Indonesian treaty, contains no proviso: Australia, Canada, Fiji, Malaysia, Singapore, Sweden, and the United Kingdom. The New Zealand-United Kingdom Article 4(1), for example, reads:

For the purposes of this Convention, the term “resident of a Contracting State” means, as the context requires: (b) any person who is resident in New Zealand for the purposes of New Zealand tax.

The relevant terminology in the Japan treaty is to a similar effect but takes a different form. The treaty with the United States, which is influenced by the United States model draft, contains a second proviso, subparagraph (b) in the relevant article:

In the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

These various versions of Article 4(1) pose the question: where a trustee is resident in New Zealand in the ordinary meaning of the term, but is not taxable on trustee income in New Zealand because the income is foreign and no settlor has any New Zealand connection, can the trustee be considered to be resident in New Zealand for treaty purposes? The United States formula poses the question most acutely. It is arguable that the question must be answered by reference to liability as a trustee alone, because New Zealand treats a trustee’s income independently from the trustee’s personal income.³

Robert Venables takes the view that mere residence of a trustee within the jurisdiction of a treaty partner does not give a trust foreign-residence status vis-à-vis the United Kingdom revenue authorities. He says in *Non-Resident Trusts*⁴

It should be borne in mind that even if the trustee is resident in a jurisdiction which has a DTT⁵ with the UK and for the purposes of that treaty is regarded as a resident of the other jurisdiction and not of the UK, the treaty will not deem him to be non-resident in the UK for any purpose other than that of his own taxability. In particular, it will have no bearing on the question of where the trust of which he is trustee is resident.

Venables’s opinion may be the view that would prevail among the United Kingdom Commissioners of Inland Revenue. Moreover, that opinion is probably the better view in general. On the other hand, a study by John Avery Jones and others published in 1989 took the view that at least in the United States, the United Kingdom, Canada, and Australia, “a trustee is reasonably clearly to be treated as a person, who can therefore

³ Income Tax Act 1994 s HH 4(1).

⁴ 5th ed 1993, ¶6.1.2.

⁵ Double Tax Treaty (footnote added).

probably be a resident of a state for treaty purposes.”⁶ Avery Jones points out that this conclusion fits awkwardly with treaty rules that apply to resolve dual residence issues that arise for trustees, because the criteria by which treaties determine the residence of individuals (availability of a permanent home, centre of vital interests, an habitual abode, and nationality)⁷ are not appropriately applied to persons in their capacity as trustees. Referring initially to Canadian law, Avery Jones explains:⁸

It is arguable that because a trustee in his capacity as such does not have a permanent home, a centre of vital interests, an habitual abode or a nationality (particularly in the case of a corporate trustee), the tests set out in article 4(2) are inappropriate and therefore inapplicable. If this argument prevails, article 4(3) applying the place of effective management to persons other than individuals, would presumably apply. ... Article 4(3) would apply in the United Kingdom, where a trustee is not treated as an individual, and the United States, and Australia.

Avery Jones’s argument appears to be that although, as explained in the previous paragraph, a trustee is a *person*, and therefore can be resident somewhere for treaty purposes, it is not appropriate to determine the residence of a trustee by tests that apply to *individuals*. The need to make this argument gives rise to the question as to whether Avery Jones’s basic premise can be correct. If a trustee is a “person” for treaty purposes, but if trustees who are individuals are not to be treated as such, the text of Article 4(2) and (3) does not aptly apply to them. But if this is so, why should we assume that Article 4(1) is meant to apply to trustees as well? That is, one could argue that a state that adopts Article 4(2) and (3) is perhaps assuming that none of Article 4 (in particular, not Article 4(1)) applies to taxpayers in their capacity as trustees. This conclusion leads back to the argument of Robert Venables, discussed above, that the personal residence of individuals does not determine their residence as trustees if they happen to be trustees. Nevertheless, it is worth examining particular treaty drafts to determine whether there are possible contrary views, at least in respect of some versions of Article 4(1). One thesis of this paper is that, all things considered, these contrary views must command considerable respect.

INTERPRETING DIFFERENT FORMS OF RESIDENCE CLAUSES

As mentioned in section 2 of this paper, subject to certain exceptions, section HH 4(3B) of the New Zealand Income Tax Act 1994 provides that where a trustee is resident in New Zealand, that New Zealand residence does not render the trustee liable for New Zealand tax on foreign source income that he or she receives as trustee.⁹ How does this rule mesh with the several versions of the residence rule in New Zealand’s treaties?

Where it is a question of the taxation of income that is sourced in the jurisdiction of one or other of New Zealand’s treaty partners, the answer to this question is ultimately a matter for the courts of those treaty partners. Nevertheless, because countries try to adopt similar approaches to the interpretation of double tax treaties, one can

⁶ J.F. Avery Jones et al “The Treatment of Trusts under the OECD Model Convention–II” [1989] *British Tax Review* 65, 66. This article collects the relevant authorities.

⁷ OECD Model Convention Art 4(2) 1977.

⁸ J.F. Avery Jones et al “The Treatment of Trusts under the OECD Model Convention–II” [1989] *British Tax Review* 65, 67, footnotes omitted.

⁹ New Zealand Income Tax Act 1994 s HH 4(3B).

reasonably make an attempt to identify the relevant questions and sometimes to answer them.

RESIDENCE OF DIRECTORS

New Zealand resident trustees may be either individuals or companies. In the case of a company the residence of directors does not make any difference to the fiscal residence of the company from the point of view of New Zealand domestic law.¹⁰ Double tax agreement rules on residence of companies are generally to the same effect. Both the OECD model and the incarnations of that model in New Zealand's tax treaties take a fairly formal approach to the question of the separate personality of companies. As a result, by the terms of those treaties residence of shareholders and directors is not directly relevant to the determination of fiscal residence of a company.

EFFECT OF "SUBJECT TO TAX IN THE TREATY STATE" PROVISIONS

What is the import of Article 4(1) of the OECD model and its counterparts in New Zealand's treaties? Take first the United States treaty. It is the only agreement that contains text to the effect of its subparagraph (b), which was quoted earlier.¹¹ Suppose that a New Zealand resident company derives United States source income, income that the company receives beneficially and that arises from United States investments that the company owns beneficially. In those circumstances, and in respect of that income, vis-a-vis the United States Internal Revenue Service the company must be treated as a New Zealand resident that can make use of the protections that are in the treaty. The same applies to an individual taxpayer who is resident in New Zealand.

Suppose, however, that the company receives the income as a trustee. Then, as far as that income is concerned, it would seem that the company would not be a New Zealand resident for the purposes of the United States treaty, because the income would not be "subject to tax in [New Zealand] as the income of a resident." Accordingly, the income could not claim treaty protection from United States taxation. This company, receiving income as a trustee, may be taken as a generic example of a New Zealand resident, either a company or an individual, who is trustee of a trust where settlor and income are foreign.

Secondly, take a residence definition from a treaty that includes a counterpart to the proviso to Article 4(1) but no counterpart of the United States subparagraph (b): say the treaty with France. The relevant text of the proviso is: "[resident] does not include any person who is liable to tax in [New Zealand] in respect only of income from sources in [New Zealand]." In respect of French-source income, does this text disqualify the company from treaty protection?

STRICT INTERPRETATION APPEARS CORRECT

When the treaty is strictly interpreted, the answer seems to be no, the proviso does not disqualify the company from protection. The important factor is that the fulcrum of Article 4(1)(a) is the taxpayer (that is, the resident), not the tax. Unlike the New Zealand-United States paragraph (b) that is considered above, Article 4(1)(a) does not focus on particular income streams, treating a taxpayer as resident in respect of one

¹⁰ Income Tax Act 1994 s OE 2.

¹¹ Section 3 of this paper.

income stream and not in respect of another. In contrast, Article 4(1)(a) simply postulates a test whereby the taxpayer either is or is not resident for treaty purposes.

As a resident of New Zealand, the company is liable to New Zealand tax on both domestic income and foreign income if the company should happen to derive income of either type. This is the position whether the company derives the income beneficially or as a trustee. In respect of trustee income, the rule is subject to the exception that is vital to the theme of this paper. That is, section HH 4(3B) of the New Zealand Income Tax Act 1994 simply relieves the company from liability for tax on foreign source income that it derives as a trustee where, to generalize, there is no settlor resident in New Zealand.

ALL-OR-NOTHING ARGUMENT

Article 4(1)(a) of the New Zealand–France treaty is drafted on an all-or-nothing basis. For treaty purposes, the taxpayer either is, or is not, a resident of the relevant contracting state. Looking first at the “all” basis of this dichotomy, it follows that the correct interpretation of Article 4(1)(a) seems to be that if a taxpayer who is resident in one of the countries is liable to tax on at least some types of foreign source income if the taxpayer were to derive those types of income, then the taxpayer is to be treated as a resident of that country for all treaty purposes. It follows, for instance, that if a New Zealand-resident taxpayer is protected by the treaty in respect of any income that has its source in France, then the treaty protects the New Zealand resident in respect of all French-source income (assuming that the income is income of one of the kinds that enjoys treaty protection).

A consideration of the possible alternative (that is, the “nothing” alternative in the all-or-nothing dichotomy) reinforces the interpretation offered here. The “nothing” alternative would say that if someone who appears to be a New Zealand resident does not qualify for treaty protection in respect of one kind of income (in this case, income derived as a trustee that New Zealand chooses not to tax) then that apparent resident would appear not to be a resident for any purposes of the relief of double taxation as far as the treaty is concerned. This argument can hardly be sustained. First, it has no support from the text of the treaty. Secondly, it would mean that few New Zealanders could benefit under a treaty that is clearly meant to protect them from double taxation.

The problem is that in principle, many, perhaps most, New Zealand resident taxpayers are potential trustees (in that some day someone may appoint them as trustees) and, as trustees, they may one day receive trustee income from France, income that would not be assessable in New Zealand (assuming that the settlors of the trusts in question were foreign). If the New Zealand–France treaty fails to protect the New Zealand taxpayers in these circumstances it would appear not to protect them in any circumstances. That is an absurd result. The New Zealand–France treaty cannot intend that the possibility that New Zealand resident taxpayers might one day derive foreign-source income as trustees (being income that New Zealand does not tax) should disqualify these same New Zealand resident taxpayers from the protection of the treaty in respect of other income that the New Zealand residents may derive. One is forced to reject the “nothing” conclusion and to adopt the “all” conclusion.

TAXPAYERS TWO NOTIONAL PERSONS?

A response to the argument just made is that the treaty requires taxpayers to be treated as two notional persons. In the case of companies, the first is an artificial person that is

taxed as an ordinary corporate taxpayer. The second is the company in its capacity as a trustee. Qualification for or disqualification from treaty protection of someone in the company's second (trustee) capacity has no effect on the company's treaty rights as an ordinary corporate taxpayer.

This response is attractive from a policy point of view. No doubt, that is how treaties *should* work.¹² The problem is that the text of a double tax convention that is drafted in terms of the New Zealand-France treaty offers no support for this interpretation. One can argue that a taxpayer who is a trustee cannot be resident in respect of trust income, but the text contains no basis for saying that a taxpayer can be resident for some fiscal purposes and not for others. More so, if a taxpayer that is a trustee is excluded from treaty benefit, why stop at that point? What about taxpayers who might one day be trustees? Such a result seems to be compelled by the logic of the "nothing" alternative, but it would be absurd to exclude taxpayers from treaty benefits on the basis that they might one day become trustees. As argued above, it seems to follow that trustees may take treaty benefits, both as trustees and in their own capacities as taxpayers.

SUBSTANTIVE INTERPRETATION NOT COMPELLING

A more substantive interpretation might suggest that the focus should be neither on the taxpayer, nor on whether the taxpayer is potentially liable to tax on some foreign source income, but on items of foreign source income, on a case-by-case basis. Is the New Zealand taxpayer assessable to New Zealand tax on this particular income from France, being trustee income? If not, the argument runs, the treaty should not protect the income. The answer to this argument is that the proviso deals with persons, not items of income. A person either is, or is not, entitled to treaty protection. Article 4(1)(b) of the New Zealand-United States treaty, on the other hand, considers income on an item-by-item basis, as already explained. When New Zealand's treaties were drafted, income on an item-by-item basis could have been added to the treaty text to the effect of the New Zealand-United States Article 4(1)(b). The omission arguably shows an intention to retain the taxpayer-by-taxpayer approach that is mandated by a literal interpretation of the proviso. The better view, therefore, is that the French treaty, and others like it, protect income derived by New Zealand resident trustees even where the receipts are trustee income and not subject to New Zealand tax.

It follows with greater force that where the corresponding article takes the simplified form that is found in the United Kingdom treaty,¹³ foreign source trustee income derived by New Zealand resident trustees enjoys treaty protection in the same manner. This conclusion, and the conclusion in the previous paragraph, may be modified by consideration of the second question raised by double tax agreements that is relevant in the present context. This question is whether a trustee can be said to derive income as a "beneficial owner", which is commonly a pre-requisite for treaty protection, at least in respect of passive income. That question is considered next.

¹² See also the view of Robert Venables QC, discussed above under heading 3.

¹³ Convention between New Zealand and the United Kingdom for the Avoidance of Double Taxation (1983) Article 4 (1): "For the purposes of this Convention, the term 'resident of a Contracting State' means, as the context requires: (a) any person who is resident in the United Kingdom for the purposes of United Kingdom tax; or (b) any person who is resident in New Zealand for the purposes of New Zealand tax."

DOUBLE TAX AGREEMENTS AND LIMITS ON WITHHOLDING TAX

Apart from the treaty with Japan, all New Zealand's double tax agreements provide for a reduction in withholding tax on interest, dividends, and royalties that flow between parties resident in New Zealand and the relevant treaty partner, provided that the recipient is the beneficial owner of the income in question. In this respect, like other countries, New Zealand follows the OECD treaty model. The 1963 OECD model omitted the "beneficial owner" requirement, but it has been present since 1977. The OECD model royalty articles are reproduced here by way of example. Articles 12 and 13 of the New Zealand-United Kingdom treaty, which apply to interest and to royalties, follow, as examples of adaptation of the OECD model in practice.

OECD Article 12(1) Royalties 1963. Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other state.

OECD Article 12(1) Royalties 1977. Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other state if such resident is the beneficial owner of the royalties.

OECD Article 12(1) Royalties 1997 and 2003. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other state. [Amendment to the model made in 1995.¹⁴]

New Zealand-United Kingdom treaty signed 1983.

Article 12(1). Interest arising in a Contracting State which is derived by a resident of the other Contracting State may be taxed in that other State. However, such interest may also be taxed in the Contracting State in which it arises and according to the law of that State but where the beneficial owner of such interest is a resident of the other Contracting State the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

Article 13(1). Royalties arising in a contracting state which are derived by a resident of the other contracting state may be taxed in that other state.

Article 13(2). However, such royalties may also be taxed in the Contracting State in which they arise and according to the law of that State, but where the beneficial owner of such royalties is a resident of the other Contracting State the tax so charged shall not exceed 10 per cent of the gross amount of the royalties.

A number of New Zealand's treaties use "beneficial ownership" or "beneficially entitled"¹⁵ in their passive income provisions, rather than "beneficial owner", but there appears to be no difference in meaning. For simplicity, the present paper uses "beneficial owner" as an appropriate generic term.

The Japan treaty has no limitation for tax on interest or royalties, but caps tax on outward-flowing dividends at fifteen per cent. Uniquely in New Zealand's treaties, although this limit is available to recipients of dividends who are "resident in the other Contracting State", there is no requirement that such residents must own the dividends beneficially.

¹⁴ OECD Committee on Fiscal Affairs, *OECD Model Convention on Income and on Capital*, Commentary on Article 12, loose leaf, Paris, first published 1997.

¹⁵ Eg, Australia-New Zealand, 1995.

THE REQUIREMENT OF BENEFICIAL OWNERSHIP

If a New Zealand resident trustee were to receive, say, royalties, from someone in the United Kingdom, would the trust be able to take advantage of the ten per cent limitation on withholding tax on royalties that is imposed in the United Kingdom-New Zealand Treaty? The answer to this question is a matter for the law of the United Kingdom, rather than for New Zealand law; the answer depends on how United Kingdom courts would interpret the double tax agreement. Similarly, in respect of interest, dividends, or royalties received by the trustee from any other jurisdiction with which New Zealand has a double tax agreement, the effect of the beneficial ownership requirement is a question for the courts of that jurisdiction.

Having said that, one should note that in a number of countries the beneficial ownership condition is thought to have relatively little effect in practice. That is, taxpayers pay out dividends, interest, and royalties to people or companies that are residents of treaty partner countries, and, reputedly more often than not, deduct withholding tax at only the reduced treaty rate without questioning whether the recipient is the beneficial owner of the income. This is said to happen without adverse reaction by the revenue authorities in the source country, though some fiscal authorities make regular inquiries of people who pay out passive income to alleged “beneficial owners” in other jurisdictions, and other fisces are becoming more interested in the question.¹⁶

THE COMMENTARY ON THE MODEL CONVENTION

The approach that is reputedly a fairly general practice has some justification in law, in that the OECD draft model on which the New Zealand treaties are based does not clearly intend that the beneficial ownership limitation should exclude trustees from treaty benefits. For instance, the official Commentary to Article 12, Royalties, of the 1977 draft (in force when most of the New Zealand treaties were signed) states:

Under paragraph 2 [of the draft convention] the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all member countries). States who wish to make this more explicit are free to do so during bilateral negotiations.

The Commentary on Article 12 was slightly modified in 1995, and the words in brackets were inserted into the ambulatory OECD model and Commentary that was extant from 1997 to 2003. There were similar amendments to the Model in respect of Articles 10, Dividends, and 11, Interest.

What the Commentary stated is true: that is, the Model Convention text was amended, and the new versions of the articles do make a little clearer “this point”, being the point that treaty benefits are intended for beneficial owners only; but there has never been serious doubt on that score. Where doubt exists is, what is meant by “beneficial owner”? The 1995 amendments to the Model Convention and the 1997 amendments to

¹⁶ Informal discussions between the author and tax practitioners in several jurisdictions.

the Commentary shed no light on this question. The Commentary changed again in the 2003 edition of the Model, to read in respect of Article 12:¹⁷

The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the state of source is not obliged to give up taxing rights over royalty income merely because that income was immediately received by a resident of a State with which the State of source has concluded a convention. The term “beneficial owner” is not used in a narrow, technical sense, rather, it should be understood in its context and in light of the object and purpose of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

COMMENTARY BEFORE 2003

It is helpful to focus first on the Commentary as it read before the amendments of 2003. As explained, the Commentary said that it was “an intermediary such as an agent or nominee” who was intended to be excluded from treaty benefits. It is doubtful whether a trustee can sensibly be called an “intermediary” at all, but a trustee is certainly not “an intermediary such as an agent or nominee”.

In common law jurisdictions there is considerable difference between a trustee, on the one hand, and an agent or nominee on the other hand. As recipients of income, the latter have no relevant status independent from their principal. Use of an agent or a nominee to receive income is in substance not much different from using an address of convenience. Trustees, in contrast, have functions that are independent of their beneficiaries and settlors (apart from bare trustees, who should be treated as nominees). On the other hand, and again in common law jurisdictions, the very essence of ownership as a trustee is that it is different from beneficial ownership. From a common law point of view the whole point of being a trustee is that one is not a beneficial owner.

Nevertheless, some commentators argued that, at least where trustees accumulate income, and are not obliged to distribute it in the same year to beneficiaries, the trustees do have beneficial ownership of the income in the sense that is required by the standard formulation in double tax conventions.¹⁸

THE AMENDMENTS OF 2003

The 2003 amendments both erode and reinforce this argument. The erosion is by virtue of the deletion of the words “such as an agent or nominee”, which tended to limit the scope of the meaning “intermediary” to someone who, unlike a trustee, has no powers independent of the principal. The deletion of these words potentially allows greater scope to “intermediary”, scope that might include “beneficiary” in its technical sense as used by common law jurisdictions in the law of trusts. On the other hand, the 2003 version of the Commentary immediately dispels this argument by saying that “the term ‘beneficial owner’ is not used in a narrow, technical sense”. The only “narrow, technical sense” of “beneficial owner” comes from the common law of trusts. The implication is that in the view of the OECD Committee on Fiscal Affairs,

¹⁷ OECD Committee on Fiscal Affairs, *OECD Model Convention on Income and on Capital*, Condensed Version, Paris, 2003, 173.

¹⁸ See below, section 19, “Opinions of civil law jurists as to “beneficial ownership”.

who wrote the Commentary, at least some trustees may be “beneficial owners” for purposes of the relevant treaty articles. That is, at least some trustees are not disqualified from treaty benefits by a narrow, technical interpretation of “beneficial owner”.

“BENEFICIAL OWNERSHIP” AND THE NEW ZEALAND OBSERVATION

A number of New Zealand’s treaties address the question of the interpretation of “beneficial owner” or “beneficial entitlement” by provisions in the interpretation article, which is ordinarily Article 3. There is a typical example in the agreement with Canada:

In determining, for the purposes of Articles 10, 11, or 12, whether dividends, interest, or royalties are beneficially owned by a resident of a contracting state, dividends, interest, or royalties in respect of which a trustee is subject to tax in that Contracting State shall be treated as being beneficially owned by that trustee.

Such provisions in treaties to which New Zealand is a party have their origin in a New Zealand observation to Article 3 (General Definitions) of the OECD Model:

For the purposes of Articles 10, 11, and 12, New Zealand would wish to treat dividends, interest, and royalties in respect of which a trustee is subject to tax in the State of which he is a resident as being beneficially owned by that trustee.

The New Zealand observation and provisions in treaties that reflect it are relevant to cases where trustees *are* subject to tax in the state of residence. They do not directly address the question that is at issue in this paper: whether trustees who derive passive income can be described as “beneficial owners” of that income even though they are *not* subject to tax on the income in their state of residence. Indirectly, however, the New Zealand-Canadian provision and others like it suggest that trustees are not “beneficial owners” as the expression is used in treaties, (otherwise there would be no need for the provision) and, if they are to be treated as beneficial owners when they bear tax on the income in question, there must be a special rule to enable that to happen.

It follows that, to put it at its lowest, if trustees are to argue that they are entitled to double tax agreement relief that depends on beneficial ownership status, then they start with a handicap if the agreement that they rely on contains a provision of the kind just discussed. A further consideration is that the words in the New Zealand observation, “treated ... as beneficially owned”, suggest that the ordinary meaning of “beneficially owned” would not embrace income derived by a trustee.¹⁹ The New Zealand agreements that contain provisions that reflect the observation are those with Australia, Belgium, Canada, Denmark, Fiji, Finland, Korea, Malaysia, Norway, Singapore, and Sweden. This paper passes now to consider whether, even in the absence of such a provision, in general principle trustees can be thought of as “beneficial owners” for double tax agreement purposes.

¹⁹ Cf J.F. Avery Jones et al, “The Treatment of Trusts under the OECD Model Convention”, 1989/12 *European Taxation* 391.

“BENEFICIAL OWNERSHIP” IN PRINCIPLE

Working at the International Bureau of Fiscal Documentation, Amsterdam, Mr C.P. du Toit completed in 1999 a doctoral thesis on *Beneficial Ownership of Royalties in Bilateral Tax Treaties*, under the supervision of Professor J.W. Zwemmer of the University of Amsterdam. While the thesis is directed to royalties only, du Toit’s work is equally relevant in respect of dividends and interest. Addressing the meaning of “beneficial ownership” du Toit adopts the following analytical framework, which appears to have been correct at the time when he wrote (the 2003 amendments to the commentary on the OECD Model may necessitate reconsideration).²⁰

The OECD Model does not define “beneficial owner”. Similarly, most, if not all, treaties contain no definition. There are therefore two possibilities. First, Article 3(2) of the Model Convention or its counterpart in individual treaties requires interpretation to be according to the domestic law of the treaty partner whose courts are seized of the question in any particular case, unless the context otherwise requires. Secondly, despite the apparently imperative terms of Article 3(2) that domestic law should apply, it may be that “beneficial owner” should be classified as part of an “international tax language” and interpreted in a consistent manner across all tax conventions that follow the OECD Model. That is so even though there is nothing in standard treaty articles on dividends, interests, or royalties that suggests that “beneficial owner” should not be subject to the ordinary Article 3(2) rule of interpretation according to domestic law.

Du Toit’s conclusion is that in most cases where “beneficial owner” falls to be interpreted the practical result of the two lines of reasoning is the same. If one resorts to domestic law interpretations, at least in common law countries it is hard to depart from the ordinary meaning that the term bears in the context of the law of trusts, that is, “equitable owner” as opposed to owner as trustee.²¹

On the other hand, if the second line of reasoning is correct, there is still the question of deciding what “beneficial owner” means as a term of an international tax language. In pursuing this inquiry, it is logical to start with legal systems that recognize the term, being common law systems. This route leads again to the conclusion that “beneficial owner” bears the meaning that it enjoys in the common law.

TRUSTEES AS BENEFICIAL OWNERS

Contrary to de Toit’s opinion, there are several arguments that the expression “beneficial owner” can include trustees. First, it was only in the 1977 draft that the OECD Model Convention inserted the beneficial ownership requirement into the dividends, interest, and royalties articles. The former, 1963, draft had no such reference.²² Also in 1977, the OECD decided to refer in the Commentary to nominees and agents only, and not to trustees, as examples of people who are not beneficial owners. Nevertheless, by 1977 the question of whether trustees could be beneficial owners for treaty purposes had been a live issue for some years. Considering that people were well aware of the issue at the time, reference to trustees cannot have been omitted by accident. Had the OECD intended to exclude trustees in the Model as

²⁰ See discussion above, under heading 13.

²¹ Eg *Wood Preservation Ltd v Prior* (Inspector of Taxes) (1968) 45 TC 112, 132-133 per Harman LJ, CA; *J Sainsbury plc v O’Connor* (Inspector of Taxes) [1991] STC 318, 330 Per Nourse LJ, CA.

²² Section 11 above quotes examples from different editions of the Model Convention.

possible beneficial owners it could have done so. Moreover, there was no change in the ambulatory draft of the Model that was promulgated in 1995.

The 2003 amendments to the Commentary that have been discussed²³ reinforce the argument. If the question of whether “beneficial owner” can include some trustees was a live issue in 1977, by 2003 the OECD Committee on Fiscal Affairs can have been in no doubt that this question was a major, perhaps the major, issue in the interpretation of relevant articles in the model. The fact that, in these circumstances, the Committee said that “the term ‘beneficial owner’ is not used in a narrow, technical sense” is most significant. Until publication of the 2003 edition of the Model, du Toit’s arguments that “beneficial owner” should be interpreted according to trustee law in common law countries had a good deal of traction. From 2003, the prohibition on interpreting the term in a narrow, technical sense can refer only to its sense in the law of trusts. If so, the contention that trustees *can* be “beneficial owners” for treaty purposes becomes increasingly telling.

OPINIONS OF CIVIL LAW JURISTS AS TO “BENEFICIAL OWNERSHIP”

Secondly, at least some civil law jurists, whose legal systems do not know the trust, appear to be comfortable with categorizing trustees as beneficial owners. Vogel asserts that:

The “substance” of the right to receive certain yields has a dual aspect. The first is the right to decide whether or not a yield should be realised – ie, whether the capital or other assets should be used or made available for use – the second is the right to dispose of the yield. ... recourse to the treaty is justified – ie is not improper – if he who is entitled under the private law is free to wield at least one of the powers referred to. Hence, the “beneficial owner” is he who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields therefrom should be used or (3) both.²⁴

Vogel’s criteria certainly embrace those who the common law calls trustees. Recognising that the element of control is typically crucial to the trust, Vogel submits that trustees may correctly be called “beneficial owners” for tax treaty purposes.²⁵

Romyn, a Dutch commentator, appears to take the view that because of the terms of the OECD Commentary, the only recipients who are not to be regarded as beneficial owners are nominees and agents. He says:

In my opinion neither text nor the commentary of the OECD Model Convention allows leeway for applying the provision at issue [beneficial ownership] outside formal “agency” and “nominee” relationships.²⁶

²³ See discussion in section 13 above.

²⁴ K Vogel et al, *Klaus Vogel on Double Taxation Conventions* (1997) 562, cited by C du Toit, *Beneficial Ownership of Royalties in Double Tax Treaties* Doctoral Thesis for the University of Amsterdam (1999) 89.

²⁵ Idem.

²⁶ M Romyn, “De uiteenindelijk gerechtigde; Wie geniet inkomsten voor verdragsdoeleinden? In Van Dijk Bundel (1988) 319, translated and quoted by C du Toit, *Beneficial Ownership of Royalties in Double Tax Treaties* Doctoral Thesis for the University of Amsterdam (1999) 94.

Romyn is not alone in taking this formalistic view. Commentators have expressed similar opinions in both Belgium and France.²⁷ Since 2003, when the reference to nominees and agents was removed, Romyn's argument has lost some of its force, though he would no doubt take comfort from the Commentary's eschewing of the "narrow, technical sense" of "beneficial owner" that has been discussed.²⁸

HISTORICAL ARGUMENT

Even in common law countries, there are arguments for the proposition that in referring to agents and nominees the OECD meant to focus on agents and nominees alone, and did not intend the commentary to extend to the more difficult case of trustees.

The first argument is historical. It is based on *MacMillan Bloedel Ltd v Minister of National Revenue*,²⁹ where the Canadian court held in effect that even a mere nominee was entitled to benefit from the reduced tax on dividends afforded by the Canada-United States treaty so long as the nominee was resident in the United States and was registered as owner of the Canadian shares in question. (The then treaty had no beneficial ownership rule.) That is, the *MacMillan Bloedel* case can perhaps be cited for the view that at the time of the 1977 draft the OECD was indeed concerned with such formalistic recipients as nominees and agents, and was not trying to get to grips with trustees, whose ownership rights are much more substantial.

POLICY ARGUMENT

The second argument is based on assumed policy of the drafters of the OECD Model. The argument is that if for treaty purposes *some* trustees fail to qualify as beneficial owners, it follows that *no* trustees so qualify.³⁰ That is, no trustee can ever take advantage of treaty provisions to minimise double taxation on income that the trustee accumulates. That cannot be the policy of the Model, it is argued.

The premises of this argument are robust. The argument notes that the contention that trustees cannot be "beneficial owners" starts from the clear common law distinction between trustee and beneficiary. Because at common law a trustee is clearly not a beneficiary it follows according to the contention that a trustee can never be a beneficial owner of income for treaty purposes.

Logically, it is possible that the drafters of the OECD Model intended that trustees should never qualify for treaty benefits; but that conclusion is implausible. Bear in mind that the issue was certainly before the minds of drafters, even if only by virtue of the New Zealand observation discussed in section 12 of this paper.

This second argument draws our attention to a fundamental characteristic of the overall problem of whether trustees can qualify for treaty benefits: this characteristic is that the answer must inexorably be all or none in paradigm cases. Consider treaties where there are no relevant anti-avoidance rules, no rules that limit trustee residence to cases where the trustee is taxed domestically on the income in question, and no other

²⁷ Authorities are collected in C du Toit, *Beneficial Ownership of Royalties in Double Tax Treaties* Doctoral Thesis for the University of Amsterdam (1999) 98 – 99.

²⁸ See above, sections 13 and 18.

²⁹ (1979) 79 DTC 297, 304.

³⁰ The writer is indebted to Dr Philip Baker for drawing his attention to this argument.

rules that provide a definite answer to the question of whether trustees can be classified as beneficial owners. Such treaties are the paradigm cases for this paper. An example is the New Zealand-United Kingdom treaty. To quote again from Article 12:

Interest arising in a Contracting state which is derived by a resident of the other Contracting State may be taxed in that other State may ... be taxed in the Contracting State in which it arises ... but where the beneficial owner of such interest is a resident of the other Contracting State the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

Consider first a New Zealand resident trustee who derives and accumulates interest from the United Kingdom, but who is not taxable on the interest because there is no New Zealand resident settlor. One argument is that the trustee should not be entitled to treaty benefits because New Zealand will not tax the income.³¹ But suppose that the same trustee distributes the income to a New Zealand resident beneficiary in a later year. New Zealand will tax this beneficiary. Indeed, New Zealand will impose tax at a penal rate in response to the deferral that the income has enjoyed since the trustee derived it.³² In these circumstances, it would not seem unreasonable for the trustee to enjoy a treaty benefit. Whichever set of facts obtains the New Zealand-United Kingdom treaty must be interpreted in the same way: either “beneficial owner” includes a trustee who accumulates or it does not. Those who advance the argument now under discussion say that only a positive answer is consistent with the general policy of double tax conventions.

FRENCH TEXT AND CONCLUSION

A third argument is that the French text of the OECD Model, supports the proposition that “beneficial ownership” included ownership by a trustee. The French expression is “*bénéficiaire effectif*”. Because French law does not recognise trusteeship “*bénéficiaire effectif*” includes both full owners and trustees. Since the French and English texts of the Model are equally authoritative it follows that the English text must have the same meaning. Admittedly, this meaning does not necessarily travel the long route from the French version of the Model to a New Zealand treaty. However, the broad adherence to the OECD Model that is apparent in all bilateral tax conventions indicates a strong international commitment to consistency of interpretation.

The matters discussed in the foregoing paragraphs may offer some comfort to trustees who receive passive income from foreign countries that are treaty partners of the trustees’ jurisdictions of residence. There is much to be said for the point of view that “beneficial owner” should be interpreted in the same manner in all treaties, and for the argument that Vogel’s civil law meaning of the expression should be considered as some kind of lowest common denominator. Although it would be rash to claim that this lowest denominator is established as the law, the 2003 amendments to the Commentary³³ add a good deal of force to Professor Vogel’s arguments.

CAPITAL GAINS DERIVED BY NEW ZEALAND TRUSTEES

New Zealand has no general capital gains tax, but some gains that are capital according to ordinary concepts are taxed as income. The primary example is gains in

³¹ Income Tax Act 1994 s HH 4(3B).

³² Income Tax Act 1994 s HH 3(4).

³³ Discussed above, section 13 and 18.

respect of financial arrangements. For example, discounts on bonds and foreign exchange gains or losses are treated as revenue items.³⁴ A second example is gains that result from profit-making schemes, or gains from the sale of property that was acquired with the intention of sale.³⁵ The tax bite is more comprehensive when the property in question is land.³⁶ Thirdly, the principle in *Californian Copper Syndicate Ltd & Reduced v Harris*³⁷ applies in New Zealand, with effect that, *inter alia*, financial institutions that as part of their business have to turn their investments over now and then must treat those investments as being on revenue account. However, these considerations are not likely to be relevant to trustees of foreign-source income where beneficiaries and settlors are also foreign.

A further consideration is that in New Zealand the same rules apply to capital gains that are assessable as income as apply to income in general. That is, if a New Zealand resident trustee derives a foreign-source gain that is potentially taxable as income, the gain, like an income receipt, will not be assessable if there is no connection to the trust by way of a New Zealand resident settlor or beneficiary.

CAPITAL GAINS AND DOUBLE TAX AGREEMENTS

Most of New Zealand's double tax agreements contain a clause like Article 13(7) of the United States treaty, which reads:

Income or gains from the alienation of any property other than property referred to in the previous paragraphs of this Article shall be taxable only in the Contracting State of which the alienator is resident.

Article 13(7) can perhaps be referred to as a "residual property exemption provision". The gains referred to in the "previous paragraphs" of the article are, in brief, gains on the disposal of real property; on shares in companies that own real property principally or wholly; on property that forms part of a permanent or fixed establishment of a business; or on ships or aircraft. Important exceptions include corporate shares, bonds, and debentures that are held as ordinary investments. That is, if the words are given their plain meaning, a sale by a New Zealand resident trustee of "residual property", such as shares in a United States company, is not assessable for capital gains tax in the United States. Nor is the sale assessable in New Zealand because (a) there is no capital gains tax and (b) the gain is in any event foreign source income.³⁸

The fact that the gain accrues to a trust rather than to a beneficial owner does not appear to be significant. The benefits that Article 13 of the United States-New Zealand agreement accords to residents of the two countries are not confined to gains that people derive as beneficial owners. That position is the same in respect of other New Zealand treaties that contain a similar article, viz. New Zealand's treaties with Belgium, Denmark, Finland, France, Germany, Indonesia, Korea, and with the Philippines.

³⁴ Income Tax Act 1994 subpart EH, known as "the qualified accrual rules".

³⁵ Income Tax Act 1994 s CD 4.

³⁶ Income Tax Act 1994 s CD 1.

³⁷ (1904) 5 TC 159.

³⁸ Proposition (b) assumes that there is no settlor of the trust who is resident in New Zealand. See above, section 2.

There is no alienation of property article in New Zealand's treaties with Fiji, Japan, Malaysia, or Singapore. The relevant articles in the treaties with Australia, Sweden and Canada do not contain residual property exemption provisions like the New Zealand-United States rule. New Zealand's treaty with Norway has a residual property exemption provision, but there are certain limitations in respect of property that comprises substantial participatory shareholdings.

The New Zealand-Ireland treaty has a residual property exemption provision, but it is followed by a proviso of uncertain scope:

Provided that where under the law of that Contracting State [the state of residence of the alienator] an individual, in respect of such gains, is subject to tax thereon by reference only to the amount thereof which is received in that Contracting State, the foregoing provisions of this paragraph shall not operate in relation to so much of such gains as is not received in that Contracting State.

In spirit, this proviso is presumably meant to withhold the benefits of the New Zealand-Ireland residual property exemption provision from taxpayers who are not assessable on gains derived from alienating property located in the other jurisdiction. If so, a New Zealand-resident trustee could not use the residual property exemption provision to escape tax on profits derived from alienating property located in Ireland. However, literally the proviso does not have this effect. It withdraws benefits only where gains would be taxable if received in that alienator's jurisdiction, but are not in fact received. Where the alienator's gains are not taxable at all, whether received in the jurisdiction or not, the proviso has no application if it is interpreted literally. The literal interpretation is probably correct, since the terms of the proviso are tolerably clear.

Oddly, the treaty with China seems intentionally to give jurisdiction to tax to the country of situs of movable property, just as it and others do in respect of immovable property and property that is associated with permanent establishments or fixed bases. The net result is that the article as it relates to gains from property located in the jurisdiction of a contracting state is essentially in the following form: the country of situs may tax where the property is type X; it may also tax where the property is type Y; it may also tax when the property is of any other type, except ships or aircraft operated in international traffic: altogether an elaborate way of saying something rather simple. In any event, New Zealand resident trustees get no comfort from the New Zealand-China treaty.

THE UNITED KINGDOM TREATY AND CAPITAL GAINS

Oddly, the relevant clause in the United Kingdom treaty, Article 14(4), omits the word "only". Like the corresponding provisions in New Zealand's other double tax agreements, the clause fairly closely follows Article 13(5) of the 1977 OECD Model Double Taxation Convention, which contains the word "only". However, the versions that are printed in both the New Zealand Statutory Regulations and in the relevant United Kingdom Statutory Instrument³⁹ each omit "only". The author's checking shows that the word was omitted also from the original signed versions of the treaty. As a result, Article 14 (4) reads:

³⁹ No 365 of 1984 (Part I, page 1041).

Income or gains from the alienation of any property other than that referred to in paragraphs (1), (2), and (3) of this Article, shall be taxable ["only" omitted] in the Contracting state of which the alienator is resident.

It is probable that the omission from the New Zealand-United Kingdom convention is inadvertent, and the treaty should be read as if it included "only". Perhaps the main argument is that otherwise Article 14(4) is pointless, because the country of residence does not need the authority of the treaty to tax the gains in question.

Whether this argument should be accepted is a matter for the United Kingdom courts. If it is accepted, the result appears to be that a New Zealand trustee who derives a gain from the sale of movable property in the United Kingdom (apart, mainly, from property that forms part of a permanent establishment of the taxpayer) is not taxable on that gain.

Tax Reform in the China Context: The corporate tax unit & Chinese enterprise

Nolan Sharkey*

Abstract

Research into the relationships between people and organizations that drive social behaviour and institutions in China has produced some profound findings on the structure of society in China. The network structure of private enterprise and the importance of Guanxi are often highlighted. While some scholars of comparative law have investigated the implications these issues have for legal reform/ development in China, too many projects assume that emulation of the laws in developed legal systems is the way forward for China. This ignores the importance of tailoring China's laws to the structure of Chinese society. The debate surrounding the reform of income tax laws in China is no exception with many commentators looking to Western tax laws to solve such severe problems as tax avoidance and low revenue yields. This paper seeks to address some of the issues that arise in applying income tax laws based on those of developed countries to private enterprise in China with a particular focus on the legal design of the income tax unit.

INTRODUCTION

China's income tax laws have developed rapidly over the course of the past quarter century in conjunction with the opening of China and its transition to a (socialist) market economy. During this time there have already been two major reform efforts and numerous other changes that have attempted to create an effective and efficient income tax law. At present, major income tax changes are again being debated. The reform efforts are all predicated on the shortcomings of the current income tax laws. These shortcomings include low tax yield relative to national income, lack of clarity in the law, distortionary tax effects and high levels of tax avoidance in China¹. For many commentators the problem with China's income tax laws is that they are not yet fully developed along the lines of the income tax laws in place in countries with developed market economies² that do not suffer from the serious tax problems that China does³. The solution to the problem therefore lies in further reforms aimed at developing a law that mirrors those in place in these countries. This entails, amongst other actions, the refinement of legal definitions and an increase in the detail of the laws to clearly articulate who the taxpayer is and what income they have earned during the tax period.

The income tax unit is one of the key foci of the contemporary debate on income tax reform in China. The tax unit or taxpayer is a fundamental building block of any tax and its definition is critical to the scope of the tax. This is the case with any income

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¹ For an excellent summary of tax revenue problems in China see: OECD (2002). *The Current Tax System and Priorities for Reform. China in the World Economy: The Domestic Policy Challenges*. Paris, OECD: 623 - 644.

² including the USA, UK, Germany, Australia and Canada

³ For a major recent study looking to foreign tax laws for solutions in China see: China International Taxation Research Institute and IBFD (2004). *China Tax Reform and the WTO Accession Project*. Amsterdam, IBFD Publications BV.

tax where the law needs to define “whose” income is to be calculated for the relevant period and “who” is liable to pay the tax. In most developed income taxes, the tax unit is defined as both the individual and a company/ body corporate. Most of these taxes also develop rules to deal with other forms of business such as partnerships, trusts and joint ventures. These are sometimes treated as taxpayers in their own right but are more usually treated as transparent vehicles with only the underlying individuals and companies viewed as taxpayers. The essential rationale for the individual/ company tax unit is the concept of legal person where companies are viewed as persons in their own right at law. They have the right to sue and can be sued. More importantly the property of the company is its property and not that of the shareholders. The shareholder’s property is shares in the company. The company management has the day to day power to determine the company’s activities and controls the company property. Despite the fact that shareholders are the ultimate owners of the company property they have little day to day say in how it is to be applied or enjoyed. This separation of management from ownership is why a company taxpayer is used in most income taxes alongside the individual. It recognises the inequity of taxing shareholders directly on the income of the company when they have little control of it. It is more appropriate to tax the company directly and tax the shareholders when they receive distributions from the company as this accords with the concepts of horizontal and vertical equity⁴. In the case of other entities such as partnerships, the separation of ownership from management does not exist and they are therefore not treated as taxpayers in their own right.

China’s current income tax laws⁵ do not rely upon the individual/ company taxpayer dichotomy. Instead the three tax laws distinguish between individuals and “enterprises”. The income of individuals being taxed under the Individual Income Tax while the income of enterprises is taxed under one of the two Enterprise Income Taxes depending on whether the enterprise is domestic⁶, foreign-invested or foreign⁷. The tax unit dichotomy is therefore individual/ enterprise. Enterprises are defined in Article 2 of the FIET and Article 2 of the DEIT⁸. However, these articles do not provide a strong conceptual definition of what an enterprise is. Instead they provide a list including vehicles/ operations allowed under various Chinese laws as well as companies, organisations and enterprises⁹. The specifically listed enterprises are:

- Chinese-Foreign Equity Joint Ventures
- Chinese-Foreign Contractual Joint Ventures
- Wholly Foreign Owned Enterprises¹⁰

⁴ Horizontal equity requires that those in similar positions are treated similarly while vertical equity allows for difference with different situations.

⁵ I use the term “laws” loosely to include both laws that have passed through the NPC and regulations issued by State Council. This is necessary as not all of China’s taxes are imposed by law. The Domestic Enterprise Income Tax, for example, is imposed by Regulation.

⁶ These are taxed under the Domestic Income Tax Regulations of 1993

⁷ These latter two are taxed under the Foreign Investment Enterprise and Foreign Enterprise Income Tax Law of 1991

⁸ I refer to the Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (1991) as the FIET while the Provisional Regulations of the People’s Republic of China on Enterprise Income Tax are referred to as the DEIT.

⁹ Neither of these latter two are further defined.

¹⁰ The first three listed are included in the FIET

- State Owned Enterprises
- Collective Enterprises
- Private Enterprises
- Joint Venture Enterprises
- Joint Stock Enterprises¹¹

There are several noteworthy features to the above list. Firstly, all references relate to one of China's other laws allowing for commercial enterprise. Hence, the reference to "Private Enterprises" is a reference to commercial activities sanctioned and registered under China's Provisional Regulations on Private Enterprises (1988) and not to "private enterprises" in general. In a similar manner "Wholly Foreign Owned Enterprises" is a reference to those activities sanctioned and registered under the Law on Enterprises Operated Exclusively with Foreign Capital (1986) as opposed to a reference to any business with only foreign capital (for example a foreign company).

The next noteworthy feature is the length of the list. To persons only familiar with tax laws in other jurisdictions, this is a long list. This feature can only be understood in the historical context of China's post-1978 transformation and the gradual opening of the economy to new forms of enterprise (both domestic and foreign). Essentially, in the centrally planned period prior to 1978, little economic activity outside of the plan was tolerated and economic activity or enterprise was the province of State Owned Enterprises (SOEs). In the years since 1978, more and more types of enterprise have been tolerated, allowed and eventually encouraged. However, at least in the first decade and a half of reform, China's policy makers were careful to specify exactly what form of enterprise was being allowed as they were still essentially committed to state ownership and the plan. This resulted in the great variety of commercial laws seen today as a specific law or regulation was promulgated each time a new form of enterprise was sanctioned. Hence when policy makers decided to allow urban households to commence small private enterprises with no more than 7 employees in the early eighties, these were sanctioned by law¹². It was not until 1988 that larger (more than 7 employees) private enterprises were allowed through the promulgation of the Provisional Regulations on Private Enterprise (1988). Likewise all the different listed enterprise categories in the income tax laws resulted from this gradual allowance of a greater variety of enterprise activity. Only an appreciation of this gradual acceptance of private enterprise will make sense of the large number of different laws allowing commercial activities. Reference to these laws is also necessary to understand what the essential features of the various categories are.

During the 1980's China introduced a variety of income tax laws to tax the different types of enterprises that had been gradually sanctioned. This resulted by the end of the decade in a complicated situation where in addition to the variety present in the commercial laws; there was a variety of income taxes to tax these¹³. These taxes were quite different from one another. The confusion caused by this situation was one of the reasons for the tax reform that took place in China during the early nineties. The approach taken by policy makers during this reform was to adopt the "enterprise" tax

¹¹The last five listed are included in the DEIT

¹² They were incorporated in the General Principles of Civil Law (GPCL) in 1986.

¹³ For an excellent review of China's taxes in the 1980's see: Ho, D. H. K. (2001). "Tax law in Modern China: Evolution, Framework and Administration." *Hong Kong Law Journal* 31(1): 141 to 159.

unit and define all the various forms of activities sanctioned by law as “enterprises” thereby creating a uniformity of income tax treatment. The only distinction that remained was that between the domestic and foreign which were covered by the two different enterprise income tax laws. However within these two laws the various business forms were branded as “enterprises” allowing for a single tax unit and uniform treatment. The foreign sector reform was completed in 1991 with the introduction of the FIET Law while the domestic sector reform was finalised in 1993 with the introduction of the DEIT Regulations. It should be noted that some forms of enterprise still fall under the Individual Income Tax¹⁴. These are the above mentioned Industrial and Commercial Households whose essential feature was the limitation of seven employees¹⁵.

The adoption of the “enterprise” tax unit in the reforms of the early nineties was, as mentioned above, driven by the need for uniformity in tax treatment. However, the simple deeming of a list of various activities/ entities established under a host of other laws as “enterprises” is the most noteworthy feature of China’s tax unit. This is because comparative reference to these various laws indicates that highly divergent and sometimes overlapping categories of both activities and entities are being treated as tax units. Most critically there is no real nexus with the concept of legal person or any other qualitative characteristic such as “business” or “entity” that determines whether you have an enterprise or a tax-transparent business vehicle. In each of the commercial laws there will be such a nexus but this varies between activity, class of activity, type of investor, business structure (i.e. enterprise) and legal person. For example a Wholly Foreign Owned Enterprise (WFOE) is an activity allowed under that law (see above). However, it is possible for a WFOE to elect to be a legal person or not. Likewise, Private Enterprises may or may not be legal persons. However, both WOFEs and Private Enterprises remain “enterprises” for tax purposes regardless of their elections. At the same time an Industrial and Commercial Household is regarded as an individual despite the fact that there may be little substantial difference between it and some Private Enterprises. Some forms of “enterprise” are always legal persons. These include SOEs, companies and Equity Joint Ventures (EJVs). However, with Contractual Joint Ventures (CJVs) there is, again, a choice on the part of the venturers. It can therefore be concluded that despite the prima-facie uniformity created by the “enterprise” tax unit, there is arguably little horizontal equity in that very different categories of operation/ entity are being treated in a similar manner¹⁶.

Having concluded that the “enterprise” tax unit used in China’s income tax law is simply a category created to catch a variety of different situations and treat them as if they were similar, it is worth considering the operation of this tax unit in situations where there is no legal personality. When there is legal personality, the adoption of the body-corporate as a tax unit operates in a conceptually similar manner to the individual tax unit. In essence the income being taxed is that earned by the person which is an increment to the private property of that person. In other words it is a question of gain by a person. However, if the tax unit is not a person (legal or real), this concept of gain in private property cannot apply as there is no private property. Therefore, a quite distinct concept is in operation when a non-person tax unit is adopted. The income *of the* “enterprise” in this case must become the income

¹⁴ A law (1999), the model for the current version initially promulgated in 1994

¹⁵ Article 2 of the IIT (1999)

¹⁶ Horizontal equity requires similar treatment in similar situations

generated by the enterprise as opposed to a gain in the private property of a person. In reality, the two concepts will often yield the same results but they are quite distinct and can lead to very different results. When a pure “enterprise” tax unit is used in China’s tax laws (in the sense of an activity as opposed to a person), the laws are operating in an internationally innovative manner. There is little doubt that this innovation is the result of an attempt to clarify taxation in relation to a great number of different commercial laws that were introduced in a firmly socialist era to allow types of economic activity as opposed to types of private property rights. At the same time it is an innovation that is worthy of consideration in any international tax reform debate. I shall return to this issue further on in this paper.

The above discussion will no doubt already give an indication as to why further reform in relation to defining the income tax unit is considered a priority in China. The current unit remains complicated despite the early nineties reforms. This is because there is no clear conceptual definition of the tax unit with many competing forms and activities all branded “enterprise”. This leads to confusion as to who the taxpayer is and therefore compliance costs, tax arbitrage opportunities and tax avoidance opportunities. Finally, as mentioned above, the current tax unit is not equitable as very different situations are being treated in a similar manner. There is therefore a need to refine the tax-unit to allow easy identification of the taxpayer and their income.

The most often proposed solution for China is the adoption of the individual/ company tax unit covered earlier. The virtues of this are clear as discussed above. Essentially, this tax unit looks to individual persons as tax payers unless there is a legal person in which case the legal person will be the taxpayer. This treatment accords with the company’s status as “person” at law. It also accords with the concept of equity given the restricted rights of the underlying shareholders vis-à-vis the company itself.

The adoption of the individual/ company tax unit also accords with the views of many commentators that the problem with China’s income tax laws is that they are not yet fully developed along the lines of the income tax laws in place in countries with developed market economies.¹⁷ These countries do not suffer from the serious tax problems that China does and therefore if China emulates their laws it will solve its tax problems. It is, of course, also accepted that China needs to develop the rest of the commercial (and other) legal framework that supports the income tax laws as they do not stand-alone. They rely upon property laws, company laws, partnership laws, trust laws and numerous other laws as well as administration to be effective. However, it is often proposed that when China fully develops a world standard legal framework, it will significantly reduce its tax problems¹⁸.

There is also another strong argument in favour of a company/ individual tax unit in China and this is that it has become the internationally used standard tax unit. The importance of this should not be underestimated. In an increasingly internationalised world, there is a need for international regulatory systems to deal with transnational activities. Harmonisation of national tax systems plays an important role in creating a consistent international tax system as opposed to a collection of conflicting national laws. This is the reason why contemporary double taxation agreements (DTAs) strive to use similar formats and terminology. Conflicting definitions at best create increased

¹⁷ including the USA, UK, Germany, Australia and Canada

¹⁸ World standard here refers to a similar framework to that in place in developed countries.

compliance costs as taxpayers and administrators strive to reconcile the differences. At worst they create holes in the system making way for arbitrage or avoidance opportunities or double taxation. This can be seen with China's current enterprise tax unit, for example, if you attempt to reconcile China's tax treatment with Australia's tax treatment of a non-legal person enterprise with foreign investors that has international activities. In this case it can be extremely difficult to identify the relevant taxpayer under the DTA. Finally, China's focus on attracting foreign investment means that this factor is going to be even more important.

The need for reform of the tax unit in China is not contested. The above discussion gives a strong rationale for such reform. However, putting aside arguments for international harmonisation, it is important to consider the perceived benefits of the company/ individual tax unit in China. These are outlined above and are anticipated in China on the basis of international experience. However, proponents of internationally successful institutions often neglect the context in which they arose and how this may conflict with the current context, in this case China.

The use of the corporate tax unit is linked to the concept of legal personality. Under the concept, a company or corporation is regarded as a person and therefore it is appropriate for it to constitute a tax unit. The development of the concept of legal personality, however, is inextricably linked to the evolution of the independent firm. Large undertakings with separation of ownership from management developed prior to the specific concept of legal personality. Courts and then legislators recognised that with such activities funded by groups of individuals, it would be more appropriate to treat the firm as a person and all the relevant property as belonging to the firm independent of the individual investors and management. This was because of the differentiated property rights of the individual shareholders and the company management where neither the investors nor managers had the full rights of control usually associated with property. Instead these rights were divided between them. This recognition became formalised through the concept of companies as legal persons and a raft of other law and institutions designed to ensure company independence. The formalisation itself then further reinforced the concept of the independent company. The independent company is therefore not only the product of law but also of Western society and ideology with its focus on independence as an ideal¹⁹. A genuine body corporate is therefore a "real" social entity and not a simple legal fiction superimposed on individuals. However, with the formalisation of incorporation procedures in Company laws, it is possible to create a company that is not a "real" independent social body. These are nevertheless recognised as persons at law as the result of judicial acceptance of the company as simply a legal fiction²⁰. Such companies amount to little more than a legal fiction.

The appropriateness of the corporate tax unit depends very much on whether the company in question is a "real" independent body or simply a legal fiction. In both cases the company is treated as independent at law but if there is not some genuine independence of management from ownership, the company will not be genuinely independent. A clear example of a company that is little more than legal fiction is a

¹⁹ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. *The economic organization of East Asian capitalism*. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

²⁰ *Salomon vs Salomon & Co Ltd*. [1897] AC 22

single director/ shareholder company. Here, the same individual is the company management as well as the investor. This company cannot be viewed as independent of this individual and the individual has de-facto control of the company property. At the other extreme a listed company with widely dispersed shareholders is a clear example of a “real” independent body. The shareholders here have very little control of the company’s property and genuinely own only their shares.

Serious tax problems can arise when non-independent companies that are mere legal fictions are treated as tax units. Their treatment as a separate tax-unit creates significant tax-arbitrage as well as possible evasion opportunities. The basic root of these opportunities is that a non-independent company allows a person (natural or “real” company²¹) to artificially alter their individual circumstances. As tax treatment is dependent upon a person’s circumstances (for example, total annual and type of income, location of residence, economic position etc.), an ability to change these creates arbitrage opportunities. A raft of common tax schemes from an individual using a company to obtain a lower tax rate to the use of tax havens rely upon the artificial separation granted to non-independent companies. In summary, the rationale for the corporate tax unit discussed earlier is significantly diminished, if not eliminated, when a company amounts to nothing more than a legal creation. To make use of the principle of equity again, in these cases it can be seen that the corporate tax unit allows those in a similar position to be treated differently and those in a different position to be treated the same. This is contrary to the principle. Of course, it can be argued that legal incorporation always creates rights and obligations that are different to the pre-incorporation situation. The primary example being limited liability. It may therefore be appropriate to treat any incorporated business differently to a non-incorporated equivalent. However, these minimal differences do not merit the type of different treatment that a “real” company does.

Given the above analysis, the issue that arises is why so many tax systems in Western countries have been able to successfully adopt a corporate tax unit and not suffer dire tax avoidance problems. The answer to this is essentially twofold. The primary reason is that the majority of the market in Western countries is made up of companies that are “real” and independent legal persons as well as independent natural persons. As is pointed out by comparative sociologists such as Biggart and Hamilton²² and Fei²³, independence and autonomy are deeply rooted ideals in Western society. They can be traced back to classical philosophies, Christianity and nineteenth century politics of democracy²⁴. As touched on above, these ideals prompt the introduction of laws and institutions that then reinforce the independence of companies and individuals. The assumption that the market is comprised of independent actors (companies or individuals) is a central tenet of neoclassical economics. The general accuracy of

²¹ I include “real” companies as they too can make use of non-independent companies in tax-planning. For example, a genuinely independent public company may seek to shift its profits offshore using a non-independent subsidiary.

²² Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

²³ Fei, X. (1992). From the Soil: The Foundation of Chinese Society. Berkley, University of California Press.

²⁴ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

neoclassical economics in explaining Western economies and markets results from this assumption generally holding true²⁵. As this majority of companies are “real” independent bodies, the tax problems mentioned do not arise in relation to them.

The secondary reason that the major tax problems do not arise in relation to “non-real” companies in Western societies is closely related to the primary reason. The general independence of persons and the insitutionalisation of independence in these societies result in the use of contracts and records when two or more persons are not independent. These are required to ensure that rights and responsibilities are enforceable and protected given the general presumption of independence. For this reason, non-independent or non-“real” persons and their relationships to other persons can generally be identified through records. This allows the drafting and implementation of anti-avoidance rules in tax laws that can be used to identify non-independent persons and prevent them from being used for unacceptable tax purposes.

A review of the income tax law in a typical Western society such as Australia serves to illustrate these rules. Any registered company is generally treated as a tax unit. However, in a number of situations there are special rules that look through this independence. The following situations describe some of the more direct of these rules:

- When associates are dealing with one another on non-arm’s length terms, arm’s length terms are deemed
- When profits are being indirectly taken from companies by owners or associates without the declaration of a dividend, a dividend is deemed²⁶
- When a controlled foreign corporation is in use, the profits are deemed to be earned by the controller²⁷
- When a corporate group exists, it may be consolidated
- When losses or tax preferred amounts are being carried in a company and the majority underlying interests change, the losses and tax preferred amounts can be lost
- When personal services are performed in the name of a company, the company may be ignored

The law is generally effective as records²⁸ can be used to identify associates, controllers and other related persons such as partners, subsidiaries and parent companies. If records do not indicate any such relationships, the presumption is that they do not exist. As discussed above, due to the nature of the society, this presumption will be generally correct. Tax laws in Western societies do, however, recognise that when dealing with close family relationships such as spouses, parents, children and siblings, the general presumption of independence may not hold true and that there may be no records to indicate the nature of any relationship. For this reason these relationships are more closely scrutinised. However, the natural limit on the size of families means that these relationships will not result in significant tax problems. When the nature of these relationships cannot be determined, they can be ignored and

²⁵ Ibid.; 45

²⁶ Division 7A of the Income Tax Assessment Act (1936)

²⁷ Part X of the Income Tax Assessment Act (1936)

²⁸ These could include registries, contracts & agreements, deeds and titles

tolerated with resultant tax avoidance opportunities. Alternatively they can be treated as if tax avoidance is occurring with resultant possible inequities.

In summary, it can be said that in Western societies, the company tax unit is appropriate as most significant companies represent “real” autonomous bodies that are more than mere legal fictions superimposed on the underlying individuals. This is because of the unique situation in which none of the natural persons involved, either as investors or managers, have the full property rights and control that a person normally has over their property. The property can therefore only be regarded as the company’s. With companies that are no more than legal fictions (that is, they are not independent bodies), the serious tax problems that can arise are prevented through the correct structure of the law including anti-avoidance rules. These rules are effective because non-independent and non-“real” persons can be identified through records. These records also allow the nature of any relationship to be determined. It is likely that any person (natural or legal) will be independent and autonomous unless either a record (for example, a registry or an agreement) indicates otherwise or there is a close family relationship. This is because of the institutionalisation of independence in Western society.

Having considered the context in which the corporate tax unit has worked effectively and efficiently, the context in which it is hoped that that success will be replicated needs consideration. For the corporate tax unit to be as effective in China as it is elsewhere, the preconditions for that success need to exist in China. The nature of Chinese society, business styles and economic organisation has been the subject of much research in the social sciences. The findings of this research reveal some stark contrasts to the Western equivalents that merit close review.

At a fundamental level traditional Chinese society does not idealise the independent, autonomous person. As mentioned above, this ideal has its origins in classical philosophy, Christianity and the politics of democracy and is reinforced by social values and the legal system. Quite contrary to this, Chinese society values specified social relationships that directly challenge an individual’s independence as an ideal. The basis for this being in classical Chinese philosophies such as Confucianism reinforced by history, social values and traditional laws. According to Chinese sociologist Fei Xiaotong, one of the defining features of Chinese society is that it revolves much more significantly around networks of individuals than independent individuals, as is the case in the “West”²⁹.

The concept of Guanxi is critical in Chinese society in general and business relationships in particular. The term is loosely translated as “relationship”. However, it is more specific than that. Guanxi refers to a particular type of relationship that involves mutual obligation³⁰. These relationships are the bonds that bound together the networks referred to by Fei. The relationships between family members will amount to Guanxi as will long-term friends and friends of friends etc. Individuals work to build their Guanxi networks which are instrumental in the conduct of business. They will seek to establish relationships with those who are likely to be useful in business. This

²⁹ Fei, X. (1992). *From the Soil: The Foundation of Chinese Society*. Berkley, University of California Press.

³⁰ A detailed study of Guanxi can be found in: Yang, M. M.-h. (1994). *Gifts, Favors and Banquets: The Art of Social Relationships in China*. Ithaca, Cornell University Press.

is done socially through gift-giving, banquets etc. Through the successful pursuit of Guanxi, persons can become part of extensive networks that go well beyond the extended family and friends. The networks are employed to pool resources in the pursuit of business enterprises³¹. The essential point about these network bonds is that they have very real enforceable value in terms of mutual obligation. There is however no written contract or record to show the connection as it is socially and not legally reinforced. There is no need to rely upon legal reinforcement due to the values of Chinese society which, in themselves, provide effective sanctions against those that violate social obligations. The reason for this is the non-presumption of independence and autonomy with instead a presumption of connectivity with the appropriate persons. This has historically translated into a dislike of written contracts and law that are viewed as an indicator of poor relationships or even immorality.

Social bonds and networks provide a solution when business enterprises need to be operated effectively in weak or hostile institutional environments. The communist experience in the People's Republic of China has therefore reinforced the reliance upon Guanxi networks. Prior to 1979, private enterprise was effectively illegal in China due to communist doctrine. However, even after reform commenced, private enterprise was frowned upon and the Party's commitment to its development far from certain. There was during the 1980's a very real possibility of a return to hard-line communism. It was not until Deng Xiaoping's famous 1992 tour of the South and its symbolic approval of private enterprise that a degree of certainty of direction could be felt by private enterprise. At the same time, China's institutional infrastructure was still very weak with many problems in the legal and banking sectors (to note just two). All this reinforced the use of Guanxi networks in doing business in China as private entrepreneurs sought to both remain invisible and circumvent institutional weaknesses. In other Chinese societies in colonial and post-colonial states, hostile and weak institutional environments have also reinforced the tendency to operate through Guanxi networks. The fact that much of the foreign investment and activity in China has come from Overseas Chinese networks has again meant mutual reinforcement of business through these networks that now span the region³².

³¹ A recent study of Guanxi in China can be found in: Gold, T., D. Guthrie, et al. (2002). Social connections in China : institutions, culture, and the changing nature of Guanxi. Cambridge ; New York, Cambridge University Press.

³² There is an extensive literature on overseas Chinese networks see: EAAU (1995). Overseas Chinese business networks in Asia. Parkes Australia, East Asia Analytical Unit Dept. of Foreign Affairs and Trade, Lever-Tracy, C., D. F.-K. Ip, et al. (1996). The Chinese diaspora and mainland China : an emerging economic synergy. Houndmills, Basingstoke, Hampshire New York, Macmillan Press ;

St. Martins Press, Weidenbaum, M. L. and S. Hughes (1996). The bamboo network : how expatriate Chinese entrepreneurs are creating a new economic superpower in Asia. New York, Martin Kessler Books, Twang, P. Y. (1998). The Chinese business elite in Indonesia and the transition to independence, 1940-1950. Kuala Lumpur ; New York, Oxford University Press, Wong, B. P. (1998). Ethnicity and entrepreneurship : the new Chinese immigrants in the San Francisco Bay Area. Boston, Allyn and Bacon, Budiman, A., B. Hatley, et al. (1999). Reformasi : crisis and change in Indonesia. Clayton, Australia, Monash Asia Institute Monash University, Tseng, Y.-F., C. Bulbeck, et al. (1999). Asian migration : Pacific Rim dynamics. Taipei, Taiwan, Interdisciplinary Group for Australian Studies (IGAS) National Taiwan University, Bolt, P. J. (2000). China and Southeast Asia's ethnic Chinese : state and diaspora in contemporary Asia. Westport, Conn., Praeger, Brown, R. A. (2000). Chinese big business and the wealth of Asian nations. Basingstoke, Hampshire ; New York, Palgrave, Cartier, C. L. (2001). Globalizing South China. Oxford ; Malden, Mass., Blackwell Publishers, Gomez, E. T. and X. Xiao (2001). Chinese business in Southeast Asia : contesting cultural explanations, researching

In addition to the above factors, the commodification process during the reform period in China has further strengthened the development and use of Guanxi networks. Extensive field and theoretical work by David Wank³³ has considered the role of commodification in developing China's business modalities. The term commodification refers to the conversion of state assets into commodities in China's market economy. There are no clear property rights in relation many valuable State (or former State) assets in China. They are, however, under the control of local government. These assets include resources as critical to enterprise as land and buildings. Control of these assets and the ability to let others use them, has led to the absorption of local officials into Guanxi networks that dominate much of China's economy. In most cases successful private entrepreneurs have strong Guanxi links to local officials if they are not officials themselves. The ability to use these assets subject to "fuzzy" property rights in Guanxi based business networks incorporating local officials as well as entrepreneurs has proven effective and efficient in China. It allows assets to be moved quickly through the network to where they can be effectively used³⁴. It has been strongly argued by Hendrischke³⁵ that the success of this modality of business leads to a demand for "fuzzy" property rights in China. It is worth contrasting this with the politics of democracy in the West where there was a clear drive for clear property rights³⁶.

In summary the nature of Chinese society in combination with the formerly hostile and current weak institutional environment and the process of commodification of State assets have resulted in a situation in contemporary China where the primary actors are business networks rather than independent companies and individuals³⁷. Business is conducted by and through networks held together by strong Guanxi –

entrepreneurship. Richmond, Surrey, Curzon, McKeown, A. (2001). Chinese migrant networks and cultural change : Peru, Chicago, Hawaii, 1900-1936. Chicago, The University of Chicago Press, Koehn, P. H. and X.-h. Yin (2002). The expanding roles of Chinese Americans in U.S.-China relations : transnational networks and trans-Pacific interactions. Armonk, N.Y., M.E. Sharpe, Yan, Q. (2002). The ethnic Chinese in East and Southeast Asia : business, culture and politics. Singapore, Times Academic Press, Ma, L. J. C. and C. L. Cartier (2003). The Chinese diaspora : space, place, mobility, and identity. Lanham, Md., Rowman & Littlefield, Wu, X. A. (2003). Chinese business in the making of a Malay state, 1882-1941 : Kedah and Penang. London ; New York, RoutledgeCurzon, Gomez, E. T. and X. Xiao (2004). Chinese enterprise, transnationalism, and identity. London ; New York, RoutledgeCurzon.

³³ Wank, D. L. (1999). Commodifying communism : business, trust, and politics in a Chinese city. Cambridge England ; New York, Cambridge University Press.

³⁴ Hendrischke, H. (2002). The Role of Social Capital, Networks and Property Rights in China's Privatization Process. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies.

³⁵ Ibid.

³⁶ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

³⁷ Hendrischke, H. (2002). The Role of Social Capital, Networks and Property Rights in China's Privatization Process. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies, Krug, B. and H. Hendrischke (2002). China Incorporated: Property Rights, Privatisation, and the Emergence of a Private Business Sector in China. INSEAD Euro-Asia Centre, Fontainebleau. Wank, D. L. (1999). Commodifying communism : business, trust, and politics in a Chinese city. Cambridge England ; New York, Cambridge University Press, Chan, K. B. (2000). Chinese business networks : state, economy and culture. Singapore

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Nordic Institute of Asian Studies, Gold, T., D. Guthrie, et al. (2002). Social connections in China : institutions, culture, and the changing nature of Guanxi. Cambridge ; New York, Cambridge University Press, Menkhoff, T. and S. Gerke (2002). Chinese entrepreneurship and Asian business networks. London ; New York, RoutledgeCurzon.

social bonds. The entrenched economic and political strength of these networks and their desire for “fuzzy” property rights as well as the nature of Chinese society mean that there is unlikely to be a change in this situation despite Government attempts to strengthen the institutional environment. More to the point, in many respects, these factors push for the weaker institutional environment.

Commentators such as Biggart and Hamilton³⁸ concluded that Asian capitalism and markets are fundamentally different to those in the West as they are based on networks rather than autonomous individuals and firms. They also concluded that the differences between the structure of Asian capitalism and markets and those elsewhere in the world are so significant that they should be considered entirely different models as opposed to flawed versions of accepted ideals. They based their conclusions on sociological observations in Asia by themselves and seminal studies such as that by Fei³⁹. The additional forces at play in post-1978 China discussed above can only strengthen their conclusions as far as China is concerned.

Having considered the context in China it is clear that it is very different to Western nations in which the corporate tax unit has been proven effective and efficient. The potential dangers of a corporate tax unit have been discussed above. In broad summary, when a company is nothing more than a legal fiction, significant tax-arbitrage and avoidance opportunities arise. This has not proved a significant problem in Western countries as the majority of companies do represent “real” independent persons. When they are not their relationship to other persons can be identified through written and other records/ agreements. This allows tax laws to be drafted to prevent tax avoidance through non-“real” companies.

The context in China severely challenges the requirements for an effective corporate tax unit. The business networks can be thought of as analogous to “real” unnatural persons such as independent companies in the West. This is because many of the assets employed by the network could not be said to belong to any one of the underlying individual members of the network and are therefore owned by the network alone. However, the corporate tax unit would refer to companies incorporated under China’s Company Law (1994). These are not the same as the business networks and therefore there is a dramatic departure from the situation in the West where Company law developed to recognise and reinforce “real” companies. Companies incorporated under China’s Company law are much more likely to be mere legal fictions. There is therefore potential for the severe tax problems considered earlier. The solution to these tax problems in other jurisdictions is to develop your law to identify non-independent companies and the nature of their relationships to others. The law can then be written to prevent tax avoidance/ arbitrage. However, the ability of a tax law to do this is reliant on the records and agreements identifying relationships. These are generally available due to the reliance on contracts and law to reinforce property and other rights in a society made up of independent or presumed independent persons. This is in stark contrast to Guanxi networks in China that actively avoid the use of the law and written agreements to enforce rights preferring

³⁸ Biggart, N. W. and G. G. Hamilton (1997). On the Limits of Firm-Based Theory to Explain Business Networks: The Western Bias of Neoclassical Economics. The economic organization of East Asian capitalism. Thousand Oaks, Calif., Sage Publications.: 33 - 54.

³⁹ Fei, X. (1992). From the Soil: The Foundation of Chinese Society. Berkley, University of California Press.

social sanctions as an enforcement. The preference for “fuzzy” property rights adds further reinforcement to this.

Another critical factor to consider is the private sector’s aversion to paying income tax. Having considered the rationale for reliance on social networks rather than legal agreements in China, it can be seen that the ability to avoid taxation only adds to this. Business networks have had a new reason to remain invisible in China in the Nineties. During the Eighties they feared a Central Government backlash, now they fear that the Central Government will gather revenue from them. Governmental attempts to strengthen the institutional environment and property rights through initiatives such as the introduction of the Company Law can be counterproductive when social bonds are stronger than legal rights. This is because instead of simply being invisible, networks can make use of the new laws to create legal rights that they are able to readily circumvent. Regulators on the other hand will treat the legal rights as a correct representation of the situation. There is evidence that assets are simply placed into companies and removed at will by networks and that legal entitlements to dividends are simply ignored when profits are shared⁴⁰.

In summary, it may be concluded that the adoption of a corporate tax unit in China’s income tax will not result in the benefits anticipated based solely upon its successful adoption in Western taxes. The possibilities for tax avoidance and arbitrage are far greater than in Western economies due to the use of social Guanxi connections and networks and the preference for “fuzzy” property rights in China. This stands in stark contrast to the preference for legal agreements and records and clear property rights in the West. It can also be concluded that the benefits of tax avoidance for the private sector may reinforce the desire to rely upon Guanxi rather than contracts.

The above conclusions do not, however, lessen the need for reform of China’s income tax unit as considered above. A different solution needs to be found. One possible answer lies in the innovative use of “enterprise” as discussed earlier. The concept of an enterprise as an activity as opposed to a person was adopted in a socialist situation where use of increments in private property to define income was inappropriate. The income of an enterprise in these situations referred instead to profits generated by a commercial activity. This subtle conceptual difference may be a suitable starting point in the development of China’s contemporary income tax unit. This is because it does not rely upon the accurate identification of a person’s property rights. Another theoretical possibility is to identify and tax the business network itself. This is appropriate conceptually but unlikely from a practical perspective due to the difficulty of identifying the network.

A final issue relevant to China’s reform of its tax unit is the need to fit into the international system. As discussed earlier, there are real pressures towards convergence and harmonisation of income tax laws due to the internationalisation of business. Attempts to make use of a radical concept when designing a tax system are therefore likely to be criticized and objected to by international business and organizations. This is because variation creates compliance costs and inefficiencies. However, against this China’s effective revenue collection needs to be considered and

⁴⁰ Hendrischke, H. (2002). *The Role of Social Capital, Networks and Property Rights in China’s Privatization Process*. Chinese Enterprise Models, University of New South Wales, Sydney, UNSW Centre for Chinese Studies.

it cannot be simply ignored to benefit international interests. China does, after all, represent a significant portion of the world and what it does should therefore be considered a variation of international standards as opposed to a departure from them. Any new concept will therefore need to be reconciled to the internationally standard corporate tax unit.

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Perceptions of Tax Evasion as a Crime

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Abstract

This paper considers on aspect of the deficit faced by the U. S. economy. It considers the contribution to this deficit made by the taxpayers that do not fully report taxable income and/or do not pay taxes on their income. The gap between what is owed in tax and the amount of tax actually paid is estimated at \$310 billion. What portion can be attributed to underreporting and non filing? The study reported in this paper attempted to measure the perceptions of US citizens as to the seriousness of tax evasions relative to other crimes and violations. The results show that tax evasion ranked 11th among the twenty-one offences surveyed. This means that the average person views tax evasion as only somewhat serious. Compared to other white collar crimes it ranked below accounting fraud, violation of child labour laws and insider trading, and equal to welfare fraud and higher than violation of minimum wage laws.

INTRODUCTION

Today the U. S. economy faces the largest deficit in its history. There are many factors that contribute to this problem. One of those factors is the vast number of taxpayers that do not fully report taxable income and/or do not pay taxes on their income. The difference between the amount of tax that is theoretically owed versus the amount of tax actually paid is called the 'tax gap'. The Internal Revenue Service (IRS) estimated that the tax gap was \$95 billion in 1992 and \$275 billion in 1998 (IRS, 1996, 2002). More recently, the National Taxpayer Advocate, Nina Olson suggested that the single largest part of the estimated \$310 billion tax gap is attributable to self-employed non-compliance (Tax Notes, 2004).

Although filing a tax return is "voluntary", it is against the law to underreport your income to the IRS. Yet, in a recent field study (Karlinsky and Bankman, 2002), researchers noted that small business owners were remarkably open and honest about their tax evasion behaviour relative to the non-reporting of cash income. One potential reason for this openness is that taxpayers may view tax evasion as a relatively minor offence. Obviously, the public's perception of the severity of a crime has important implications for society. As discussed in Roberts and Stalans (1997), the government and its judges have an interest in how societal members perceive the seriousness of offences. First, in order to secure compliance with the law, the public must believe that the laws are legitimate (Robinson and Darley, 1995). Also, punishment that exceeds public perception of the severity of an offence may lead to Constitutional issues under the cruel and unusual punishment provisions of the Eighth Amendment (Finkel, Maloney, 1995). It is also helpful for public prosecutors to use public perception of an offence's severity to allocate scarce resources (Miethe, 1984).

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This study was designed to measure the perceptions of U.S. citizens as to the severity of tax evasion relative to other offences (crimes and violations). If tax evasion is not viewed as a serious offence, it may somewhat explain the degree of non-compliance with the tax laws. The current study investigated people's perceptions of the severity of tax evasion as a crime when compared to twenty other offences. The results of the study show that tax evasion ranked 11th among the twenty-one offences surveyed. The results indicate that the average person views tax evasion as only somewhat serious. When compared to similar white collar crimes it ranked less severe than accounting fraud, violation of child labour laws and insider trading, while it was ranked equal to welfare fraud and higher than violation of minimum wage laws. The results of this study are important as they emphasize the fact that people do not perceive tax evasion as a serious crime. This perception plus lack of enforcements efforts¹ has led to an environment where some people may not be afraid of cheating on their tax return. The study also tries to observe if there is a correlation between the relative severity of a crime by whether a victim is involved or not.

LITERATURE REVIEW

There are numerous studies on the severity of crimes in the U.S. and international criminal justice, sociology and psychology literature, but very few in the accounting and tax literature.

Rosenmerkel (2001) found that people rate white collar crimes², such as tax evasion, to be less serious than other types of crimes. In the current study people's perception of the seriousness of white collar crime was examined by including insider trading, tax evasion and accounting fraud as factors in the study. Given the charged atmosphere in the press and in Congress in light of Enron, WorldCom, Tyco and corporate tax shelters, it may be interesting to see if the wrongfulness of white collar crimes will be perceived differently today.

Another study that looked at people's perception of crimes was performed by the Australian Institute of Criminology (1986). This study had people rank the seriousness of 13 different offences. Stealing a bicycle was used as the benchmark offence and the subjects were asked to evaluate how many times more serious was a particular crime. The authors gave a one line scenario for each of the offences like "A person stabs a victim to death" or "A person illegally receives social security cheques worth \$1,000". In this study, murder was viewed as 27 times more serious than stealing a bicycle. Tax evasion was viewed as roughly 6 times more serious than stealing a bike, and was rated about the same as Medicare fraud, but less serious than social security fraud (which was 7.5 times more serious than bicycle theft). Interestingly, the social security fraud scenario involved \$1,000 and yet it was viewed as more serious than a \$5,000 evasion on either their income taxes or excess Medicare receipts by doctors. The Australian Institute noted that the top 7 offences were found to be crimes involving a victim. The current study updates and expands on this study.

¹ The IRS estimates that the audit rate for all taxpayers is less than 1 percent. This rate has decreased from 1.37% in 1996 to .48% in 2002 (IRS, 2003).

² Unfortunately, his categorizing of white collar crime, such as overcharging for automotive repairs or overcharging for credit when selling goods, is very different than in the current study and therefore, there is no pre-Enron benchmark to compare the results to.

The perceived seriousness of crimes may be measured across countries and cultures³. IVCS Survey polled individuals in 17 countries (including Australia, England, Netherlands, Sweden, Canada, USA, France, Japan and Switzerland) and found that Unrecovered Car Thefts was the most serious offence of those crimes surveyed followed by sexual assault, recovered car thefts and then robbery involving a weapon. The least serious crime was bicycle theft. We included several of these offences in our survey instrument, namely carjacking, robbery and bicycle theft.

In a February 2001 Criminal Intelligence Service Alberta telephone interview study⁴ examined 26 different crimes (but no violations) of which seven (7) overlapped with the current study's focus. Using a 10 point scale (10 being the most serious) the interviewees were asked to rate the seriousness of various crimes. Sexual exploitation of children was ranked the most serious crime (9.53) with murder being slightly less serious (9.39) followed by robbery (8.66). Interestingly, prostitution was viewed as more serious (7.38) than car theft (6.92) or insider trading (6.61). Demographic factors solicited were gender, marital status and age.

In one of the few studies that examined the perception of the seriousness of tax evasion, Song and Yarbrough (1978) investigated taxpayers' perceptions of tax ethics in a small rural university town in North Carolina⁵. As part of their survey, they asked the subjects to measure tax evasion against eight other crimes (four of which were violent crimes and four were property related crimes). The result of their survey was that people viewed tax evasion more like a violation than a crime⁶. Almost 50% of respondents felt that tax violators should be fined but not punished with jail time. When tax fraud was compared with four violent crimes, it was ranked a distant fifth. Compared to property related crimes, tax evasion was ranked slightly higher in perceived seriousness than stealing a bicycle and lower than bribery, embezzlement and arson.

The current study extends Song and Yarborough (1978) by investigating current societal perceptions of the seriousness of a crime. First, our study uses a richer litany of offences by examining 20 other crimes and violations (besides tax evasion), and includes some offences that involve victims and others that are victimless (see survey instrument in Appendix A). Second, the Song and Yarborough (1978) study was performed a generation ago and perceptions may have changed in the interim, especially given Enron, WorldCom, Tyco, and the publicity of corporate tax shelters. Also the current study uses subject from both North Carolina and California urban and suburban communities.⁷

Song and Yarbrough (1978) also looked at various demographics to see if there is any correlation between a subject's characteristic and tax ethics. We have included in our study many of the demographics that they (and other studies) utilized including gender, income level, home ownership, political affiliation, and marital status. Because the focus of the current study is tax evasion, respondents were also asked if

³ see, Criminal Victimization in Seventeen Industrialised Countries

⁴ Provincial Public Opinion Survey on Organized Crime: Alberta Canada

⁵ The town's population was 34,000 in 1975 when the study was conducted.

⁶ A violation is an offence that is usually punishable by a fine while a crime is an offence that is punishable with a jail sentence.

⁷ The subjects were principally drawn from the California Bay Area including San Jose which is the country's 11th largest city and from the Charlotte, NC region which is the country's 35th largest city.

they prepared their own tax returns and/or if they had ever been audited by the IRS. This study also extends the work of Song and Yarborough (1978) by examining the relative perceived severity of white collar offences such as insider trading, accounting fraud and tax evasion. Another study (Eicher 2002), tested peoples' perception of various crimes, including cheating on their tax return, focusing on potential difference between men and women respondents. When asked "How much, if any, do you think is an acceptable amount to cheat on your income taxes?", roughly 1/3 of both the male and female subjects responded that they cheated a little here or there. 18% of men and 9% of the women said as much as possible, while 49% of men and 59% of women said it is not at all acceptable to cheat on your income taxes. The study found that overstating tax deductions was acceptable to 44% of the males and 36% of the females.

The Eicher study also examined six behaviours of which five have the roughly equivalent offence in our study (speeding, tax cheating, DUI, running a red light, shoplifting). The study found that driving 10 miles over the speed limit was somewhat or very acceptable for 82% of women and 78% of men. Overstating tax deductions was somewhat or very acceptable to 44% of the males and 36% of the females. Shop lifting was viewed as not at all acceptable by 44% of men and 54% of women. This is to be compared with running a red light which 51% of men and 57% of women said should not be at all acceptable. DUI was viewed by 83% of the females and 67% of the male subjects as not at all acceptable behaviour. In effect, this study found that DUI was by far the most serious offence, running a red light was the second most serious offence, with tax cheating and shoplifting being almost equivalent offences, followed by speeding which was viewed by both men and women as the least offensive (with only 22% of men and 18% of women viewed driving at 10 miles over the speed limit as not too acceptable or not at all acceptable).

Based on the previous studies it appears that people do not view tax evasion as a serious offence. However, all of the prior work was performed pre-Enron and contained a very limited number of offences, especially with regards to white collar offences. The current study adds to the body of knowledge because it extends the research to a post-Enron time frame and expands the number of offences examined.

METHODOLOGY

Survey Instrument

A four page survey was administered. The survey took the subjects less than ten minutes to complete (see Appendix A). The first page explained that the participant's identity would be kept anonymous to encourage a frank and candid response to the survey instrument. Since respondents were being asked for their personal perceptions, the survey emphasized that there was no right or wrong answer. The perceived severity of each offence was rated on a five-point Likert scale ranging from Not Serious (1) to Extremely Serious(5)⁸.

In the survey instrument, Q.2 asked if the person had trouble understanding any of the offences listed. Only four people (out of over 360 subjects) responded to Q.2. Two comments were that they did not know the degree of the offence. For example, was

⁸ To control for any order effect, there were five randomised versions of the test instrument used. Tests showed there was no order effect in the results.

the Speeding at a safe speed or out of control. One subject did not know what jaywalking was and left it blank, and another person did not know what DUI/DWI was and left that factor blank.

In exit interviews with several people, we were complimented for the simplicity of the test instrument. Comments like 'it was easy to use', 'it was quick and simple' and 'other surveys should take lessons from this instrument' were expressed by test subjects.

Sample

The sample included surveys from 364 respondents. The respondents came primarily from California and North Carolina. The sample was made up of 144 from California and 202 from North Carolina. Fifty-eight percent of the sample was male.

RESULTS OF THE SURVEY

Table 1 shows the overall rating of all 21 offences. The rating is the average of all response in the survey. The most serious offences rated by the sample were not surprisingly, Murder, Rape and Child Molestation, while Jaywalking, Illegal Parking and Ticket Scalping were rated as the least serious offences. The average rating for tax evasion was 3.3, which was the eleventh most serious or least serious offence in the survey depending upon your point of view.

TABLE 1: AVERAGE SCORES OF CRIMES SURVEYED

Crime	Overall rating	Ranking
Murder	5.0	1
Rape	4.9	2
Child Molestation	4.8	3
Robbery	4.0	4
DWI	3.9	5
Carjacking	3.8	6
Child Labour	3.8	7
Accounting Fraud	3.7	8
Insider Trading	3.3	9
Welfare Fraud	3.3	10
Tax Evasion	3.3	11
Minimum Wage	3.3	12
Shoplifting	2.8	13
Prostitution	2.8	14
Running a Red Light	2.6	15
Bike Theft	2.3	16
Smoking Marijuana	2.3	17
Speeding	2.1	18
Ticket Scalping	1.8	19
Illegal Parking	1.5	20
Jaywalking	1.3	21

The average rating for tax evasion (3.3) was compared to the three violent crimes in the survey, Murder, Rape and Child Molestation (4.9). Based on a t-test, the difference between the rating for tax evasion and violent crimes was significant at a .01 level (See Table 2). These results support the findings of both Rosenmerkel

(2001) and Warr (1989) that white collar offences were rated as less serious than violent offences.

In previous studies white-collar offences as a whole have been compared to violent offences or to property offences. The prior studies have not broken white-collar offences out to various types. In our survey there are six white-collar offences: tax evasion, accounting fraud, violation of child labour laws, insider trading, violation of welfare laws and violation of minimum wage laws. The ranking of tax evasion was compared to the rankings for the other five white collar offences in the survey. Based on the results of the paired t-tests, there was a significant difference in peoples' perception of the seriousness of tax evasion and accounting fraud and violation of child labour laws, but there was no difference between tax evasion and insider trading, violation of welfare laws or the violation of minimum wage laws (See Table 2).

TABLE 2: COMPARISON OF TAX EVASION TO OTHER CRIMES

Tax evasion	Violent crimes	Accounting fraud	Violation of child labour laws	Insider trading	Violation of welfare laws	Violation of minimum wage laws
3.3	4.9*	3.7*	3.8*	3.3	3.3	3.3

* Significant at the .01 level

Of the six white collar offences, violation of child labour laws and accounting fraud were rated as the most serious. However, the rankings of all six white collar offences fall together in the list, ranking from the six most serious offence to the twelfth most serious offence in our survey. These results support prior research that suggests people do not perceive white collar offences to be as serious as violent offences but more serious than most property offences⁹ (Warr, 1989). The significant difference between tax evasion and accounting fraud may be a product of the current business environment and the related press coverage surrounding the Enron, Worldcom, and Tyco scandals and the subsequent Sarbanes-Oxley legislation.

Ball (2001) found that citizens in different communities had different opinions as to the seriousness of a crime. In addition, Davis (1990) and Smith and Huff (1982) found a difference in the perception of crime between urban residents and their rural counterparts. However, Weisheit, Falcone and Wells (1996, 1994) did not find a clear difference between urban and rural perceptions. In fact, their 1996 study suggests that any difference between urban and rural perceptions appear to be decreasing. The typical definition of rural is low density population or small size, but rural can also relate to the type of economy, the character of social life, cultural attitudes, beliefs and values of an area (Weisheit, et al., 1996). Our survey includes respondents from the San Jose area of California, a very progressive and liberal area of the United States and from the area surrounding Charlotte, North Carolina, a more conservative part of the country. The perception of the seriousness of tax evasion was compared based on where the respondent lived (See Table 3). The results showed that respondents in

⁹ Robbery and carjacking are property offences that have historically been viewed as more serious in nature which is consistent with our findings. On the other hand shoplifting and bike theft are property crimes that have been perceived as low on the severity scale.

North Carolina rated tax evasion as more serious than those in California. Based on the t-statistic, this difference was significant at the .01 level; thus, supporting prior research (Ball 2001; Davis, 1990; and Smith and Huff, 1982) that location makes a difference in people's perceptions of crimes.

TABLE 3: PERCEPTION OF TAX EVASION BASED ON LOCATION

	California	North Carolina
Total Sample	3.2	3.4*

* Significant at the .01 level

VICTIM VS. VICTIMLESS OFFENCE ANALYSIS

From the law literature, we note that there is a need to differentiate between violations and crimes. The latter is an offence that warrants going through the entire criminal justice system (including arrest, processing, arraignment and trial, etc.). Violations, on the other hand, are punished with a summons, ticket or sometimes just a warning. The literature is replete with findings that people would classify violations as less serious than crimes, and those offences that involve people are viewed as more severe than those involving property. The current study included four of the Big Seven crimes (murder, rape, robbery and grand larceny auto, but excluded felony assault, burglary and grand larceny)¹⁰. These are crimes that police stations track on a regular basis.

We will use the current study to investigate people's perceptions of the severity of victim vs. victimless crimes and violations by including at least three offences in each of four standard categories: crime/victim, crime/victimless, violation/victim, violation/victimless. The crime/victim class would clearly include murder, rape and child molestation. The crime/victimless category would include tax evasion, prostitution or welfare fraud. By victimless we mean that no one else was involuntarily involved in the offence. For example, prostitution or ticket scalping involves two people, but both participants are voluntary. A violation/victim includes insider trading, violating minimum wages laws or violating child labour laws. A victimless violation would include speeding jaywalking, or ticket scalping.

As can be seen from Table 4, with two exceptions (shoplifting and bike theft), crimes involving victims were perceived as more severe than crimes without victims. The two exceptions are likely due to the perceived low nominal dollar value involved in the theft. In effect, its wrongfulness is high but its harmfulness is minimal.

When you compare perceived severity of violations, every victim violation is rated significantly higher than a victimless violation.

¹⁰ The reason that three of the big seven were excluded is that it was felt that it may be difficult for the general population (as opposed to a law enforcement agent or an attorney) to understand the fine distinction between burglary, grand larceny and robbery, and to understand what a felony assault is.

TABLE 4: RELATIVE SEVERITY OF VICTIM/VICTIMLESS OFFENCES

Crime/Victim		Crime/Victimless	
Murder	5.0	DWI	3.9
Rape	4.9	Welfare Fraud	3.3
Child Molestation	4.8	Tax Evasion	3.3
Robbery	4.0	Prostitution	2.8
Carjacking	3.8	Smoking Marijuana	2.3
Accounting Fraud	3.7		
Shoplifting	2.8		
Bike Theft	2.3		
Violation/Victim		Violation/Victimless	
Child Labour Law	3.8	Running a Red Light	2.6
Minimum Wage	3.3	Speeding	2.1
Insider Trading	3.3	Ticket Scalping	1.8
		Illegal Parking	1.5
		Jay Walking	1.3

DEMOGRAPHICS

Following Song and Yarbrough (1978) we included demographic variables in our survey to see if there was a correlation between a respondent's characteristics and tax ethics. Based on our tests there was no significant difference in the average scores for the seriousness of tax evasion between males and females, Democrats and Republicans, churchgoers and non-churchgoers or those that had their tax returns professionally prepared versus those that prepared their returns personally.

LIMITATIONS

There are two primary criticisms about this type of survey. First, critics may argue that the scales do not explicitly define what is meant by the term seriousness (Blum-West, 1985). Sherman and Dowdle (1974) determined that there would be a consensus among respondents in studies that were vague as to the definition of the term seriousness. However, when respondents apply their own concepts of criminal harm, they base judgments on a varying scale of crime importance. Rossi and Henry (1980) found that more variation would occur if respondents were instructed to rate seriousness based on their own opinions. To control for this problem, respondents in the current survey were asked to rate the seriousness of crimes based on their own opinions and experiences, which should provide variation in the respondents' answers.

A second criticism of the type of scale used in this study is the reliance on samples of offences that are not representative of everyday crime. Too few offence types have been included in prior studies to permit generalizing the findings to all offences (Rosenmerkel, 2001). Most crime seriousness studies over represent serious, violent criminal acts (Rosenmerkel, 2001). For example, more than 90% of all crimes are property crimes (Meier and Short, 1982). Over representation of serious crimes has the potential to sensitise respondents to the crimes that are most uncommon (Meier & Short, 1982). The current study included 21 offences, only three of which would be

classified as violent criminal acts. Of the remaining 18 crimes there are five property crimes, six white-collar crimes, three motor vehicle offences and four other types of crime

CONCLUSION

It is important to understand why people do not report taxable income and/or pay their income taxes. Prior research indicates that one reason may be that they do not perceive tax evasion to be a serious crime. Our study surveyed 364 people to see how serious they perceived tax evasion to be. We found that in a list of twenty-one crimes, tax evasion was ranked 11th and rated only as somewhat serious. We also found that tax evasion was considered to be less serious than the white collar crimes of accounting fraud and violation of child labour laws. We also tested to see what characteristics correlated with tax ethics and found that where the respondent lived made a difference on how serious a crime tax evasion was considered but other characteristics tested did not. We also confirmed that offences involving victims are perceived as more serious than victimless crimes. This would lead to the tax policy concept that if the tax evasion crime could be personalized more, then the perception of its severity might be increased with a concomitant higher tax compliance rate.

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APPENDIX A

Survey Document

We are three professors doing a study on people's perceptions of the seriousness of selected offences. Thank you in advance for taking five or ten minutes out of your busy schedule to share your opinions with us.

Since we are only interested in your opinion, there are no right or wrong answers. So, please just tell us how you honestly feel about each offence. Please note that your responses are totally anonymous.

To make full use of your responses, we need you to answer all opinion and background questions.

Thank you,

Cindy Blanthorne
UNC Charlotte

Hughlene Burton
UNC Charlotte

Stewart Karlinsky
San Jose State University

1. In your opinion, how serious is each offence listed below?

Item	Description of offence	Not serious	Somewhat serious	Serious	Very serious	Extremely serious
1	Bicycle theft					
2	Welfare fraud					
3	Speeding					
4	Carjacking					
5	Prostitution					
6	Accounting fraud					
7	Robbery					
8	Shop-lifting					
9	DWI / DUI					
10	Illegal parking					
11	Violating child labour laws					
12	Smoking marijuana					
13	Child molestation					
14	Insider stock trading					
15	Jay walking					
16	Running a red light					
17	Murder					
18	Ticket scalping					
19	Tax evasion					
20	Paying employees less than minimum wage					
21	Rape					

2. If you had trouble understanding any of the offences listed, please identify the problems (by item number or description of offence) and briefly explain the problem.
3. Please rank the five **most** serious offences (list the most serious offence first).

Seriousness	Item Number or Description
Most serious offence	
Second most serious offence	
Third most serious offence	
Fourth most serious offence	
Fifth most serious offence	

4. Please rank five **least** serious offences (list the least serious offence first).

Seriousness....	Item number or description
Least serious offence	
Second least serious offence	
Third least serious offence	
Fourth least serious offence	
Fifth least serious offence	

Participant Background Information

Our goal is to identify trends among different people. To do this, we need some anonymous background information.

5. What is your primary employment status?

..... self employed student retired
.....employee not currently working

6. What is the highest level of education that you have completed?

.....some high school some college graduate
degree

.....high school college degree

7. What is your political affiliation?

.....Republican Independent None
.....Democrat Other

8. What is your household income level?

.....<< \$20K	\$41 – 60K	>> \$80K
.....\$20 – 40K	\$61 – 80K	

9. What is your age range?

.....< 20 years 31 – 40 years >60
.....20 – 30 years 41 – 60 years

10. Is English your first language? Yes No

11. Do you own your own home?YesNo

- | | | |
|---|------------|--------------|
| 12. Are you married? |Yes |No |
| 13. Do you attend church regularly
(at least once a month)? |Yes |No |
| 14. Do you hire someone to prepare
your income tax return? |Yes |No |
| 15. Are you a tax professional
(tax preparer, IRS agent, etc.) |Yes |No |
| 16. Has your income tax return been
audited (by IRS or state)? |Yes |No |
| 17. Have you or someone close to you had
personal experience
with any of the offences listed? |Yes |No |
| 18. Are you male or female? | Male | Female |
| 19. Please indicate the state in which you live? | | |

THANK YOU. Your contribution is greatly appreciated!

Globalisation, Innovation and Information Sharing in Tax Systems: The Australian experience of the diffusion and adoption of electronic lodgement

Liane Turner* and Christina Apelt†

Abstract

The aim of this research was to apply a new conceptual framework to describe and explain the factors that have enabled the diffusion, adoption and operationalisation of electronic lodgement within the Australian tax system. The uptake of electronic lodgement of tax returns by both tax agents and taxpayers has increased significantly since introduction. Electronic lodgement of tax returns is part of a burgeoning global trend by OECD members to engage in and broaden the implementation of e-government applications.

This research applied an eight factor framework to analyse the diffusion and adoption of electronic lodgement of tax returns within Australia. These eight factors were the circulation of ideas, national context, tax policy context, technological context, path of entry, effectiveness of champions, roles of key constituents and internal and external networks of support. The methodology comprised textual analysis and in-depth interviews.

This study revealed that a coalescence of factors and actors were pivotal in enabling the diffusion and adoption of electronic lodgement services within the Australian national context. Globalisation, information exchange and advances in technology in computer hardware and software were key drivers. Contemporary issues in the Australian tax administration system and the broader national context were also influential. This study highlights that Australia was amongst the countries championing the global phenomenon of use of electronic lodgement services within tax authorities. The framework provided a comprehensive means to analyse and explain the diffusion and adoption of electronic lodgement strategies within the Australian environment.

THE SEA CHANGE FROM PAPER TO ELECTRONIC LODGEMENT OF TAX RETURNS

In the early to mid 1980s, the concept of electronic lodgement of tax returns was being trialled in the United States. By 1987, the Australian Taxation Office (ATO) piloted the initial use of electronic lodgement services, heralding a potential sea change in the lodgement and processing of tax returns. By 2002/03, approximately 70% of Individual taxpayers lodged their tax returns via tax agents. Currently, it is estimated that 97% of tax agents use the Electronic Lodgement Service (ELS). In the same financial year, approximately 10% of Individual taxpayers lodged electronically through e-tax via the ATO website, with a further 1% using TaxPackExpress via Australia Post. By 2004, the suite of electronic lodgement services offered by the ATO has grown substantially.

The pervasiveness and rapidity with which this phenomenon has surged internationally is evident in the number of countries that have adopted this sea change

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of the increasing displacement of paper processing of tax returns through the implementation of differing types of electronic lodgement services. In the past two decades, the diffusion and adoption of electronic lodgement innovations by tax authorities has swept the globe with countries such as Australia, Canada, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Singapore, Sweden, Switzerland, United Kingdom and the United States offering these computer-based facilities to their taxpayers.

The extent of diffusion of electronic lodgement services in tax authorities both in Australia and internationally raises sociological questions. Such questions include what were the key drivers enabling the spread of this innovation, how did ideas pertaining to electronic lodgement services migrate globally, and who were the champions?

To date, a limited body of research has been conducted to explain the diffusion of electronic lodgement services in the Australian context. This literature consists primarily of historical and descriptive accounts chronicling events in the ATO in general and the implementation of Electronic Lodgement Service in particular (ATO, 2001, 1993). This study aims to further our understanding of this diffusion and adoption process.

THE FOCUS OF THIS STUDY

The aim of this research was to apply a new conceptual framework to describe and explain factors enabling the diffusion, adoption and operationalisation of electronic lodgement within Australia. This was achieved by examining three electronic lodgement modalities implemented by the ATO, namely Electronic Lodgement Service (ELS), TaxPackExpress and e-tax. This study is neither an evaluation of the effectiveness of the process of electronic lodgement diffusion and adoption within Australia, nor an exhaustive history tracing all events entailed in this process. The conceptual framework and methodology for this analysis are now outlined.

ON THE DIFFUSION OF INNOVATIONS

This research tests the applicability of employing a new framework for analysis of the diffusion and adoption of electronic lodgement in Australia specifically and of innovation in tax systems more generally. An earlier version of this study's conceptual framework was devised to describe and explain the diffusion into and within the Australian context of a health policy and technological innovation, namely Diagnosis Related Groups (Dregs)¹ (Turner: 2002). Used for information, management and funding purposes, Dregs were operationalised through the development and use of a range of financially oriented software products applied by governments, insurers and hospitals to calculate resources required by acute care inpatient services.

This conceptual framework is based on the work of sociologists Rogers (1962), Kimberly and de Pouvourville (1993a), Kimberly (1993) and sociologists of translation (Callon, 1986, 1991; Latour, 1988, 1991). Rogers (1962) constructed a theory of the diffusion and adoption of innovations. For Rogers (1962: 13), an innovation is "an idea perceived as new by the individual" rather than one that is novel

¹ This casemix system predicts patients in each DRG will utilise similar amounts of healthcare resources.

as objectively measured by the duration of time since it was initially discovered or used. Building on the work of Rogers (1962), Kimberly and de Pouvoirville (1993b) constructed a six factor framework to analyse the diffusion of DRGs in Western Europe. These factors were the health policy context, technical context, path of entry, role of champions, roles of key constituents and internal and external networks of support (Kimberly & de Pouvoirville, 1993b). Each factor was found to have influenced the outcome of the DRG diffusion and adoption process by both governments and key stakeholders in nine countries studied. Path of entry by government officials was found to be pivotal in advancing the adoption of an innovation in government policy.

Kimberly (1993) identified the national context and the international circulation of ideas as additional factors which should be examined, as well as suggesting application of analytical strategies devised by sociologists of translation, so as to provide a more comprehensive understanding of the diffusion and adoption of an innovation. Furthering the work of Kimberly (1993), Turner (2002) devised a new eight factor conceptual framework that also integrates analytical insights from the sociology of translation to enable the analysis and explanation of diffusion processes for policy innovations which were operationalised through the use of computer-based technology.

The present study applies a modified version of Turner's (2002) conceptual framework to examine and explain the diffusion and adoption of electronic lodgement in Australia. The eight framework factors used to guide data-gathering and data-analysis phases of this research are the tax policy context, technical context, roles of key constituents, internal and external networks of support, effectiveness of champions, path of entry, country context and the larger context of the circulation of ideas in general.

This study applies definitions used in prior research. Emergence is defined as the process of invention by which innovations are created, and which occurs as "part of a larger pattern of social, political and economic activity" (Kimberly & de Pouvoirville: 1993b: 4). For Rogers (1962: 13), diffusion "is the spread of an idea from its source of invention to its ultimate users or adopters." Adoption is defined as, and evidenced by, the government's incorporation of an innovation in its policy (Turner, 2002).

This section outlines the characteristics of the framework factors, before delineating the analytical insights from the sociology of translation incorporated into the framework.

Tax policy context pertains to government actions, organisations, services and legislation that shape and constitute the tax system. This factor requires analysis of the basic contours of the country's tax system, issues of concern or policy debate, and the presence of government goals that could promote a policy climate conducive to change.

The attributes of the *technical context* include the types of data sets collected by a tax authority as well as the types of hardware, software and telephony technology that existed when electronic lodgement innovations were considered and trialed in Australia.

Next, the roles of *key constituents* are considered. ‘Key constituents’ are actors who are affected by the diffusion of electronic lodgement services in the pivotal roles of taxpayers, tax agents, policy makers, software developers and consultants. In this study, the terms key actors, key constituents and key participants are used interchangeably.

Analysis of *internal and external networks of support* requires identifying both the presence of, and roles played by, electronic lodgement support networks characterised as being either ATO specific (internal) or outside the ATO organisation either nationally or internationally (external) that are established or linked into by champions.

To determine the *effectiveness of champions* requires analysis of whether these actors are able to mobilise resources and support. ‘Champions’ are defined as people who are resolute supporters of an innovation, evident in their preparedness to “invest extraordinary amounts of personal time, energy, and reputation to ensure its implementation” (Kimberly & de Pourville: 1993b: 13-14).

The *path of entry* of electronic lodgement innovations into Australia will be determined by applying the Kimberly and de Pourville (1993b) typology of actors, namely government officials, academic researchers, business people and consultants.

Analysis of the *national context* requires consideration of the presence of pre-existing or concurrent public sector reforms and the nation’s economic and political circumstances.

Examination of the *larger context of the circulation of ideas* requires identification of emerging and dominant ideas, such as economic schools of thought, developments in the finance industry, and perspectives on government approaches to service delivery that were debated and influenced government policy at the time.

SOCIOLOGY OF TRANSLATION ANALYTICAL STRATEGIES AND INSIGHTS

Given the innovation of electronic lodgement of tax returns can be conceptualised as a policy and a technological innovation, this study draws on the analytical insights from the sociology of translation, also known as actor-network theory. Devised by Latour (1986, 1987) and Callon (1986, 1991) and their associates, this approach is applied to explain the emergence and spread of scientific and technological innovations.

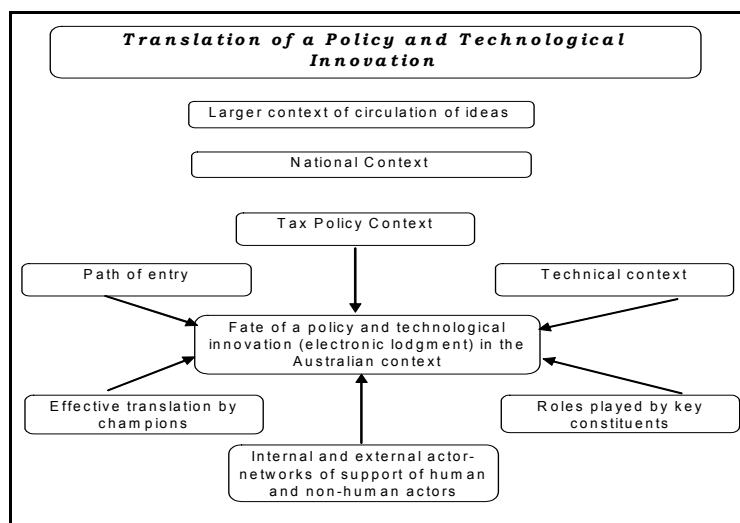
Challenging the notion that the diffusion of innovations is an inevitable process, sociologists of translation maintain that the spread of an innovation is dependent upon the roles played by, and resources obtained from, many actors (Latour: 1986) who assist its passage. The value of sociology of translation lies in its demonstration that the diffusion of an innovation can be understood more fully by attention to, and acknowledgement of, the roles played by both human and non-human actors which are examined, not as single entities, but in terms of network alliances or actor-networks (Callon, 1986, 1991; Law, 1992; Latour, 1988, 1991; Singleton & Michael, 1993). An actor can be a person, a machine, an organisation, a government or a text such as legislation.

Callon (1991) highlights the importance of the roles played by specific non-human actors, termed ‘intermediaries’, in enabling the diffusion of an innovation. Examples of intermediaries are texts, technical objects, skills and money.

Further, Latour (1988) revealed the significance of examining the roles played by trials of strength – consisting of pilot studies – in the spread and adoption of innovations. Pilot studies are used to establish credibility and to broaden the mobilization of allies, by convincing other actors of the benefits of using the innovation.

Of particular pertinence to this study, sociology of translation views innovations as both historical artefacts of a specific era and dynamic entities. This is achieved by revealing the nexus between science (knowledge production) and society (social, political and economic arrangements) that together provide the conditions to shape the formation and modification of innovations (Latour, 1991; Latour et. al, 1992; Scott 1992). To demonstrate this interrelationship, Latour (1991) analysed the emergence of the Kodak camera (technological innovation) and the mass market for amateur photography (social context/society). Subjected to modification enabled by technological advances and demanded by customers, each successive version of the Kodak camera was designed to increase interest in its adoption by highlighting its user friendliness and affordability. Latour illustrated that actor networks comprised of both humans (developers, researchers, technicians, investors and photographers) and non-humans (knowledge, skills, capital, paper, film plates, film rolls, patents, mass production methods and advertisements) were crucial in enabling the spread and adoption of this innovation.

Applying the sociology of translation, Chua (1995) and Turner (2002) revealed how the diffusion and adoption of DRGs in three New South Wales hospitals and in Commonwealth Government policy respectively was contingent on the roles played by human and non-human actors. Human actors included champions, researchers, public servants, hospital staff and consumers. Non-human actors included disciplinary knowledge, cost accounting practices, government departments, software companies, computers, software packages, pilot studies, files and research grants. The studies by Latour (1991), Chua (1995) and Turner (2002) reveal that the absence of any of the human or non-human actors could have caused the innovation to be a different entity, which could have influenced its diffusion and adoption. Figure 1 delineates the conceptual framework for the analysis of the diffusion and adoption of innovations.

FIGURE 1: TRANSLATION OF A POLICY & TECHNOLOGICAL INNOVATION

METHODOLOGY

Two methods of data collection were employed. Firstly, textual analysis was applied in order to examine reports, policy documents, media releases, journal articles, and other written material. Secondly, in-depth interviews were conducted with 15 key actors who participated in the diffusion, adoption and implementation processes of electronic lodgement innovation services in Australia. In-depth interviews were conducted to augment and corroborate material collected for the textual analysis. Data analysis for both textual material and records of interviews was guided through use of the study's eight factor conceptual framework. Further, thematic analysis² was applied to the data to ensure additional factors and emergent themes were identified for their influence on the diffusion and adoption of electronic lodgement services in the Australian tax system. The authors conducted both the data-gathering and data-analysis phases of this research.

THE AUSTRALIAN EXPERIENCE OF THE DIFFUSION OF ELECTRONIC LODGEMENT

This paper now presents the data from both texts and interviews that are pertinent to the implementation and adoption of electronic lodgement technology within the Australian Taxation Office. This section also reflects on the adoption of electronic lodgement technology internationally.

Prior to September 1942, under Australia's federal system of Government, both the Commonwealth and the states could levy Individual Income Taxes. As a consequence of World War II, the Commonwealth became the sole government responsible for the management of Personal Income Tax, initially on a trial basis in September 1942 and then permanently by 1946.

The Central (National) Taxpayer System came into operation in South Australia on 1 July 1975. It was the largest computer-based system in the Southern Hemisphere at

² Kellehear (1993:38) notes that thematic analysis is a method in which themes are sought "as these emerge from the narrative of the interview or written work or behaviours".

that time. Data from income tax returns was entered into the computer network and the edit programs eliminated a high proportion of taxpayer, assessor and keying errors. The corrected data was then transferred to a central computer complex in Canberra for further processing. The first stage of the national roll-out commenced in June 1976 when the system began processing the returns of taxpayers in New South Wales (NSW) and the Australian Capital Territory (ACT) (Interviewee 2, 2004; ATO Story, 2001).

In 1984, Trevor Boucher replaced William O'Reilly as Commissioner (ATO Story, 2001). One of Boucher's first actions was establishing the Assessing Review Group from which legislation for self assessment was enacted in 1986 (ATO Story, 2001). To operationalise self assessment, the ATO needed to support the taxpayer with service and tools that assisted compliance rather than just process returns and enforce taxation law (ATO Story, 2001; Interviewee 2, 2004). Self assessment mandated a paradigm shift in the way the ATO interacted with the taxpayer, triggering a massive re-organisation, including the redeployment of thousands of staff. It was planned that this would bring about an increase in the total tax revenue without a corresponding increase in costs.

During the late 1980s and early 1990s the Commonwealth pursued a micro-economic reform agenda aimed at enhancing efficiencies within the public service (King & Lloyd, 1993; Pusey, 1992; Rees, Rodley & Stilwell, 1993; Stilwell, 1993).

In 1987 Boucher took his Modernisation plan, outlining a massive investment to upgrade computer resources for the ATO, to the Government. It was planned that over time Modernisation would rationalise the ATO's data systems and business activities and staff would perform their tasks using an integrated set of computer-aided tools (ATO, 1990b). The Government agreed to fund the plan and the ATO made a commitment to cost the Government less over the following 10 years. This amounted to the implementation of a major workplace redesign process and an improvement in job processes for the ATO staff. Michael Carmody, then Second Commissioner in charge of the ATO's Revenue Collection and Taxpayer Audit functions, was charged with responsibility for the Modernisation program (ATO Story, 2001).

A large portion of the ATO Modernisation Program was premised on significant savings from automating its information-gathering processes, so at the coal face new workstation furniture and computers were installed. Additionally, LAN and computer rooms needed to be built to assist with the transitions in work processes and ready the ATO for a fundamental shift in terms of its internal focus (Interviewee 2, 2004). Computerisation within the organisation at this time was a major factor that enabled the continued swell of change initiatives that followed (Anon., 1994; ATO Story, 2001).

At this time Trevor Boucher visited the United States and saw the experimental trial of an electronic lodgement facility being developed by the Inland Revenue Service. Boucher returned to Australia and injected the idea for the development of an electronic lodgement system into the ATO (Interviewee 11, 2004; Interviewee 6, 2004; Interviewee 5, 2004; Deuchar, 1989). Boucher set up a small project team to work directly under Michael Carmody (Interviewee 12, 2004). Carmody mobilised the necessary resources in the organization to make this project happen (Interviewee 1, 2004). ELS commenced with a small trial in South Australia where one tax agent lodged some 150 returns in 1987. Initially, only Individual (Form I) income tax

returns could be lodged. This trial was given support by Adelaide's Deputy Commissioner, Ron Kelton (Interviewee 10, 2004; ATO, 1993).

Internally, the ATO had some very clear business pressures to drive the development of an electronic lodgement system. ELS was the first Modernisation project and was seen to have a central role in the push towards modernising ATO business systems and achieving the increased efficiencies and improved job design promised by the Program (Interviewee 12, 2004; Interviewee 6, 2004; Deuchar, 1989; ATO, 1990b). Electronic lodgement by tax agents was central to the ATO shift away from being a paper processing organization with all of the associated job design benefits for staff and clients (Interviewee 1, 2004).

ELS involved the lodgement of income tax return information through the use of tax preparation software on the tax agent's own computer equipment. The transfer of the information from the tax agent to the ATO occurred electronically via telephone lines on the Telecom (now known as Telstra) Austpac network or on a floppy disk. It was form of Electronic Data Interchange (EDI). The Data Take-On machine validated that the data met ATO standards, either rejecting the tax return back to the tax agent for correction or forwarding it through to an electronic security break then to the ELS processing machine. The data then moved to the National Taxpayer System (NTS) for processing and then the Automated Document Despatch system that produced the assessment notice (ATO, 1993). The NTS (established in 1975) was an enabling factor. Its existence provided the ATO with the processing capability (including the algorithms) to process the tax returns received via ELS (Interviewee 2, 2004).

The entire process was automated and staff intervention was not needed unless an NTS edit error occurred (Interviewee 3, 2004; Interviewee 13, 2004; ATO, 1993). The closed user group security (CUG) facility provided by the Austpac network effectively restricted access to the ATO Data Take-On machine to those tax agents who had been formally approved by the ATO for electronic lodgement (Deuchar, 1989; Interviewee 3, 2004; Interviewee 13, 2004). In the early implementation of ELS tax agents could also lodge on floppy disk, rather than online through Austpac. The floppy disk was then read into the ATO systems (Interviewee 10, 2004).

Due to evidentiary requirements, the paper copy of the electronic information had to be printed and signed by the taxpayer and the tax agent prior to its transmission to the ATO. Under the standing operations of ELS at introduction, the signed paper was to be forwarded and received by the ATO before processing could begin. This was later amended so the tax agent held a hard copy of the return on file. The legislative change recognising the electronic return as furnished by the taxpayer was not made until much later, in 1997 (ATO, 1993; Interviewee 2, 2004).

Concurrent with the introduction of the ELS innovation into Australia was the start of a swell of technological developments (Interviewee 12, 2004). Several factors that existed in the wider technological arena enabled the development and adoption of ELS. A key factor was the emergence of Packet Switching Technology in the telecommunications world and this was in place for the trial of ELS technology in 1987. The Packet Switching Network was run by the Telecom X25 network and called Telenet. This was an international standard, and the precursor to the current Internet technology (Interviewee 5, 2004). Prior to Packet Switching, computers were networked with fixed point-to-point wires with leased landlines to each Branch Office. In the absence of Packet Switching technology it would have been necessary for each

tax agent to buy a dedicated line service from Telecom to connect to the ATO. The emergence of this technology made it much cheaper for tax agents to link to the ATO and adopt ELS (Interviewee 5, 2004).

At the same time, the PC revolution was putting personal and business computers within easy reach (Interviewee 5, 2004). The computerisation of business was happening rapidly and some tax agents had already recognised the growing business imperative to increase their familiarity with this technology and were using computers to assist them in preparing tax returns. The information on these forms was then re-keyed into ATO systems (ATO, 1993; Jones, 1998). Supporting this trend, software producers had begun developing and marketing programs designed specifically for tax return preparation and tax agents found these very attractive (Interviewee 6, 2004).

The ATO also needed to improve the quality of data gathered from income tax returns. The period for issue of assessment notices had extended up to 16 weeks and tax agents were under increasing pressure from their clients for faster refunds, and were in turn, putting pressure on the ATO to meet demand for a faster turnaround (Interviewee 1, 2004; James, 1998). Electronic lodgement dealt with this by 'error checking' at the point of transmission, that is, where it was lodged by the tax agent (Interviewee 1, 2004). ELS passed data keying and initial error management to the tax agent. Checks were at lodgement or at the ATO gateway and tax returns were able to be immediately corrected by the tax agent (Interviewee 7, 2004; Interviewee 1, 2004).

At a broader level, the ATO believed that the future business of banks, government agencies and tax agents would depend on electronic document interchange (ATO, 1990b). There was a sense of urgency about the ATO being at the cutting edge of this technological wave and utilising it to ensure the organisation was at the forefront of gaining the benefits (Interviewee 6, 2004). Self assessment, introduced the previous year, the Modernisation Program and the development and implementation of ELS in Australia produced a 'convergence of the planets' in relation to technology and policy going hand in hand and the ATO was in a position to ride the crest of the wave of the opportunities that this provided (Interviewee 2, 2004). ELS encouraged tax agents to purchase computers for their business and modernise their systems ready for the sea change in the way they communicated with the ATO (Interviewee 12, 2004).

The project team that so successfully developed, piloted and implemented ELS existed separately from the mainstream office structure (Interviewee 2, 2004). In the development phase approximately twenty to thirty people worked in the ELS project team directly under Michael Carmody and headed by Project Manager Mike Cebalo (Interviewee 1, 2004; Interviewee 2, 2004).

The ELS acronym originally stood for Electronic Lodgement System and was renamed to Electronic Lodgement Service when Cebalo's son, then aged nine years, suggested the 's' for system should stand for service (Interviewee 2, 2004; Interviewee 13, 2004; Interviewee 3, 2004). The emphasis on 'service', suggested by Cebalo junior was fundamentally embedded in this innovation.

Staff numbers increased as the project progressed into national implementation. The team consisted of technical people, Client Relations Officers (CROs), Business Implementation Managers (BIMs) and administration staff. There were many technical issues to overcome and the ELS project team was working from scratch,

with no useful precedents internally or externally (nationally or internationally) on which to call for examples or experience (Interviewee 6, 2004).

They worked closely with the Privacy Commissioner (Kevin O'Connor), Attorney-General's Department and the Defence Signals Directorate to establish the protocols and standards (encryptions and privacy keys) needed to operationalise ELS (Interviewee 2, 2004). The result of cooperation with external parties was the establishment of security measures for direct data transmission, which included a physical break between the Data Take-On machine, used to accept tax agent data, and the internal ATO processing machine, measures involving the use of passwords, network identifiers, tax agent registration and log-on codes and addresses (Deuchar, 1989).

In December 1989, the project changed focus from development activities to operationalisation. The role of the Client Relations Officers (CROs) was crucial as it entailed going onsite to the tax agents and providing training and information on ELS (Interviewee 13, 2004). The service ethic, internal drive and professionalism of the ELS project team who developed, implemented and ensured the diffusion of ELS is part of ATO mythology and was pivotal to the success of this project (Interviewee 2, 2004).

Critical to the successful implementation of ELS was the support and involvement of tax agents, tax agent software developers, systems vendors and the telecommunications people (Carmody, 1990). ELS implementation involved the staff and management in sixteen Branch Offices, the National Office, over 3,000 tax agents and their representative professional bodies (such as the Institute of Chartered Accountants members who participated in the pilots), Public Service staff associations, twenty-four software producers, Austpac and numerous vendors of systems software and hardware systems (Interviewee 2, 2004; ATO, 1990b; Deuchar, 1989).

The ATO worked closely with the software developers, supplying them with the specifications from which to devise the software applications tax agents would need to enable ELS. Developers then made their software application commercially available in the marketplace (Interviewee 12, 2004). The strength of this arrangement is that it retained the widest possible range of choice for the consumer, in this case, accountants and tax agents (Tebbutt, 1994).

The ATO engaged Prime Computers as the major hardware and software vendor to take the project national (Interviewee 12, 2004). They supplied four Data Take-On machines (Model 6150) and), fifteen ELS processing machines (Models 2755 to 6450), as well as a number of terminals (PT250) for development and operating consoles. Prime also provided the development and operating software: Primos, Prime Information, Info Basic, Prime Recovery and Prime Link. Austpac provided the public network facilities and support. Sixteen PC installations for tax agent floppy disk upload were supplied by NCR. ABC Computers supplied TurboTerm, software that connected the individual TaxLan workstations to the ELS processing machines (ATO, 1990b).

In 1988, volume increased to 27,000 returns lodged via ELS in Adelaide (ATO, 1993). From July 1 1989, the service was offered to all agents in South Australia and Darwin as well as a further small test in Melbourne (ATO, 1993). After these trials the

national implementation project was initiated in January 1989. Their task was to have ELS fully operational in all sixteen Branch Offices by July 1990 (ATO, 1990b).

In July 1990 the ATO officially announced the national release of the system. This represented several firsts for the ATO. These, included:

- a commitment to increase the payments in stages to achieve 'benchmarks' of 15 percent of the married rate of pension for children under 13, and 20 per cent of the married rate for older children, and then to index the payments. These benchmarks were reached in 1989;
- The on-line real time data base used for ELS was the first of its type installed in the ATO;
- For the first time external agencies could electronically exchange documents with the ATO; and
- The introduction of ELS was achieved co-operatively with internal and external parties involved (Interviewee 2, 2004, ATO, 1990b).

There were firsts internationally as well, which included:

- The use of Prime Recovery software package that enabled recovery of database information in the event of system failure; and
- Turboterm terminal software that connected individual PCs on a local network directly into the Prime minicomputer. Previously only single PCs could be linked in this way (Interviewee 2, 2004, ATO, 1990b).

Uptake was achieved using testimonials from tax agents who were involved in the pilot as key speakers at ATO arranged ELS seminars. In addition, the ATO provided a free advertising poster to each ELS registered tax agent announcing a '14 day turnaround'. The promise of a faster refund was an attractive incentive to taxpayers and the tax agents used this poster to attract clients, thus differentiating their 'premium' ELS service from their competitors. The posters enticed taxpayers with the 14 day turnaround and created market competition between tax agents, encouraging their adoption (Interviewee 1, 2004, Interviewee 2, 2004).

The premise was that this technology would be translated into basic savings for practitioners, by giving them faster and more accurate ATO service (Anon., 1994). This premise was fulfilled. ELS slashed turnaround times for taxpayer assessment and refunds and improved service to tax agents (James, 1998). It also paved the way for tax agents to achieve better cash flow management (ATO, 1993; Interviewee 11, 2004).

ELS was the biggest electronic tax administration network in the world (James, 1998; ATO, 1990b).

"The ATO was seen to be doing significant things, innovative things, practical and service friendly things" (Interviewee 6, 2004). Findings published in the Portfolio Evaluation of the impacts of the Electronic Lodgement Service Report (1993:3) concluded that: "...the performance of ELS surpassed expectations. ... ELS is widely regarded as a quality system which has delivered much more than it originally promised."

The ATO objective was that 80% of electronically lodged returns would be processed and assessments issued within 14 days. The result after the first year of operation was that 87% of electronically lodged returns were turned around in fewer than 14 days, while the average turnaround time for an ELS return was 9 days (ATO, 1993).

In its first year of operation (1990) 45% of ELS returns needed human intervention because the information did not meet the ATO standards. In preparation for its second year of operation (1991), the ATO tightened the ELS software specifications requiring the inclusion of additional data integrity checks (edit tests) in the agents' ELS software packages. The result was that in its second year only 29% of ELS returns required human intervention (ATO, 1993).

In 1991, the ATO was awarded the Technology Productivity Gold Award (for improvements to productivity, service and efficiency) for the implementation of ELS (Interviewee 2, 2004). Between July, 1991 and January 1992, 95% of ELS returns were assessed within 14 days and 87% within 10 days (ATO, 1993).

Under Michael Carmody, as Second Commissioner, the ATO worked with Australia Post during 1991 to implement the TaxPackExpress (or Fast Tax as it was originally called) initiative. The pilot was conducted in the ACT. Aware of the fact that ELS service was not available to people who could not access tax agents, the ATO staff sought to implement options to address this issue (Interviewee 11, 2004). An option already in existence was the ability for taxpayers to lodge electronically using commercially available software to generate a return that was saved on floppy disk which then was taken to an ELS registered tax agent for lodgement. A new innovation, namely TaxPackExpress was developed to enable taxpayers who did not go to tax agents to lodge electronically, thus providing consumer choice (Interviewee 13, 2004; Interviewee 3, 2004). Both options provided individuals with comparable turnaround time for Notice Of Assessment (NOA). "There was the imperative of the level playing field so that it wasn't just the tax agents that were advantaged, but technology was available for both tax agents and taxpayers directly" (Interviewee 1, 2004). People could take their tax return to Australia Post who would key and lodge the return electronically via ELS. There was a small charge for the service (Interviewee 11, 2004; Interviewee 1, 2004; Interviewee 12, 2004).

The ELS structure allowed other developments to occur progressively and new types of returns were converted to the ELS stream in 1992 (Interviewee 10, 2004). ELS was extended to cover business applications, including: partnerships, trusts, companies, superannuation funds, approved deposit funds, public trading trusts and corporate unit trusts (James, 1998).

In 1993, newly appointed Commissioner Michael Carmody announced the national release of TaxPackExpress.

By 1994 notable advances were being made in the software sector with the emergence of a new generation of workgroup and workflow products for tax agents – the 'groupware' phenomenon. These products build functionality between tax software and productivity tools such as e-mail and tax practice information software (Tebbutt, 1994). This reflected a growing technological sophistication by tax agents.

In 1997, the Prime Minister introduced the establishment of electronic service delivery (ESD) targets as part of the strategic plans for Information Age Government. Australia's ESD target was to have all appropriate Federal government services capable of being delivered electronically via the Internet by 2001 (United Kingdom Cabinet Office, 2000).

The Commissioner Michael Carmody had an interest in making electronic lodgement directly available to self-preparers who used TaxPack (Interviewee 9, 2004; Interviewee 10, 2004). He saw this as the way of the future and wanted products to take advantage of electronic solutions and make inroads into the community's electronic and Internet usage, which was increasing (Interviewee 10, 2004).

This Commissioner's imperative was operationalised through mobilising the resources needed to deliver an electronic version of the TaxPack, later known as e-tax (Interviewee 10, 2004). The stated aims of the e-tax project included:

- To match the Commissioner's undertaking to develop an electronic TaxPack;
- To encourage the lodgement of tax returns electronically, thereby reducing keying or imaging;
- To improve the quality of data in self-preparers' returns;
- To facilitate the process of completing a tax return, and thereby to encourage taxpayers with simpler tax affairs to view an electronic TaxPack as an easier alternative to using the paper TaxPack; and
- To offer a faster refund service compared to paper lodgement (ATO, 1996).

At the same time software was also becoming more sophisticated. This allowed the development of software that could step the individual through the TaxPack, masking the complexities of tax law (Interviewee 11, 2004). Also important at this time was the proliferation of the use of Microsoft Windows software, thus providing a cohesive standard of software and hardware that enabled tax agents to interact with ATO systems (Interviewee 7, 2004). This led to the disk version of the electronic TaxPack in 1997, initially this was not downloadable as there were still some authentication problems at that time (Interviewee 9, 2004).

Proof of identity was a key technical issue early in development and it was seen as critical that taxpayers had confidence that their information was transferred to the ATO in a secure environment. From this, the Public Key Infrastructure (PKI) method of digitally signing the return emerged (Interviewee 9, 2004). Digital certificates are produced by PKI to provide a high level of authentication using cryptographic techniques (ATO Connect, 2003). Late in 1997, a legislative amendment provided the basis that allowed the ATO to accept an electronic signature. This Act is cited as *Taxation Laws Amendment Act (No.4) 1997*/(174 of 1997), Schedule 7, Electronic lodgement and electronic funds transfer. (ATO Law, 2004).

The ATO's first website, *ATO assist* was established soon after in April 1998 and in its first year was the third most accessed government site in Australia (James, 1998). *ATO assist* provided access to all ATO publications and other public information products, including rulings, draft legislation and tools to support tax calculations (James, 1998). It also provided the technological facility for an electronic tax return. This enabled the change from floppy disk to website lodgement and was followed by a further trial of an electronic TaxPack in 1998.

The technology allowed individuals to download the free software from the website, eliminating the use of a floppy disk or paper. This provided a faster, simpler and easier tax return solution for self-preparers (Interviewee 9, 2004).

The e-tax product delivers the data to the ATO in a form that feeds directly into the ELS. Error checks are performed at lodgement, that is, at the taxpayer's PC, before the data is sent, improving the quality of the data in self-preparers' tax returns (Interviewee 10, 2004). E-tax also introduced calculations embedded in the software to help taxpayers to understand what they needed to do and help them in a practical way to get it right, improving compliance (Interviewee 8, 2004; Interviewee 14, 2004). There is a major system update in June/July each year to incorporate legislative and functional changes. (Meeting of International Tax Agencies, 2002).

E-tax was developed by a relatively small team of people. The Project Manager was John McCarthy and Chris Mobbs was then Assistant Commissioner for Individuals – Non Business (INB), now called PTax, in charge of TaxPack, TaxTime marketing and telephone services (Interviewee 10, 2004; Interviewee 9, 2004). Around a dozen people developed the technical side of e-tax (Interviewee 9, 2004). A contract for the PC software was awarded to the successful tenderer, a consortium formed for this purpose. Interface specifications were borrowed from ELS (Interviewee 12, 2004; Interviewee 10, 2004).

E-tax was released nationally in 1999 with little or no advertising (Interviewee 14, 2004). Word of mouth and publicity in national newspapers and journals such as Australian Personal Computer and Business Review Weekly raised public awareness for the service (Interviewee 14, 2004). This alone was sufficient to generate initial taxpayer enthusiasm for the product (Interviewee 14, 2004).

The ATO was proactive in marketing e-tax in the media from 2000 onwards. (Interviewee 14, 2004). One of the marketing strategies implemented to raise awareness for the product was the use of well known media identity, financial advisor, Paul Clitheroe, in 30 second advertisements on radio stations (Interviewee 14, 2004). From 2002 onwards e-tax was actively promoted through TaxPack, TaxTime and the ATO website (Interviewee 11, 2004, Interviewee 14, 2004) as well as positive word of mouth.

E-tax adoption increased rapidly each year. It achieved 27,000 lodgements in 1999 and over 833,000 in 2003 (Interviewee 14, 2004). Internet use by Australians has similarly grown: in 1998 to a third (32%) of Australian adults had Internet access, by June 2003 this had grown to over half (59%) of the adult population (NOIE, 2003).

The new e-tax product for 2003 incorporated an improved security function where verification was incorporated into the e-tax software (previously performed on the e-tax website), an auto completion function where previous claim information (such as Baby Bonus) is automatically completed for the user, and a function that rolls over data (for many questions) from the previous year into the current return (ATO Connect, 2004a). In the future it will also handle tax return amendments (Meeting of International Tax Agencies, 2002).

The ELS and e-tax innovations were the forerunners of others. Commissioner Michael Carmody's commitment to realising the full potential of electronic lodgement was evident in his announcement in 1999 outlining the following points:

- The ATO is committed to the delivery of its services to the community in ways that make them low cost, easy to access and easy to use;
- To accomplish this goal we will exploit and emphasise electronic alternatives to traditional means of service delivery;
- We will work with the community and stakeholders to establish their needs and preferences; and
- Where necessary we will lead the community in the establishment and take-up of electronic services (Carmody, 1999).

July 2000 was the start of The New Tax System and earlier that year businesses began to register for an Australian Business Number (ABN) in preparation. From June 2002 the Australian Business Register (ABR) was upgraded to allow real time online processing of Australian Business Number (ABN) registrations (ATO Media Release, 1999; ATO Connect, 2004c).

The Easier, Cheaper, More Personalised approach that was embedded in the ideas of ELS in the 1980s, was formalised into an ATO strategic sub plan from July 2003 (ATO, 2003).

Currently it is estimated that 97% of tax agents use ELS (Interviewee 8, 2004). In the future web services for tax agents will replace ELS and vastly expand two way information flows (Meeting of International Tax Agencies, 2002). E-tax users are predicted to exceed one million in 2004 (Interviewee 8, 2004). Use of TaxPackExpress on the other hand, is declining with the expansion in electronic and telephone media lodgement methods (Meeting of International Tax Agencies, 2002).

The following section provides an insight into the global diffusion of the electronic lodgement innovation and describes the electronic experience in selected countries.

The ATO's continued participation in a range of international forums over the years has furthered information sharing on electronic lodgement innovations and other tax authority matters. The diffusion of electronic innovations globally stems from both considerable co-operation between countries in sharing ideas and a degree of competitiveness within the international community of tax authorities (Interviewee 1, 2004; Interviewee 2, 2004; Interviewee 4, 2004; Interviewee 12, 2004). For example, the ATO received worldwide recognition for the use of PKI technology to provide a high level of authentication for e-tax lodgements (Interviewee 14, 2004). Although other countries offered lodgement methods similar to e-tax, and were technologically advanced in some areas, all lacked the authentication security offered in the Australian system by PKI technology (Interviewee 14, 2004). Countries not using PKI were keen to look at the Australian experience and information was shared through visits, journal articles and attendance at international forums (Interviewee 14, 2004).

Australia is an active member of the following international forums:

- Forum on Tax Administration e-services sub-group;
- Pacific Association of Taxation Administrators (PATA), the US, Canada, Japan and Australia;
- Study Group on Asian Tax Administration and Research (SGATAR);
- Commonwealth Association of Tax Administrators (CATA); and

- Organisation for Economic and Cooperation Development (OECD).
(ATO, 2003; United Kingdom Cabinet Office, 2000).

Experience with electronic lodgement globally includes the following country examples:

United States of America

The Inland Revenue Service (IRS) in the US began trials of electronic lodgement prior to the development of the innovation in Australia (Deuchar, 1989). Adoption of electronic lodgement has been slowly and steadily increasing since trials in 1986. Taxpayers in 35 states and the District of Columbia can file federal and state taxes electronically. In 1997, nearly 16% of individual income tax returns were filed electronically rising to 50% in 2000 (Guttman, 1998). Commercial software companies offer a range of software packages to enable individuals to file taxes electronically; there is no 'free' IRS version. The IRS plans to roll out a new filing system for corporations in 2004. Signature and authentication solutions remain a challenge for them (Meeting of International Tax Agencies, 2002).

Singapore

The Inland Revenue Authority of Singapore (IRAS) piloted e-filing via the Internet around the same time as Australia's pilot of e-tax. It was available nationally in 1999 and recorded 270,000 lodgements. It was planned to achieve half a million participants by 2000. The Singapore government takes active steps to market electronic services and influence demand and take-up. (Meeting of International Tax Agencies, 2002).

Canada

The Canadian Customs and Revenue Agency (CCRA) introduced e-FILE, a third party tax filing system in 1990. This was followed by a pilot of NETFILE in 2000. This enables individuals to file tax and benefit returns via the Internet. The CCRA works closely with the software industry on commercial products that utilise NETFILE. Similar to the Australian experience, electronic confirmation of receipt is received in seconds and the tax return is processed in around 2 weeks. (Meeting of International Tax Agencies, 2002).

United Kingdom

The UK's Inland Revenue launched self assessment Internet filing for individuals in April 2000 and a service for the filing of electronic VAT returns (EVR) was launched in April 2001. Both of these services built on the electronic lodgement service to tax agents in operation since 1997. A variety of electronic services for employers, contractors and agents are available via Electronic Lodgement Service and Electronic Data Interchange (EDI). The service has been built to accept Public Key Infrastructure (PKI) arrangements, similar to Australia's. The IR provides free software to those using this service (Aplin, 2000; Meeting of International Tax Agencies, 2002).

Other Countries

In Norway, one third of returns are now filed electronically and they aim to have all individual returns filed electronically by 2004. The Ministry of Finance in Italy reports the initial pilot in March 2000 of Internet filing achieved 16% of lodgements for taxes for citizens and business through the UNICO 2000 system. Relevant software is downloaded to create the tax file which can then be submitted online.

Sweden's National Tax Board is also moving towards a basic e-file without schedules. They have plans to establish Internet filing of taxes by 2003 (Meeting of International Tax Agencies, 2002).

TABLE 1: KEY EVENTS IN THE AUSTRALIAN ELECTRONIC LODGEMENT EXPERIENCE

1946	Amendment to the Income Tax Assessment Act (1936) resulting in the Commonwealth being the sole government with the responsibility to levy personal income tax.
1984	Trevor Boucher appointed Commissioner.
1986	Self assessment legislation passed.
1987	ATO Modernisation Programme accepted by the Federal Government. Michael Carmody appointed Second Commissioner for Modernisation.
1988	ELS pilot with one tax agent in Adelaide.
1989	ELS pilot was expanded to include more tax agents in Adelaide and Darwin.
1990	ELS trial was expanded to Melbourne.
1991	July - National release of ELS. TaxPackExpress pilot conducted in ACT. ATO was awarded the Technology Productivity Gold Award (for improvements to productivity, service and efficiency).
1992	TaxPackExpress trial was expanded to NSW. ELS was extended to cover business applications, including: partnerships, trusts, companies, superannuation funds, approved deposit funds, public trading trusts and corporate unit trusts.
1993	Michael Carmody was appointed Commissioner. National release of TaxPackExpress.
1997	Nov 1997 - Legislative amendment. Taxation Laws Amendment Act (No.4) 1997/(174 of 1997). Schedule 7 Electronic lodgement and electronic funds transfer.
1998	Public Key Infrastructure (PKI) digital signatures emerged. Electronic TaxPack was trialed on the website. ATO website, ATO assist established.
1999	National release of Electronic TaxPack - called e-tax. ATOLaw made available to tax agents through ATO assist.
2002	ABR was upgraded to allow real time online processing of ABN registrations.
2003	E-tax identity verification is incorporated in the software. The Easier, Cheaper and More Personalised sub-plan became operational from 1 July.

ANALYSIS OF THE AUSTRALIAN EXPERIENCE OF ELECTRONIC LODGEMENT

This section now answers the study's research question regarding what factors enabled the diffusion, adoption and implementation of electronic lodgement within Australia by firstly applying the study's eight factor conceptual framework and then drawing on analytical insights from the sociology of translation.

Interview and textual material reveal that the path of entry of electronic lodgement of tax returns into the Australian Tax Policy domain occurred through government officials. ATO Commissioner Boucher had visited the United States where this innovation was being trialled in one state. The evidence reveals that the Commissioner facilitated the migration of the idea of electronic lodgement of tax returns through bringing the idea back into Australia and establishing a small project team to enable the transition of this innovation from an idea to implementation. In relation to e-tax,

the data evidences that Commissioner Carmody acted as the path of entry, championing the introduction of this innovation to honour a commitment to have an electronic version of TaxPack.

The evidence is now considered in relation to the factor, the *effectiveness of champions*. Interview and textual material highlighted the presence of a number of effective champions. Most notably, these were the successive Commissioners Boucher and Carmody and senior members of the Office who championed the operationalisation of ELS and e-tax, including Cebalo, Kelton, Mobbs and McCarthy. Together, these champions were pivotal in driving the diffusion and implementation of electronic lodgement innovations in the ATO. The personal commitment, credibility, standing, ability and ‘can-do attitude’ of these champions were critical in mobilising the requisite resources of people, skills, funds and hardware to build the momentum to effect the spread of electronic lodgement innovations in the Australian tax policy domain.

The *tax policy context* is now examined. There is considerable textual and interview material highlighting that this factor was critical in influencing the diffusion and adoption of electronic lodgement services within Australia. In terms of its basic contours, the Commonwealth Government was able to drive the national diffusion of electronic lodgement services of tax returns for Individuals as a consequence of the prior exclusion of the states from levying personal income tax. This occurred due to World War II, initially on a trial basis in September 1942, then permanently by 1946, with resultant amendments in those years to the *Income Tax Assessment Act (1936)*. The presence of Government goals of the Self Assessment System in 1986 and the Modernization Program in 1987 promoted a policy climate conducive to change that facilitated the adoption and implementation of electronic lodgement, in particular ELS in 1987. Two issues of concern prompted the adoption of electronic lodgement innovations. In relation to ELS, the issue was the length of time the ATO took to process tax returns. The importance of this issue lay in the fact that the majority of taxpayers lodged their returns on paper. With regard to the implementation of TaxPackExpress and e-tax, the issue pertained to the ATO’s goal of levelling the playing field to enable taxpayers who did not use the services of a tax agent to have access to electronic lodgement options.

With reference to the *technical context*, textual and interview material evidenced the ATO harnessed advances in computing hardware and software as well as telephony and later Internet capabilities to achieve its goals of implementing ELS, TaxPackExpress and e-tax. ELS was at the forefront of cutting edge technology, as at the time of its implementation, this innovation was the largest electronic tax administration network in the world, allowing tax agents across the nation to dial into the ATO. E-tax implementation was assisted by the prior implementation of ELS data processing capabilities. Through a series of extended pilots for ELS, TaxPackExpress and e-tax, the ATO successfully built the technical infrastructure and addressed issues of data security and community confidence to drive the adoption of these innovations by key constituents.

The influence of *internal and external networks* of support is now examined. The evidence substantiates that the ATO established internal networks of support consisting of dedicated project teams that built network relations with other departmental sections. Team members were highly expert and motivated. External networks of support consisted of software developers, computer hardware vendors and

key constituent groups, which in the case of ELS consisted of tax agent professional bodies, tax agents and their taxpayer clients. Interview data highlighted the importance of international networks. Data evidenced there is an admirable willingness to engage in information sharing amongst tax authorities in international forums and via international visits, on a range of matters including electronic lodgement innovations.

The evidence highlights the pivotal roles played by *key constituents* in the diffusion and adoption of an innovation. Through its use of pilot studies, the ATO enrolled key constituents in the use of these innovations. The positive reception accorded electronic lodgement innovations by tax agents and taxpayers influenced its rate of adoption. The data reveals that the initial take-up rate for ELS was 80% of tax agents. Market pressure was found to be a critical factor influencing tax agent adoption of ELS. Agents that used ELS could offer their clients refunds in 14 days. This commercial advantage encouraged agents to adopt this innovation or face losing clientele to their competitors who already had embraced ELS. Further, this study's findings highlight that the testimony of early adopters who advocate the use of an innovation such as tax agents in the case of ELS and taxpayers in terms of e-tax were pivotal in championing and driving its further diffusion and uptake by other potential users.

This study found that the *national context* was an important driver in relation to both ELS and e-tax. It is evident from texts that the Commonwealth Government was pursuing broad public sector reform aimed at achieving efficiency. Commonwealth departments were charged with making operational savings in the form of efficiency dividends. The ATO enacted changes to its work practices, such as the introduction of ELS, aimed at achieving efficiency goals. In regard to e-tax, the presence of ESD targets as well as other electronic innovations such as e-banking, e-commerce and e-government in the *national context* were concurrent factors influencing the diffusion of e-tax and its adoption by users.

Textual and interview data evidence the influence of the *larger context of the circulation of ideas* upon the diffusion of electronic lodgement within Australia. This is evident in the range of international forums in which the ATO participates. Further, there is both considerable co-operation in sharing ideas and a degree of competitiveness within the international community of tax authorities. For instance, the emergence of ELS in Australia stemmed from Commissioner Boucher's visit to the United States where he witnessed the trial of electronic lodgement. Also, the influence of globalisation evident in the emergence of ideas and practices associated with e-banking and e-commerce both influenced the diffusion and adoption of e-tax in Australia. This is apparent as well in the actions of numerous international delegations visiting Australia to acquire knowledge of electronic lodgement innovations implemented by the ATO. This study reveals the influence of globalisation and information sharing on the diffusion of ideas in terms of the number of countries that have implemented a range of electronic lodgement innovations in their tax authorities.

TABLE 2: FACTORS INFLUENCING ELS DIFFUSION, ADOPTION AND IMPLEMENTATION WITHIN AUSTRALIA

<i>Tax policy context</i> • Prior introduction of the self assessment system • Concurrent implementation of the Modernisation Program and Workplace design • Concurrent re-engineering of work processes within the ATO and tax agent practices • Increasing efficiency through reducing processing costs • Improving client service with 80% of returns processed in 14 days • Promote transition from paper to electronic lodgement processes • Improve data quality by reducing error rates in tax returns before receipt by ATO • Improving job opportunities for ATO staff by changing organisational focus from processing and verifying returns to service assisting taxpayers with self assessment
<i>Technical context</i> • Tax agents' adoption of computers due to easier availability through the PC revolution • Increasing availability of software programs in the market devised to assist tax agents with return preparation • Existence of the Austpac – Telecom (now Telstra) network for transferring data • Advances in electronic data transfer such as packet switching technology and Telnet • ATO enhancement of electronic capability through National Taxpayer System and concurrent implementation of the Modernisation Project and data-take on machines • Separation of data-take-on (receipt of tax returns from agents) and processing in ATO
<i>Path of entry</i> • Path of entry was governmental
<i>Role of key constituents</i> • High level departmental support • Participation by software/hardware providers, tax agents and tax agent professional bodies • Phenomenal adoption of ELS by tax agents and their taxpayer clients
<i>Effectiveness of champions</i> • Combination of champions who introduced and implemented ELS to effect its national diffusion, namely government officials, Commissioners Trevor Boucher and Michael Carmody as well as Ron Kelton and Mike Cebalo
<i>Internal and external networks of support</i> • Highly expert and motivated internal ATO team • Broad participation by ATO management and staff across national office, branch offices across 16 sites as well as tax agents, software developers, computer hardware vendors, Austpac, Privacy Commissioner, Attorney-General's Department and Defence Signals Directorate • A co-design process was pioneered by the ATO through ATO business analyst staff working closely with tax agents on this innovation • International tax forums including the OECD Tax Forum and access to technology libraries
<i>National context</i> • Efficiency in government operations as Commonwealth pursued public sector reform
<i>Larger context of circulation of ideas</i> • Electronic lodgement trial in US • Range of formal and informal international forums in which the ATO participates • Globalisation and the emergence of e-banking and e-commerce

TABLE 3 FACTORS INFLUENCING E-TAX DIFFUSION, ADOPTION AND IMPLEMENTATION WITHIN AUSTRALIA

<i>Tax policy context</i> • To fulfil the Commissioner's undertaking to develop an electronic TaxPack • To ensure electronic lodgement was available to all taxpayers, not just tax agent clients • To simplify the process of completing and lodging tax returns • To encourage use of electronic lodgement • To improve the quality of data in self-preparers' returns • To improve job satisfaction for ATO staff by reducing paper processing requiring keying • Legislative amendment enacted to recognise digital signature
<i>Technical context</i> • Prior existence of ELS • Development of Public Key Infrastructure (PKI) • Establishment of ATO assist • PC revolution with expanding availability and affordability of computers in the community • Increasing use of Internet by the community • The presence of Windows technology through Microsoft products
<i>Path of entry</i> • Path of entry was governmental
<i>Role of key constituents</i> • High level departmental support • Support of taxpayers evidenced in the pilot and in successive years post implementation
<i>Effectiveness of champions</i> • Combination of champions who introduced and implemented e-tax in the tax policy domain to effect the national diffusion of this innovation, namely – government officials, Commissioner Michael Carmody as well as Chris Mobbs and John McCarthy
<i>Internal and external networks of support</i> • Dedicated e-tax project team, internal IT expertise and e-tax help desk • ATO working with software development consortium as contractor • International tax forums including the OECD and Tax Administrators' Forums - PATA, SGATAR and CATA
<i>National context</i> • Emergence and implementation of e-commerce and e-government as well as ESD targets • Increasing community use of Internet technology
<i>Larger context of circulation of ideas</i> • E-banking, e-commerce and e-government • Range of formal and informal international forums in which the ATO participates • Ascendancy of notions of consumer choice in service delivery

Sociology of translation strategies now are applied to examine the data. Both textual and interview material reveals that the champions of electronic lodgement were successful in mobilising the resources to establish and maintain the actor-networks required to drive the adoption, implementation and national diffusion of ELS, TaxPackExpress and e-tax. These actor-networks were comprised of both human and non-human actors. In relation to ELS, a substantial actor-network was established. Human actors included ATO officers — Commissioners, senior management, the ELS project team, IT officers, Business Analysts and Client Relations Officers, as well as software producers, computer vendors, contractors, tax agents and their taxpayer clients. Non-human actors included software programs, computer hardware, tax files, packet switching, telephony lines, pilot studies, Austpac and government departments,

namely the Privacy Commissioner, Attorney-General's Department and Defence Signals Directorate.

With regard to e-tax, human actors included ATO officers — Commissioners, senior management, the e-tax team, software developers and taxpayers. Non-human actors included ELS, Internet, ATO web site, e-tax software program, computer hardware, tax files, telephony lines, pilot studies, legislation and government departments.

The data revealed key roles played by intermediaries, namely *technical objects*, *skills*, *texts* and *money*. *Technical objects* such as the differing software packages for tax agents devised by software providers varied in their functionality and cost, which in turn assisted the spread of this innovation by enhancing user friendliness and affordability for potential adopters. The ATO's non-provision of a free software package for tax agents prompted enrolment of software developers in the market place to drive the ELS innovation. This occurred through software developers competing against each other to devise software applications that captured market share amongst tax agents. Also, the alliance of *technical objects*, namely home computers, the Internet and e-tax software, was essential in enabling the broad scale adoption of e-tax by taxpayers.

Skills in programming applied by ATO staff members and consultants were pivotal for the implementation of ELS and e-tax. Computer literacy skills of tax agents and taxpayers were essential for the uptake of ELS and e-tax. Texts such as legislation and annual Individuals tax return forms played important roles as these contained tax rules, which software producers translated into software packages. Such texts provided the basis for ATO officers to devise specifications for e-tax software. The *Income Tax Assessment Act (1936)*, November 1997 legislative amendment, *Taxation Laws Amendment Act No. (4) 1997/(174 of 1997)* and Schedule 7 Electronic lodgement and electronic funds transfer were pivotal in formalising new practices embodied in the paperless lodgement of tax returns. *Funds* were critical to the adoption of ELS and e-tax to purchase hardware and fund project teams and contractors.

Textual and interview material demonstrated the significance of the roles played by a series of pilot studies in the Australian experience of diffusion and adoption of electronic lodgement innovations. Firstly, the 1987 trial of ELS in Adelaide with one agent evidenced that this innovation was credible and feasible. This outcome served to further mobilise resources resulting in the trial being extended in 1988 to include tax agents in Adelaide, and in 1989 to tax agents in Melbourne. Secondly, the success of the TaxPackExpress pilot conducted by the ATO in 1991 in the ACT resulted in its extension into New South Wales in 1992. The success of this pilot culminated in the launch of TaxPackExpress in 1993. Thirdly, the 1997 pilot of the forerunner of e-tax called Electronic TaxPack with 1,200 people using floppy disks to lodge their tax returns provided the basis for a further trial in 1998 also enlisting 1,200 taxpayers. However, this second trial differed markedly, as it harnessed Internet technology, demonstrating that this mode of electronic lodgement was faster and a better solution than its predecessor, prompting its national launch in 1999. These pilot trials were critical in enabling the ATO to identify and address technical infrastructure, as well as security and community confidence issues.

The sociology of translation views innovations as both historical artefacts of a specific era and dynamic entities. Each version of software offered by software developers to

tax agents and via the ATO web site to taxpayers through e-tax reveals the historicity of these innovations in terms of their link to specific legislative requirements and changes in particular years embodied in tax rules. The dynamic nature of these innovations stems from three drivers that each resulted in the modification of successive versions of software packages designed for tax agents. Firstly, the ATO devises specifications that software developers have to meet. Secondly, changes in legislation need to be incorporated into the software to ensure these packages are current for tax agents' purposes. Thirdly, competitive pressure within the market place amongst software developers led to the incorporation of technological advances such as edits, checks and calculation facilities, which were aimed at enhancing their market share amongst tax agents. Together, these changes facilitated the achievement of receipt of 'right' data at point of entry to ELS in the ATO.

REVIEWING FINDINGS ON THE DIFFUSION OF INNOVATIONS IN LIGHT OF THIS RESEARCH

The current study substantiated the findings of Kimberly and de Pouvourville (1993a) and Turner (2002) by demonstrating that a coalescence of factors were crucial in enabling the diffusion, adoption and implementation of a policy and technological innovation, that was operationalised through computer software and hardware. Similarly, the combination of these factors assisted in providing a means to analyse and describe the phenomenon of the adoption and diffusion of computer-based innovations.

This study substantiates earlier findings by Kimberly and de Pouvourville (1993a) and Turner (2002) that two factors, namely the *path of entry* by government officials and the *effectiveness of champions* located within government departments were both crucial factors that expedited the adoption and implementation of an innovation. These studies each found that presence of effective champions was pivotal in mobilising the resources of people, skills, funds and hardware necessary to build the momentum to effect the spread of an innovation and its uptake by key stakeholders.

The conclusions of this study confirm findings of Kimberly and de Pouvourville (1993a) and Turner (2002) regarding the policy context. These studies found that *policy context* characteristics such as the implementation of government initiatives to modernise the public sector and the presence of issues of concern can combine to provide a conducive environment facilitating the adoption, implementation and diffusion of an innovation.

Consistent with prior studies by Kimberly and de Pouvourville (1993a), Kimberly (1993) and Turner (2002), the findings of this research highlight the pivotal roles played by the *technical context and internal and external networks of support* to enable the diffusion and implementation of a computer based innovation. The magnitude of the technical work that had to be undertaken did not act as a deterrent factor for an adopting organisation committed to the implementation of an innovation. Rather, these studies evidence departments that are successful in championing the diffusion of innovations also will have established internal and external networks of support devised to address technical and key constituent issues so as to achieve their organisational goals.

The findings of this study substantiate those of Kimberly and de Pouvourville (1993a), Kimberly (1993) and Turner (2002) in evidencing the roles played by *key constituents*, particularly early adopters, is crucial to the successful diffusion and adoption of an

innovation. Each study found that the uptake rate of an innovation by other potential users was advanced by the presence of early adopters in key constituent communities who took on the role of champions in advocating the invention's adoption.

The importance of the *national context* is now considered. This study found that Government's pursuit of broader public sector reform aimed at achieving efficiency influenced the adoption and diffusion of ELS. Further, this research revealed that the presence of other electronic innovations in the broader community such as e-banking, e-commerce and e-government raised taxpayers' familiarity with computer literacy, Internet and electronic transaction services, which in turn facilitated the uptake of e-tax by taxpayers. These findings are supportive of prior research (Kimberly, 1993; Turner, 2002) highlighting the need to examine the national context for its role in influencing the diffusion and adoption of innovations by governments and key constituents.

Similarly to the findings of Kimberly (1993) and Turner (2002), the current study highlights that *the larger context of the circulation of ideas* furthered the global diffusion and local adoption by specific countries of innovations. These ideas are circulated primarily through international forums, visits to other countries and texts.

This study substantiates research undertaken by sociologists of translation, finding that an inadequate explanation of an innovation's spread and adoption will result unless equal attention is given to the roles of both *human* and non-human actors (Callon, 1986, 1991; Chua, 1995; Law, 1992; Latour, 1988, 1991; Turner, 2002). This study found the diffusion and adoption of electronic lodgement innovations were contingent on the presence of human and non-human actors. Human actors included ATO officers — Commissioners, senior management, project teams, IT officers, software producers, computer vendors, contractors, tax agents and taxpayers. These human actors could not have achieved their goals without enlisting the contribution of crucial non-human actors such as self assessment system, software programs, computer hardware, tax files, packet switching, telephony lines, pilot studies, Austpac and a range of government departments.

The current study also substantiated *the* findings by Callon (1991), Chua (1995) and Turner (2002) with regard to the importance of the roles played by intermediaries, such as *money, texts, technical objects* and *skills* as essential to the diffusion of innovations.

Consistent with the studies by Latour (1988) and Turner (2002), this research highlighted the significance of the roles played by trials of strength – consisting of pilot studies – in the spread and adoption of innovations. These studies each demonstrated that pilot studies established and furthered the credibility of an innovation.

In common with sociology of translation research (Latour, 1991; Latour et. al, 1992; Scott 1992), this study found innovations are both historical artefacts of a specific era and dynamic entities evident in successive versions influenced by transformations in science (technological advances) and society (social, political and economic arrangements).

INSIGHTS ON THE SUCCESSFUL DIFFUSION AND IMPLEMENTATION OF INNOVATIONS

The success of ELS and e-tax is evident in the rapidity and extent of adoption of these innovations by key constituents. Therefore several insights can be garnered from this Australian experience to assist persons considering championing the diffusion, adoption and implementation of policy and technological innovations.

Firstly, this study highlights the benefits of examining the role of eight factors for their potential influence in facilitating or hindering the diffusion and adoption of innovations. It is evident from this study that the diffusion of an innovation is contingent on the *effectiveness of champions* who are willing to invest time and effort in procuring the resources of both human and non-human actors to achieve their goal. The findings reveal how champions harnessed opportunities afforded by *the larger context of ideas in circulation* from other countries and via international forums as well as events in their own *national context* to evidence and support the need to adopt and implement electronic lodgement innovations. Also, the *tax policy context* and *technical context* should be explored for opportunities to harness existing resources or recent changes that can be enlisted to provide additional support to facilitate the implementation of the innovation.

Further, this research evidences that successful diffusion, adoption and implementation of an innovation within the tax policy domain can be expedited if the *path of entry* is enabled through government channels, which is an internal mechanism. This has implications for members of tax authorities regarding organisational considerations, but also for entrepreneurs, consultants and researchers aiming to have their chosen innovation adopted through furthering network alliances.

Further, this study highlights the necessity for champions of establishing and maintaining *internal and external networks of support*. This research evidences that champions need to consider both the network resources required and the strategies to be devised to achieve the enlistment of such resources. Further, attention needs to be given to the constituent elements of the actor-network alliances regarding the enrolment of both human and non-human actors. Champions must be mindful to implement strategies to enlist and maintain *key constituents* within their *internal and external networks of support*. The possibility of such enrolment is heightened through revealing the benefits of the adoption of an innovation to the key constituents. In turn, this minimises resistance that may hinder the diffusion and adoption process.

CONCLUSION

The present study contributes to the body of knowledge on the diffusion of innovations within Australia, both conceptually and in terms of specific findings.

This study found that use of this framework enabled a more comprehensive analysis of the diffusion of electronic lodgement innovations in Australia, than would have been possible by only examining the eight factors and/or focusing on the roles of human actors alone. Use of sociology of translation strategies ensures that the pivotal roles played by non-human actors in the process of the diffusion and adoption of innovations were not overlooked. Further, this study reveals that the diffusion and adoption of electronic lodgement innovations within the Australian tax system were contingent on a coalescence of factors. Changes in any one of these factors may not have prevented this diffusion and adoption process; however, it is possible that the process and outcome may have been different and was not inevitable.

This study contributes to existing knowledge by demonstrating that the path of entry of ELS and e-tax into the Australian tax policy domain occurred by government channels. The findings of this research highlight that the larger context of the circulation of ideas apparent in the influence of both globalisation and information sharing amongst tax authorities has facilitated the sea change of an increasing number of countries adopting and implementing electronic lodgement innovations in their tax authorities.

The conclusions of this study also reveal insights into factors that can be harnessed by champions considering driving the diffusion and adoption of innovations.

This study evidences that Australia was a world leader in implementation of this cutting edge technology, particularly with regard to ELS. A comprehensive comparative analysis of electronic lodgement services of tax returns in Australia specifically and internationally more generally was beyond the scope of this study. Therefore, further research is merited on this topic.

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