AVOIDANCE, EVASION AND REFORM: WHO DISMANTLED AND WHO'S REBUILDING THE AUSTRALIAN INCOME TAX SYSTEM?

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I. CLOSING THE TAX AVOIDANCE DOOR

Not long ago, in the 1970s, the Australian income tax system was subject to a wave of avoidance and evasion unprecedented in this country and probably unmatched anywhere else in the world. The episode cost revenue billions of dollars,[1] did untold damage to the social fabric of our country and permanently altered the public perception of both the legal profession and the judicial process in Australia. Ultimately it led to a major tax reform initiative by the Hawke Labor government that resulted in the broadening of the income tax base to include some capital gains, the adoption of a separate fringe benefits tax, the introduction of a lump sum superannuation payments tax regime, a company/shareholder imputation system, a foreign tax credit system and a cap on the egregious negative gearing tax avoidance ploy,[2] as well as a minor scaling back of the scope of a few of our more questionable

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1 Selected statistics illustrating the magnitude of the problem may be found in R. Krever, "Tax Reform in Australia: Base Broadening Down Under" [1986] 34 *Can Tax J* 346, n.5, 352.

2 The anti-avoidance provisions were subsequently repealed in mid-1987 in response to vigorous lobbying pressure.

tax expenditures such as the tax subsidy for the Australian film industry.[3]

One of the most significant consequences of the tax avoidance and evasion era was the wholesale shifting of tax burdens onto the backs of those deriving income from salaries and wages, a development which greatly contributed to the popular myth that Australia was a heavily taxed nation. Quite the opposite is the case — Australia was and continues to be a relatively lightly taxed country.[4] However, the inequitable distribution of the tax burden that arose during the avoidance and evasion era led many to question for the first time the desirability of the progressive income tax system. Almost from Federation, the redistributive aims of progressive income taxation have been a cornerstone of the Australian ideal of a socially just participatory democracy.[5] The discrediting of the income tax is almost certainly a factor behind the new threats to our social system.

If any one lesson was learned from the tax avoidance era by that segment of our society dedicated to the goal of reducing their personal tax burdens, it surely must be that explicit and highly visible tax avoidance will ultimately dig its own grave. The Australian public is sufficiently sophisticated to realise who will ultimately bear the burden of the tax avoiders' grab at the public revenue and a decade of shouldering the effects of the tax minimisation schemes has lowered its tolerance for carrying the load. Next time it happens, widespread tax avoidance will no doubt take a different form, clothed in far more subtle and insidious tax planning devices that quietly chip away at the fragile facade of progressive income taxation. The difficulty of exposing the discrete new generation of tax schemes makes it crucial that we dig out the root causes of the era just passed and take steps to alter them.

To date, our attempts to ascertain the causes of the episode immediately past have been pitiful and our attempts to correct them even more so. Conventional wisdom places much of the blame on the Barwick High Court, whose endorsement of artificial and highly contrived avoidance schemes laid

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3 Some of the most dubious remained, however. For example, a proposal to end the $100 million tax expenditure dole handed out annually to the gold mining industry was subsequently withdrawn for political reasons, resulting in a generous $5 billion windfall to shareholders who had invested in shares of gold mining companies. (Interestingly, in *Reform of the Australian Tax System: Draft White Paper*, AGPS, 1985, the government provides two measures of the tax handout — in the final accounting the government estimated lost revenues of $90 to $100 million (p.243), while its original estimate for the cost of the tax expenditure was $35 million (p.50). The two estimates cover different time periods — it is possible anticipated gold mining revenues, and resulting tax subsidies were expected to rise over the period). A Parliamentary Committee had estimated the tax expenditure cost $75 million in 1981-1982, see Report from the House of Representatives Standing Committee on Expenditure, *Taxation Expenditures*, AGPS, 1982, 29. See also D. Tweed, "Govt's gold tax rejection 'adds $5bn to share values'" *The Australian*, Tues. July 7 1987, 17 (quoting from a report prepared by accounting firm Ernst and Whinney).

4 OECD statistics from 1982 showed that of 22 other OECD countries, 16 were taxed more heavily than Australia. The OECD statistics considered by the government in the course of its tax reform policy formulation are reproduced in D. Morgan, "An Agenda for Tax Reform" in J.G. Head, *Changing the Tax Mix*, Australian Tax Research Foundation, 1, 4-5.

5 The first Commonwealth income tax was introduced in 1915 but state income taxes dated back to 1880 when Tasmania adopted the first limited income tax in Australia.

the groundwork for the development of a thriving tax avoidance industry. Commentators have also pointed critical fingers at the tax lawyers responsible for drafting the avoidance arrangements presented to the Court and at the taxpayers who urged the lawyers to devise those schemes. These recriminations and allegations have obfuscated the real roots of the problem. Yet to be addressed is the underlying reason for the past proliferation of tax avoidance schemes, a structurally unsound income tax system.

This article looks at the three parties most usually blamed for tax avoidance — taxpayers, tax advisors, and the courts — and examines the validity of the allegations and the extent to which subsequent counter-measures will succeed in preventing or minimising the incidence of future avoidance. It shows that ultimately none of these candidates really bears the blame for the tax avoidance era. It also shows that directing anti-avoidance efforts at these groups is a misguided and inefficient policy.

The behavior of taxpayers, tax lawyers and the courts was discreditable but the criticism of conventional wisdom is badly misplaced. In the end, tax avoidance was made possible because the legislature lacked the political courage to address the crucial flaws that undermined the entire income tax structure. Its failure to protect the integrity of the tax base and progressive rate structure left this country's income tax system devoid of principles or purpose. For the moment, tax 'reform' has papered over the worst excesses of the tax avoidance era. The root causes of the avoidance remain, however, and will continue to do so until the legislature is prepared to legislate the real reforms the Australian tax system desperately needs.

II. THE TAX AVOIDANCE TRIUMVIRATE

1. The Taxpayers

In a market driven economy such as ours, tax avoidance and evasion survive only as long as taxpayers are willing to remunerate tax advisors with a share of the income that those advisors help divert from the public purse, as Australian taxpayers were in the 1970s.

The ready endorsement by taxpayers of dubious tax minimisation tactics and the geometric growth of avoidance schemes suggest the presence of extraordinary catalysts among the causes of heightened taxpayer demand for avoidance schemes in the 1970s. A prior half century of docile income tax compliance by the groups who fuelled the tax avoidance conflagration made it clear that historically tax avoidance was not a general social norm.[6]

6 Were Australian taxpayers a particularly avaricious breed that demanded and received tax avoidance advice on a scale not sought elsewhere? To be sure, there are those who attribute to Australian taxpayers qualities not duplicated overseas. It has been suggested that our prison colony origins and subsequent anti-authoritarian streak are factors that help explain the growth of avoidance and evasion. See, *e.g.* Y. Grbich, "Problems of Tax Avoidance in Australia" in J.G. Head, (ed.), *Taxation Issues of the 1980s* (1983), 413, 414. Presumably the suggestion was made tongue in cheek — neither our national roots nor genetic lineage in themselves provide a convincing explanation for the phenomenon.

However, the 1970s brought new pressures that taxpayers had not previously experienced. The Whitlam Labor government's push towards more acceptable levels of social justice and opportunity required new revenues and the successor Fraser Liberal government was able to make only limited cuts in popular social programmes. The period of increased revenue needs coincided with an extended period of rampant inflation, which combined with an unindexed rate structure to push those with median incomes into the brackets formerly reserved for only the wealthiest fraction of taxpayers.[7] The large rise in tax burdens in a short period caused many to reconsider their commitment to the social pact.

At the same time, there emerged a growing public awareness about the state of the Australian income tax base. Income from capital was completely exempt from taxation, provided its recipient was sufficiently well advised to extract it in the form of capital gains rather than severable receipts, and significant portions of income from labour were similarly untaxed so long as they could be characterised as fringe benefits,[8] remuneration for employment termination,[9] ex-gratia payments or consideration for negative covenants.[10] An increasing body of taxpayers resented the exemption of too many of their fellow citizens from tax obligations notwithstanding their clear ability to pay, and thus sought to equalise the perceived inequities by lowering their own tax burdens. The success of those slipping through the tax avoidance door quickly bred, first, a circle of demand and, second, the development of new schemes in response to that demand, as less adventurous taxpayers decided to cash in on the good thing they saw others successfully exploiting.

Acknowledging the role of taxpayers in seeking tax avoidance does not mean they should bear primary responsibility for the subsequent avoidance nor that tax avoidance can be prevented by concentrating on taxpayers. Directing efforts elsewhere will be more effective. Taxpayers can only exploit tax avoidance schemes when there are anomalies in the tax base that make the schemes possible; they need professional advice to restructure their

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7 By 1984-1985, immediately prior to the Government's tax reform initiatives, almost 40% of full-time employed persons faced a marginal tax rate of 46% or greater, compared with 1% of taxpayers in that group three decades earlier. At the same time, the top marginal rate cut in at 1.6 times average yearly earnings compared to 18 times in 1954-1955. That top rate cut in at $35 000 while in 1954-1955 it applied to incomes $400 000 and over (when translated to 1984-1985 dollars). See *Reform of the Australian Tax System,* note 2 *supra,* 3 and Morgan, note 3 *supra,* 7.

8 In theory fringe benefits were subject to income taxation under s. 26(e) of the Income Tax Assessment Act. In practice, potential administration and valuation difficulties combined with political pressure to discourage the application of that section except in rare cases.

9 5% of some termination payments were subjected to taxation under s. 26(d) of the Act, but in many cases it proved not to be difficult to characterise deferred remuneration as tax-free capital payments, much to the relief of those taxpayers not content to receive only 95% of their gains free of tax.

10 A negative covenant is a pledge not to work. For example, a movie star might accept a lower fee for making a film as well as payments for his promise not to make films for competitor companies in lieu of the higher salary his services might otherwise attract. The famous English case of Sir Laurence Olivier (*Higgs (Insp. of Taxes)* v. *Olivier* [1952] Ch 311), where precisely this happened, became an important precedent in Australia.

affairs and take advantage of the schemes; they need courts willing to endorse those schemes; and they need a legislature willing to ignore the schemes or ignore the structural defects that make them possible.[11]

2. The Tax Advisors

The essence of most successful tax avoidance schemes was the legal rearrangment of a commercial or investment transaction to arrive at a gain or loss for tax purposes that bore little or no relationship to the real economic gain or loss resulting from the transaction. Responsibility for the design and implementation of the paper arrangements necessary to achieve this end was undertaken by a select group of tax experts within the legal and accounting professions. Without the active participation of these professionals, the tax avoidance era could not have come about.

Whether the conduct of tax advisors during the 1970s was 'wrong' depends on the ethical, moral and social standards one wishes to impose on legal professionals. It could be argued that the legal profession, by virtue of its self-governing status and role as officers of the court, should have steered well away from advice that deliberately sought to contravene the clear or merely probable intention of crucially important social legislation. Leading tax advisors insisted that a lawyer's duty was to give any advice about tax avoidance relevant to the client's interest and to invent new schemes when so requested.[12] As one prominent tax solicitor explained it, once the law had been framed, the roles of morality, equity and fairness were at an end.[13]

A minority of tax lawyers, to their credit, recognised the irresponsibility of merging their pecuniary interests with the tax avoidance interests of their clients and on ethical grounds refused to participate in the design of tax avoidance schemes. However, the image of tax lawyers was altered forever by the actions of the majority. They were exposed as little more than high status tradespeople dedicated to the sevice and interests of their wealthy clients.

Viewed in this light, the actions of tax practitioners are easy to understand and accept, perhaps even to excuse. The moral stature of tax advisors is no better and no worse than that of any other trade or profession. For most occupations, socially undesirable behavior is constrained by externally imposed controls — licensing requirements, bureaucratic checks and so forth. However, what is good enough for car mechanics and plumbers is not considered appropriate for lawyers and this profession remains self-policing

11 One important Committee on Taxation certainly chastised taxpayers, however, as well as their advisors — see *Report of the Commonwealth Committee on Taxation (Ligertwood Committee)* (1961), xii-xiii.

12 See, *e.g.*, N.H.M. Forsyth, "Tax Avoidance and the Responsibility of the Professional Legal Adviser" (1981) 55 *ALJ* 582, 588.

13 M. Leibler, "Should the Law Institute of Victoria Take a Public Stand Against Artificial and Contrived Tax Avoidance Schemes? — The Case Against" (1980) 54 *L Inst J* 562, 562.

(or self-tolerating, depending on one's perspective).[14] If society is not prepared to place constraints on the conduct of lawyers, it must be prepared either to accept or to forestall the consequences. Ultimately the fault must lie with those who let the lawyers get away with it.

The best defence which tax advisors can advance in response to criticism of their tax avoidance initiatives of the 1970s is the success of most of those initiatives — they were endorsed by the courts responsible for establishing the limits of acceptable tax manipulation. Lawyers who were asked for legal advice about tax avoidance schemes quite properly turned to the precedents of the High Court of Australia for guidance and discovered that our supreme judicial body was busily endorsing outrageous schemes. The message tax lawyers received from that Court was unambiguous — the real economic consequences of a transaction would be ignored in favour of artificial legal constructs. So long as appropriate formalities were followed, the High Court was saying, income could be called capital and gains could be called losses for tax purposes.

The judiciary responsible for guarding the integrity of the law endorsed the most adventurous tax avoidance efforts of lawyers. This fact undermines the criticism levied at tax professionals for their actions and the criticism levied on the profession for its failure to police itself.[15] The professsion is quite right in its claims that the High Court had the power to stop tax avoidance dead in its tracks. Determining why it failed to do so must take priority over calling lawyers to account for their tax avoidance initiatives.

3. *The Judiciary*

Given the nature of the subject matter with which it deals, tax legislation must be drafted more broadly than the transactions to which it will be applied. Identical economic consequences can be effected through an almost limitless number of legal structures and relationships, only a fraction of which will be foreseen by the legislative drafters when the law is put into place. Not surprisingly, the general provisions that emerge from the legislative process are often open to a myriad of interpretation possibilities. It is the responsibility of the courts to determine whether and how specific provisions apply to particular fact situations. The active cooperation of the judiciary in achieving the policy goals of that legislation is the sine qua non of our

14 The Australian experience should be contrasted with that of the U.S., where the American Bar Association has devoted great efforts to the promulgation of standards for lawyers' tax opinions — see, B. Wolfman and J. Holden, *Ethical Problems in Federal Tax Practice* (1981) 310-313, 336-339. It should also be contrasted with the experience of the accounting profession, whose governing bodies adopted strict standards of professional responsibility in income tax matters, a breach of which may, in extreme cases, lead to expulsion from the profession. See Australian Society of Accountants and the Institute of Chartered Accountants in Australia, "Statement of Taxation Standards", in Institute of Chartered Accountants, *Members Handbook* (looseleaf) APS 6, para. 25.

15 This is not to suggest arguments on the need for a new professional attitude by tax lawyers are without a sound basis. The most cogent and pursuasive presentation of those arguments remains Y. Grbich, "Should the Law Institute of Victoria Take a Public Stand Against Artificial and Contrived Tax Avoidance Schemes? The Case For" (1980) 54 *L Inst J* 560.

democractic legislative system.

Historically, Australian courts have filled their protective role well. Although judges have long asserted that taxpayers are free to organise their affairs so as to minimise the tax costs of those affairs and resolved legislative ambiguities in favour of taxpayers, it was rare for a court not to apply statutory language to prevent taxpayers from deliberately flouting the clear intention of the government where that was easily ascertainable.

A new pattern emerged in the 1970s, however, in a series of High Court decisions on avoidance schemes that appeared to be prohibited by the Act. The criticism has frequently and widely been made that in these decisions the Court gutted unambiguous statutory provisions of their intended effect to find in favour of taxpayers.[16] It is reputed to have done so through the application of a pedantic literalism, devoid of any contextual relationship to the structure and purpose of the governing legislation. In each case the legislature was forced to respond with complicated new anti-avoidance measures to supplement those already in effect and bring about the result it thought it had already achieved.[17] At best, it has been said, the Court's attitude amounted to abdication of its historical responsibilities in the common law legal tradition because it purposely frustrated legislative intent;[18] at worst, it may have been nothing more than a smokescreen to

16 Officials for the Taxation Office are reported to have suggested that it was the restrictive interpretations provided by the High Court that prevented that Office from initiating prosecutions and taking appropriate action to curb tax avoidance. See P.W. McCabe, "Background to the 'Bottom of the Harbor' Investigation" in D. Collins (ed.), *Tax Avoidance and the Economy* (1983) 1, 4.

17 Examples of legislation of this sort include the addition of s.82KJ denying taxpayers immediate deductions for certain capital expenses, which s.51(1) already appeared to do, and the replacement of Division 13 of Part III to prevent the international transfer pricing tax avoidance apparently already prohibited by the original Division.

18 Mr Justice Murphy's comments in his dissenting judgment in *Federal Commissioner of Taxation* v. *Westraders Pty Ltd* (1980) 11 ATR 24, 39-40 are particularly apt: "The transactions in this case are conceded to be a major tax avoidance scheme. The supporters of the scheme seize upon the bare words of [a section of the Income Tax Assessment Act] and claim that these should be applied literally even if for purposes not contemplated by Parliament. The history of interpretation shows the existence of two schools, the literalists who insist that only the words of an Act should be looked at, and those who insist that the judicial duty is to interpret Acts in the way Parliament must have intended even if this means a departure from the strict literal meaning ... It is an error to think that the only acceptable method of interpretation is strict literalism. On the contrary, legal history suggests that strict literal interpretion is an extreme, which has generally been rejected as unworkable and a less than ideal performance of the judicial function. ... In tax cases, the prevailing trend in Australia is now so absolutely literalistic that it has become a disquieting phenomenon. Because of it, scorn for tax decisions is being expressed constantly, not only by legislators who consider that their Acts are being mocked, but even by those who benefit. In my opinion, strictly literal interpretation of a tax Act is an open invitation to artificial and contrived tax avoidance. Progress towards a free society will not be advanced by attributing to Parliament meanings which no one believes it intended so that income tax becomes optional for the rich while remaining compulsory for most income earners."

For a thorough review of the Barwick Court's infamous tax avoidance decisions and Mr Justice Murphy's attempt to stem the tide and reverse prevailing tax doctrines, see R. Krever, "Murphy on Taxation" in J. Scutt (ed.), *Lionel Murphy: A Radical Judge* (1987) 128-144. A complete collection of relevant extracts of Mr Justice Murphy's taxation decisions and background explanations of the taxation issues raised in the cases may be found in T. Blackshield, et al, (eds), *The Judgments of Lionel Murphy* (1986).

obscure the Court's strategy of frustrating the tax collection aims of Parliament.[19]

The role of the High Court in undermining the legislature's taxation objectives in cases such as these cannot be overemphasised. Viewed on their own, the bad decisions of the Barwick High Court reflect poorly on the Court and those of its members who concurred in the results.[20] Viewed in light of the Court's historical record and contemporary international judicial norms, the decisions expose the Court to ridicule.[21]

However, a serious examination of the Barwick High Court's decisions reveals a strong case for tempering criticism of that Court. While they generated widespread publicity and intense debate in the Court and in public, cases in which the Court had the option to choose between alternative interpretations of the applicable provision and selected the one that defeated the clear policy objectives of the legislation made up only a small fraction of the tax disputes heard by the Court during the 1970s. The vast majority of High Court tax avoidance cases decided in favour of taxpayers involved ambiguous or anomalous provisions of the Income Tax Assessment Act that failed to indicate any clear legislative policy. In most of the tax cases coming before it, the Court was asked to make difficult decisions on the outcome of disputes to which there were no right answers.

Viewed in this light, the Barwick High Court's record during the tax avoidance era is not as outrageous as its critics assert. Of course, that Court had its share of bad decisions. The fact remains, however, that most of the schemes which came before it relied on internal inconsistencies in the income tax legislation and the willingness of the High Court to endorse and

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19 A variation on this thesis was argued persuasively by Geoffrey Lehmann in "The Income Tax Judgments of Sir Garfield Barwick: A Study in the Failure of the New Legalism" (1983) 9 *Monash U L R* 115.

20 For a critique of the peculiar, indeed, perverse legal reasoning applied in those decisions, see Krever, note 17, *supra.*

21 By way of contrast, in the U.K., the House of Lords was dismantling the last remnants of literalism in that jurisdiction and beginning to establish English versions of the U.S. economic reality doctrines, which seek to accord tax liability with real economic gains, whatever their legal characterisation. See generally R. Krever, "Furniss v. Dawson — Tax Jurisprudence re-enters the Real World" (1984) *Taxation in Australia* 1057. Canadian jurisprudence from the mid-1970s provides an even more striking contrast. In what was to become one of the leading Canadian income tax cases from that era, *Dominion Bridge Ltd* v. *The Queen* 75 DTC 5150, the Court explained, "[i]t is surely not the name given to transactions or operations that determines their nature. Their nature is found by looking at what in fact they are, not at what they appear to be or are made to appear to be", 5159-5160. In Australia, the High Court concerned itself only with the legal formalities of an arrangement and deliberately avoided considering the economic substance of the transactions at the heart of tax avoidance schemes before it. As Mr Justice Murphy said in one famous dissenting opinion, the taxpayer's scheme endorsed by the High Court was "a feat of modern magic, successful only because observers allow themselves to be deceived." (See *Westraders*, note 17 *supra*, 39). Mr Justice Stephen, in his dissenting opinion in *Curran* v. *Federal Commissioner of Taxation* 74 ATC 4296, 4307, 4310 delivered a more guarded, but equally effective criticism of the literalist approach of the majority, as he carefully explained how their "artificial statutory definition" led to a result contrary to the "truth and reality of the situation".

encourage exploitation of those inconsistencies was not unreasonable in the absence of *any* statutory principles on the basis of Australian income taxation.

Courts can only be expected to interpret legislation in a purposive and responsible manner when the aim of the legislation is ascertainable. The policy of a statutory provision must be derived from the framework of the Act itself. In the absence of a cohesive and structured whole, the courts have no guidelines by which a measure can be interpreted and the result, even if contrary to what is felt by the legislators to be the policy of the legislation, cannot be said to be bad or irresponsible. In these cases, blame must be placed on the legislature for not ensuring that the policy of the Act is clear and unambiguous.

By the 1970s, after half a century of progressive income taxation in Australia, the governing Act had degenerated into a hopeless morass of confusion, contradictions, inconsistencies and anomalies. There simply were no underlying principles to be discerned from the provisions. The tax status of receipts was built on obscure English equity law doctrines dating back centuries before the advent of income taxation.[22] The choice of taxpayer was similarly based on the application of equitable and common law doctrines concerning the transfer of real and incorporeal property. None of the governing doctrines bore any relation to real economic gains or losses and none were concerned with ability to pay, the twin cornerstones of most modern income tax regimes. A pattern of judicial interpretation in favour of taxpayers and against revenue authorities could not be unexpected given the underlying sympathies of the judiciary. Their response was, if anything, encouraged by the governments of the decade, which consistently responded to unwelcome decisions with a patchwork of ad hoc unconnected measures that offered the judiciary no supplementary guidelines and affirmed no principles for the interpretation of the legislation.

The leading tax avoidance cases of the 1970s involved disputes over the definition of income, dividend stripping schemes and income splitting schemes. All three of these ambiguous statutory areas, successfully exploited by tax avoidance schemes in the 1970s, remain devoid of consistent principles in the post-reform Tax Act and our courts continue to apply fiscal legislation with no statutory framework to guide them.

4. *The capital/income distinction*

The term 'income' has never been comprehensively defined in Australian income tax legislation. Income tax was purely a creature of statute and the common law contained no guidance as to its scope or application. So the courts looked elsewhere for precedents and doctrines they might use when considering the new legislation. They found both in the law of equity which,

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22 For a comprehensive and very critical review of the consequences of the application of inappropriate English trust and property law doctrines, see R. Parsons, "Income Taxation — An Institution in Decay?" (1986) 3 *A T Forum* 233, 238-253.

for hundreds of years, had concerned itself with the distribution of estates between life tenants and remainderpersons, or income and capital beneficiaries as they were called. In this manner, a new form of fiscal legislation started out with an ancient and familiar case law. The trust law concepts of income and capital were incorporated into Australian income tax law and have remained there ever since.

Accordingly, tax liability rested on criteria that bore no relationship to economic gains or ability to pay. Instead, it was based on the correspondence between receipts and the qualities commonly associated with the entitlements of life (income) beneficiaries on a temporal division of property rights. Thus the hallmarks of income for tax purposes became characteristics such as periodicity, recurrence and severability and gains with different features were considered realisations of capital outside the scope of the assessment provisions.

The economic world of industrialising Australia was far different from that of feudal England, whence the trust concepts of income and capital had emerged, and the doctrines developed in a different time for different reasons proved barely adequate for the task to which the courts turned them. In pre-industrial England, commerce was based on trades and sales of the fruits of land and labour. But in twentieth century Australia commerce proceeded through an infinite variety of economic arrangements. Profits from ordinary trading, gains from the provision of labour and interest and dividend returns from investments were easy to deal with, but courts found it increasingly difficult to apply the simple trust law concepts to new complicated commercial arrangements, particularly the sale of assets other than trading stock.

The judiciary turned to new concepts and precedents for guidance. Considerable reliance was placed on the judgments of English courts in the application of U.K. revenue law, despite the fact that the U.K. legislation bore no resemblance to its Australian counterpart.[23] Eventually the courts settled upon two tests to determine the character of gains from the disposition of assets other than trading stock.

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23 The U.K. income tax legislation imposed no tax liability on income per se; instead the U.K. Act established a schedular system taxing selected receipts falling into desiginated classes of gains enumerated under particular schedules. The first Australian Act of 1915 actually bore a great resemblence to the 1913 U.S. Income Tax Act. This was the third federal income tax in the U.S., the first having appeared during the U.S. Civil War. The U.S. tax system was totally comprehensive in its application and the only exceptions or preferences found in the system were those deliberately inserted by Congress.

Despite the differences in legislation, the judicial tests eventually adopted in Australia to distinguish tax-exempt capital gains from taxable ordinary income were modelled on those established by English courts. One immediate effect of this approach was the incorporation into Australian income tax law of the class biases inherent in U.K. income tax jurisprudence. The English doctrines applied in Australia effectively insulated from taxation the trading activities of the landed gentry and urban gentlemen. The assertion made by some (see *e.g.* R. Parsons, "Capital Gains Taxation — A Lawyer's Perspective" (1984) 1 *A T Forum* 122, 125) that this was an unconscious result surely must be taken with a grain of salt.

The primary test adopted by the courts was based on the taxpayer's acquisitory intention with regard to the asset that generated a gain. It was decided that gains on assets acquired with the purpose of resale at a profit constituted income while gains on assets acquired with other aims in mind were capital in nature. An alternative test looked at the manner in which the gain was realised; assets sold in the course of profit-making schemes (whatever they might be) generated income while assets sold in a more casual manner would return capital gains to the seller.

The government accepted the courts' limitations on the income concept for tax purposes and even incorporated the two principal judicial tests regarding intention and the manner of dealing with the asset into the Act. In retrospect, the government's decision to adopt an income tax base established by irrelevant judicial criteria in preference to one based upon legislative precedents from other jurisdictions with more mature income tax systems seems an unwise decision.[24] But to be fair to the government of the day, its ignorance was that of innocence. The sciences of public finance and tax policy were still in their infancy and many countries had yet to rationalise their income tax systems in light of modern fiscal objectives.[25] Furthermore, the income tax was not an overwhelming priority in the eyes of the government. Basic exemptions were high and until the Second World War the tax only applied to a small fraction of the citizenry.

With the war-time expansion of the income tax into a universal levy and its development into the principal revenue source for the development of the modern Australian welfare state, the scope of the tax became a much more important concern. By that time, however, the narrow income base had become entrenched and, under the influence of those taxpayers able to arrange their affairs so that their gains fell outside the narrow concept of income, the government preserved the original judicial criteria as the basis for post-war income tax liability.

In the 1970s there emerged a new generation of taxpayers whose entrepreneurial activities generated profits that often fell in the grey area between taxable and non-taxable receipts. When informed by their legal advisors that their potential liability for income taxes rested on intangible metaphysical inspirations and the form of their activities, not the measurement of their economic gains, taxpayers quickly rearranged their affairs and set about acquiring the appropriate psychic karma that would exempt them from income taxation.

These taxpayers found the Barwick High Court sympathetic to their objectives. Although they aroused much criticism at the time, the Court's

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24 *Ibid.*

25 The provision adopting these two tests was first inserted into the Income Tax Assessment Act in 1930. The first important theoretical study of the comprehensive income concept appearing in English was Robert Haig's *The Federal Income Tax* published in 1921. Henry Simons' *Personal Income Taxation*, which established the definitive criteria for the comprehensive income tax base and which remains the 'bible' of income tax reformers, appeared in 1938.

decisions cutting back on the scope of section 26(a), the statutory enactment of the judicial test, appear neither illogical nor irrational when viewed in the context of the prevailing income tax law. An example is the High Court's treatment of cases in which, prior to sale, taxpayers gifted to family members assets that had originally been acquired for the purpose of resale at a profit. As far as the Court was concerned, the recipients acquired the property with the purpose of accepting a gift or bequest, and the gain realised upon subsequent disposition thus escaped the application of section 26(a), notwithstanding the donor's original intent. The Court saw no reason to impugn the acquisition motive of a donor to a donee.[26]

Other restrictive rulings narrowed the application of the provision even further. One key holding was the decision that the profit-making by sale intention which led to a tax liability must have been the dominant acquisitory purpose of the taxpayer, not simply one of the reasons for the acquisition of property.[27] As long as a taxpayer contemplated other speculative objectives when acquiring property, gains on resale could most often be realised free of taxes. Furthermore, the Court read the section as requiring a continuity of identity between the asset acquired for the purpose of resale at a profit and the asset actually sold.[28] Thus a purchase of a leasehold interest and subsequent sale of the fee simple would not have fallen within the scope of the provision. Similarly, the interposition of a legal intermediary such as a company or trust between the taxpayer and the asset acquired for the purpose of resale at a profit would insulate the taxpayer from a tax liability if the taxpayer sold the shares in the company or trust interest rather than arrange for the company or trust to sell the asset directly.

For a short time the Chief Justice actually attempted to shift to the Commissioner the onus of proof regarding a taxpayer's acquisition purpose. The move provoked considerable criticism and the High Court eventually

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26 A separate problem raised by several judges was the technical question of measuring profits on a sale in the absence of statutory rules, even if the gains were considered income. Would the profits be the difference between the final proceeds of disposition and the original price paid by the donor or between the amount received and the value of the property at the time it was gifted? The extent to which this technical problem reinforced the decision to exempt donees from the application of the provision, can be seen in the judgment of Stephen J. in *Steinberg* v. *Federal Commissioner of Taxation* (1975) 5 ATR 565 and the judgment of Menzies J. in *Federal Commissioner of Taxation* v. *Williams* (1972) 3 ATR 283.

27 One of the leading cases establishing this rule is *Eisner* v. *Federal Commissioner of Taxation* (1971) 2 ATR 3, a decision of great interest to students of evidence. The taxpayer in *Eisner* had a history of involvement in tax avoidance schemes and Walsh J., hearing the case before the High Court, concluded that the taxpayer's version of the facts was, at best "highly suspect" and statements in his evidence were "contrary to the facts". Walsh J. decided in favour of the taxpayer, however, on the basis of further evidence from parties, after noting the probable biases of many of the witnesses in favour of the taxpayer and questioning the accuracy of statements by other witnesses.

28 See, *e.g.*, the decisions in *Macmine Pty Ltd* v. *Federal Commissioner of Taxation* (1979) 9 ATR 638; *A.L. Hamblin Equipment Pty Ltd* v. *Federal Commissioner of Taxation* 74 ATC 4310; *Steinberg* note 25 *supra*.

retreated from that extreme position.[29] On the face of it, shifting the onus of proof from the person with all the facts at hand to the party without access to those facts seems perverse. But in the context of the taxing provision, the decision does not appear quite so absurd. If tax liability is to be based on subjective intention rather than an objective measurement of ability to pay, why not make the taxing authorities ascertain the incorporeal qualities that signalled the existence of a taxable gain?

The second limb of the provision, taxing gains realised in the course of 'profit-making' schemes was likewise read down to relative impotency[30] and it is no exaggeration to suggest that by the end of the 1970s section 26(a) only applied to ill-advised taxpayers. The High Court had shifted the line between taxable and non-taxable transactions significantly, a process that contributed to the general transfer of tax burdens from entrepreneurs and speculators onto those earning income from labour. Was it wrong to do so? Arguably not — the High Court was confronted with a senseless taxing provision designed to achieve no rational objective whatsoever, apart from codifying inappropriate and outdated common law precedents from another, quite unrelated body of law. The government, for its part, had acquiesced in the original income defining initiatives of the judiciary and left in place a tax base that inexplicably exempted from taxation a vast range of real world gains without reference to a plan or purpose. Provisions establishing tax subsidies designed to achieve a definite legislative objective can be interpreted and applied by the courts with the purpose of the subsidy in mind. No-one could ask or expect a court to deal logically and purposively with an irrational preference that had no rhyme or reason apart from its obscure origins in medieval property rites. Determining tax liability on the basis of the subjective intention of a taxpayer at the time of acquisition of an asset is no more sensible than basing taxes on the taxpayer's sex, race, religion or the colour of his or her shoes. Indeed, to the extent that these latter criteria are at least objectively ascertainable, they may in fact be preferable.

5. *Dividend stripping*

It has long been a fundamental principle of public finance that corporations, artificial legal entities, have no 'ability to pay' in the normal sense of income tax usage, because they do not consume in their own right. Any outgoings they incur are used in the production of further profits. The beneficiaries of corporate income, the shareholders, are therefore considered

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29 Hints of the Chief Justice's new approach appeared in the *Steinberg* case, note 25 *supra*, and it was fully articulated in *Gauci* v. *Federal Commissioner of Taxation* (1975) 5 ATR 672. The absurdity of the doctrine was well exposed in Y. Grbich's thoughtful essay, "Section 26(a) in the Judicial Melting Pot" in R. O'Neill et al (eds), *Tax Essays Volume 1*, (1979) 148. A majority of the High Court finally rejected the shift of onus in *McCormack* v. *Federal Commissioner of Taxation* (1979) 9 ATR 610.

30 See, *e.g.*, the decisions in *Milne* v. *Federal Commissioner of Taxation* (1976) 5 ATR 785, *Federal Commissioner of Taxation* v. *Bidencope* (1978) 8 ATR 639 and *Burnside* v. *Federal Commissioner of Taxation* (1977) 8 ATR 305.

the appropriate taxpayers for the taxation of income earned through the corporate form.

This basic principle of income taxation was applied, through various legislative regimes, to the income of companies and shareholders until the middle of the Second World War, at which time wartime fiscal needs necessitated the temporary abandonment of the system integrating company and personal taxes. The temporary system of double taxation that ensued — taxing company profits first when they were earned by the company and then again when they were distributed in the form of dividends to shareholders — remained in effect until only a few months ago.[31]

Taxpayers who wished to avoid the second level of tax imposed on distributed dividends could avail themselves of gaps in the tax base, most notably the exclusion of capital gains, to realise the value of company profits in a tax-free manner. The price of shares in a private company reflects the value of profits retained in the company and an alternative to extracting retained earnings by a distribution of taxable dividends is simply to sell the shares for an amount that includes the value of those retained earnings. Although dividends were taxable, gains on the sale of shares were considered non-taxable capital receipts. No logical tax principle explained this different treatment of similar gains.

To introduce some order into the chaos the taxing authorities adopted a rough rule of thumb to determine the assessability of gains realised by shareholders who sold their shares. If the purchaser paid for shares with funds from other sources, the tax office was willing to treat the seller's gains as tax-free capital gains. If, on the other hand, the purchaser paid for the shares with money extracted from the recently acquired company, revenue officials treated the gains as taxable dividends in the seller's hands, reasoning that the proceeds of sale really amounted to a circuitous distribution of company profits via a third party instead of directly. The extraction of company profits in this way was known as dividend stripping.

While it may have lacked an underlying principle, for a time the solution hit upon by the tax authorities proved workable. However, this quasi-tracing procedure was highly vulnerable to judicial interference given its lack of legislative sanction, and the tax office thus found itself with no safety net when the Barwick High Court finally decided the practice had no basis in law. In a series of important cases, the High Court concluded that the tax treatment of the proceeds of a sale of shares in a private company should be based on the legal characterisation of the receipt, whatever its economic substance in the real world.[32] As long as the amounts received by the seller

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31 Australia has adopted a full imputation system from 1 July 1987. This system reduces the tax liability of shareholders by the amount of income taxes previously paid by the company on distributed income.

32 Many tax experts continue to believe the leading dividend stripping cases such as *Patcorp Investments Ltd* v. *Federal Commissioner of Taxation* (1976) 10 ALR 407 and *Slutzkin* v. *Federal Commissioner of Taxation* (1977) 7 ATR 166 were wrong as a matter of law, whatever policy considerations are taken into account — see, *e.g.*, R. Parsons, "Reforming the System: A Lawyer's View" in Collins, (ed.) note 15 *supra*, 57, 62.

were treated by the parties as proceeds for the transfer of sale, it was unimportant that the buyer may have paid for the shares with money extracted from the company. With that, the door to widespread dividend stripping was formally opened.[33]

The new attitude of the High Court upset long standing settled practice. But tax office practice is not in itself a sound policy basis for interpretation of taxing legislation and the Court's decisions in favour of dividend stripping schemes did no violence to any sound tax policy objectives. The government was unhappy with the decisions and acted quickly to reverse them and guard its revenue base.[34] Yet apart from the fiscal needs, no explanation was ever offered as to why the line that had been drawn earlier by the tax authorities was any better than that chosen by the High Court. The government wanted to restrict the tax-free sale of company shares to sellers who found purchasers with external funds while the Court was willing to extend the same benefit to all sellers. No tax or non-tax objective was sought or achieved by the preference accorded the first group of sellers and no convincing reason was offered for denying it to others.[35] Ultimately, of course, the distinction was as meaningless as the capital-income distinction that made the schemes possible in the first place.

6. Choosing the correct taxpayer

A progressive income tax system is concerned with the appropriation and redistribution of increases in taxpayers' economic power, that is, their potential command over economic resources. The keys to its success are the proper measurement of economic gains (choosing the correct tax base) and the proper attribution of those gains to the taxpayer who really commands them (choosing the correct tax unit). Diversions of income for tax purposes cannot be tolerated in a progressive income tax system — the power to divert income is an exercise of the very economic power the system seeks to redistribute. Without strict controls against income transfers, high income

33 The decisions almost directly led to the growth of criminal bottom-of-the-harbour schemes. In effect, the High Court had said that taxpayers would not be liable for taxes because of acts carried out by purchasers after the sale of a company was completed. Tax promoters then had no difficulty in convincing owners of cash rich companies to sell their interests in the companies before company taxes for the year were due. Advisors suggested the sellers could walk away from the transaction free of any tax liability however much they may have suspected that the buyers intended to strip the profits out of the company without paying the taxes that would be due soon after the sale was completed.

34 The schemes were first attacked by making them undesirable from the purchasers' viewpoint. Ss 46A and 46B were added to the Income Tax Assessment Act to ensure the dividends extracted from the companies by the purchasers were fully taxed in their hands and ss 36, 36A and 52A were modified or added to deny the purchasers any offsetting deductions if the newly acquired shares were later sold. Later, s. 177E established a blanket prohibition on dividend stripping, though it failed to define the practice.

35 It is sometimes suggested that the preference was granted only when funds stayed actively working in an enterprise, which would only occur when the buyer retained profits in the transferred business. However, an equally strong case can be made for an incentive to free those funds for reinvestment elsewhere, on the presumption that the primary motive for a seller to leave the investment was to reinvest elsewhere in the economy where higher returns were available.

taxpayers would be able to choose low income recipients in whose hands part of their income would be taxed. Recognising income splitting transfers of this sort would be akin to offering taxpayers the opportunity to pay taxes at the rate of their choice, a proposition that makes a mockery of the graduated rate structure.

In countries such as Canada and the United Kingdom, protection of the progressive rate structure has been accomplished through legislative prohibitions against the transfer of income for tax purposes. Statutory guidelines proved unnecessary in the United States, where the Supreme Court demonstrated its understanding of the policy objectives behind progressive taxation by refusing to recognise income transfers for tax purposes, however valid they may have been under state property law. It was a distinction Australian judges failed to comprehend when they were first confronted by income transfer schemes. Judicial decisions in early Australian income splitting cases were based solely on equity law doctrines and property law formalities governing the alienation of choses in action rather than tax policy considerations.

High income taxpayers were allowed to transfer their incomes for tax purposes at will, providing the transfers conformed to the strictures of appropriate legal precedents and the local property law Act. The only restrictions enforced by the courts, arising out of the peculiarities of ancient assignment doctrines, were dual prohibitions on the transfer of contingent property income and the transfer of income from labour.[36]

Rather than act immediately to put a complete stop to income splitting avoidance, the government and Legislature turned a blind eye to the practice. High bracket taxpayers interpreted the legislature's inaction as a silent endorsement of their income splitting practices, a characterisation that may not have been inaccurate given the ideological opposition of many Australian governments to the social redistributive goals of progressive taxation. Government action, when it eventually appeared, was piecemeal and counter-productive.[37] Rather than prohibit the income tranfers for tax

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36 Determining which property income was certain and which was contingent was and is a somewhat speculative affair in itself. In the leading High Court decision of *Norman* v. *Federal Commissioner of Taxation* (1963) 109 CLR 9, the Court concluded that the right to dividends, which may or may not be declared by a company's directors, was too contingent to qualify as a presently existing right capable of assignment. But two years later, not long after the appointment of Garfield Barwick as Chief Justice, the High Court decided in *Shepherd* v. *Federal Commissioner of Taxation* (1965) 113 CLR 385 that the right to future royalties was not too contingent to qualify for assignment, despite the fact that the agreement giving rise to a royalty entitlement never guaranteed that the product on which royalties were to be paid would ever be manufactured.

37 In contrast to the limited efforts of the legislature, tax commissions and expert reports, apart from the 1961 Ligertwood Tax Committee, had recommended comprehensive reform. The Ligertwood Committee, (note 10 *supra*), called only for the elimination of some income transfers to children (at 149) while the Downing study (R. Downing et al, *Taxation in Australia* (1964)), issued only three years later, advocated a complete pooling of a family's property income to prevent any splitting (at 136). The 1975 Asprey Report similarly called for measures to counteract any income transfers leading to income splitting (see Taxation Review Committee, *Full Report (Asprey Report)* AGPS, 1975, 152).

purposes, the government actually endorsed the schemes but restricted their use to long-term tax avoiders. So-called reform legislation[38] simply voided tax avoidance transfers made for less than seven years, a move that had almost no impact on the practice, apart from encouraging longer transfers.

More telling than the ineffective legislative initiatives was the complacency of the legislature in the face of adverse court decisions undoing the value of the few provisions that had been adopted. The most glaring example of legislative apathy followed the judicial dismemberment of a provision preventing income splitting via trusts established by a taxpayer for the benefit of his or her children.[39] When the High Court decided that the provision could be avoided by the simple expedient of having another person — lawyer, accountant or friend — establish the trust with a nominal settlement and then arranging for the taxpayer to transfer funds into the existing trust, the legislature did nothing.[40]

By the beginning of the tax avoidance era, income splitting by wealthy taxpayers had become the norm, not the exception. The limited judicial restrictions on transfers of apparently contingent property income had been cut back substantially and for rich taxpayers in receipt of property income progressive taxation was an interesting theory whose impact could be avoided at will. Wealthy taxpayers in receipt of income from labour were able to overcome the common law restrictions on direct transfers of non-property income by earning it through the medium of partnerships and trusts, which operated as business shells for the purpose of income distribution.[41]

The one group of high income taxpayers unable to take advantage of the most popular income splitting devices comprised the professional tax advisors responsible for arranging the schemes. The judicial restriction on transfers of income from labour prevented lawyers and accountants from making direct transfers and they were denied access to alternative income splitting vehicles by professional rules which prevented them from operating through trusts or entering into partnership with persons not professionally qualified. But, encouraged by the judicial pronouncements emanating from the Barwick High Court, tax advisors launched a renewed assault on progressive taxation. By the close of the decade their campaign had finally

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38 S. 102A, inserted in 1964.

39 S. 102(1)(b).

40 The somewhat infamous High Court decision that rendered the provision impotent was the 1970 case *Truesdale* v. *Federal Commissioner of Taxation* (1970) 1 ATR 582. Interestingly, when faced with the same fact situation and a similar provision, the N.Z. Courts had reached an opposite conclusion. To protect the obvious purpose of the provision, the N.Z. Court treated the subsequent transfer of funds into the trust as the establishment of a new and separate trust, albeit upon the same conditions as the one into which the funds were transferred — see *Tucker* v. *Inland Revenue Commissioner* (N.Z.) (1965) 9 AITR 658.

41 Anti-avoidance measures directed at these alternative means of splitting income from labour proved to be as piecemeal and ineffective as those aimed at arrangements to split income from property. Examples include s. 65 designed to control excessive salaries paid to family members (without specifying any definition of excessive salaries) and s. 94, intended to restrict the use of ersatz family partnerships (once again, without establishing any clear, easy to administer statutory criteria for prohibited partnerships).

met with success and the High Court had delivered what was to become one of its most criticised tax judgments.

The new generation of income splitting schemes adopted by the high income professionals took two forms. The first device, known as a *Phillips* scheme, involved the use of a service trust. To utilise this avoidance scheme, a professional or partnership of professionals would first establish a family trust responsible for providing secretarial and support services to the professional's business. Secretaries, typewriters, photocopiers, law books, and so forth were transferred to the trust which then charged the business an inflated price for the provision of the same services it had enjoyed at a fraction of the cost before the trust was established. The professional was then able to deduct as a business expense an amount far greater than the real costs incurred, with the excess being treated as taxable income of his or her lower tax bracket family members. The Commissioner of Taxation's attempts to halt the new wave of tax avoidance failed when the courts concluded the schemes would work so long as the trusts did not charge an exorbitant amount for their services.[42] The Commissioner's defeat prompted no response from the legislature.

The final avoidance scheme to meet with success turned out to be even simpler than the service trust — so simple, in fact, that it is surprising no one had thought of it earlier. Property income could be transferred for tax purposes while income from labour could not. The obvious answer was thus to characterise income from labour as income from property. For at least one group of professionals, lawyers (and some accountants) who operated through partnerships that distributed profits without regard to actual individual billings, the legal fiction to accomplish this objective was already in place. Prima facie, the incomes of these taxpayers were related to their partnership interests, which, according to the law of equity, were a form of equitable property.

The taxpayer in the *Everett* case,[43] the High Court decision which legitimised the second type of professional income splitting, assigned to his spouse rights to part of his interest in the law firm in which he was a partner. He then arranged for the firm to distribute to her a percentage of the partnership profits equal to the proportion of the partnership interest which had been 'transferred', claiming that for tax purposes the income was her income from the property, not his income from labour.

Notwithstanding the characterisation of the transferred income as income from property, it was clear that the entitlement to a share of partnership income actually arose as a result of the lawyer's contributions to the firm's

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42 In the case which first established the effectiveness of these income splitting arrangements, *Phillips* v. *Federal Commissioner of Taxation* (1977) 7 ATR 345, the Supreme Court of N.S.W. recognised that the scheme was designed solely for income splitting purposes but made it quite clear that the issue would be decided on the basis of "the legal effect — as distinct from the economic consequences" of the arrangements.

43 *Everett* v. *Federal Commissioner of Taxation* (1980) 10 ATR 608.

total billings. To argue that a lawyer's income was actually generated by property and not labour required some far-fetched legal gymnastics but it was an argument that the Barwick High Court bought (over a vigorous dissent by Mr Justice Murphy) in the 1980 *Everett* case. Income splitting transfers of lawyers' incomes were thus valid for tax purposes and *Everett* tax avoidance schemes soon became an established feature of legal practice in Australia.

Income splitting is the Achilles heel of the Australian income tax system. It costs the government millions[44] and is probably the most important single factor in the unfair distribution of tax burdens in Australia. Much of the income splitting that now plagues us was a direct product of decisions by the Barwick High Court. Can the Court be blamed for those decisions? Once again, the answer must be an unambiguous no. Never has the government provided the judiciary with any guidance as to the principles governing the choice of taxpayer in Australia's progressive income tax system. The government accepted a tax system in which rich property owners could avoid the pressures of a graduated tax scale if they chose, but labourers could not. Did the High Court then make a mistake by allowing property owners indirectly to transfer income to children through trusts when they could already do it directly? Or did it err when it decided the privilege of tax avoidance should be extended to wealthy lawyers? There is certainly no sound policy reason for treating these taxpayers differently from other high income tax avoiders. The new lines drawn by the Barwick High Court between acceptable and unacceptable income transfers were irrational and illogical. They were, however, no worse than those that had been accepted previously by the Legislature.

III. TAX REFORM AND TAX AVOIDANCE

The proliferation of tax avoidance in the 1970s can be traced in large part to a series of High Court decisions that encouraged tax advisors to devise and promote to their cients a wide range of new avoidance techniques. The endorsement of tax avoidance schemes by the High Court prompted a barrage of criticism. Much of the criticism is well deserved, but the Court is largely innocent of the principal charge levied against that institution, that its literal interpretation technique and pro-taxpayer bias combined to defeat the will of Parliament. For in the situations that gave rise to most of the leading tax avoidance cases of that decade, the Legislature had never indicated its will.

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44 Treasury estimates the revenue cost of income splitting to be at least $500 million annually (see *Reform of the Australian Tax System* note 2 *supra*, 62). The significant rate reductions in the Centre of Policy Studies' proposal for flatter taxes, which became the basis for the Liberal Party's election platform in the 1987 Federal election, were funded almost entirely from the revenues picked up though cutbacks on income splitting. However, the Liberals eventually decided the rate reductions could be offset by reductions in government expenditure instead of eliminating income splitting. See, M. Porter, J. Cox and G. Bascand, "Tax Reform Proposal from Centre of Policy Studies" (1985) 2 *A T Forum* 273.

Almost all of the situations confronted in the tax avoidance cases involved issues that the Legislature had deliberately ignored. Rather than devise and implement clear and comprehensive directives to give effect to sound tax policy objectives, the Legislature turned responsibility for establishing the parameters of the income tax system over to the courts. The government abandoned its legislative responsibility to the judiciary and, in the absence of policy expertise in the area, the courts had no choice but to rely on traditional legal formulae to resolve tax issues.

The Labor Government's tax reform initiatives since 1983 have brought about sweeping changes, unparalleled in degree in the past, to the Australian income tax system. To what extent have the initiatives remedied the fundamental faults revealed in the tax avoidance era and helped ensure against its repetition? Regrettably, the answer to that question is not at all.

1. The capital/income distinction

On 19 September 1985 the Treasurer announced that henceforth some capital gains would be subject to income taxation. The government's reform package brought capital gains into the income tax base, but it did so on preferential terms accorded to no other types of income gains. Unlike the case with trading gains, interest gains, rental gains, etc., which are taxed in full, only a portion of capital gains are taxed under the reform system. An important preference was accorded capital gains in the form of a complete exclusion of the inflation component from taxation.

At the time of its introduction, the Treasurer announced no reason for the tax preference accorded capital gains. The preference was likely intended to subsidise and encourage some forms of investment, but the introductory documents that heralded its implementation offer no clue as to its objectives. Even more remarkable, the enacting legislation offered no definition of the "capital gains" that were to receive the benefit of what remains the most significant tax preference in the Australian income tax system. It was thus left to the courts, without any guidance or policy indications from the Legislature, to determine the reason for the capital gains preference and the type of gains the government might have intended the preference to benefit.[45]

Over the forthcoming decades, millions of investors will rely on judicial decisions establishing the line between fully taxed income gains and preferentially taxed capital gains to redirect substantial portfolios in ways that will affect the economic well-being of this country forever. The men and women drawing that line will do so from court benches without the benefit of tax policy training and with no facilities to ascertain the likely economic and social consequences of their decisions. They will rely on the same mystic

45 Coincident with the introduction of a preferential capital gains tax, the legislature repealed s. 25A (the successor to s.26(a) discussed earlier), the provision that established profit-making purpose/profit-making scheme tests to distinguish between fully taxed income gains and preferentially treated capital gains. Given that the provision was a codification of existing common law, it is probable that the original tests will continue to be applied.

notions of acquisitive intent that they have always employed — criteria that can offer no guidance as to the likely objectives of the new tax preference. Unlike its predecessor, this preference is not the result of judicial initiative. It is the codification of a deliberate policy decision by the Legislature, the aims of which are completely unascertainable by the body responsible for protecting that policy. In this respect, reform has resolved nothing. It is only a matter of time before the courts' initiatives are used once again as the basis for a new generation of tax minimisation arrangements.

2. Dividend stripping

On 1 July 1987 Australia adopted an imputation system of company and shareholder taxation. Distributed income is now taxed only once, at the prevailing company tax rate of 49%.[46] Undistributed income retained by the company may be taxed at a fraction of that nominal rate, depending on the type of business carried on. As was the case with the pre-reform company/shareholder tax system, owners of private companies may be able to realise substantial tax savings if they sell their shares in a company instead of withdrawing the company profits in the form of dividends. The differential has been reduced, but the incentive to engage in dividend stripping remains.

The government has responded to the threat of renewed dividend stripping with a wide arrangement of provisions attacking the practice. None of anti-avoidance measures employing the term actually define dividend stripping. The Act and the government remain silent as to the rationale for fully taxing distributed profits and preferentially taxing capital gains. Given the tax advantages of dividend stripping, taxpayers will no doubt continue to approach tax advisors for assistance in converting their dividend income to capital gains. Extensive anti-avoidance provisions will make that goal much more difficult to accomplish now than was the case a decade ago. But schemes that skirt the edges of those provisions will inevitably emerge and when they do, it will fall to the courts to rule upon their effectiveness.

The existence of a large and complex body of anti-avoidance provisions will make the task of the modern judiciary quite different from that of their predecessors in the 1970s. In one aspect it remains the same, however — in the absence of clear policy objectives, the courts will turn to established judicial precedent to interpret the anti-avoidance measures. And the result, when it finally emerges, will be neither right nor wrong. In the end, the line between dividend stripping and capital gains remains as indistinct and inexplicable as that which existed a decade ago.

3. Choosing the correct taxpayer

Income splitting and income transfers remain the most significant loophole in Australian income tax law.

46 The tax is either paid by the company when income is earned or by the shareholder when untaxed company income is distributed.

The government's reaction to the High Court's leading income splitting decisions, particularly the *Everett* decision, was shocking. *Everett* transfers were nothing more than naked tax avoidance schemes that resulted in an immediate transfer of income burdens from the rich to the poor and which could not be justified on the basis of any economic or social theory. But the government did nothing at first. And when it did finally act, its conduct was inexcusable. The government, speaking through a Second Commissioner of Taxation, effectively endorsed the schemes and announced that the government's new general anti-avoidance provisions, located in Part IVA of the Income Tax Assessment Act, would not be used against *Everett* transfers[47] notwithstanding their clear application to those tax avoidance schemes. That policy has been continued by the present government.

Prior to tax reform, the government's White Paper on the tax system addressed the question of income splitting in some detail and mapped out alternative programmes for eliminating the practice. It was the only type of tax avoidance that the government failed to address in any manner when the tax reform package was announced. The legacy of past legislative inaction and judicial initiatives remains the governing system of tax attribution today.

IV. DIRECTIONS FOR CHANGE

More than 80 years of income taxation has failed to accomplish the redistribution aims of a progressive rate structure and bring about a levelling of equality and opportunity in Australian society.[48] The reasons for its failure were dramatically exposed in the tax avoidance era of the last decade. Taxpayers sought to avoid taxes, tax advisors offered them the schemes that would make it possible and courts endorsed those schemes. And all three parties did nothing more than exploit the anomalies and inconsistencies already in the tax legislation. Tax reform, with superficial base broadening, has failed to address the fundamental structural problems that gave rise to avoidance in the first place. The agenda for reform has already been set; it was explicitly revealed by the High Court in the leading tax avoidance cases of the 1970s. It remains to be acted upon. Real reform must address the question of rational preferences for capital gains and the need to protect the integrity of the individual tax unit.

1. *Preferences for Capital Gains*

In some ways, tax reform was a retrogressive step with regard to the adoption of a sound tax base. The irrationality of the capital/income distinction, based as it is on the meaningless concept of intention that bears

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47 The statement may be found in N. Challoner and R. Richardson, *Tax Avoidance — Implications of the 1981 General Provisions (Part IVA)* CCH, (1981) 175.

48 A review of studies highlighting the continuing disparities in wealth in Australia may be found in P. Saunders, "An Australian Perspective on Wealth Taxation" in Head, note 5 *supra*, 397, 403-406. More recent data includes J. Piggott, "The Distribution of Wealth in Australia: A Survey" (1984) 60 *Econ Record* 252 and J. Piggot, "The Nation's Private Wealth — Some New Calculations for Australia" (1987) 63 *Econ Record* 61.

no relationship to real economic gains and ability to pay, was demonstrated for all to see in the leading tax avoidance cases. Continued exposure of the absurdity of the law may have led eventually to its replacement with a more logical exemption or preference for certain types of gains considered worthy of a legislatively initiated subsidy. The government's reform solution — to tax partially undefined capital gains — has reduced pressure on the Tax Commissioner's office to pursue the borderline cases, and the entrenchment of the current or wider judicial tests for gains entitled to the preference now seems inevitable. To the extent that it accords a preference without reference to any rational criteria or standards, the capital gains tax in its present form is closer to a codified tax avoidance regime than the simple preference for investors that it is often claimed to be.

The introduction of a limited capital gains tax in a society that has resisted the concept for so long was an important initial move to tax reform. Real reform requires further work, however. A preference of the type presently accorded capital gains requires legislative definition and refinement if it is to achieve its economic or social objectives in the most cost-effective, efficient manner possible. Targeting that subsidy without reference to sound economic policy principles is a job the courts cannot and should not do.

A rational preference for capital gains must be aimed carefully to reach those investment sectors that will most directly further the aims of the subsidy. Thus, for example, a government wishing to see the rental housing stock increased might wish to use a tax preference for capital gains on buildings to encourage the diversion of investment capital into the rental housing market. The subsidy will only be effective, however, if it is narrowly targeted. An across-the-board preference for capital gains realised on all real property investments, including not only rental housing in urban centres but also luxury condominiums in resorts, ski chalets in the mountains, summer homes by the ocean, office towers in Hong Kong and hotels in Singapore, is not the logical way to proceed.

It might similarly be concluded that a preference for capital gains on intangible investments such as shares and bonds will help divert needed capital to Australian manufacturing enterprises, whose expansion will increase the nation's gross domestic product, reduce its unemployment and help redress its balance of payments problems. Once again, a blanket subsidy for the entire range of portfolio investments will contribute little to this goal. Extending the subsidy to investors in Japanese shares, Swiss debt securities and United States equity trust investments as an inducement for some to put additional funds in Australian companies is senseless. Yet this is how the subsidy has been framed by the courts.

Capital gains taxation cannot be reformed until the targets for a capital gains subsidy are identified and legislation restricting the preference to those target areas implemented. If it is to be used as a tool of economic management, the capital gains preference must be carefully carved out of a comprehensive income tax, not indiscriminately handed out by the courts without rhyme or reason.

2. Dividend Stripping

Dividend stripping is a problem only because of the different tax treatment accorded to distributed dividends and capital gains. If both were fully taxed or both were preferentially taxed, the incentive for dividend stripping would immediately disappear.

The key to resolving the dividend stripping problem thus lies in the reform of the capital gains tax. At present, some gains on sales of shares in private corporations qualify for preferential capital gains treatment and some do not. For the moment the operative distinction turns on the source of the funds used by the buyer to purchase the shares. If a rational explanation for the present distinction can be made, detailed tracing provisions should be codified to ensure the consistent application of whatever policy objectives the preference is designed to achieve. If, as is more likely the case, a review of policy objectives reveals no basis for the current distinction, the preference should be redirected to those gains which further the aims that the government hopes to achieve with its capital gains tax subsidy.

3. Income splitting and income transfers

Of all tax avoidance techniques revealed by the leading avoidance schemes of the 1970s, none was more widespread than income splitting and income transfers. None has been more completely ignored by the government subsequent to that time. None is easier to end. For many schemes no legislation is required — the broad anti-avoidance provisions found in Part IVA of the Income Tax Assessment Act already prohibit many types of income splitting and income transfers and much of the practice would end if the Treasurer asked the Comissioner of Taxation to enforce the law already in place.

A complete and comprehensive legislative programme to close off those last loopholes was prepared in the months prior to the introduction of the government's tax reform measure, but was omitted from the final package.[49] The reforms were dropped for a variety of reasons, both administrative and political. The introduction of fringe benefits taxation, imputation and the foreign tax credit system placed considerable pressure on the Commissioner's Office and it was felt further reforms of a comprehensive nature would be unmanageable. From the political perspective, it was thought that allowing high income taxpayers, especially articulate lawyers, to continue their personal tax avoidance schemes would significantly reduce the political fallout that was anticipated from the other reforms.

None of the concerns which prevented comprehensive reform continue to justify further procrastination — the time to act is now. Proposals for effective

49 Ironically, an unintended effect of the tax reforms which were implemented was the restriction of some types of direct income transfers, particularly *Everett*-type assignments. An *Everett* assignment by a taxpayer belonging to a partnership which has formed or reformed after 19 September 1985 now triggers a capital gains tax liability which renders the subsequent tax avoidance uneconomic.

reform of income splitting tax avoidance revolve around the implementation of four important principles — an end of income assignments, the attribution of income from transferred property, the restriction of the tax benefits of partnerships to genuine partners, and a limitation of deductions to income splitting service trusts. The essential elements of those four principles are:

(a) Income Assignments

The first step to eliminating income splitting is the repeal of the seven year assignment provision and adoption of a rule rendering income transfers to spouses and minor children void for tax purposes.

(b) Attribution Rules

The second step necessary in a reform package is the adoption of comprehensive attribution rules which guarantee that all income generated by property transferred to a spouse or minor child (other than for arm's length fair market value consideration) is attributed back to the tranferor for tax purposes. Transfers for interest-free promissory notes and interest-free loans are included in the class of transfers for less than market value.

(c) Partnerships

Income splitting via partnerships is easily controlled by a rule preventing distribution of income for tax purposes to family partners whose labour contributions fail to justify the entitlement otherwise due to them. This is determined by the adoption of measures requiring detailed accounting of actual hours worked and duties performed in all partnerships between spouses and between parents and minor children. The additional administrative burden this accounting entails is easily offset by the tax advantages available to genuine contributing partners.

(d) Service Trusts

The final means of income splitting can be eliminated by a rule limiting the deductions available to taxpayers utilising the services of family service trusts to the outlays incurred by the trusts to provide those services. Excess payments are merely diversions of income, serving no business purpose, and should not be recognised for tax purposes.

4. Real Reform

The government has thus far failed to advocate, let alone implement, comprehensive tax reform. To be sure, crossing that second threshold will not be easy. The problems are well illustrated by recent history. The White Paper on tax reform and the legislation that finally emerged from it show the difficulty of overcoming the conservatism and inertia of the federal taxing bureaucracy. The 1985 Taxation Summit illustrated the impossibility of attaining consensus amongst the many interest groups with a stake in existing

tax *deform*.[50] The difficulty of passing controversial measures without control of the Senate was highlighted by the government's now abandoned attempts to implement legislation to collect lost revenue from taxpayers who participated in bottom-of-the-harbour schemes.[51] And, at a time when increased tax revenues are needed to fund desperately needed social and economic objectives, the revenue neutrality of the government's tax reform programme demonstrates how hard it is to be a taxing government even where real tax increases would hurt only a few and benefit many.

The structural faults in the Australian tax system are no secret. The solutions have already been formulated. The path to real reform lies ahead. Hopefully, the government will embark upon the path soon.

50 The parochial self-interest of spokespersons for leading lobbies at a national summit designed to achieve compromise and consensus was quite remarkable. See generally, *National Taxation Summit: A Record of Proceedings*, AGPS, 1985.

51 That legislation was twice defeated in the Senate. Fringe benefits tax, capital gains tax and lump sum superannuation tax were only passed after the government made significant compromises on already diluted legislation to appease the Democrats, who controlled the balance of power in the Senate.