



Law Council
OF AUSTRALIA

Business Law Section

Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: bettertax@treasury.gov.au

1 June 2015

Dear Madam/Sir

Re-think: Tax Discussion Paper

The Law Council of Australia (**Law Council**) is the peak body representing lawyers in Australia and the Taxation Committee of the Business Law Section of the Law Council (the **Committee**) is pleased to contribute to a continuing discussion on the issues raised in the Tax Discussion Paper.

Members of the Business Law Section of the Law Council may have differing views on matters of economic and fiscal policy, which forms a substantial part of the Tax Discussion Paper. However, the Business Law Section is committed to improving the process of conceiving new tax systems, designing them and drafting them. The majority of recommendations in this submission therefore concern the Design, Architecture and Process of legislative reform, based on the significant experience of and research into successful and unsuccessful reform processes both in Australia and internationally. The remaining recommendations relate to substantive legal and administrative policy issues.

Executive Summary

The fundamental issue is that in redesigning a tax system, there is significant experience internationally and domestically of how to do it well and how to do it badly. The essential point of the recommendations below is that:

- there are a series of key criteria;
- which need to be actively applied against any design;
- to achieve a logical and well-constructed outcome;
- that can be justified in a highly contested environment.

Summary of Recommendations

1. We recommend the use of the summary principles identified below in quality assuring the design constructed in the White Paper.

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2. We recommend that any redesign of the tax system includes careful review of the overall legislative and administrative framework using criteria such as those provided in *Bentley*¹, or available from the IMF, World Bank and OECD to assist in quality assuring tax system design.
3. We recommend that the Board of Taxation conduct an adequately resourced review under the terms of its Charter to identify the higher level architecture of the tax law including its design, framework for the legislation, and principles for drafting, to be applied in current and future tax reform processes. This should include consideration of the following matters:
 - a. A commitment to the primacy of legislation over Explanatory Memoranda;
 - b. Reversion to the well-established and coherent principles-based approach to drafting of tax law;
 - c. Review of the good policy for the drafting of plain and effective new tax law that was established by the 'Tax Law Improvement Project'² which re-wrote substantial parts of the law in the *Income Tax Assessment Act* 1936 into the *Income Tax Assessment Act* 1997;
 - d. Restoration of the successful approach that combined tax law policy design and legislative drafting by 'embedding' Parliamentary Counsel in the team responsible for tax law policy design (previously within the ATO and now the Treasury), and implementation of the recommendation to retain and include experienced experts from the tax advisory community in the drafting process;
 - e. Implementation of processes to give effect to good policy and thereby avoid the problem of 'bolting on' new legislation without reviewing it holistically and contextually.
4. We recommend that the current reform is based on:
 - a. a clearly identified mechanism and process for building relational capacity with the electorate and key influencers, preferably distanced from a particular political proponent;
 - b. embedding the reforms in the social mindset; and
 - c. ensuring that any reform proposal can meet the fundamental legislative criteria to achieve passage of the legislation.
5. We recommend that Federal and State Governments collaborate to invest in systems to maximise the efficiency of the tax system, while ensuring protection of fundamental taxpayer rights.
6. We recommend that a principled approach similar to that set out in the Australian Law Reform Commission Report 107 to safeguard appropriately Client Legal Privilege be applied and that the same approach should be used in the design of any new or redrafted law to protect existing taxpayer rights.
7. We recommend consideration of three approaches to policy design of technical aspects of taxation:
 - a. It is good policy to have tax law rest on the general law and not artificial tax concepts, which are heavily defined, not intuitive and out of step with other countries.
 - b. Tax law should not drive commercial activity.
 - c. Tax system reform should take full opportunity to ensure simple rules that are necessary and able to be followed and applied.

¹ D Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law International 2007), available in electronic form, at <http://epublications.bond.edu.au/theses/36/>.

² The Law Council was represented on this Panel.

Design: Principles for change

Any significant legislative change should be predicated on accepted principles. This is particularly relevant to taxation law reform. In our view, insufficient attention is paid to the principles that should underlie any reform process as set out in Chapter 2. The principles articulated lack reference to the literature that explores their meaning and, while valid, they are incomplete. They are also insufficiently applied to assess the impact of the proposals set out in the remaining chapters. There is a strong sense that they are used almost as slogans to provide legitimacy to a set of proposals. As set out below, careful articulation of the principles and why they are important would add significant weight both to the framing and assessment of the policy outcomes and also to the ability to generate a broader community consensus on their acceptability.

As the pace of change continues unabated, it is inevitable and advantageous that reports into tax design are founded on fundamental tax design principles. This is of critical importance given the challenges set out in Chapter 1. Australia's response to the imperative to rethink its tax design cannot be divorced from developments in its major trading partners. In the interests of common understanding and consistency, *Alley* and *Bentley* provided an analysis of the broad principles used in major tax reform documents domestically and internationally, together with a synopsis of their meaning.³ Subsequent reports, both internationally and domestically, have used principles aligned in whole or part to this summary. They provide a more comprehensive set of principles to guide the next stage of development of the Re:think process and to provide clear evidence of validation of each proposal, together with a rationale for why one proposal is preferred over another.⁴

Equity and fairness

- Taxation system design should take account of horizontal and vertical equity.
- It is important that the public perceives the tax system as fair.
- Inter-nation equity should be considered for international elements.

Certainty and simplicity

- Tax rules should not be arbitrary.
- Tax rules should be applied to commerce in accordance with the structures and mechanisms by which commerce operates. Commerce should not be compelled to operate in a manner which is convenient for the collection of tax.
- Tax rules should be as clear and simple to understand as the complexity of the subject of taxation allows, so that taxpayers can anticipate in advance the tax consequences of a transaction including knowing when, where and how the tax is to be accounted.
- There should be transparency and visibility in the design and implementation of the tax rules.

Efficiency

- Compliance and administration costs should be minimised and payment of tax should be as easy as possible.

³ C Alley and D Bentley, "A remodelling of Adam Smith's tax design principles" (2005) 20 *Australian Tax Forum* 579.

⁴ *Ibid*, 622.

Neutrality

- The tax system should not impede or reduce the productive capacity of the economy.
- Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- Capital import neutrality and capital export neutrality should be considered.

Effectiveness⁵

- The system should collect the right amount of tax at the right time without imposing double taxation or unintentional non-taxation at both the domestic and international levels.
- The system should be flexible and dynamic to ensure a match with technological and commercial developments.
- The potential for active or passive non-compliance should be minimised while keeping counter-acting measures proportionate to the risks involved.

These principles will always compete and overlap with each other. The art of taxation design is to balance the principles most effectively in achieving the intended purpose. Vertical equity, for example, is often sacrificed to achieve other principles. As the Carter Commission put it:⁶

“We realize that some of the objectives are in conflict, in the sense that movement toward one goal means that others might be achieved less adequately. Simultaneous realization of all the goals in some degree will constitute success if, as we hope, our choices as to the appropriate compromises adequately reflect the [informed] consensus...”

The above principles cover those set out at Chapter 2.1 of the Tax discussion paper in a more ordered framework and we recommend the use of the above principles in assuring the quality of the design of the system to be constructed in the White Paper.

The two areas of procedural principles and proper consultation and review need further consideration. The latter is considered below at part 5.

It is universally accepted that there are basic legal and administrative rights and obligations (which includes procedural principles) that should underpin any tax system. The OECD periodically provides a comparative international analysis.⁷ Bentley provides a comprehensive analysis in *Taxpayers' Rights: Theory, Origin and Implementation*⁸ together with a Model, which can be used to assess the validity of the legal and administrative rules governing any proposed system recognising the importance of both the law and administration for effective implementation. Other commentators provide useful models to assess the fairness of the tax system, but often favouring legislation over

⁵ This principle incorporates the principles of 'sustainability' and 'policy consistency' articulated in the 'Henry Review': *Australia's Future Tax System: Final Report*, Chapter 2:1 available at http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm.

⁶ Canada, *Report of the Royal Commission on Taxation* ('Carter Report') Vol 2, *The use of the tax system to achieve economic and social objectives* (1966) ch 1.

⁷ OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies*, (OECD Publishing 2013), available at http://www.oecd-ilibrary.org/taxation/tax-administration_23077727.

⁸ D Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law International 2007), available in electronic form, at <http://epublications.bond.edu.au/theses/36/>.

administrative rules, which can increase complexity, as identified below.⁹ We recommend that any redesign of the tax system includes careful review of the overall legislative and administrative framework using principles such as those listed in *Bentley*, or available from the IMF, World Bank and OECD, to assist in quality assuring tax system design.

Architecture of the tax legislation

The 2015 budget highlighted the difficulty in “bolting on” tax measures to an existing complex system, without continuing the broader, long-term overhaul of the architecture of the system. The current range of taxes and the complexity of their application are among the issues that have been well canvassed in the current and prior tax reviews. It is well settled internationally that there needs to be a well-functioning tax process if the legislative and administrative framework is to be high quality, work effectively and gain the widespread taxpayer acceptance essential to ensure high levels of compliance.

Australia is privileged to have multiple groups reviewing and monitoring the tax system on a continuous basis. This includes input from widespread and regular consultation and lobbying from different interest groups. The Board of Taxation is charged with advising the Treasurer on:¹⁰

- “the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.”

In 2008 the ‘Tax Design Review Panel addressed the factors relevant to good tax law design and implementation. The Panel delivered a report to the Government, which accepted all of its recommendations. Later, the Board of Taxation reviewed the Government’s implementation of the 2008 Panel’s recommendations and in 2011 delivered its report to the Government. The review noted the lack of full transparency and effectiveness of the Treasury project management of tax design.¹¹

It is timely to consider the higher level architecture and design of the tax system and the Board of Taxation is well placed to conduct such a review in the context of the range of major structural reforms under consideration from the cumulating recommendations of past reviews and the current Tax discussion paper. Particular issues of concern to the Law Council and which we recommend should be included in a review are as follows:

1. The ‘Tax Law Improvement Project’ commenced re-writing the tax law in the *Income Tax Assessment Act 1936*, in ‘plain English’, into the *Income Tax Assessment Act 1997 (ITAA 97)*. This project pioneered a very effective policy/technique of ‘embedding’ a member of

⁹ For example, see the comprehensive international analysis in M Cadesky, I Hayes and D Russell, *Towards Greater Fairness in Taxation: A Model Taxpayer Charter Preliminary Report* (2013 AOTCA, CFE, STEP).

¹⁰ The Function of the Board of Taxation contained in the Charter of the Board of Taxation, available at www.taxboard.gov.au.

¹¹ Board of Taxation, *Post-implementation Review of the Tax Design Review Panel Recommendations* (December 2011) 16, available at www.taxboard.gov.au.

Parliamentary Counsel (**OPC**) into the Tax Office and Treasury teams responsible for the re-write. This saved preparing and absorbing extensive drafting instructions and gave the team the benefit of the OPC's intelligence and insight into the design process. The Tax Design Review Panel also recommended that the design and drafting process include experienced experts, which the Law Council supports.

2. The various re-writes of the tax legislation leading to the ITAA 97 and some subsequent amendments are incomplete; the principles-based approach to legislation has not been uniformly implemented; different taxes have different arrangements for compliance and administration; and the international framework within which our domestic legislative arrangements must sit is becoming increasingly important.
3. There are 'bolt on' problems with adding further good policy on existing bad law embedded in the domestic law. The same can be said about existing laws relating to dealings outside Australia. The base laws need to be overhauled at the same time.

Recent proposed budget amendments, however appropriate in principle, provide an example of potential unintended consequences arising from lack of a clear design framework and process. In this case, the example shows the difficulty in announcing a "bolt on" law that does not take full account of the international context (particularly in the context of simply adding on to Part IVA). Changes to the GST on digital supplies from overseas and pre-emptive action on business enterprise profit-shifting, while politically supportable, threaten to create unnecessary complexity in the implementation of the tax laws that may have to be unwound once a more holistic international approach is determined.

4. There appears to be a disconnect between the way in which the Courts are interpreting legislation and the increasing prominence being given to the Explanatory Memoranda as a supplementary guide to the interpretation of tax and other legislation. We refer to our submissions to the Office of the Attorney-General of 28 November 2013 and 19 March 2014 on the relationship between Explanatory Memoranda and Federal legislation (copies are attached for ease of reference). A fundamental point, as stated in our 28 November 2013 submission and which relates to our recommendation in relation to drafting above, is that:

"consistent with the Courts' approach, clear primacy be given to legislation. If important and or operative matters need to be provided for, the proper place for doing so is in the legislation and not the explanatory memorandum to the introducing bill. This may require express instructions to that effect be given to relevant government agencies including the Office of Parliamentary Counsel. The [Law Council] understands that the processes of drafting legislation and explanatory memoranda are separate and that sponsoring agencies or departments of government are responsible for explanatory memoranda. Accordingly, it is probably necessary for this matter to be addressed on a whole of government basis."

5. We understand that Treasury is seeking to include legislative instruments in taxation laws. While not yet enacted, we understand that both the proposed Commissioner's statutory remedial power and new provisions to address concerns with section 974-80 will be drafted with, in the former, the ability for the Commissioner to issue legislative instruments to give effect to legislative changes and, in the latter, examples to provide guidance of the application of the laws being issued through legislative instruments. While we understand the need to balance flexibility and the pressures on Parliament, we query whether this approach will, in years to come, produce a complex and wieldy legislative regime like the US

approach of having to not only consider the terms of the Internal Revenue Code but then needing to undertake a detailed analysis of supporting Treasury Regulations.

The Board of Taxation should be charged with and resourced to provide a long-term tax law architecture that will allow for: “new tax policy choices, changes in the economy, improved techniques or tax avoidance, and earlier bad choices in policy, drafting, and administration”.¹² It is important that the Board of Taxation has research support to understand comparative good practice (often available through the OECD and IMF) and domestic and international research into the theory behind and the consequences of adopting certain approaches.¹³

The “coherent principles approach to tax law design”¹⁴ has been applied intermittently and inconsistently since the ITAA 97 was drafted. This has meant that there has not been a well-constructed and coherent approach to combine tax policy with effective drafting. The starting point for future tax law design and drafting should be to accept and adopt in a disciplined manner the coherent principles approach. Improvements should not alter the approach but the way it is used. Currently there seems little discipline in applying it properly.

The Australian taxation system has been a focus of significant domestic and international research. Yet, the support for reviews to take full advantage of it has been limited. This is unfortunate given the increasing demand by both the legislature and the electorate for evidence-based rationales for change that can stand-up to scrutiny by diverse interest groups.

Gain Community Acceptance for Legislative Reform

Analysis of tax reform in multiple jurisdictions, especially in Australia, demonstrates that the success of passing any reform will be driven primarily by the politics.¹⁵ Although this may be driven by factors reflective of the power balances in Australia’s political institutions, from a practical standpoint, it means that the Government must first build relational capacity with the electorate and key influencers: a strong network of relationships

¹² RK Gordon and V Thuronyi, “Tax Legislative Process” in V Thuronyi (ed), *Tax Law Design and Drafting* (1996 IMF) 1, 2. See the updated chapter by V Thuronyi, “Drafting Tax Legislation”, available at <https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch3.pdf> in which he states:

The discussion in this chapter is organized according to the criteria for a well-drafted law. I have identified these as understandability, organization, effectiveness, and integration.

Understandability refers to making the law easier to read and follow. Organization refers to both the internal organization of the law and its coordination with other tax laws. Effectiveness relates to the law's ability to enable the desired policy to be implemented. Finally, integration refers to the consistency of the law with the legal system and drafting style of the country. These criteria are, of course, interrelated and somewhat overlapping. Organization is important for understandability, and all the criteria contribute to the effectiveness of the law.

¹³ For example, see the development of theory in Australia and as critiqued in relation to the UK in the articles by Graeme S. Cooper, “Legislating Principles as a Remedy for Tax Complexity” [2010] BTR 334; G. Pinder, “The Coherent Principles Approach to Tax Law Design” [2005] *Treasury Economic Roundup* (Autumn) 75; and J Freedman, “Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited” [2010] BTR 717.

¹⁴ See Pinder, *ibid*.

¹⁵ See the analysis of the literature in the context of the politics of GST reform in C Alley, D Bentley and S James, “Politics and Tax Reform: A Comparative Analysis of the Implementation of a Broad-Based Consumption Tax in New Zealand, Australia and the United Kingdom” 24 (2014) *Revenue Law Journal*, available at <http://epublications.bond.edu.au/rlij/vol24/iss1/>.

that can draw together the fragmented interest groups across Australian society to act collectively in pursuit of commonly agreed tax reform.¹⁶

This could be done in several ways. New Zealand established an independent office to build the case for GST reform, prior to its introduction. Treasury or a dedicated team from a Government Department could drive the discussion. A Parliamentary Committee could be established. The aim would be not only to consult on a detailed package of reform with the Commonwealth, States and appropriate government agencies such as Treasury, the ATO and department of Social Services, but also with key interest groups such as the Australian Council of Social Service, Business Council of Australia and, very importantly, all parties and independent members in Federal and State Parliaments. An associated component of the work would be to provide transparency and information on key concepts. If this is done over the period before the next Federal election it would build both collective agreement and electoral understanding. It would allow full exploration of the issues and provide transparent, accessible and evidence-based information to inform the debate.

Second, reform will be driven by how embedded the reforms have become in the social mindset: the extent to which the broader community shares the political goals of the reform.¹⁷ This should be done by using the networks and influencers developed in the first stage of the reform process and focusing on the equity and fairness of the reform package.¹⁸ It would require the government and other champions of reform to own and drive it.

A feature of reforms in both Australia and New Zealand has been the importance in the politics of personality: for example, on the introduction of the GST, it was clearly critical to the success of each of their platforms that Prime Minister Howard and Treasurer Costello championed the introduction of the GST as did Treasurer Douglas in New Zealand. But political championing is most effectively done once there is broad consensus accepting the need for change by the wider community (and thus 'consensus building' is important). Recent New Zealand governments have achieved significant reform by moving slowly and steadily, one reform at a time, getting the design right and taking the electorate with them. Adopting as balanced approach as is possible, together with a focus on socialising the proposed reforms, caters to what have proven to be critical principles for success: fairness and equity.

Third, the Commonwealth must meet the fundamental legislative criteria to achieve passage of the legislation and, if the GST is changed, to persuade the States and pass the legislation. For example, the current legislative criteria to change the GST require that the amendment ensures the integrity of the GST base and administrative simplicity, while minimising compliance costs for taxpayers.¹⁹ Unless this step is taken prior to legislation being put to both the States and to both houses of Federal Parliament, experience shows that the integrity of any proposal may disappear into the cauldron of vigorously pursued political interests.

This three-pronged approach represents a political challenge for governments, but has been shown both in Australia and internationally to provide the most effective approach to

¹⁶ Alley, Bentley and James, *ibid* and Richard Eccleston, 'Taxing Times: A Political Retrospective' (2002) 17 Australian Tax Forum 287, 298. and *Taxing Reforms: The comparative political economy of consumption tax reform in the United States, Canada, Japan and Australia* (Edward Elgar, 2007).

¹⁷ *Ibid*.

¹⁸ *Ibid*.

¹⁹ *Section 11 A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth).

achieve successful political acceptance of tax reform. We therefore recommend that the reform is based on:

- a clearly identified mechanism and process for building relational capacity with the electorate and key influencers, preferably distanced from a particular political proponent;
- embedding the reforms in the social mindset; and
- ensuring that any reform proposal can meet the fundamental legislative criteria to achieve passage of the legislation.

Legal and Administrative Policy Issues

The answers to Questions 61 and 62 are self-evident. The basic principles underpinning a tax system require investment in the most efficient systems and processes available. Australia has maintained strong investment in technology but it needs to ensure that, with the significant commitment to international tax co-operation in compliance and administration, that it has the resources to maintain service standards and high levels of voluntary compliance.²⁰ A critical issue for the Law Council is that Government ensures that any systems changes satisfy the principles set out in our other recommendations. This is particularly important in relation to increased collaboration by the ATO with other revenue agencies and both domestic and international rights to privacy.

An ancillary and integrally connected issue is to ensure that systems are designed to protect fundamental taxpayer rights, including client legal privilege. Client legal privilege in Federal investigations was reviewed by the Australian Law Reform Commission (**ALRC**), which in 2008 published *Report 107, Privilege in Perspective: Client Legal Privilege in Federal Investigations (Report 107)*.²¹

Report 107 recognised that client legal privilege should *prima facie* apply in a regulatory context (including in relation to tax) and recommended the enactment of legislation of general application to deal with the process regarding the making and assessment of client legal privilege claims in federal investigations. To the extent that client legal privilege was to be abrogated or modified, the ALRC recommended (Recommendation 5-3) that “The Australian Government should ensure that any legislative scheme which seeks to abrogate or modify client legal privilege does so by express reference to the particular sections or divisions within that scheme that confer coercive information-gathering powers which abrogate or modify the privilege.”

The LCA supports the maintenance of fundamental taxpayer rights and the broader application of the latter principle, that in considering changes to the tax laws, any modification or abrogation of client legal privilege or the accepted rights of taxpayers more broadly, should be both expressly stated in the legislation and given as narrow scope as possible while achieving the legislative intent. Report 107 provides useful analysis of how legislative design should approach modification or abrogation of rights, how those rights can be best safeguarded while allowing Federal agencies to fulfil their functions and how this should be translated

²⁰ OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies*, (OECD Publishing 2013), available at http://www.oecd-ilibrary.org/taxation/tax-administration_23077727.

²¹ Available at <https://www.alrc.gov.au/report-107>.

effectively into practice and procedure. Given the extensive consultation and review by the ALRC in producing Report 107, which included the current Chief Justice of the High Court of Australia and Justice Kiefel as part-time Commissioners, the Report is a useful guide as to how to design and draft tax legislation to take account of broader legal rights.

There are three approaches to policy design of technical aspects of taxation that deserve consideration:

1. It is good policy to have tax law rest on the general law and not artificial tax concepts, which are heavily defined, not intuitive and out of step with other countries.
2. Tax law that does not drive conduct is better than the opposite. While there are significant social policy merits in maintaining a progressive tax system, the Committee considers that there has been an increasing tendency over time for taxation legislation to focus on integrity outcomes. Put simply, there are aspects of our current tax system where the fiscal tail now wags the commercial dog.
3. We should look to avoid (and abolish, where existing) overly complicated tax law which is difficult to apply.

If you have any questions in relation to this submission, in the first instance please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or via email:

adrian.varrasso@minterellison.com

Yours faithfully

A handwritten signature in black ink, appearing to read 'John Keeves', with a long horizontal flourish extending to the right.

John Keeves, Chairman
Business Law Section