Source Text:


All quotation marks retained as data
All unambiguous end-of-line hyphens have been removed, and the trailing part of a word has been joined to the preceding line.

*Australian Etexts 1940- income taxation law prose nonfiction*

2003
Creagh Cole Coordinator
Final Checking and Parsing
## CONTENTS

<table>
<thead>
<tr>
<th>List of Tables</th>
<th>xv</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>xvii</td>
</tr>
<tr>
<td>1. THE NEED FOR TAX REFORM</td>
<td>1</td>
</tr>
<tr>
<td>I. Reasons for a Review</td>
<td>1</td>
</tr>
<tr>
<td>II. Committee's Approach</td>
<td>3</td>
</tr>
<tr>
<td>2. THE AUSTRALIAN TAX SYSTEM IN PERSPECTIVE</td>
<td>5</td>
</tr>
<tr>
<td>I. Historical Perspective</td>
<td>5</td>
</tr>
<tr>
<td>II. International Perspective</td>
<td>8</td>
</tr>
<tr>
<td>3. CRITERIA FOR TAX SYSTEMS</td>
<td>11</td>
</tr>
<tr>
<td>I. Terms of Reference and their Interpretation</td>
<td>11</td>
</tr>
<tr>
<td>Fairness</td>
<td>12</td>
</tr>
<tr>
<td>Simplicity</td>
<td>15</td>
</tr>
<tr>
<td>Efficiency</td>
<td>16</td>
</tr>
<tr>
<td>Other Objectives</td>
<td>17</td>
</tr>
<tr>
<td>II. Appraisal of Particular Taxes</td>
<td>17</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>17</td>
</tr>
<tr>
<td>Company Income Tax</td>
<td>18</td>
</tr>
<tr>
<td>Capital Gains Taxes</td>
<td>18</td>
</tr>
<tr>
<td>Estate and Gift Duties</td>
<td>19</td>
</tr>
<tr>
<td>Wealth Taxes</td>
<td>19</td>
</tr>
<tr>
<td>Taxes on Goods and Services</td>
<td>19</td>
</tr>
<tr>
<td>Narrow Based Taxes</td>
<td>19</td>
</tr>
<tr>
<td>Broad Based Taxes</td>
<td>19</td>
</tr>
<tr>
<td>Grants</td>
<td>20</td>
</tr>
<tr>
<td>III. Alternative Tax Systems</td>
<td>20</td>
</tr>
<tr>
<td>4. THE POSITION OF PROGRESSIVITY</td>
<td>23</td>
</tr>
<tr>
<td>I. The Statistical Situation</td>
<td>24</td>
</tr>
<tr>
<td>II. Tax and Non-tax Policies in Redistribution</td>
<td>29</td>
</tr>
<tr>
<td>III. The Distributional Objective</td>
<td>32</td>
</tr>
<tr>
<td>5. THE GOALS OF TAX REFORM</td>
<td>35</td>
</tr>
<tr>
<td>I. The Options</td>
<td>35</td>
</tr>
<tr>
<td>II. Immediate and Long-term Perspectives</td>
<td>37</td>
</tr>
<tr>
<td>6. INFLATION AND TAX REFORM</td>
<td>39</td>
</tr>
<tr>
<td>I. Taxes and Inflation Control</td>
<td>40</td>
</tr>
<tr>
<td>II. Effects of Inflation on Taxes</td>
<td>47</td>
</tr>
<tr>
<td>Tax Payments</td>
<td>48</td>
</tr>
<tr>
<td>Tax Drift</td>
<td>48</td>
</tr>
</tbody>
</table>
### 7. INCOME TAX: THE BASE

#### I. Problems of Definition
- **The Concept of Income**
- **Capital Gains**
- **Bequests and Gifts Received**
- **Lottery and Casual Gambling Winnings**
- **Retirement Benefits and Compensation for loss of office**
- **Compensation for physical injury to person received in a lump sum or for injury to reputation**
- **Non-money Income**
- **Deduction of Expenses**
  - **Expenses Incurred in Deriving Income**
  - **Other Deductible Expenses**
- **Exempt Income**
- **Annual Accounting**
- **Income of Particular Industries and Activities**
- **Income Moving Through Intermediaries**
- **International Aspects**

#### II. Specific Issues
- **Compensation for Physical Injury to the Person**
- **Compensation for Injury to Reputation**
- **Imputed Rent of the Owner-Occupied Home**
- **Costs of Travel to and from Work**
- **Child-Minding Expenses**
- **Expenses of Income Earning Activities Carried on at Home**
- **Subscriptions toTrade and Professional Associations**
- **Income Protection Insurance Premiums**
- **Self Education Expenses**
- **Dissection and Apportionment of Composite Receipts and Outgoings**

### 8. INCOME TAX: ISSUES RELATING TO BUSINESS AND PROFESSIONAL INCOME

#### I. Cash or Accruals Basis

#### II. Accruals Tax Accounting and Financial Accounting
- **Holding Charges**
- **Work in Progress**
- **Tax on Basis of Financial Accounting Principles**

#### III. Provisions and Accrued Expenses
- **Long-service Leave and Holiday Pay**
- **Other Provisions for Liabilities**
- **Provision for Doubtful Debts**

#### IV. Depreciation and Amortisation of Fixed Assets
- **Plant and Equipment**
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>92</td>
</tr>
<tr>
<td>Classes of Buildings which should qualify</td>
<td>95</td>
</tr>
<tr>
<td>The inclusion of Existing Buildings</td>
<td>95</td>
</tr>
<tr>
<td>Treatment on Change of Ownership</td>
<td>96</td>
</tr>
<tr>
<td>Demolition and Damage</td>
<td>96</td>
</tr>
<tr>
<td>Effect on Revenue</td>
<td>97</td>
</tr>
<tr>
<td>Leasehold Improvements</td>
<td>97</td>
</tr>
<tr>
<td>Other Assets and Costs of a Capital Nature</td>
<td>98</td>
</tr>
<tr>
<td>V. Trading Stock</td>
<td>98</td>
</tr>
<tr>
<td>Definition of Trading Stock</td>
<td>99</td>
</tr>
<tr>
<td>Land Held for Resale</td>
<td>100</td>
</tr>
<tr>
<td>Plant Spares and Consumable Stores</td>
<td>100</td>
</tr>
<tr>
<td>Shares, Debentures and Similar Assets</td>
<td>100</td>
</tr>
<tr>
<td>Methods of Valuing Trading Stock</td>
<td>101</td>
</tr>
<tr>
<td>Cost Price</td>
<td>101</td>
</tr>
<tr>
<td>Market Selling Value</td>
<td>103</td>
</tr>
<tr>
<td>Replacement Price</td>
<td>103</td>
</tr>
<tr>
<td>Disposal of Trading Stock</td>
<td>103</td>
</tr>
<tr>
<td>VI. Recoupment of Losses</td>
<td>106</td>
</tr>
<tr>
<td>Carry-back of Losses</td>
<td>106</td>
</tr>
<tr>
<td>Carry-forward of Losses</td>
<td>108</td>
</tr>
<tr>
<td>Exempt Income</td>
<td>109</td>
</tr>
<tr>
<td>Effect of Dividend Income</td>
<td>109</td>
</tr>
<tr>
<td>VII. Implications of Inflation for Business Income</td>
<td>110</td>
</tr>
<tr>
<td>VIII. Sundry Costs of Business Operation</td>
<td>113</td>
</tr>
<tr>
<td>Lease Transactions</td>
<td>113</td>
</tr>
<tr>
<td>Expenditure on Repairs to Income-producing Property</td>
<td>113</td>
</tr>
<tr>
<td>Professional Libraries</td>
<td>114</td>
</tr>
<tr>
<td>Travelling and Entertainment Expenses</td>
<td>115</td>
</tr>
<tr>
<td>Anti-pollution and Ecological Expenditures</td>
<td>115</td>
</tr>
<tr>
<td>IX. Conclusion</td>
<td>116</td>
</tr>
<tr>
<td>9. INCOME TAX: ISSUES RELATED TO EMPLOYMENT AND INVESTMENT INCOME</td>
<td>117</td>
</tr>
<tr>
<td>I. Employment Income</td>
<td>117</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>117</td>
</tr>
<tr>
<td>Adequacy of Present Law</td>
<td>118</td>
</tr>
<tr>
<td>Kinds of Benefits</td>
<td>119</td>
</tr>
<tr>
<td>Housing</td>
<td>119</td>
</tr>
<tr>
<td>Board and lodging</td>
<td>119</td>
</tr>
<tr>
<td>Use of motor vehicle</td>
<td>120</td>
</tr>
<tr>
<td>Goods and services supplied at discount</td>
<td>120</td>
</tr>
<tr>
<td>Low interest loans</td>
<td>121</td>
</tr>
<tr>
<td>Prizes and gifts</td>
<td>121</td>
</tr>
<tr>
<td>Stock option and stock purchase schemes</td>
<td>121</td>
</tr>
<tr>
<td>Goods and services supplied by others and paid for directly by the employer</td>
<td>122</td>
</tr>
<tr>
<td>Allowances made available to employees for travel and entertainment expenses</td>
<td>123</td>
</tr>
<tr>
<td>Tax Instalment Deductions</td>
<td>123</td>
</tr>
<tr>
<td>Other Issues</td>
<td>124</td>
</tr>
</tbody>
</table>
Education Expenses 170
Medical Expenses 170
Payments to Medical and Hospital Benefits Funds and Medical Expenses Generally 172
Expenses of Blind Persons or Persons Confined to Bed or Invalid Chair 174
Funeral Expenses 174
IV. Zone Allowances 174
Zone Boundaries 175
Deduction or Rebate 175
The Amount of the Concession 176
Qualifying Period 176
13. PERSONAL INCOME TAX: SOCIAL SECURITY 177
I. Social Security Payments and the Tax System 177
II. Social Security Contributions 180
14. PERSONAL INCOME TAX: RATE STRUCTURE 183
I. Complexity of Rate Scale 183
II. Surcharge on Property Income 185
III. Shape of Rate Scale 188
Low Range 188
High Range 190
Intermediate Range 192
IV. Frequency of Adjustment 193
Purpose of Adjustment 194
Statutory or Discretionary 194
Adjustment Procedure 196
V. Income Averaging 197
The Existing Law 197
Primary producer averaging 197
Drought bond scheme 198
Anti-bunching measures 198
Alternatives to the Existing Law 199
Averaging 199
Cumulative averaging 200
Block averaging 200
Marginal adjustment scheme 200
United States System 201
Income Equalisation Scheme 204
Anti-bunching Measures 205
15. INCOME TAXATION IN RELATION TO TRUSTS AND PARTNERSHIPS 207
I. Trusts 207
Present Entitlement 208
Present Entitlement of a Beneficiary under a Disability 210
Net Income of the Trust Estate and Trust Income 211
Accumulating Income 213
Losses of Previous Years 215
II. Partnerships 216
Net Income of a Partnership and Partnership Profits 216
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treatment of Losses</td>
<td>217</td>
</tr>
<tr>
<td>Payment by Surviving Partners to Retired Partner or to Estate of Deceased Partner</td>
<td>218</td>
</tr>
<tr>
<td><strong>III. International Aspects</strong></td>
<td>218</td>
</tr>
<tr>
<td>Trusts</td>
<td>218</td>
</tr>
<tr>
<td>Partnerships</td>
<td>220</td>
</tr>
<tr>
<td><strong>16. COMPANY INCOME TAX</strong></td>
<td>223</td>
</tr>
<tr>
<td>I. Present System of Company Income Tax</td>
<td>225</td>
</tr>
<tr>
<td>Criticism of the Present System</td>
<td>225</td>
</tr>
<tr>
<td>II. Unacceptable Alternatives to the Present System</td>
<td>228</td>
</tr>
<tr>
<td>Tax the Allocation of Profits</td>
<td>228</td>
</tr>
<tr>
<td>Tax Actual Distributions and Accruals in Value of Shares</td>
<td>228</td>
</tr>
<tr>
<td>Require Distribution of All Profits and Tax these Distributions</td>
<td>229</td>
</tr>
<tr>
<td>Tax the Company and Exempt Dividends from Personal Income Tax</td>
<td>229</td>
</tr>
<tr>
<td>III. Split-rate and Imputation Systems</td>
<td>229</td>
</tr>
<tr>
<td>The Choice of an Imputation System</td>
<td>231</td>
</tr>
<tr>
<td>IV. Proposed Imputation System</td>
<td>233</td>
</tr>
<tr>
<td>Amount of Imputation</td>
<td>234</td>
</tr>
<tr>
<td>Minimum Distributions by Companies</td>
<td>234</td>
</tr>
<tr>
<td>International Implications of Proposed Imputation System</td>
<td>235</td>
</tr>
<tr>
<td>Investment by Non-residents</td>
<td>236</td>
</tr>
<tr>
<td>Investment by Australian Resident in Foreign Countries</td>
<td>237</td>
</tr>
<tr>
<td>V. Imputation and Forward Shifting</td>
<td>238</td>
</tr>
<tr>
<td>VI. Proposal to Allow Election to be Taxed as a Partnership</td>
<td>239</td>
</tr>
<tr>
<td>Eligibility to Elect</td>
<td>239</td>
</tr>
<tr>
<td>Amount and Nature of Company Profits</td>
<td>239</td>
</tr>
<tr>
<td>Number and Nature of Shareholders</td>
<td>240</td>
</tr>
<tr>
<td>Capital Structure of the Company</td>
<td>240</td>
</tr>
<tr>
<td>Manner and Timing of Election and Manner of Termination of Election</td>
<td>240</td>
</tr>
<tr>
<td>Consequences of Election and Termination of Election</td>
<td>241</td>
</tr>
<tr>
<td>VII. Appropriateness of Special Provisions for Small Enterprises</td>
<td>241</td>
</tr>
<tr>
<td>VIII. Aspects of Present Company Taxation</td>
<td>242</td>
</tr>
<tr>
<td>Minimum Distribution Requirements</td>
<td>242</td>
</tr>
<tr>
<td>Income of Private Investment Companies</td>
<td>245</td>
</tr>
<tr>
<td>Assessment of Company Groups</td>
<td>246</td>
</tr>
<tr>
<td>The Treatment of Company Groups in Other Countries</td>
<td>246</td>
</tr>
<tr>
<td>United States</td>
<td>246</td>
</tr>
<tr>
<td>New Zealand</td>
<td>247</td>
</tr>
<tr>
<td>Canada</td>
<td>247</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>247</td>
</tr>
<tr>
<td>The Choice of Method of Relief</td>
<td>247</td>
</tr>
<tr>
<td>Holding and Subsidiary Companies</td>
<td>248</td>
</tr>
<tr>
<td>Trading and Consortium Companies</td>
<td>248</td>
</tr>
<tr>
<td>Restrictions on Carry-forward of Company Losses</td>
<td>249</td>
</tr>
<tr>
<td>Loan Capital and Share Capital</td>
<td>250</td>
</tr>
<tr>
<td>Convertible Notes</td>
<td>251</td>
</tr>
<tr>
<td>High Gearing</td>
<td>251</td>
</tr>
<tr>
<td><strong>17. INTERNATIONAL ASPECTS OF INCOME TAXATION</strong></td>
<td>253</td>
</tr>
</tbody>
</table>
I. The Taxation of Foreign-source Income of Australian Residents
   Concept of Resident of Australia
   Foreign-source Income not Subject to Australian Tax
   Credit for Foreign Tax on Foreign-source Income subject to Australian Tax
   Exemption and Credit as Methods of Giving Relief Against Double Taxation
      Equity
      Efficiency
      Simplicity
   Committee’s Proposals
II. Australian-origin Income of Non-residents
   Justification for Taxing Income of Non-residents on the Basis of Origin in Australia
   Taxation on the Basis of Source in Australia
   Tax on Australian-origin Income by Withholding
   Tests of Foreign Origin of Income
   Reconstruction of Australian-source Income of Non-residents
   Reconstruction of Income of Australian Residents from Transactions with Non-residents
   Taxation of Branch Operations in Australia
III. Double Taxation Agreements
Appendix A: Rules for Determining Source of Income of Non-residents
   Income from Sale of Goods Imported into Australia
   Income from Purchase and Sale of Goods that are at all times in Australia
   Income from Purchase of Goods in Australia and their Sale Abroad
   Income from Manufacturing Operations in Australia
   Income from Sale of Australian Real Property
   Income from Sale of Shares
   Income from Services Performed as an Employee
   Income from Services Performed Otherwise than as an Employee
   Income in the Form of Rentals in respect of Real Property
   Income in the Form of Rents of Chattels
   Income in the Form of Payments for the use of Commercial or Industrial Property
   Income Arising from Payments for Scientific, Technical, Industrial or Commercial Knowledge or Information
   Income in the Form of Dividends
   Income in the Form of Interest
18. INCOME TAXATION IN RELATION TO PARTICULAR INDUSTRIES: PRIMARY PRODUCTION
   The Definition Provisions
   Valuation of Livestock
   Spreading and Averaging Provisions
   Capital Expenditure and Depreciation
   Losses of Previous Years
   Restriction of Benefit of Primary Production Provisions
19. INCOME TAXATION IN RELATION TO PARTICULAR INDUSTRIES: MINING
I. General Mining
   Conduct of Mining Operations
   Determination of Net Income from Mining
   Provisions of the Act
<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exploration and Prospecting Expenditure</td>
<td>293</td>
</tr>
<tr>
<td>Development of a Mine and Mining Infrastructure</td>
<td>294</td>
</tr>
<tr>
<td>Processing and Treatment of Minerals</td>
<td>296</td>
</tr>
<tr>
<td>Overseas Exploration and Prospecting</td>
<td>297</td>
</tr>
<tr>
<td>Anti-pollution and Ecological Expenditure</td>
<td>297</td>
</tr>
<tr>
<td>Depletion Allowance</td>
<td>299</td>
</tr>
<tr>
<td>Purchase of Mining or Prospecting Right or Information</td>
<td>300</td>
</tr>
<tr>
<td>Proceeds of Sale of Mining Right or Information</td>
<td>302</td>
</tr>
<tr>
<td>Section 23(o)</td>
<td>302</td>
</tr>
<tr>
<td><strong>II. Recent Amendments to the Act</strong></td>
<td>303</td>
</tr>
<tr>
<td>Exploration Expenditure by General Mining Companies</td>
<td>304</td>
</tr>
<tr>
<td>Allowable Capital Expenditure: Costs of Company Formation and Capital Raising</td>
<td>305</td>
</tr>
<tr>
<td>Immediate Write-off Provisions</td>
<td>305</td>
</tr>
<tr>
<td>Housing and Welfare Expenditure</td>
<td>307</td>
</tr>
<tr>
<td>Transportation Expenditure: Division 10AAA</td>
<td>308</td>
</tr>
<tr>
<td><strong>III. Petroleum Mining</strong></td>
<td>308</td>
</tr>
<tr>
<td>Overseas Exploration and Prospecting</td>
<td>309</td>
</tr>
<tr>
<td>Exploration and Prospecting Expenditure</td>
<td>309</td>
</tr>
<tr>
<td>Development Expenditure</td>
<td>311</td>
</tr>
<tr>
<td>Depreciation Allowances</td>
<td>312</td>
</tr>
<tr>
<td>Acquisition of Prospecting Information or Mining Right</td>
<td>312</td>
</tr>
<tr>
<td><strong>IV. Quarrying</strong></td>
<td>312</td>
</tr>
<tr>
<td>Nature of Quarrying Industry</td>
<td>313</td>
</tr>
<tr>
<td>Expenditure Incurred in Quarrying</td>
<td>313</td>
</tr>
<tr>
<td>Quarrying Plant Depreciation</td>
<td>314</td>
</tr>
<tr>
<td>Exploration Expenditure</td>
<td>314</td>
</tr>
<tr>
<td>Development Expenditure</td>
<td>315</td>
</tr>
<tr>
<td>Anti-pollution and Ecological Expenditure</td>
<td>316</td>
</tr>
<tr>
<td>Acquisition Costs and Proceeds of Sale of Quarry</td>
<td>316</td>
</tr>
<tr>
<td><strong>Appendix A: Mining Taxation: A Comparative Survey</strong></td>
<td>319</td>
</tr>
<tr>
<td>I. Exploration Costs</td>
<td>319</td>
</tr>
<tr>
<td>Australia</td>
<td>319</td>
</tr>
<tr>
<td>General Mining</td>
<td>319</td>
</tr>
<tr>
<td>Petroleum</td>
<td>320</td>
</tr>
<tr>
<td>Transfer to Purchaser of Benefit of Deduction</td>
<td>320</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>321</td>
</tr>
<tr>
<td>Canada</td>
<td>322</td>
</tr>
<tr>
<td>‘Principal Business Corporations’</td>
<td>322</td>
</tr>
<tr>
<td>Taxpayers other than ‘Principal Business Corporations’</td>
<td>322</td>
</tr>
<tr>
<td>United States</td>
<td>323</td>
</tr>
<tr>
<td>South Africa</td>
<td>323</td>
</tr>
<tr>
<td>New Zealand</td>
<td>324</td>
</tr>
<tr>
<td>Mining Companies</td>
<td>324</td>
</tr>
<tr>
<td>Loss Carry-forward</td>
<td>324</td>
</tr>
<tr>
<td>Appropriations</td>
<td>324</td>
</tr>
<tr>
<td>Mining Operators</td>
<td>325</td>
</tr>
<tr>
<td>Non-resident Mining Operators</td>
<td>325</td>
</tr>
</tbody>
</table>
II. Capital Expenditure on Plant and Development

Australia
  General Mining
    Railways, Roads, Pipelines
  Petroleum
    Sale of Prospecting or Mining Rights or Information
    Disposal of Mining and Petroleum Mining Assets

United Kingdom

Canada
  Depletion Allowances
  Additional Allowances
  Capital Cost Allowances

United States
  Depletion Allowances
    Percentage Depletion
  Development Expenditure

South Africa
  Computation of Deduction
  Closing Down of Mine
  Change of Ownership

New Zealand

III. Investment Incentives

Australia
  Deductibility of Capital Subscription
  Exempt Income
  Losses Incurred in Gaining Exempt Income

United States

Canada

New Zealand

South Africa

20. INCOME TAXATION IN RELATION TO PARTICULAR INDUSTRIES: GENERAL INSURANCE, EXEMPT ORGANISATIONS AND MUTUAL ASSOCIATIONS

I. General Insurance
  Determination of Earned Premiums
  Claims Incurred but not Reported
  Catastrophe Fund
  Reinsurance with Non-residents

II. Exempt Organisations and Mutual Associations
  Local Governing Bodies, Public Authorities and Institutions of a Charitable Kind
  Non-profit Associations and Societies Formed for Particular Purposes
  Co-operative Companies
  Friendly Society Dispensaries

21. INCOME TAXATION IN RELATION TO SUPERANNUATION AND LIFE INSURANCE

I. The Case for Special Treatment
II. Superannuation, Retiring Allowances and Related Matters
  Background and Present Legislation
  Taxation of Lump Sum Payments on Retirement
Rate Structure
Concessions for Dependents
Other Concessions
Adjustments for Inflation
Advance Provision for Payment of Tax
Quick-succession Relief
Fall in Value of Assets after Death
Valuation of Assets
Jurisdiction of Integrated Estate and Gift Duty
Incidence of Integrated Estate and Gift Duty
Assessment Procedures
A National Estate and Gift Duty
Appendix A: The Base of an Integrated Estate and Gift Duty
I. Powers Over Property
II. Options
III. Settled Property
   Life Estates
   Estates for a Term of Years or for the Life of Another Person
   Discretionary Trusts
   Accumulating Income
   Special Cases
IV. Annuities
V. Gift of Services
VI. Use of Property
VII. Debts
VIII. Partnerships
IX. Companies
   Transfer of Assets to a Company
   Power or Control in Relation to Companies
   Benefits from a Company
   Gifts in Transactions Involving Companies
   Gift to a company
   Gift by a company
   Allotment of shares
   Variation in share rights
   Change in share rights without concurrent company action
   An obligation to sell shares to specified persons at a price specially determined
   Declaration of dividends
   Definition of a ‘Family’ or ‘Closely Controlled’ Company
X. Involuntary Gifts
XI. Insurance and Superannuation
XII. Joint Ownership
XIII. Exempt Transactions
XIV. Interrelation of Income Tax and Gift Tax
Appendix B: Rate Structure
I. Present Duties and Grossing-up
II. Illustration of a Scale of Integrated Duty


III. Adjusting the Rate Scale 480
IV. Quick-succession Relief 481
Appendix C: Situs of Assets 483
Reservation by R. W. Parsons 485
Reservation by K. Wood 487

25. CHARITIES 489
I. Deductibility from Income of Gifts to Charities 489
II. Income of Charities 490
III. Charities in Relation to Gift and Estate Duties 491
IV. Issues of Principle 492
Subsidy by Deduction 492
Subsidy by Exemption of Income 493
V. Uniformity of Tax Treatment 495
Appendix A: Extract from Income Tax Assessment Act 497
Appendix B: Extract from Estate Duty Assessment Act 501
Appendix C: Tax Treatment of Charities 503

26. WEALTH TAX 505
I. Overseas Experience 505
II. Appraisal 506
III. Conclusion 510

27. TAXATION OF GOODS AND SERVICES 511
I. Existing Taxes on Goods and Services 511
II. Broad-based Taxes 515
Turnover Tax 516
Wholesale Sales Tax 517
Retail Sales Tax 517
Value-added Tax 518
III. Level of VAT and Transitional Problems 520
Appendix A: Sales Tax as a Continuing Tax 523
I. Tax Base and Rates of Tax 523
II. Structure and Administration of the Law 523
Simplification of the Law 523
Time for Lodgment of Returns 524
Objections and Appeals 524
Freight Charges 526
Avoidance of Tax 526

28. CONCLUSION 529
Advertisement of Terms of Reference and Invitation to Submit 533
List of Authors of Submissions 535
List of Commissioned Studies 547
Treasury Taxation Papers 549
Members of the Professional Staff who assisted the Committee for varying periods 551
Professional Firms, Universities and Organisations who made Professional Staff Available to the Committee 551
Members of the General Services Staff 551
Important Statutory Alterations to the Taxation Legislation since the Taxation Review Committee commenced its work 553
Index 559
<table>
<thead>
<tr>
<th>Table</th>
<th>Particulars</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.A</td>
<td>Tax revenue: selected years since 1901–02</td>
<td>5</td>
</tr>
<tr>
<td>2.B</td>
<td>Taxation and its uses: all levels of government, selected years since 1949–50</td>
<td>6</td>
</tr>
<tr>
<td>2.C</td>
<td>Australian government taxes: selected years since 1949–50</td>
<td>7</td>
</tr>
<tr>
<td>2.D</td>
<td>Numbers of taxpayers, resident and non resident, assessed for income tax: selected income years since 1944–45</td>
<td>8</td>
</tr>
<tr>
<td>2.E</td>
<td>International tax comparisons: OECD countries, 1965 and 1971</td>
<td>9</td>
</tr>
<tr>
<td>4.E</td>
<td>Average annual income of full-time male workers, by educational attainment and age group, 1968–28</td>
<td>28</td>
</tr>
<tr>
<td>6.A</td>
<td>Effect of rising money incomes and an unaltered progressive income tax schedule</td>
<td>43</td>
</tr>
<tr>
<td>6.B</td>
<td>Personal rate schedule: marginal tax rates</td>
<td>49</td>
</tr>
<tr>
<td>6.C</td>
<td>Effects of inflation on ‘real’ income rate schedule</td>
<td>50</td>
</tr>
<tr>
<td>6.D</td>
<td>Tax on average earnings per employed male unit</td>
<td>52</td>
</tr>
<tr>
<td>6.E</td>
<td>Percentage of individual taxpayers with net income in excess of $3,000,$6,000 and $10,000</td>
<td>52</td>
</tr>
<tr>
<td>6.F</td>
<td>Deduction for dependants, 1973–74: effect of failure to adjust fully for inflation</td>
<td>53</td>
</tr>
<tr>
<td>6.I</td>
<td>Effect of imposing 30 per cent capital gains tax when capital appreciates at same rate as inflation</td>
<td>57</td>
</tr>
<tr>
<td>8.A</td>
<td>Long-service leave entitlement</td>
<td>87</td>
</tr>
<tr>
<td>10.A</td>
<td>Taxes paid by equal-income families: existing system</td>
<td>135</td>
</tr>
<tr>
<td>14.D</td>
<td>Taxable income and tax payable: unchanged rate schedule</td>
<td>197</td>
</tr>
<tr>
<td>14.E</td>
<td>Illustration of primary producer averaging</td>
<td>198</td>
</tr>
<tr>
<td>14.F</td>
<td>Illustration of marginal adjustment scheme</td>
<td>201</td>
</tr>
<tr>
<td>Appendix A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16.A</td>
<td>Number of resident company returns lodged and company tax paid</td>
<td>223</td>
</tr>
<tr>
<td>16.B</td>
<td>Combined rate of company and personal income tax under present ‘separate’ system, by size of 226 shareholder's income and proportion of profits retained</td>
<td>226</td>
</tr>
<tr>
<td>16.C</td>
<td>Combined rate of company and personal income tax under full imputation (A) and present 230 ‘separate’ system (B), by size of shareholder's income and proportion of profits retained</td>
<td>230</td>
</tr>
<tr>
<td>16.D</td>
<td>Mechanics of partial imputation system with dividend tax credit of one-quarter of the dividend received: company tax rate 50 per cent and 50 per cent distribution of after-tax profits</td>
<td>235</td>
</tr>
<tr>
<td>16.E</td>
<td>Mechanics of partial imputation system with dividend tax credit of one-third of the dividend received: company tax rate 50 per cent and 50 per cent distribution of after-tax profits</td>
<td>236</td>
</tr>
<tr>
<td>Section</td>
<td>Description</td>
<td>Page</td>
</tr>
<tr>
<td>---------</td>
<td>------------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>23.A</td>
<td>Inflation and capital gains: period of holding</td>
<td>417</td>
</tr>
<tr>
<td>23.B</td>
<td>Spreading of capital gains</td>
<td>421</td>
</tr>
<tr>
<td>23.C</td>
<td>Non-spreading of capital gains</td>
<td>421</td>
</tr>
<tr>
<td>24.A</td>
<td>Death and gift duties: revenue statistics</td>
<td>439</td>
</tr>
<tr>
<td>27.A</td>
<td>Taxes on goods and services, by categories of expenditure and estimated split between excise duty and sales tax, 1970–71</td>
<td>512</td>
</tr>
<tr>
<td>27.B</td>
<td>Estimated personal expenditure on services at retail level, 1970–71</td>
<td>516</td>
</tr>
<tr>
<td>27.C</td>
<td>Value-added taxes in Europe</td>
<td>519</td>
</tr>
</tbody>
</table>
PREFACE

On 11 April 1972 the then Treasurer (the Right Honourable B. M. Snedden, Q.C.) announced that the Government had decided to institute a full-scale public inquiry by a Committee to be appointed into the operation of the taxation system which would put the Government in a position to have an overall look at tax policy.

On 18 May 1972 the then Treasurer announced that the Government had drawn up the following terms of reference for the inquiry:

1. The functions of the Committee of Inquiry are—

(a) to examine and inquire into the structure and operation of the present Commonwealth taxation system;
(b) to formulate proposals for improving the Commonwealth taxation system, either by way of making changes in the present system, abolishing any existing form of taxation or introducing new forms of taxation; and
(c) to report to the Treasurer of the Commonwealth accordingly.

2. The Committee of Inquiry shall, in carrying out its functions, do so in the light of the need to ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth and have regard to—

(a) the effects of the present Commonwealth taxation system, and of any proposals formulated by the Committee, upon the social, economic and business organisation of the community and upon the economic and efficient use of the resources of Australia; and
(b) the desirability of the Commonwealth taxation system being such that, so far as is practicable, there is a fair distribution of the burden of taxation, and revenue is raised by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense.

3. For the purposes of these terms of reference, the present Commonwealth taxation system shall be taken to be the system under which the Commonwealth raises revenue by means of the following forms of taxation:—

Income Tax
Sales Tax
Estate Duty
Gift Duty
Duties of Excise imposed for the purpose of raising general revenue, and
duties of Customs that correspond with duties of Excise so imposed.’

On 14 August 1972 the Honourable Mr Justice K. W. Asprey, a Judge of Appeal of the Supreme Court of New South Wales, was appointed as Chairman of the Committee and subsequently on 10 September 1972 the following persons were appointed as members of the Committee:

Mr D. M. Bensusan-Butt, M.A.
Sir Peter Lloyd, M.A.
Professor R. W. Parsons, B.A., LL.B.
Mr Kenneth Wood, F.C.A.

and Mr M. C. Kahl, A.A.S.A., was appointed as Secretary of the Committee.

The first meeting of the Committee was held on 14 September 1972. Possession of the premises of the Committee at 107 Pitt Street, Sydney, was taken on 23 October 1972.

Because of the pressure of other commitments Mr Bensusan-Butt resigned from the Committee shortly after the completion of the preliminary report on 1 June 1974. Mr Bensusan-Butt made a reservation to the then Chapter 9 of the preliminary report dealing with capital gains. In view of the change in the form of that chapter (now Chapter 23), this reservation has not been repeated in this report. The Committee desires to acknowledge its indebtedness to Mr Bensusan-Butt for the part played by him in the preparation of the preliminary report.

The Committee advertised widely throughout Australia calling for written submissions to be made to it. The form of the advertisement appears on page 533.

Advertisements were inserted in the press and journals with an extensive coverage in October and November 1972 and in February 1973. The Committee also wrote to a great many individuals, companies and representative bodies and organisations specifically inviting them to make submissions to the Committee.

Originally the Committee asked for submissions to be forwarded by 31 March 1973 but this date was subsequently extended and during the period for forwarding submissions the Committee on several occasions obtained press coverage publicising the closing date for submissions.

The Committee, in answer to inquiries, made known that it was prepared to confer with any person or body desirous of making a submission with a view to rendering assistance as to the format of a submission and a number of persons and bodies were interviewed by the Committee for this purpose.

The Committee received in all 605 written submissions and had the opportunity of conference and discussion with certain authors of submissions. Many of these are very substantial documents showing that much time and expense were devoted to their preparation. A list of those persons, organisations and companies who made submissions to the Committee appears on p.535. The Committee also received a number of submissions on a confidential basis.

The Committee desires to thank all those who have made submissions to it and those who have also given of their time to confer with the Committee in person.

In addition to seeking written submissions, the Committee has commissioned studies by experts in special fields where it was considered that their views would be of great assistance to the Committee. Other studies have been prepared for the
use of the Committee in its deliberations and reference to these is made in various places in the report. The Committee desires to thank all those who have assisted it in this fashion. A list of studies which their authors agree may be published appears at p.547 of this report. It must be clearly understood that these studies are not a part of the Committee's report and the Committee takes no responsibility for their contents which represent the personal views of their authors.

The Committee has received from the Treasury and the Taxation Office a series of well-balanced and informative background studies prepared by senior officers on a wide variety of subjects. Though these studies did not, of course, make recommendations to the Committee, they have been of considerable assistance in its deliberations. Thirteen of these studies have been published by the Government for public information and a list of these appears on p.549 of this report.

The Committee desires to record its thanks and appreciation to the Secretary of the Treasury (Sir Frederick Wheeler, C.B.E.), the Commissioner of Taxation (Sir Edward Cain, C.B.E.) and their officers for their ready assistance at all times in supplying information to the Committee concerning the administration and operation of the taxation legislation. The Committee also wishes to express its appreciation of the continuous help and co-operation afforded to it by the Second Commissioner (Mr W. J. O'Reilly, O.B.E.) who acted throughout as a liaison between the Committee and the Treasury and the Taxation Office.

Apart from its investigation of the relevant taxation statutes of the Australian Parliament and the Parliaments of the several States, the Committee has also given consideration to the appropriate taxation systems of the United Kingdom, Canada, New Zealand, South Africa, the United States, and a number of the countries of Europe and South America. It has obtained information as to operation of these systems by various means and desires to thank all those who have supplied this material. Lastly the Committee has had the benefit of reports, articles and commentaries on practically every aspect of taxation from other commissions of inquiry, taxation experts in Australia, and in the other countries mentioned above.

The professional staff of the Committee has included lawyers, accountants and economists. Throughout the life of the Committee its numbers have fluctuated but a complete list of the persons who have served as members of the professional staff is appended at p.551 The Committee is keenly appreciative of the work performed for it by its professional staff and desires to thank them for the indispensable services and assistance given by its members to the Committee.

The Committee also desires to thank those professional firms, universities and other organisations which at inconvenience to themselves so readily made available to the Committee the persons who constituted its professional staff. A list of the professional firms, universities and organisations which greatly aided the Committee in this connection appears on p.551.

The Committee also acknowledges the assistance which it has received from its general services staff who at all times worked so well in the duties undertaken by its members. A list of these appears on p.551.

The Chairman also wishes to thank his Associate (Mrs Jean Johnson) and his Tipstaff (Mr D. R. Parker) for their cheerful and constant help to him during
holiday periods in addition to the usual working weeks.

The Committee wishes to acknowledge a special debt of gratitude to its Secretary, Mr M. C. Kahl, A.A.S.A., upon whom a great burden of the work of this Committee has fallen from the commencement to its conclusion. Without the whole-hearted devotion and efficiency at all times of Mr Kahl, the Committee would not have been able to complete its work by this date.

A similar acknowledgement of the indebtedness of the Committee must be made in respect of the invaluable work performed by its Chief Economist, Mr A. H. Boxer, B.A., B.Phil., upon whom a great burden of the work has also fallen. At all times Mr Boxer carried out his work for the Committee without regard to hours or to his own personal convenience.

Following upon the change of Government resulting from the Federal election on 2 December 1972, the present Government in office confirmed the continuation of the Committee's work. The Committee agreed in February 1974 after some earlier discussion to a request by the then Treasurer (the Honourable Frank Crean) to make a preliminary report so as to place before the Government by 1 June 1974 the Committee's views as at that date of some of the broad alternatives in relation to tax reform, having regard to the presentation of the Budget for 1974-75. Accordingly, the preliminary report was submitted on the understanding that it would be treated on the same confidential basis as any other document prepared in conjunction with the framing of the Budget.

The committee then emphasised that this was a preliminary report only and that many of the opinions in it were at that stage necessarily either provisional or expressed only in a broad-brush way to be filled out in greater detail in the full report. This was also apparent from the manner in which a number of the Committee's views were expressed.

The Committee had concluded its deliberations more particularly upon Chapter 23 of this report (Capital Gains Tax) and had arrived at its decision to recommend deferral of this tax prior to the announcement made on 29 January 1975 that the Government's plans for the introduction of a capital gains tax had been postponed. No attempt has been made in the discussions and recommendations of this report to take account of this change in the Government's policy.

Where there is not unanimous agreement upon the recommendations contained in any chapter of this report, a reservation by a member or members appears at the end of that chapter.

It must be clearly understood that this report supersedes the preliminary report, although it contains a large proportion of the material which appeared in the preliminary report.

In conclusion, the Committee would like to make it clear that, in undertaking a task of such magnitude, set by its terms of reference, it has always had a full realisation that it was entering upon a field in which controversy will never cease and that, upon the issues of taxation and economic policies which are inextricably interwoven in all questions of the reform of a taxation structure in any country, opinions as to the true and best path to follow will invariably differ. The history of every committee of inquiry into a taxation system is proof enough of that fact.
Accordingly, this Committee expresses the hope that, out of the discussions which appear and the recommendations which are contained in this report and from the disputation which will inevitably follow upon its publication, a fairer, simpler and more efficient taxation system will eventually emerge than the one which presently produces the revenue for the Australian Government.

K. W. Asprey
Chairman
J. P. D. Lloyd
Ross W. Parsons Members
K. Wood
31 January 1975

¹These are collected in a companion volume: Taxation Review Committee, Commissioned Studies (Australian Government Publishing Service, Canberra, 1975).
Taxation Review Committee
Chapter 1 The need for Tax Reform

I. Reasons for a Review

1.1. There are a number of distinguishable, though overlapping, reasons why a broad review of the Australian tax system is timely.

1.2. There has been nothing approaching such a review since two Royal Commissions on Taxation, the Warren Kerr Commission (1921–23) and the Ferguson Commission (1932–34), reported. Several Commonwealth Committees on Taxation were set up in the 1950s—the Spooner Committee (1950–54), the Hulme Committee (1954–55) and the Ligertwood Committee (1959–61)—but each was restricted by its terms of reference to aspects of income tax. Even if, as is not the case, the Australian system were generally agreed to be as satisfactory as any tax system is ever admitted to be, a periodic thorough inspection would be as wise a precaution in this area of affairs as in any other.

1.3. Many of the key features of the present tax system were introduced in the 1930s and 1940s for good short-term reasons connected with the Depression and World War II, without much thought to their longer-run implications. This is true, for instance, of the adoption of sales tax in 1930, of the discontinuance in 1940 of company tax rebate on dividends to individuals, and of the introduction in 1941 of payroll tax (now under the control of the States) and Federal gift duty. Three decades or more later it is reasonable to examine the permanent consequences of these changes as well as to take stock of the piecemeal accumulation of minor changes that have since occurred. The present Australian fiscal legislation is best viewed more as an historical growth than as a system in the sense of a deliberately conceived and integrated structure in which every part has a defined role to play. The Anglo-Saxon tradition is to adapt slowly; but a periodical re-examination of the logic of what has grown up remains appropriate.

1.4. The wide range of tax structures to be found in countries with economic, social and political systems not unlike Australia's, to which reference is again made in Chapter 2, points to a variety of experiences from which much can obviously be learned, whether as precept or warning. If one wishes to choose between foreign models there are indeed many from which to make a selection. Stimulating too, though somewhat intimidating, is the long row of reports and studies produced overseas in the last few years, notably the six volumes and thirty accompanying studies of the Canadian Royal Commission on Taxation (Carter Commission,
1966), the report of New Zealand's Taxation Review Committee (Ross Committee, 1967), the several reports of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa (Franzsen Commission, 1969–70), a series of Green and White Papers and Select Committee reports on various tax changes under consideration in the United Kingdom, and the many volumes of evidence submitted to the 1969 and 1973 Congressional hearings on tax reform in the United States.

1.5. Of more immediately pressing significance is the increasing discontent with the existing system. A decade ago four economists from Australian universities published a book entitled *Taxation in Australia: Agenda for Reform*, under the auspices of the Social Science Research Council. Their study, though traversing much that the present report has to cover, attracted little public attention. The 600 or so submissions received by the Committee reveal a less ready acceptance of the existing system. While few of these submissions discuss taxation in the broad, and many deal with quite small points of detail, collectively they reveal widespread and lively criticism. No doubt the impact of a rapid rate of inflation and the upward trend in government spending with its accompanying increases in the overall level of taxation partly account for this shift in public attitudes, but there is certainly revealed also the existence of a number of anomalies and inequities, many very real, in the tax system we now have.

1.6. The two factors just mentioned—inflation and the rising trend of government expenditure—provide further reasons for the urgency of a radical discussion of tax reform. The Australian tax structure was not designed for, and is still not adapted to, an economy in the throes of inflation. The implications of inflation warrant separate detailed examination and discussion is postponed to Chapter 6. Present comment is directed to the other factor—the increase in government spending.

1.7. A great part of the sharply rising totals of government expenditure, referred to again in Chapter 2 where statistics are given, can be explained by the rising unit costs of normal government expenditure of all kinds and the increase in population. But not of course all, since expenditure has also been increasing as a proportion of gross national product. The existence of this trend, and its likely future, are an important factor in tax policy.

1.8. The Committee's terms of reference instruct it to have regard to 'the need to ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth'. This may be taken to exclude from this report any substantial discussion of the relative place of taxation and borrowing in the overall public finances of Australia. But it may be noted that in some countries government capital expenditure is financed almost exclusively from borrowing, leaving taxes to cope with current needs. In
Australia, however, a sizeable fraction of government investment is met from taxation. Were this fraction to be lowered and the fraction represented by borrowing correspondingly raised, the pressure for increasing taxation would be that much relieved. However, whether such a further lowering would be practicable over the years ahead is not something the Committee is competent to judge, involving as it does issues of economic policy and monetary management that go beyond its terms of reference. But the point deserves to be noted.

1.9. Even if rather more borrowing is resorted to, it is virtually certain that government spending will continue to increase as a percentage of gross national product. This has recently been happening in Europe and appears to be nearly universal: the varying political complexions of governments, it would seem, do no more than cause some dispersion in the speed of the growth.

1.10. In Australia, as summary figures in Chapter 2 serve to remind us, both the main overall categories of public expenditure—on goods and services involving a shift in real resources from the private to the government sector, and on transfer payments chiefly in the form of cash social service grants—have been gradually, if not quite steadily, rising as a proportion of gross national product for many years. They will do so again in the current financial year, and it is reasonable to assume that the upward trend will continue over the next few years. The Committee is aware that a number of commissions and inquiries are at work or have recently made recommendations in such fields as the relief of poverty, national superannuation, compensation for injury, illness or disability, and resource matters, all of whose findings are likely to invite consideration of measures that will make very large demands upon public revenue. It is conscious that it has to recommend a structure of taxation capable of meeting present and future revenue needs.

II. Committee's Approach

1.11. In presenting its findings, the Committee could adopt one of two approaches. Either it could go through the provisions of the legislation as it now stands, stating its immediate and long-term proposals about the revision of each Act, explaining in some detail its suggestions for additional legislation, and letting the broad picture of the implications of the whole set of reforms emerge gradually; or it could first settle the broad outline of the kind of tax system it would like to see established eventually and work back from that to the changes in the present system that would have to be made before that long-term aim could be realised.
1.12. The second approach has been adopted as the Committee believes that this will prove the more useful procedure. There are some detailed areas of tax legislation that the Committee has not fully explored. It is also, of course, uninformed of many of the short-term pressures and constraints under which the Australian Government must labour, as all governments must always labour. If it advanced precise proposals for immediate adoption, and especially if it gave them exact numerical content, many would be likely to turn out, in the event, to be untimely. In matters of taxation, committees of inquiry are ill-advised to offer neat time-tables and precise rates or quantities. Moreover, and above all, when a tax system becomes somewhat ossified and somewhat incoherent as has the Australian, and when rather sweeping reforms are under consideration, much public discussion and understanding are essential before large changes can be attempted. Structural reforms will inevitably take some years to implement, rate changes have to be made gradually as the circumstances of the day permit, and transitional problems of much intricacy have to be solved at every point. A proper appreciation of the ultimate aims of what is being proposed requires a presentation that in the first place is in terms of general principles rather than legal or quantitative detail. Strategy comes before tactics.

1.13. Hence in this report the Committee will reach its conclusions by first discussing the long-term aims of tax reform of a general but not, it is hoped, unduly abstract kind. This will occupy Chapters 3–5, after a brief descriptive survey in the next chapter. Chapter 3 will examine the competing criteria of merit for individual taxes and tax systems; Chapter 4 will describe and debate the issues surrounding the central problem of the right progressivity of the tax system as a whole; Chapter 5 will outline the prime options of direction for long-term reform from which, in the Committee's view, a choice needs to be made, and state the Committee's own preference. Inflation has major implications both for long-term reform and for immediate tax revision, and these will be identified and discussed in Chapter 6. Then a succession of chapters will examine existing and possible taxes with respect to some changes that should be made as soon as possible, to others that would have to be effected gradually if the Committee's recommended strategy were to prove acceptable. In the final chapter, a brief restatement of the matters covered in the earlier chapters is presented.

1.14. By its terms of reference the Committee's attention is confined to the taxes imposed by the Australian Government and it has not therefore closely examined the taxes levied by other authorities in this country. It has, however, taken these taxes into account when viewing the tax system
as a whole and will need at a number of points to mention particular areas where the several tax systems crucially impinge on one another.

1.15. One further point. In a review that touches on basic issues about what society wants and does not want its taxation system to do, the Committee must be deliberately tentative in those of its recommendations whose merit turns upon social and political judgments about which there can never be one right answer. It should not pretend to replace the political process or suggest the exact compromises that may have to be made. At the same time it should hope to clarify the factual basis upon which these value judgments ought to be founded, and to draw attention to gaps in the information when these are particularly important.
Chapter 2 The Australian Tax System in Perspective

2.1. This report concerns the future of the tax system rather than its past, but it is helpful in considering what lies ahead to have some slight perspective on what has gone before. It is the Australian system being examined and not overseas ones, but a greater awareness of the possibilities of change is provoked if the Australian system is compared with those of other prosperous countries with kindred political and social institutions. This chapter therefore provides short descriptive accounts of these matters, designed merely as background.

I. Historical Perspective

2.2 In 1973–74 the various governments in Australia between them raised over $13,750 million in taxes. The figure had been gradually, though not continuously, climbing to this total ever since Federation, with the increase in population, in money income per head, and in the range of government activities. Some salient statistics, revealing among other things the lasting impact two major wars have had on the level and pattern of taxes and on the Australian Government's share of them, are given in Table 2.A.

TABLE 2.A: TAX REVENUE: SELECTED YEARS SINCE 1901–02 ($ million)

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<td>1,339</td>
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<tr>
<td>Total</td>
<td>1</td>
<td>3</td>
<td>33</td>
<td>52</td>
<td>84</td>
<td>559</td>
<td>1,339</td>
<td>2,724</td>
<td>7,523</td>
</tr>
<tr>
<td>Other domestic</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australian Gov.</td>
<td>3</td>
<td>4</td>
<td>22</td>
<td>34</td>
<td>66</td>
<td>300</td>
<td>1,011</td>
<td>1,493</td>
<td>2,810</td>
</tr>
<tr>
<td>State &amp; local</td>
<td>9</td>
<td>12</td>
<td>25</td>
<td>64</td>
<td>72</td>
<td>146</td>
<td>523</td>
<td>967</td>
<td>2,830</td>
</tr>
<tr>
<td>Total</td>
<td>12</td>
<td>16</td>
<td>47</td>
<td>98</td>
<td>138</td>
<td>446</td>
<td>1,534</td>
<td>2,460</td>
<td>5,640</td>
</tr>
<tr>
<td>Tariff revenue</td>
<td>15</td>
<td>19</td>
<td>23</td>
<td>59</td>
<td>62</td>
<td>155</td>
<td>168</td>
<td>275</td>
<td>605</td>
</tr>
<tr>
<td>Total taxes</td>
<td>28</td>
<td>38</td>
<td>103</td>
<td>209</td>
<td>284</td>
<td>1,160</td>
<td>3,041</td>
<td>5,459</td>
<td>13,768</td>
</tr>
<tr>
<td>Tax per adult ($)</td>
<td>13</td>
<td>15</td>
<td>33</td>
<td>54</td>
<td>62</td>
<td>216</td>
<td>479</td>
<td>758</td>
<td>1,655</td>
</tr>
</tbody>
</table>

(a) Estimate only.
2.3. These figures can be better understood, and be more readily acceptable to those who pay taxes, if they are related to the growth of the economy as a whole, as reflected in estimates of gross national product, and to a broad classification of the multifarious uses made of tax revenue. Statistics for the more distant past are not, however, readily available. In rough terms, the total taxes as a proportion of gross national product have risen from 6 per cent in the initial years of Federation, to 9 per cent in the early 1920s, 16 per cent by the end of the 1930s, and 24 per cent at the height of World War II. More trustworthy estimates are available for less distant years and these, with some figures for the main uses of taxation, have been assembled in Table 2.B. They show that while taxes remained a fairly stable proportion of gross national product during the 1950s—at around 22–23 per cent, the proportion was only a little lower than the wartime peak—they have recently been gaining ground and now correspond to over 27.5 per cent of gross national product. Government spending presents a similar picture.

### TABLE 2.B: TAXATION AND ITS USES: ALL LEVELS OF GOVERNMENT SELECTED YEARS SINCE 1949–50

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total taxation</td>
<td>$1,160</td>
<td>$2,184</td>
<td>$3,041</td>
<td>$4,622</td>
<td>$7,722</td>
<td>$13,768</td>
</tr>
<tr>
<td>Uses—</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current goods and services</td>
<td>$426</td>
<td>$941</td>
<td>$1,323</td>
<td>$2,066</td>
<td>$3,677</td>
<td>$6,869</td>
</tr>
<tr>
<td>Transfer payments(a)</td>
<td>$520</td>
<td>$811</td>
<td>$1,230</td>
<td>$1,872</td>
<td>$2,900</td>
<td>$4,978</td>
</tr>
<tr>
<td>Contribution to government investment(b)</td>
<td>$214</td>
<td>$432</td>
<td>$488</td>
<td>$684</td>
<td>$1,145</td>
<td>$1,921</td>
</tr>
<tr>
<td>Percentage of gross national product(c)—</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxation</td>
<td>22.8</td>
<td>22.8</td>
<td>22.2</td>
<td>23.6</td>
<td>25.9</td>
<td>27.7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government expenditure on goods and services (current and capital)</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total government expenditure (including transfer payments)</td>
<td>26.8</td>
<td>27.4</td>
<td>29.6</td>
<td>31.4</td>
<td>31.5</td>
</tr>
<tr>
<td>Contribution of taxation to government investment as per cent of government investment</td>
<td>51.0</td>
<td>49.6</td>
<td>40.2</td>
<td>36.9</td>
<td>41.6</td>
</tr>
</tbody>
</table>

(a) Includes cash benefits to persons by way of social services, unfunded employee retirement benefits, subsidies to producers, interest paid, grants for private capital purposes, and transfers overseas. (b) Equivalent to excess of taxation over current disbursements. Other sources of finance of government investment are mainly loan raisings and operating surpluses of government businesses: they account for the difference between the percentage figures for taxation and those for total government expenditure (including transfer payments) given later in the table. (c) Gross national product has recently been re-labelled gross domestic product in accord with international convention. To avoid confusion, however, the earlier terminology is used in this chapter and elsewhere. (d) It must be emphasised that these figures relate to all levels of government. In fact the Australian Government in recent years has been in a position to meet all its investment requirements from
2.4. One of the key issues examined in this report concerns the tax mix. Recent trends for the principal taxes levied by the Australian Government are summarised in Table 2.C. Undoubtedly the most striking feature of this table is the mounting importance of personal income tax. In 1973–74 just over half of the Australian Government's tax revenue derived from personal income tax and the figure is expected to be close to 55 per cent in 1974–75, whereas scarcely a dozen years ago personal income tax accounted for little more than a third of revenue.

**TABLE 2.C: AUSTRALIAN GOVERNMENT TAXES: SELECTED YEARS SINCE 1949–50**

<table>
<thead>
<tr>
<th>Year</th>
<th>Income tax—Persons</th>
<th>Income tax—Companies</th>
<th>Estate and gift duty</th>
<th>Customs duties</th>
<th>Excise duties</th>
<th>Sales tax</th>
<th>Payroll tax(b)</th>
<th>Other(c)</th>
<th>Total</th>
<th>Percentage of total taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949–50</td>
<td>392</td>
<td>167</td>
<td>14</td>
<td>155</td>
<td>132</td>
<td>85</td>
<td>45</td>
<td>24</td>
<td>1,014</td>
<td>38.7</td>
</tr>
<tr>
<td>1954–55</td>
<td>720</td>
<td>343</td>
<td>22</td>
<td>202</td>
<td>286</td>
<td>201</td>
<td>83</td>
<td>17</td>
<td>1,874</td>
<td>38.4</td>
</tr>
<tr>
<td>1959–60</td>
<td>884</td>
<td>455</td>
<td>32</td>
<td>168</td>
<td>504</td>
<td>328</td>
<td>110</td>
<td>37</td>
<td>2,518</td>
<td>35.1</td>
</tr>
<tr>
<td>1964–65</td>
<td>1,569</td>
<td>722</td>
<td>49</td>
<td>268</td>
<td>631</td>
<td>363</td>
<td>150</td>
<td>67</td>
<td>3,819</td>
<td>41.1</td>
</tr>
<tr>
<td>1969–70</td>
<td>2,855</td>
<td>1,187</td>
<td>80</td>
<td>414</td>
<td>939</td>
<td>569</td>
<td>230</td>
<td>76</td>
<td>6,380</td>
<td>44.7</td>
</tr>
<tr>
<td>1973–74</td>
<td>5,490</td>
<td>2,033</td>
<td>76</td>
<td>605</td>
<td>1,555</td>
<td>969</td>
<td>8</td>
<td>67</td>
<td>10,938</td>
<td>50.2</td>
</tr>
<tr>
<td>1974–75</td>
<td>7,966</td>
<td>2,566</td>
<td>77</td>
<td>770</td>
<td>1,765</td>
<td>1,105</td>
<td>12</td>
<td>258</td>
<td>14,519</td>
<td>54.9</td>
</tr>
</tbody>
</table>

**Source:** Australian Bureau of Statistics publications; 1974–75 Budget Papers.
2.5. The complexity of the Australian tax system is one of the matters to which the Committee is expected to address itself. The simple facts of the numbers of taxpayers involved with income tax are given in Table 2.D: particularly significant is the very rapid growth in the proportion of adult females subject to income tax and in the numbers of partnerships and private companies. Some other facts are worth noting too. More than 80 amending Acts have altered or been added to the principal Income Tax Assessment Act since it first came into operation in 1936; as a result the 1936–1973 Act now extends to 526 pages, six times its original length.

<table>
<thead>
<tr>
<th>Excise duties</th>
<th>13.0</th>
<th>15.3</th>
<th>20.0</th>
<th>16.5</th>
<th>14.7</th>
<th>14.2</th>
<th>12.2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales tax</td>
<td>8.4</td>
<td>10.7</td>
<td>13.0</td>
<td>9.5</td>
<td>8.9</td>
<td>8.9</td>
<td>7.6</td>
</tr>
<tr>
<td>Payroll tax (b)</td>
<td>4.4</td>
<td>4.4</td>
<td>4.4</td>
<td>3.9</td>
<td>3.6</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Other (c)</td>
<td>2.4</td>
<td>0.9</td>
<td>1.5</td>
<td>1.8</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

(a) Estimate (1974–75 Budget). (b) Payroll tax was transferred to the States in 1971. The Australian Government now collects payroll tax only in its own territories. (c) Including stamp duty (Australian Capital Territory and Northern Territory); wool contributory charge and tax; wheat export charge and tax; stevedoring industry charge; radio and television licences (now abandoned); fees, fines, etc.

Practitioners' textbooks explaining the operation of the Act are today printed in four or more volumes instead of one. In 1973–74 a total of 54,401 objections were lodged against income tax assessments, 350 cases transmitted to Boards of Review, and 31 taxation appeals (mostly income tax cases) decided by the High Court or State Supreme Courts. The several Acts covering Federal estate and gift duty occupy nearly 60 pages, while the sales tax legislation is covered in 220 pages. Significant changes have been made in sales tax exemptions since 1936, with the result that the publication containing relevant sales tax rulings now runs to over 700 pages. The handbook, *Commonwealth Sales Tax*, has been expanded in length to give rulings and explanations of the application of the sales tax laws to new manufacturing processes. While all this may be necessary, it deserves continuous review.


<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals —</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male (million)</td>
<td>2.7</td>
<td>3.2</td>
<td>3.6</td>
</tr>
<tr>
<td>per cent of adult males (a)</td>
<td>90</td>
<td>93</td>
<td>91</td>
</tr>
<tr>
<td>Female (million)</td>
<td>1.0</td>
<td>1.5</td>
<td>2.1</td>
</tr>
<tr>
<td>per cent of adult females (a)</td>
<td>34</td>
<td>43</td>
<td>51</td>
</tr>
<tr>
<td>Total (million)</td>
<td>3.7</td>
<td>4.6</td>
<td>5.7</td>
</tr>
<tr>
<td>per cent of adults (a)</td>
<td>63</td>
<td>67</td>
<td>71</td>
</tr>
<tr>
<td>'000 '000 '000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partnerships</td>
<td>155</td>
<td>301</td>
<td>413</td>
</tr>
<tr>
<td>Trusts</td>
<td>65</td>
<td>108</td>
<td>113</td>
</tr>
<tr>
<td>Companies: (b)—</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private (c)</td>
<td>23</td>
<td>55</td>
<td>87</td>
</tr>
<tr>
<td>Public</td>
<td>6</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Total (d)</td>
<td>31</td>
<td>71</td>
<td>105</td>
</tr>
</tbody>
</table>

(a) Aged 20 and over. (b) Taxable companies only. (c) There are also large numbers of nontaxable private companies. In 1954–55 there were 11,595 such companies; by 1971–72 the figure had risen to 84,089. (d) Including non-profit companies, co-operatives and special section assessments.
II. International Perspective

2.6. In almost any field of human endeavour international comparisons are difficult to make and liable to be misleading. The area of taxation is no exception. Fortunately, however, international organisations nowadays have large and expert staffs making such comparisons and over the last few years the Organisation for Economic Co-operation and Development (OECD) has been assembling an impressive range of tax statistics covering all twenty-four member countries. The statistics for Australia, which joined OECD in 1971, have been recast in a form comparable with that of most of the countries with which it is interesting to make comparison. The latest document, *Revenue Statistics of OECD Member Countries 1965–71*, provides a rich hoard of information some of which is summarised in Table 2.E for the earliest and latest years available. The figures are necessarily a little out of date.

2.7. It will be seen that Australia is lightly taxed by international standards, 26.6 per cent of gross national product being taken in tax in 1971 compared with the OECD average of 31.8 per cent. The picture changes somewhat if social security contributions are excluded from the comparison, as Australia is the only country represented in Table 2.E without a separate social security contribution. But, being compulsory levies and a substitute for higher taxation, such contributions should probably not be excluded, unless that fraction of Australian taxation spent on social security is also excluded. However, social security finance is a complex issue on which more will be said in Chapter 13.

2.8. Whether the comparison is made with or without social security contributions, one thing is apparent: the tendency for taxes to rise as a fraction of gross national product, noted already in relation to Australia, is a world-wide phenomenon. In all the countries shown in the table that might be described as modern welfare states, taxes (including social security contributions) now account for a third or more of gross national product.

2.9. Table 2.E illustrates the considerable diversity of tax patterns. It is particularly noticeable that, by international reckoning, Australian income tax (especially on companies) is a heavy impost. So too are the miscellaneous levies grouped under ‘other taxes’, a fact to be explained not by any peculiarity of the Australian Government's own tax system but by the very large measure of reliance by State and local governments on

*Source: Taxation Statistics, various issues.*
stamp duties, property taxes and (in more recent years) payroll tax. By contrast, taxes on goods and services feature less prominently than they do in many countries and, as mentioned already, social security contributions fail to feature at all. In one major respect—the shift towards personal income tax—Australian experience since 1965 parallels the trend of events overseas. On the other hand, the share of company tax has not been diminishing in this country in the way that it has been elsewhere.

**TABLE 2.E: INTERNATIONAL TAX COMPARISONS: OECD COUNTRIES, 1965 AND 1971**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of total taxes</th>
<th>Taxes on goods and services</th>
<th>Income tax: persons</th>
<th>Income tax: companies</th>
<th>Social security contributions</th>
<th>Other taxes (a)</th>
<th>Total taxes as percentage of gross national product</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965—</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>34.3</td>
<td>33.9</td>
<td>15.6</td>
<td></td>
<td></td>
<td>16.2</td>
<td>23.9</td>
</tr>
<tr>
<td>Average of 22 OECD countries(b)</td>
<td>36.7</td>
<td>24.7</td>
<td>8.5</td>
<td>20.4</td>
<td>9.7</td>
<td>27.7</td>
<td></td>
</tr>
<tr>
<td>1971—</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selected OECD countries—</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>31.6</td>
<td>36.9</td>
<td>16.6</td>
<td></td>
<td></td>
<td>14.9</td>
<td>26.6</td>
</tr>
<tr>
<td>Canada</td>
<td>33.0</td>
<td>33.9</td>
<td>10.2</td>
<td>8.2</td>
<td>41.9</td>
<td>6.7</td>
<td>35.6</td>
</tr>
<tr>
<td>France</td>
<td>35.5</td>
<td>10.1</td>
<td>5.8</td>
<td>41.9</td>
<td></td>
<td>6.7</td>
<td>35.6</td>
</tr>
<tr>
<td>Germany</td>
<td>29.7</td>
<td>26.9</td>
<td>4.5</td>
<td>33.8</td>
<td></td>
<td>5.1</td>
<td>34.5</td>
</tr>
<tr>
<td>Italy</td>
<td>36.9</td>
<td>11.7</td>
<td>6.9</td>
<td>37.9</td>
<td></td>
<td>6.6</td>
<td>30.9</td>
</tr>
<tr>
<td>Japan</td>
<td>22.3</td>
<td>24.0</td>
<td>18.8</td>
<td>20.0</td>
<td></td>
<td>14.9</td>
<td>20.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>26.7</td>
<td>27.2</td>
<td>7.0</td>
<td>35.6</td>
<td></td>
<td>3.5</td>
<td>42.2</td>
</tr>
<tr>
<td>Sweden</td>
<td>31.7</td>
<td>43.1</td>
<td>3.6</td>
<td>18.0</td>
<td></td>
<td>3.6</td>
<td>41.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>28.9</td>
<td>33.2</td>
<td>7.8</td>
<td>14.1</td>
<td></td>
<td>16.0</td>
<td>35.7</td>
</tr>
<tr>
<td>United States</td>
<td>20.2</td>
<td>33.7</td>
<td>10.4</td>
<td>20.7</td>
<td></td>
<td>15.0</td>
<td>27.8</td>
</tr>
<tr>
<td>Average of 22 OECD countries(b)</td>
<td>33.9</td>
<td>26.9</td>
<td>7.3</td>
<td>22.7</td>
<td></td>
<td>9.1</td>
<td>31.8</td>
</tr>
<tr>
<td>Australia's ranking</td>
<td>15th</td>
<td>4th</td>
<td>2nd</td>
<td>22nd</td>
<td></td>
<td>5th</td>
<td>16th</td>
</tr>
</tbody>
</table>

(a) ‘Other taxes’ include property taxes (e.g. local rates, land tax), stamp duties, wealth tax, death
2.10. Even these very summary figures show the Australian tax system to be somewhat untypical. It is revealed as still more so when one looks behind these broad categories to the exact kinds of taxes they contain. What Table 2.E does not reveal, for example, is that in many countries a broad-based value-added tax is the major domestic levy on goods and services, whereas Australia mainly relies on excise duties and wholesale sales tax which weigh heavily upon only a restricted range of goods and services. Again, unlike Australia, at least nine OECD countries impose an annual wealth tax, and the United Kingdom and Ireland are proposing to do so; on the other hand Australia has never levied a wealth tax. Also Australia is somewhat unusual in employing the ‘separate’ or ‘classical’ system of taxing companies and, until now, in not imposing capital gains tax.

2.11. Another feature of overseas experience, naturally not reflected in simple statistical tables, deserves special mention. Tax systems in many overseas countries have been drastically changing in recent years and are

Source:
still under active debate. In the United States, for example, earned income has been given relief in the form of a reduction in top marginal rates of tax. In Canada, capital gains tax has been introduced, significant changes in company tax have been made and personal income tax rates are now being indexed for inflation. In the United Kingdom, much too has recently happened or is being contemplated in the fields of capital gains and development gains taxes, company tax, taxation of goods and services, taxation of capital transfers, and wealth tax. Among recent developments elsewhere are Sweden's partial abandonment of the family as the taxpaying unit under income tax, a change in the form of company tax in West Germany, New Zealand's property speculation tax, and proposed new capital taxes for Ireland. Thus the tax reformer in Australia does not need to feel deprived of possibilities to explore.
Chapter 3 Criteria for Tax Systems

3.1. The Committee's task raises a number of issues of broad principle which are reviewed in this and the next two chapters. The present chapter begins with an interpretation and amplification of the terms of reference. These are not only broad in scope, but so general in language that some interpretation is necessary to clarify discussion.

I. Terms of Reference and their Interpretation

3.2. Throughout and repeatedly in the terms of reference the phrase ‘taxation system’ is used. This way of regarding a collection of administratively distinct taxes is of fundamental importance. In a complex modern economy where government expenditure is at a high level it is impossible to raise all the revenue needed from any single tax. Each tax will have its own distinct merits and defects when judged by the various criteria commonly applied to taxation. When several taxes are used they have to be seen as supplementing each other and their interactions—and sometimes their conflicts—have to be reckoned with. Whatever their individual characteristics it is their combined impact that must primarily concern the policy-maker. The complete set has therefore to be looked at as an integrated whole, even though before this can be done it is necessary to examine the parts that have to be linked together.

3.3. The Committee is directed to carry out its review of the existing taxation system ‘in the light of the need to ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth’. It was with this phrase in mind that the Committee, while drawing attention in paragraph 1.8 to the fiscal importance of the division between taxation and borrowing in the finance of government investment, refrained from offering views of its own on the merits of existing policies about this matter. It would certainly have lightened the load of the Committee's work if this proviso could have been taken to debar any discussion whatever of public expenditure. However, for at least two reasons this is impracticable.

3.4. Firstly, where tax stops and expenditure starts is often unclear. A tax concession to a particular area of spending in the private sector can as well be looked upon as an expenditure of revenue as a failure to collect it, and it is often an issue of importance to tax policy whether such concealed subsidies should not better be given overtly. Still more important is the point that cash transfers to individuals, the whole class of social service payments of every kind, are inextricably bound up with the equity of the
taxation system. The Committee certainly does not regard itself as qualified to advise upon the details of the social services, and is aware of other inquiries at work in this area. But some consideration of cash grants, taxable or otherwise, is essential in the design of an optimal tax system. They constitute a fiscal technique to which some attention will be given later, especially in chapters 12 and 13.

3.5. These problems aside, however, once revenue requirements are set there is no scope at all for reducing total taxation: the two are simply the same thing. By this phrase in its terms of reference the Committee is prohibited from suggesting any general set of measures that would necessarily reduce total taxation below revenue needs. The Committee is uninformed, and could not have been informed, of exact future requirements. Any proposal that, explicitly or implicitly, entails a reduction of present taxation in any particular area has to be matched with proposals that, explicitly or implicitly, approve increases in others. Though the great bulk of the submissions received by the Committee very naturally contain suggestions for lowering present taxation in particular areas, it has been the Committee's task in assessing the arguments offered to ask where the taxation forgone could be recouped more fairly, more simply and more efficiently. Only in Chapter 6, in the context of inflation control, has the Committee sought to refer to tax cuts in a somewhat wider setting.

3.6. The first of the more positive commands in the terms of reference bids the Committee to consider the effects of the taxation system ‘upon the social, economic and business organisation of the community’. This is a phrase with multiple connotations. It is probably helpful to separate these out and attach them to other rather more specific injunctions which follow. Thus, the Committee is to consider the effects of the system upon the ‘economic and efficient use of the resources of Australia’, the desirability that there should be a ‘fair distribution of the burden of taxation’, and that revenue-raising be ‘by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense’. For brevity, these aims may be referred to as efficiency, fairness and simplicity. However, each of the three when one seeks to define it closely proves to embrace several distinct qualities, and these qualities may conflict with each other in particular applications. Furthermore, each of the ‘big three’ criteria will often, in some respects, conflict with the others. In deciding the best overall tax system and in deciding between alternative provisions in particular taxes, the policy-maker comes repeatedly up against choices between simplicity and efficiency, or fairness and simplicity or fairness and efficiency. These are perhaps the hardest choices he has to make, or invite others to make. Hence
it is convenient to give here fuller discussion of the meanings of these simple-seeming terms.

**Fairness**

3.7. As a quality of a tax or a tax system everyone demands fairness, or equity (the terms will be used interchangeably). But, in tax matters as in law and ethics, it is an ideal exceedingly difficult to define and harder still to measure. It is customary to distinguish the two dimensions of ‘horizontal’ and ‘vertical’ equity: the notions that it is fair that persons in the same situation should be equally treated, and those in different situations differently treated, with those more favourably placed being required to pay more. Both expressions will have to be frequently employed in this report. They reflect the ‘ability to pay’ principle and as such tend to embody the idea that taxation is no more nor less than a sacrifice. As the Committee will record later, this is an idea that needs qualification if it is not to mislead. An alternative principle used in much recent academic discussion is that of ‘benefit’, which relates taxes to the benefits individuals are estimated to receive from government-provided goods and services. Except in a small number of cases where taxes take the form of fees or prices for the direct use of publicly-provided services by particular individuals (e.g. postal facilities), this principle is prohibitively hard to apply. In any case it abstracts altogether from notions of fairness, or implicitly embodies an interpretation of ability to pay that may not be socially acceptable. Hence the Committee argues in this report in terms of ability to pay, though the benefit principle has its place in the discussion of the Australian-origin income of non-residents (Chapter 17) and the taxation of goods and services (Chapter 27).

3.8. When we say that persons in equal situations should pay the same tax we probably say so because we think of the tax as a sacrifice levied upon some kind of private ‘economic well-being’. But the ‘economic well-being’ is a sequence of barely describable psychological states of a thoroughly immeasurable kind. For purposes of practical discussion and decision-making, both the ‘sacrifice’ by way of tax and the ‘well-being’ upon which the tax is levied have to be measured in money terms. Many of the most difficult questions in tax policy stem from the arbitrariness and convention that must be accepted when making this leap from the immeasurable to the measurable, from levels of ‘well-being’ to the choice and exact definition of the tax base.

3.9. It is usually taken for granted that the best available measure of an individual's ‘well-being’ is his income. The ‘burden of taxation’ is thought
of primarily in terms of the proportion of a man's income that goes in paying taxes, whether they be taxes levied formally on that income or indirectly by elements of tax in the price of the goods and services he buys. Horizontal equity is then taken to require that two persons with the same income pay the same taxes (at least in the first place and ‘other things being equal’), while vertical equity would require that, of two individuals with different incomes, the one with the larger should pay more by some correct amount.

3.10. Even when income is so regarded, there remain very great difficulties in finding an exact and workable definition of it for tax purposes, as the length of the Income Tax Assessment Act and its frequent amendment testify. The most important of these difficulties are surveyed in later chapters. There is evidently some discrepancy between the legal approach to this problem, which seeks to extend and refine the everyday meaning of ‘income’, and the more abstract approach adopted by many economists which generates a very much wider meaning.

3.11. A further problem arises over the question of the appropriate unit for tax purposes. Many would argue, for example, that in a family the ‘economic well-being’ of individual members is likely to be measured better either by the average or by the total income of the family members than by their separate incomes. Whether or not this is so is an extremely vexed question and is discussed in Chapter 10.

3.12. Irrespective of whether individual or family income is accepted as the appropriate starting-point, it is recognised that this cannot be the end of the matter. Further argument is required before it can be concluded that two individuals should pay identical taxes simply because their incomes are the same. They will certainly be dissimilar in a great many other respects. Some of these differences would be considered irrelevant for tax purposes by almost everyone (for example, sex, race, religion, and many other personal characteristics), but others (such as health and size of family) are widely felt to be very relevant indeed. But to decide which differences are which, and how much allowance for such things should be given in calculating tax liabilities must involve much nice judgment and many decisions of an arbitrary kind. The main problems are examined in Chapter 12.

3.13. Yet other problems arise because taxes are, in most cases, calculated and levied on the basis of annual magnitudes. This is of course necessary for the administration of the public sector, but the period of a year is arbitrary from the viewpoint of fairness. Those with incomes that vary from year to year will over several years pay more tax under a progressive system than others earning the same total income in an even
stream. This aspect of a very fundamental issue is widely recognised, and opportunities for ‘averaging’ are already provided for some groups for whom fluctuations are especially marked and unavoidable. But the deeper issues that arise here are not often thought about in explicit terms. In the Committee's view most people would agree on reflection that fairness mainly requires that taxation be the same for individuals whose total ‘well-beings’ are likely to be the same over their whole lifetimes and that too much importance should not be attached to temporal differences in the way ‘well-being’ is distributed, by choice or necessity, over adult years. Indeed, more than a single lifetime is relevant when the fairness of taxation upon an individual's capacity to do his duty to his heirs is considered. This lifetime perspective is not, of course, a practicable basis for taxation, but it has its implications for the structure of an inevitably annual system.

3.14. The custom of using income as the tax base is not inconsistent with this lifetime view of things. Over any short period, say a year, an individual's consumption undoubtedly reflects his ‘economic well-being’ better than does income. A man can, by consuming out of past savings or by borrowing against future income, achieve levels of ‘economic well-being’ much greater than his current income. For many, over a lifetime, total income and total consumption will be the same. In this sense, lifetime income will be a fairly good measure of an individual's ‘well-being’, whichever base is felt to be the fairer.

3.15. But a tax on income is not at all the same as a tax on consumption, even in lifetime terms. When a tax is levied on income, it falls on savings as well as consumption; and when income is earned from those savings in later years, that income too is taxed. This means that the effective tax rate imposed on consumption which is postponed is greater than the rate imposed on current consumption: income tax falls more heavily than consumption taxes on those who prefer to save a high proportion of their incomes and do more of their consumption later in their lives. But individuals may save for reasons other than to supplement consumption in later years: because they wish to bequeath to their heirs, or because the process of accumulating wealth yields ‘satisfactions’ which contribute to ‘well-being’ directly (and independently of any income wealth may bring in). Such motives for saving will be more significant at the upper end of the income scale; but certainly at the bottom end people will primarily save in order that they may consume more in future years (specifically in their old age). For the latter persons, taxation based on consumption is probably fairer than income taxation because it does not discriminate between individuals according to how they spread their consumption over their lifetimes. Higher up, horizontal equity may well be held to require not only
taxation of income but taxation of capital as well, and this quite apart from any desire to make the system fairer in a vertical sense.

3.16. Questions of equity are complicated by inflation, as is so much else. The discussion of equity starts from the idea that taxation is a sacrifice of ‘real’ private satisfactions (however much this may be offset by the satisfactions that public expenditure may simultaneously create). But taxes have to be levied in money terms. In the case of incomes from current effort, the distinction may not much matter since incomes and prices may go up simultaneously and tax rates can be adjusted to maintain the same underlying rate structure. However, a serious difficulty arises with property incomes. The real value and the real return on assets with variable money returns may indeed be maintained by rises in their money capital value and their money returns. But the real return on fixed-interest assets declines and their real capital values fall; until redemption is near, their money capital values also fall. With an income tax this latter fall is inadequately reflected in the tax liability. There is a consequent inequity of a horizontal kind; and since fixed-interest securities are often the main financial assets of lower income groups, there may be vertical inequities too. These inequities do not arise so conspicuously—if at all—under consumption taxation.

3.17. There are good reasons, therefore, why consumption might be preferred to income as the primary index of ability to pay. Some economists, notably Lord Kaldor, have found the reasons sufficiently compelling to justify abandoning personal income tax altogether and substituting a progressive expenditure tax. The Committee is not prepared to go this far, recognising as it does that an expenditure tax would probably be even more difficult to administer than personal income tax. But the philosophy underlying an expenditure tax has much to recommend it, and the Committee has allowed itself to be influenced by this philosophy in certain of its proposals, including those bearing on the tax treatment of income-protection insurance premiums (Chapter 7), investment income (Chapter 9), and superannuation and life insurance (Chapter 21).

3.18 The issues just mentioned relate primarily to horizontal equity. Problems of an equally intractable kind arise with vertical equity. Indeed, establishing the ‘right’ degree of progressivity by reference to the criterion of equity is so fundamental to tax policy, as regards both the set of taxes to be chosen and their rates, that it will need to be explored at length in the next chapter.

Simplicity
3.19 After equity, simplicity is perhaps the next most universally sought after of qualities in individual taxes and tax systems as a whole: like fairness it is a word that, in this context, points to a complex of ideas.

3.20 Two of these are explicitly stated in the Committee's terms of reference. A tax will be called simple, relatively to others, if for each dollar raised by it the cost of official administration is small, and if the 'compliance costs', the costs in money and effort of all kinds to the taxpayer, are also small. These two ideas are of course connected, and add up to much the same as the ancient canon of certainty. Both costs will be the less if assessor and assessed can each establish with certainty what is due: uncertainty entails the costs of consultation with experts and sometimes the yet greater costs of litigation. Both kinds of cost are increased, and certainty is endangered, when a tax, whether in the interests of equity or of efficiency, requires the drawing of fine distinctions between what is and what is not liable, and when these distinctions involve such uncertain ideas as ‘purpose’ or ‘value to the recipient’. Then the legal definitions get longer and longer and beyond the comprehension of those untrained in the law, and the relevant facts in particular cases become more and more disputable.

3.21. Two further aspects of simplicity require specific mention here. First, when (as is often unavoidable) a quite complex operation is needed before the administrators can make the assessment or the taxpayer can ascertain his liability, it is desirable that the tax be such that the taxpayer, for private purposes unconnected with tax, already needs to perform such operations. A tax on company income may be fairly regarded as a simple tax if the company already calculates its income or profits on the same or very similar basis. A tax on personal income is not a simple tax if it be so structured that many taxpayers who would not otherwise wish (or without hired help be able) to keep accounts at all, have to preserve many records and learn sophisticated accounting. The point, though obvious, is often forgotten.

3.22. A second observation is perhaps even more obvious and even more frequently forgotten. The fewer, per million dollars raised, are the individuals or organisations from whom tax is collected the simpler is a taxation system. The sheikdom that can raise all the revenue it requires (and maybe much more) from a single tax on a single oil company has what is unquestionably the simplest tax system of all.

Efficiency

3.23. The ‘economic and efficient’ use of national resources is of course
a longstanding and by now almost conventional objective of public policy: the phrase was long central to the terms of reference of the Tariff Board and is now in those of the Industries Assistance Commission.

3.24. Narrowly interpreted, efficiency requires that the resources available for public use be as nearly as possible equal to the resources withdrawn from the private sector: that is, that the process by which resources are transferred involve minimal ‘waste’. One example of such waste has already been mentioned in the context of simplicity objectives: the cost of administering and complying with the tax law is a ‘deadweight’ cost to the community and ought to be minimised. Waste can however also arise where the tax system is such as to encourage individuals to substitute things they value less for things they value more, or business to continue to use or to substitute productive processes that are technically less efficient for productive processes that are more efficient. In so far as it can be presumed that, left to their own devices, individuals will spend their incomes wisely, and business will choose the most efficient means of production, the minimisation of waste requires that the tax system should not influence individual and business choices. This is the requirement that the tax system should be neutral. Thus the tax system should not interfere with the manner in which an individual spends his income by changing the relative prices of the goods he buys; it should not alter the relative rewards of the different types of work between which he has to choose, or the relative attractions of work and leisure, or the relative returns from different modes of investment; it should not alter the relative attractiveness of different types of business organisation, or the relative prices of productive resources; and it should not discriminate between different types of production.

3.25. But it cannot always be presumed that consumers will spend their incomes wisely; and even when they do, consumers and producers alike may fail to take adequate account of the effects that their activities have on others, of what economists have come to call ‘externalities’. The efficiency of the use of available resources can sometimes be improved by departures from neutrality, by government interventions to alter what would otherwise have been the outcome of private market operations. There are many such interventions by government through, for instance, tariffs, subsidies, monetary control and marketing organisations. But the tax system is an alternative instrument. Tax concessions may aim at increasing the output or consumption of goods and services the government wants to encourage. Similarly, taxes can be used to discourage the output, or increase the prices to consumers, of commodities whose unrestricted production or consumption might otherwise have harmful effects, for example on health
or urban development. Taxes can also be employed to charge the users of facilities, such as roads, on the use of which it is otherwise difficult to impose a price. Discriminatory taxes of these kinds will here be called ‘efficiency taxes’.

3.26. The Committee is persuaded that neutrality should be the general aim when efficiency is under consideration. Departures should be made only in a deliberate and explicit way for proven, explicit and quantified purposes and after it had been shown that other approaches (such as regulation and subsidy) are likely to be less effective for the end chosen. In the Committee's view, when there are circumstances warranting encouragement for a field of activity by means of a reduction in tax, any such reductions should be granted only for a specified purpose and a limited period, thereby ensuring periodical review.

Other Objectives

3.27. Equity, simplicity and efficiency seem to the Committee the three dominant tests of merit for individual taxes and for the tax system as a whole. There are others, however. In particular, flexibility in the taxation system is a characteristic of obvious importance to economic management. Economic management or ‘stabilisation’ requires, firstly, that there be at least some taxes in the total package the rates of which can be easily raised or lowered in the light of short-run fluctuations in the level of economic activity. Secondly, it requires that these taxes be such as to operate very quickly in altering revenue yields and influencing individuals’ and firms' behaviour. Thirdly, in so far as smaller rate changes are politically more acceptable than larger ones (particularly when rate increases are called for), the taxes available should have as large an impact as possible on the level of economic activity per dollar of revenue change.

3.28. Economic growth is another objective that, in the view of some, should be deliberately and distinctly pursued in taxation policy. As a general purpose of public economic policy it has, of course, been long accepted as important, though its interpretation can be the subject of much controversy. In the context of taxation its encouragement is often taken as implying that the overall level of taxation should be kept lower than it would be otherwise—a prescription upon which its terms of reference make the Committee unable to comment. It is also however taken to indicate that, in the interests of greater investment, savings should certainly not be discouraged under the tax system and perhaps even be taxed less than considerations of equity and neutrality alone would suggest. This is an argument that will need mention in the next chapter in connection with the
II. Appraisal of Particular Taxes

3.29. It is convenient next to appraise the main kinds of tax that already exist in or might be introduced into Australia, by reference to these dominant criteria. They are all taxes that will have to be surveyed in more detail later, but a short summary here will help towards a preliminary discussion in the next section of alternative kinds of tax system.

3.30. Personal income tax. If income can be accepted as the primary feature in comparisons between the ability to pay of individuals, it follows that, if the problems of definition and information-collection can be solved, a personal income tax is an admirable vehicle for fairness. An almost limitless range of provisions for horizontal equity can be introduced into it. Any degree of progressivity can be enacted. It is indeed the only tax currently in the tax system that is capable of raising large revenues and into the structure of which a refined set of progressive provisions can be incorporated. To the extent, however, that consumption represents a superior measure of ‘economic well-being’, at least for some income groups, it might still be less fair than a progressive consumption tax, were such a thing practicable. But on the whole personal income tax scores highly in terms of equity.

3.31. By contrast, and again comparing it only with potentially large taxes, it must rank lowest for simplicity. Complexity is introduced when many allowances are believed to be called for by horizontal equity; and more when, with a highly progressive scale, measures have to be taken to prevent or control the transfer of incomes from persons in high tax ranges to those lower down. As a main revenue-raiser it must fall on almost every person with income, many of whom have little taste for or skill at form-filling and many of whom, but for income tax, would have no need to keep financial records. The definition of what taxable income is to include is a matter of the greatest difficulty. It is a tax on which the administrators must perpetually compromise between the expense and intrusiveness of a rigorous administration and the losses of revenue suffered when administration is comfortably trustful. It is one too that presents the largest number of citizens with annual temptations to evade and avoid and to suspect misbehaviour in others.

3.32. As regards resource efficiency, personal income can certainly be made the vehicle for deliberate non-neutralities. Considered as a neutral tax, faults can be found with it. Since it must, in large measure, be a tax on the proceeds of work, it is not neutral between work and not working...
though it shares this defect with almost every tax. Nor, as noted already, is any general tax on income neutral between current consumption and savings. This makes the income tax rather discouraging to growth.

3.33. Company income tax. This is a most difficult tax to appraise, especially with respect to equity, not least because in this area the international aspects of tax are of the highest importance. Equity is essentially a matter of comparative justice between individuals. Any tax on corporations may (or may not) be fair to its owners, its employees or the purchasers of its products; but it cannot be said either to be fair or unfair to the corporation as such. When the tax is held to fall upon the income rights of the proprietors, its fairness will turn upon whether the sum paid is equal to what would be paid were the income in question simply added to the other income of these individual proprietors. Neither in Australia nor elsewhere is this in fact often the case.

3.34. For simplicity it will rate higher than personal income tax. The problem of ascertaining the income of a company is, in principle, no different than in the case of personal income, but the necessary accounting procedures are likely to be, if anything, more readily available, more fully required already for the company's own purposes. Furthermore, though the vast majority of companies are not large, in Australia as elsewhere a comparatively small number among them produce the bulk of the substantial revenue this tax yields.

3.35. The efficiency of company income tax is also hard to judge. It is adaptable to deliberate non-neutralities—almost too conveniently so. But even when neutrality is sought there are ways in which it will probably fail: there is likely to be some discrimination between companies and other types of legal organisation.

3.36. Capital gains taxes. The pros and cons of capital gains taxes are discussed at some length in Chapter 23. The fundamental case for such a tax rests upon equity. It is almost universally agreed that capital gains (when ‘real’ and not simply the result of inflation) are so closely akin to income in its everyday sense that equity requires that they be taxed if income is. By the test of fairness, therefore, a capital gains tax has merit, in principle, as a supplement to personal income tax. On the other hand it must be a tax of great complexity, and efforts to bring it within the bounds of administrative practicability must lead to some evaporation of its equitable advantages. It is a tax not without attractions in terms of resource efficiency. When capital gains are untaxed but income gains are, investments in the kinds of asset on which the returns come (or can be arranged to come) in the form of capital appreciation will be made relatively the more profitable. A misallocation of resources is therefore
likely which the tax serves to correct.

3.37. *Estate and gift duties.* These taxes may be taken together, since (as will be argued in Chapter 24) they lead into a tangle of inequities and avoidances without even the merit of producing large revenues unless they be integrated and tightly administered. As a supplement to income tax—or even to a consumption tax—an estate duty ranks high for equity. It taxes those assets the income from which could only with difficulty be ‘imputed’ for income tax purposes. It can also bear specifically upon inherited wealth if equity is believed to require a special levy upon it.

3.38. Estates and gift duties, and such variants as inheritance and accession duties, must however be very complex taxes. They cause less continuous trouble to those concerned than annual taxes—and this gains one good mark for simplicity—but their provisions need to be elaborate. However, if it be possible to confine them to large fortunes, they will be simple in the sense of not affecting the majority of the population. They need not be inimical to resources efficiency. They inevitably contain a nonneutrality in terms of their discouragement of accumulation for the benefit of heirs, in the same way as a progressive income tax may contain a more general discouragement to savings. But in both cases the conflict is between distinct ultimate ends and has to be resolved by judgment.

3.39. *Wealth taxes.* Wealth taxes are discussed in Chapter 26. Here they can be briefly disposed of. They have some of the advantages of estate and gift duties in terms of equity and all their disadvantages in terms of simplicity—and more, since they will be so much more frequently levied.

3.40. *Taxes on goods and services.* A distinction must be made here between ‘narrow-based’ taxes falling upon only a few consumption goods and services (even though they be ones that absorb quite a significant proportion of total expenditure) and ‘broad-based’ taxes levied on very large ranges of goods and services even if not quite all consumption. The Australian sales and excise taxes are an obvious example of the former category; the British and Continental value-added taxes belong to the latter. They are described in Chapter 27.

3.41. *Narrow-based taxes* rank badly for equity. They discriminate between persons with the same incomes but different tastes. It may perhaps be desirable to levy a heavier burden on the smoker and the drinker than on other people but if so it will be on the grounds of efficiency rather than equity and even then it has to be remembered that the real sacrifice may well be borne by the families of those on whom it is intended to lay the impost. Nor can such taxes be made in any way effectively progressive in terms either of consumption or income. They are however taxes of extreme simplicity. Exceptionally few enterprises have the legal responsibility for
payment; they will have the machinery for calculating their liability as part of their normal activities; generally their assessment can quickly be settled with the official administration. In terms of resource efficiency it is obvious that these are non-neutral taxes. They rank well for efficiency only when they are deliberately tailored to fit some desired non-neutrality, and they can be made fees for particular government services rather than taxes required for general revenue.

3.42. Various forms of broad-based taxes are discussed in Chapter 27. The choice between them chiefly turns on points of technical detail. What is more relevant here are the qualities such taxes have when at high uniform level and when very widely based.

3.43. A broad-based tax serves horizontal equity by not discriminating between savings and consumption; but by itself it cannot be adapted to the varying situations of individuals. Nor is it, by itself, suitable for vertical equity. It is essentially a proportionate consumption tax, and actually regressive as a tax on income since the proportion of consumption to income normally falls as income increases. It stands high by the test of simplicity, certainly far higher than personal income tax when both are compared as major revenue-raisers. Whatever its form it would be levied on far fewer persons or enterprises. A much higher proportion of them would have little difficulty with the paper work, much of which would be only a small addition to ordinary commercial recording. This latter advantage would be greatly diminished if the rate were not uniform. Such taxes certainly have problems of definition at their edges, even though uniformity within the boundary avoids them there, and the higher the rate the more acute they will be. However, it seems unlikely that these would ever reach the scale of those encountered in income tax. A broad-based tax at a uniform rate is inherently neutral within its ambit. Were all savings made solely for the purpose of savers’ own future consumption, it would also be neutral between consumption and savings; but to the extent that other motives enter into savings, this would not be so.

3.44. Grants. As noted earlier in this chapter cash grants by the State need to be brought into the overall assessment of taxation systems. As will become clearer in Chapter 12 they provide an alternative to concessional deductions in the personal income tax as a technique for achieving horizontal equity. Most social service grants to the needy may also be quite naturally viewed as instruments of vertical equity at the lower end of the income scale. Whether taxed or not they will, when at a flat rate, somewhat increase the net progressivity of the tax system. Since they will constitute an ever smaller proportion of the incomes of their recipients as one moves up the income scale, they serve to make the distribution of income less
unequal. They are also, when free of means test, simple since their eligibility is determined by such tests as age, parenthood, sickness, unemployment. In general too they are neutral. Unless the benefits are very large it is unlikely that child endowment could be much of an incentive to parenthood or that well-administered sickness or unemployment benefits increase the incidence of illness or unemployment to any significant extent.

III. Alternative Tax Systems

3.45. This brief survey is a reminder that when any body of advisers is invited to formulate proposals for improving the taxation system, ‘either by way of making changes in the present system, abolishing any existing form of taxation or introducing new forms of taxation’, a singularly wide range of options is laid open for review. To raise a given revenue any of a great many permutations and combinations of distinct taxes can be used, and when one combination has been selected their relative weights can be varied and the choice of detailed provisions in each is enormous. There are legions of taxation systems to choose from when the problem is considered in a longterm context.

3.46. The short assessments just given of the principal taxes among which the choice lies assist in the classification of the options. It becomes evident that different systems or ‘tax packages’ will serve the different aims of equity, simplicity and efficiency to differing extents. Because there are unavoidable conflicts between these aims, it is essential to assess their extent, and to arrive at the preferred system after a conscious effort to weigh, or give relative values to, these ultimate aims.

3.47. In general it does not appear that, in practice, the conflict between simplicity and efficiency need be very great. Certainly when the latter can be interpreted as mainly requiring neutrality, reliance upon a very simple tax, a broad-based tax at uniform rates on all goods and services used in consumption, would produce a taxation system that was simple and efficient. Though efficiency may undoubtedly require additional special taxes for special purposes it need not require many if policy instruments other than taxation are also being actively directed to this aim.

3.48. The potential conflict between the ideals of simplicity and equity, by contrast, is apparently very great indeed. The taxes most obviously adapted to the requirements of equity, those technically capable of being adapted to vary the levy upon individuals in accordance with a multitude of differences in their situations considered relevant to equity, are the most complex of taxes: income tax, capital gains tax, gift and estate duties, wealth tax. Hence it appears that a country may have a simple and efficient
taxation system or an equitable one but not both.

3.49. The dilemma is not however so stark as that, for two reasons. One is that, as has just been noticed, quite simple measures on the side of expenditure can to some extent be used to offset the inequities created by the indiscriminate impact of simple taxes. The other is more important yet. A great deal turns upon the precise quantitative interpretation that is put upon the ideal of vertical equity and how the application of this quantitative judgment works out in the particular circumstances of the economy being considered. These are quite cardinal issues in the consideration of taxation policy, and they will be examined at length in the next chapter. When that discussion is completed it will be possible to return in Chapter 5 to the problem of defining the alternative types of tax system that are there for Australia's choice.
Chapter 4 The Problem of Progressivity

4.1. The question of the proper degree of progressivity, of the extent to which a fair distribution of the burden of taxation requires that taxes should increase more than proportionally as one moves up the income scale, is perhaps the most difficult of all the basic issues in taxation policy.

4.2. To begin with, some general remarks may be offered about the phrase ‘burden of taxation’. It is frequently used, but it is misleading. It may have had some descriptive validity in pre-democratic days (and in some undemocratic countries today) when taxes supported government activities from which most taxpayers received no obvious benefit and which indeed may have been damaging to many of them. But the implication that all the taxes a citizen pays constitute a straight diminution of his welfare, that he gets nothing noticeable back from them, is not true of any advanced democratic society. Many of the public activities financed from taxation are prerequisites to the functioning of the private economy, and many of them are conducted by the State because by any reckoning the State is the most efficient instrument available. If they were not done at all, or left to private enterprise, everyone would be a great deal worse off than they are. To call such payments a ‘burden’ is to encourage confusion and prejudice. Also, much present taxation is one side only of a continuing process of removing money from people's pockets at one stage of their lives and returning it to them at another when it is more urgently needed. Again, scarcely a ‘burden’.

4.3. The belief that taxes as a whole are a burden has more rational origins in the normal human resentment at compulsion, and in the fact that, though few of us evaluate all that we get from paying them, all of us know of some government expenditure that we believe to be useless and wasteful. Nevertheless the phrase is an unhappy one and misleading especially in the discussion of progressivity. The central and sensitive question here is that of the relativity of one individual's tax bill to another's. In analysing this issue it is unavoidable to proceed by comparing the total taxes they pay, but the argument is properly about the differences between the totals rather than about the totals themselves. Even then the problem is best seen as one of the role of the tax system among the whole complex of policies by which the modern State affects the distribution and the size of the community's income and property. Thus regarded, the problem loses its false air of simplicity but it can then be approached in a more constructive fashion.

4.4. A succession of three groups of questions has to be posed:
(a) What are the present facts of the distribution of income between persons and families in Australia (i) gross, and (ii) net of all taxes and social service payments? In other words, taking the tax system as a whole and allowing for cash transfers from the State, who pays what? In particular, how progressive apparently is the present Australian system? These are statistical questions.

(b) Supposing that the situation revealed by (a) suggests a need to consider changes in the distribution of income that are unlikely to occur naturally in the evolution of society on existing policies, how far are alterations in the tax system capable of bringing them about, and to what extent should tax rather than other public policies be adapted to the ends preferred? These are substantially problems in economic analysis.

(c) Granted that the tax system is one of the necessary and, at least to some extent, effective instruments for distributional objectives, what in fact should these objectives be? This is clearly a question going far beyond the statistical and the economic into the realms of the social, political, ethical.

4.5. In the three sections of this chapter these issues will be examined in turn. Advance warnings are, unhappily, necessary. The discussion of the statistical questions will be far from providing an adequate account of the basic facts: such facts are, at present, not available. It is hoped here to go some way in a part of the analysis that might have been expected to be the easiest, but the welter of myths existing in this area cannot yet be wholly dispelled. Similarly in the examination of the second question, to which it might also be expected that an agreed expert answer could be assembled, no such answer exists. Here, too, it is necessary to end up with best estimates from which many will dissent. The third question is one to which even in principle there is no hope of attaining any scientifically demonstrable answer, and it would be foolish to pretend otherwise.

I. The Statistical Situation

4.6. Any description of the taxes actually paid by some millions of taxpayers must consist of broad generalisations. Since income is the magnitude to which most of us first look in comparing the position of individuals and families, it would be convenient to be able to classify individuals into income groups and present for each group the average of all taxes paid by members of that group. Then from further information about the family situation and other particulars of individuals, it would be desirable to go on to present a summary picture of the average taxes paid by family groups of different size and composition, again classified by income. It is lamentable that estimates of the former kind cannot be made
from the data available in Australia, and that the only source from which estimates of the latter kind can be developed is largely out of date and deficient in other ways. The extensive sample survey of family income and expenditure now being conducted by the Australian Bureau of Statistics may begin, in a year or two, to give results on which greater confidence can be placed. Meanwhile the Committee can only argue from ‘best guesses’.

4.7. A large array of statistics is inevitably generated in the administration of income tax, and in the annual volume *Taxation Statistics* a selection of the data is presented to the Australian Parliament by the Commissioner of Taxation, analysed in a variety of informative ways. These are, perhaps, the figures most inquirers turn to when considering the distribution of taxation, if only because they are virtually the only official ones available. Table 4.4.A, which presents a summary regrouping of data from the latest *Taxation Statistics*, reveals something of the distribution of individual net income as defined for statistical purposes—broadly, income less expenses of deriving income—and of average personal income tax paid by individuals in the income ranges indicated. But such information hardly serves as a basis for a general discussion of taxation policy. For example, it includes in the lower income ranges many persons who were unemployed for part of the year and omits many others who were not required to lodge returns; it excludes some income from trusts; it also excludes the undistributed income of companies and the bulk of social service grants; and of course such light as it throws on the distribution of taxation is confined to personal income tax, only about 40 per cent of total taxation. To use the Commissioner's figures in the present analysis would therefore be entirely misleading.


<table>
<thead>
<tr>
<th>Grade of net income</th>
<th>Male</th>
<th>Female</th>
<th>Total</th>
<th>Net income</th>
<th>Net tax</th>
<th>Average rate of tax on net income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>'000</td>
<td>per cent</td>
<td>'000</td>
<td>per cent</td>
<td>'000</td>
<td>per cent</td>
</tr>
<tr>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0–2,999</td>
<td>849</td>
<td>23.4</td>
<td>1,418</td>
<td>68.7</td>
<td>2,268</td>
<td>39.8</td>
</tr>
<tr>
<td>3,000–5,999</td>
<td>1,980</td>
<td>54.6</td>
<td>553</td>
<td>26.8</td>
<td>2,533</td>
<td>44.5</td>
</tr>
<tr>
<td>6,000–9,999</td>
<td>642</td>
<td>17.7</td>
<td>75</td>
<td>3.6</td>
<td>716</td>
<td>12.6</td>
</tr>
<tr>
<td>10,000+</td>
<td>155</td>
<td>4.3</td>
<td>20</td>
<td>1.0</td>
<td>175</td>
<td>3.1</td>
</tr>
<tr>
<td>Total</td>
<td>3,626</td>
<td>100.0</td>
<td>2,065</td>
<td>100.0</td>
<td>5,691</td>
<td>100.0</td>
</tr>
</tbody>
</table>
4.8. For a fuller picture of tax distribution it is necessary to rely upon estimates originally based on the material contained in the Australian Survey of Consumer Expenditures and Finances, which was conducted in 1966–68 by Professors Drane, Edwards and Gates. This ‘Macquarie survey’ is a mine of information for students of social affairs and contains vital tax data unavailable elsewhere. Though it suffers from statistical defects fully acknowledged by its authors, is now somewhat dated and will be superseded before long, the Committee has found it, and the work done upon it on the Committee's behalf, indispensible.¹

4.9. Figures in the Macquarie survey were collected on a household basis: indeed, with so much expenditure being shared, they could only have been collected on that basis if the results were to be meaningful. Taxes paid in cash are readily identifiable, but not taxes on goods and services paid indirectly: the latter have had to be estimated from expenditure information. To complete the picture company incomes, and the taxes on these incomes, have had to be assigned to particular income groups; so too have estate and gift duties. Thus in such an exercise a great many assumptions of a largely arbitrary kind have had to be made. No one, least of all the statisticians making them, would say otherwise. But if sets of alternative assumptions are made, each in its way reasonably plausible, it is at least possible to see how far the overall results differ and, when they mostly reveal much the same pattern, to attach some credence to the broad picture (if not the exact set of figures) that emerges. Over a hundred alternatives have been explored on the Committee's behalf and the patterns revealed are not in fact widely spread. One resulting estimate is shown in Table 4.B.

4.10. Though Table 4.B has to be interpreted cautiously, especially as regards the details of particular taxes, it suggests an overall distribution of taxation rather different from what most people would probably expect. Taxation, it seems, is quite sharply regressive at the lower end of the household income scale, nearly proportional in a wide middle band, and progressive only at higher levels. Indirect taxes are chiefly responsible for the large difference between this sequence and the progressivity apparently displayed in Table 4.A. (The surprising figure for company income tax paid by households with the smallest incomes is to be explained by the

Source:
Taxation
Statistics
1972–73.
disproportionate number of elderly persons on low incomes living off investments.)


<table>
<thead>
<tr>
<th>Income range(a)</th>
<th>Australian Government taxes</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Personal income tax</td>
<td>Company income tax</td>
<td>Estate and gift duties</td>
<td>Indirect taxes</td>
<td>Total State government taxes</td>
<td>Local government taxes</td>
<td>Total taxes</td>
<td></td>
</tr>
<tr>
<td>0–1,449</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td></td>
</tr>
<tr>
<td></td>
<td>11.5</td>
<td>18.9</td>
<td>30.4</td>
<td>5.6</td>
<td>4.9</td>
<td>40.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,450–2,899</td>
<td>2.9</td>
<td>7.2</td>
<td>13.0</td>
<td>23.1</td>
<td>4.1</td>
<td>2.8</td>
<td>30.0</td>
<td></td>
</tr>
<tr>
<td>2,900–4,349</td>
<td>7.8</td>
<td>3.4</td>
<td>11.6</td>
<td>22.7</td>
<td>3.8</td>
<td>2.1</td>
<td>28.6</td>
<td></td>
</tr>
<tr>
<td>4,350–5,799</td>
<td>9.4</td>
<td>1.9</td>
<td>9.9</td>
<td>21.2</td>
<td>3.3</td>
<td>1.7</td>
<td>26.3</td>
<td></td>
</tr>
<tr>
<td>5,800–7,249</td>
<td>10.3</td>
<td>2.9</td>
<td>9.0</td>
<td>22.1</td>
<td>3.0</td>
<td>1.5</td>
<td>26.7</td>
<td></td>
</tr>
<tr>
<td>7,250–8,699</td>
<td>11.1</td>
<td>2.5</td>
<td>8.6</td>
<td>22.2</td>
<td>2.9</td>
<td>1.4</td>
<td>26.5</td>
<td></td>
</tr>
<tr>
<td>8,700–10,149</td>
<td>11.9</td>
<td>1.7</td>
<td>7.5</td>
<td>21.1</td>
<td>3.0</td>
<td>1.2</td>
<td>25.3</td>
<td></td>
</tr>
<tr>
<td>10,150–13,049</td>
<td>13.2</td>
<td>3.1</td>
<td>7.4</td>
<td>23.7</td>
<td>3.3</td>
<td>1.2</td>
<td>28.2</td>
<td></td>
</tr>
<tr>
<td>13,050–17,399</td>
<td>15.8</td>
<td>9.5</td>
<td>0.9</td>
<td>8.0</td>
<td>34.2</td>
<td>5.4</td>
<td>1.3</td>
<td>40.9</td>
</tr>
<tr>
<td>17,400+</td>
<td>17.0</td>
<td>13.3</td>
<td>3.3</td>
<td>6.8</td>
<td>40.4</td>
<td>7.0</td>
<td>1.0</td>
<td>48.4</td>
</tr>
</tbody>
</table>

(a) Adjusted by consumer price index to equivalent purchasing power in December quarter 1973.

**Source:**
Based on Macquarie survey.

4.11. However, as an account of the apparent impact of public finance
upon households, these estimates represent only one side of the picture. The impact of transfers received from the government sector by way of age pensions, child endowment, sickness benefits and the like is ignored. Not surprisingly, these cash grants are heavily concentrated upon those families with small original incomes, and their inclusion substantially alters the overall result. The necessary calculations can be made in only a very rough and ready way, but some results are shown in Table 4.C. The importance of including transfers is apparent. When taxes and grants are considered together, progressivity is restored at the lower extremity of income distribution, but the system remains proportional in the middle range—a point of some importance in the Committee's argument. Despite the shortcomings of these estimates and the conceptual problems involved in constructing and interpreting ‘tax burden’ tables, the Committee is prepared to accept the validity of this conclusion as a broad statement of the apparent impact of the current tax-transfer system.

TABLE 4.C: DISTRIBUTION OF TAXES AND TRANSFERS ACROSS RANGE OF NET-OF-TRANSFER INCOMES, 1966–67 (a)

<table>
<thead>
<tr>
<th>Income range</th>
<th>Original income</th>
<th>Transfers received</th>
<th>Total income (2 + 3)</th>
<th>Tax rate (5x4)</th>
<th>Taxes (6 - 3)</th>
<th>Net taxes (7÷2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ per annum</td>
<td>$</td>
<td>$</td>
<td>$ per cent</td>
<td>$</td>
<td>$</td>
<td>per cent</td>
</tr>
<tr>
<td>0–1,449</td>
<td>194</td>
<td>1,417</td>
<td>1,611</td>
<td>41</td>
<td>661</td>
<td>-756</td>
</tr>
<tr>
<td>1,450–2,899</td>
<td>2,195</td>
<td>447</td>
<td>2,642</td>
<td>30</td>
<td>793</td>
<td>346</td>
</tr>
<tr>
<td>2,900–4,349</td>
<td>3,679</td>
<td>283</td>
<td>3,962</td>
<td>29</td>
<td>1,149</td>
<td>866</td>
</tr>
<tr>
<td>4,350–5,799</td>
<td>5,008</td>
<td>226</td>
<td>5,234</td>
<td>26</td>
<td>1,361</td>
<td>1,135</td>
</tr>
<tr>
<td>5,800–7,249</td>
<td>6,412</td>
<td>232</td>
<td>6,644</td>
<td>27</td>
<td>1,794</td>
<td>1,562</td>
</tr>
<tr>
<td>7,250–8,699</td>
<td>7,853</td>
<td>228</td>
<td>8,081</td>
<td>27</td>
<td>2,182</td>
<td>1,954</td>
</tr>
<tr>
<td>8,700–10,149</td>
<td>9,368</td>
<td>189</td>
<td>9,557</td>
<td>25</td>
<td>2,389</td>
<td>2,200</td>
</tr>
<tr>
<td>10,150–11,599</td>
<td>10,778</td>
<td>229</td>
<td>11,007</td>
<td>28</td>
<td>3,082</td>
<td>2,853</td>
</tr>
<tr>
<td>11,600–13,049</td>
<td>12,142</td>
<td>207</td>
<td>12,349</td>
<td>28</td>
<td>3,458</td>
<td>3,251</td>
</tr>
<tr>
<td>13,050–15,949</td>
<td>14,407</td>
<td>286</td>
<td>14,693</td>
<td>35</td>
<td>5,143</td>
<td>4,857</td>
</tr>
<tr>
<td>15,950+</td>
<td>23,947</td>
<td>310</td>
<td>24,257</td>
<td>45</td>
<td>10,916</td>
<td>10,606</td>
</tr>
</tbody>
</table>

(a) Income range and all dollar values adjusted by consumer price index to equivalent
4.12. Even with grants included, the picture is far from complete, since no account is taken of government expenditure on goods and services and of the distribution of the benefits of such expenditure between families. Many of the benefits of direct government spending would, by any reckoning, be very unequally distributed, and at least in certain areas like education rather more heavily concentrated in the bottom half of the income scale. But ultimately there is no way of apportioning the benefits of public spending that is not completely arbitrary, and it seems best therefore to focus only on the tax-transfer operations of the budget.

4.13. It is impossible to assess the practicability, let alone the desirability, of any substantial alteration in the incidence of total taxation and grants without regard to the number of persons and families within each income range. Given that taxation in an advanced economy may have to be of the order of one-third of national income, it is simply not arithmetically feasible to secure a major part of it from the highest income groups if the great bulk of income is earned by those in the middle and lower ranges. Some estimates of family income distribution drawn from the Macquarie survey, and from a valuable pilot survey conducted by the Australian Bureau of Statistics in 1968–69, are shown in Table 4.D. They suggest that the top fifth of families in the second half of the 1960s received about 40 per cent of total income, the bottom fifth something less than 10 per cent, and the remaining three-fifths over 50 per cent—a very substantial bunching. It needs, however, to be borne in mind that high rates of tax at the top require reasonably high rates in the middle as well, if marginal tax rates are never to reach excessive heights: reducing the tax paid on income within the range from $8000 to $10,000, for example, necessarily reduces the tax paid on that slice of income from those whose incomes lie above $10,000. If the treatment lower down the scale is too generous, then the required revenue cannot be obtained without pushing marginal rates applying on upper incomes to extreme levels. It is the joint operation of revenue requirements and the constraint that marginal rates of tax be

Source: Based on Macquarie survey.
reasonable that compels the weight of tax in lower and middle income ranges to be significant.


<table>
<thead>
<tr>
<th>Percentage of surveyed families</th>
<th>1966–67(a)</th>
<th>1968–69(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Percentage of income</td>
<td>Percentage of income</td>
</tr>
<tr>
<td></td>
<td>excluding transfers</td>
<td>including transfers</td>
</tr>
<tr>
<td>10</td>
<td>0.1</td>
<td>2.4</td>
</tr>
<tr>
<td>20</td>
<td>2.9</td>
<td>6.4</td>
</tr>
<tr>
<td>30</td>
<td>9.2</td>
<td>12.8</td>
</tr>
<tr>
<td>40</td>
<td>16.6</td>
<td>20.1</td>
</tr>
<tr>
<td>50</td>
<td>25.2</td>
<td>28.5</td>
</tr>
<tr>
<td>60</td>
<td>35.0</td>
<td>38.0</td>
</tr>
<tr>
<td>70</td>
<td>46.1</td>
<td>48.7</td>
</tr>
<tr>
<td>80</td>
<td>59.0</td>
<td>61.1</td>
</tr>
<tr>
<td>90</td>
<td>74.6</td>
<td>75.9</td>
</tr>
<tr>
<td>100</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>


4.14. These are annual figures and it is of the greatest importance in the present context to avoid being misled by them. It is tempting with annual statistics to argue as if families in each income group are there all their lives, which of course is not the case. Almost everybody's income starts, on entry to the work force, at a much lower level than it reaches later in working life and falls on retirement. Almost anyone, too, may have years of exceptionally low income during a normal working career because of sickness, unemployment or even extended holidays. Moreover, the figures in Table 4.E, drawn from the Australian Bureau of Statistics survey of 1968–69, reveal a further significant fact: the lifetime pattern of earnings varies greatly according to occupational level, at least in so far as this level is indicated by educational attainment.

**TABLE 4.E: AVERAGE ANNUAL INCOME OF FULL-TIME MALE WORKERS, BY EDUCATIONAL ATTAINMENT AND AGE GROUP,**
4.15 The implication is clear that were it possible to ascertain the distribution of Australian income in terms not of annual income but of the probable average lifetime income of persons now alive, such a distribution would (after eliminating the effects of general economic progress) be considerably more bunched than any annual figures. The great majority of individuals in the lower intervals of annual distribution (the sick, unemployed, aged) would move into higher income groups; equally, many of those towards the top on the basis of annual statistics (persons at the temporary peak of their careers or old enough to have incomes from their own savings and from inheritances) would move into lower groups. There would be far fewer very rich and far fewer very poor; the bulk of the population would be even more concentrated in the middle ranges.

4.16 It would have been desirable to round off this section with some arithmetical calculations showing the alternative patterns of progressivity in the overall taxation system consistent with a given total revenue. But available information on the distribution of income, even on an annual basis, is unfortunately too dated and too sketchy for such working estimates as the Committee has been able to make to deserve reproduction. A few brief observations of a qualitative nature must suffice:

### 1968–69 PILOT SURVEY ($)

<table>
<thead>
<tr>
<th>Age group (years)</th>
<th>15–24</th>
<th>25–34</th>
<th>35–44</th>
<th>45–54</th>
<th>55 and All age groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>University degree</td>
<td>(a)</td>
<td>6,940</td>
<td>8,910</td>
<td>10,320</td>
<td>8,920</td>
</tr>
<tr>
<td>Non-degree tertiary</td>
<td>3,430</td>
<td>5,180</td>
<td>6,600</td>
<td>6,360</td>
<td>7,150</td>
</tr>
<tr>
<td>Technician level</td>
<td>3,200</td>
<td>4,470</td>
<td>5,410</td>
<td>5,620</td>
<td>5,010</td>
</tr>
<tr>
<td>Trade level</td>
<td>3,270</td>
<td>4,030</td>
<td>4,270</td>
<td>4,120</td>
<td>3,620</td>
</tr>
<tr>
<td>Matriculation only</td>
<td>2,840</td>
<td>4,460</td>
<td>4,940</td>
<td>5,120</td>
<td>5,650</td>
</tr>
<tr>
<td>Left school at:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>2,640</td>
<td>3,970</td>
<td>4,530</td>
<td>4,360</td>
<td>5,010</td>
</tr>
<tr>
<td>16</td>
<td>2,290</td>
<td>3,750</td>
<td>4,380</td>
<td>4,630</td>
<td>4,210</td>
</tr>
<tr>
<td>14 or 15</td>
<td>2,320</td>
<td>3,440</td>
<td>3,810</td>
<td>3,770</td>
<td>3,600</td>
</tr>
</tbody>
</table>

(a) Too few observations for reliable estimate.

(a) By manipulating rates on existing taxes and widening their bases, by their tighter administration, and by such new levies as a tax on capital gains, it would certainly be possible to raise more revenue from those at the top end of the income and wealth scale, were this considered desirable.

(b) The number of persons in those groups is so small that the additional revenue would inevitably be very modest in relation to total revenue requirements.

(c) Revenue needs are now so great, and the underlying distribution of income is so concentrated in the middle ranges, that the bulk of revenue must come, in one way or another, from those ranges.

(d) Within the middle ranges there is certainly scope for more or less progressivity in marginal and average rates as opposed to the near-proportionality now apparently exhibited, but the degree of variation practicable is much less than is often supposed.

II. Tax and Non-Tax Policies in Redistribution

4.17. Even if the current distribution of income after tax were known more accurately than it is and were judged to be satisfactory, it would still of course be necessary to discuss whether the existing tax structure is contributing to the result in as simple and efficient a way it could. But if it may be assumed that society desires eventually to achieve a more equal distribution, it becomes necessary explicitly to discuss the relative effectiveness of the policy instruments available. Of these the taxation system is by no means the only one actually or potentially employable in Australia, and it is probably less all-powerful than appears at first sight. There is thus a very real problem in finding the right mixture, the most efficient balance, between the various kinds of instruments that are or can be brought into use. Hence the Committee cannot reach recommendations about the tax system without referring briefly to the other policies available, though any detailed examination of them would involve an unwarrantably wide interpretation of its terms of reference.

4.18. It is evident that were the government to possess effective and wide-ranging controls over all earned incomes and all payments for rights in land and industrial property and financial assets (rents, dividends, interest, etc.), it would thereby have a dominant control of the distribution of income. The equity objective of taxation would largely become superfluous except as regards the distribution of property income between persons as determined by the initial and evolving distribution of ownership of the property itself. The tax system could be operated instead primarily with the objectives of simplicity and efficiency in mind. Such control over incomes may effectively be the situation in totalitarian economies and they
can have very simple tax systems. While it is here assumed that control to this extent will never exist in this country, it is worth recording that in so far as, within Australia's political framework, government or other public agencies have some direct influence upon the evolution of relative gross incomes, the redistributinal tasks of the tax system can be to that extent lightened.

4.19. Policies towards monopoly and restrictive practices of all kinds are plainly relevant. The distortions of the market tackled by such policies usually, though not always, tend to increase inequality.

4.20. Policies towards land-tenure and urban development, even though primarily directed towards the achievement of decent urban conditions in the right places, may have important implications in one area of great difficulty for tax policy, that of capital gains from transactions in land.

4.21. Much social service expenditure, for example on health and counselling of one kind or another, even when not involving direct cash transfers is evidently important in preventing extremes of poverty.

4.22. Finally, and perhaps of the greatest general significance, there is the State's part in determining the amount and influencing the composition of education, general and technical and professional. At the lower end of the scale some persistent poverty can be attributed to failures at the level of elementary education. Higher up the scale much of the difference in earned incomes certainly derives from the scarcity of skills that are costly in time and money to acquire. This is a large issue, and not without many intricacies, but the point must be made that in the long term education policy is a powerful weapon in the pursuit of greater equality in incomes—perhaps indeed the most powerful available in a democratic community.

4.23. To return now to the use of taxation as a redistributive measure, one remark should be made at the outset. When contemplating any table showing the distribution of income gross, the taxes paid and grants received at each level, and the resulting distribution net, it is tempting to suppose that simply by altering taxes and grants an exactly equal alteration can be made in after-tax incomes, i.e. that the gross distribution can be taken as something fixed and upon which one may operate at pleasure. This, of course, is a mistake. A change in the tax pattern will in general have an effect upon both the size and the distribution of gross incomes, and the final result to net incomes will be affected by this interdependence, or rather by the combined outcome of a whole set of interdependencies. Some judgments about those tangled and still controversial issues must be offered.

4.24. It is important to distinguish between the initial effect of a change in the progressivity of the rate structure and the permanent effects.
Obviously a large change coming suddenly is liable to have sharp impact effects which may or may not last and which may even be reversed. In this part of the analysis it is necessary to consider only the more permanent steady differences that might be made to gross and net incomes by more or less progressive tax structures, after any initial reactions to alterations in the present structure had worked themselves out. The case of an increase in progressivity via personal income tax can be taken by way of illustration. Three types of permanent reaction have to be considered: upon work effort, upon savings, and upon gross income claims.

4.25. Few issues have been more elaborately argued at the theoretical level or more inconclusively tested empirically (or are more difficult to test) than the effects of varying tax levels upon the individual's choice of work against leisure. It is generally held that a high marginal rate of tax will limit the desire to work, but the real question is whether the effect will be large or negligible. It need not be doubted that a marginal rate of 80 per cent or more, imposed on the marginal earned income of a man who can live comfortably on a few hours' work, will inhibit him from working longer unless he has an exceptional delight in the kind of work he is doing. But within the range, more relevant to practical discussion, of say 40 to 70 per cent, the matter is problematical. It is evident on all sides that most well-to-do people now earning incomes that are taxed towards the top end of the scale do work hard and long and it may be judged that pride and interest in their work are dominant reasons for this. The effects of tax rates may well be small. At the lower income levels the consequences of medium and high marginal tax rates are perhaps much more mixed, and very much more dependent on personal and job characteristics. Hence in general the Committee is doubtful whether, within the kinds of limit that need to be considered seriously, changes in the progressivity of the tax scale would have important effects upon work incentives.

4.26. Any progressive tax system must to some extent be inimical to savings. This follows from the familiar fact that within the working-age groups the proportion of income saved, generally speaking, increases with income. But the precise sensitivity of savings to tax rates on any permanent basis is extremely hard to judge, and the difficulty is compounded in inflationary conditions when the volume and pattern of savings are likely to be dominated by varying expectations about potential returns, real and monetary, and about the stability of income. It is also to be remembered that in the industrial sector (the needs of which are often in mind when the importance of saving to growth is being emphasised) much investment is internally financed and its productivity may be determined as much by its quality as its quantity. The Committee regards incentives to save, as it
regards incentives to work, as important but not crucial factors in deciding whether the tax system should be made rather more or rather less progressive.

4.27. A still more enigmatic problem is that of the connection between the progressivity of tax rates and the occupational and hierarchical spread of gross incomes. In conditions such as those of Australia at present and in the foreseeable future, where a high proportion of incomes from effort is in one way or another collectively determined with considerations of ‘fair relativities’ very much to the fore in the debate, it is at least theoretically conceivable that any attempt to compress (or expand) established differentials in real income may be defeated by countervailing adjustments in gross incomes. This would be so if it were relativities net of tax that were involved in ideas about fair shares, and market forces were no obstacle.

4.28. It is a reasonable inference from the very frank specification of ‘fringe benefits’ which takes place in the recruitment of senior staff in many areas of the economy, that in that range levels of real income net of tax are a prime factor in settling remuneration. At other levels the matter is not so clear. Taxation is not overtly considered by the Arbitration Commission. But facts that will be relevant to the intensity of emotion behind a dispute do not need to be explicitly stated to enter the minds of negotiators. The notion of taxes as a burden may be misleading but it has a deep hold. When an increased wage, arrived at by either a Court award or direct negotiation, proves disappointing when received in the pay packet with tax deducted, consequences to the next claim may be expected. Explicit bargaining in ‘real’ terms, net of tax, is spreading overseas and the higher the general level of taxation becomes the more probable it is that it will come to Australia, more especially as, with continuing inflation, everyone is becoming used to thinking in ‘real’ terms. The matter is further considered in Chapter 6.

4.29. There are limitations on the possible extent of such tax-offsetting income adjustments. As the relative prices of the services of those who secure an upward shift of gross income increase, it will be to the interest of their purchasers to economise and to change techniques so as to use more of other, now relatively cheaper, factors of production. But this may not always be possible, even in the long run, and the power of interest groups may be such as to hamper it when it is.

4.30. The kinship is obvious between the argument here and the questions of relative shares (and inconsistent group claims about them) that are central to the debate on the causes of the inflation now endemic in western economies. There seems unfortunately to be as little hope of
agreed conclusions in this debate as in the wider one.

4.31. It is about the relationship between taxation and earned incomes that these doubts principally arise. Taxes on property income can be expected to prove more or less progressive in accordance with the rate structure. So can estate and gift duties, if adequately tightened up, and so too would a wealth tax if technically feasible. Hence the Committee does not come quite to the conclusion that the distributions of income net of tax and of property are not significantly amenable to tax policy when all repercussions are taken into account. It does however believe that the distributions are by no means so readily malleable as may appear at first sight.

III. The Distributional Objective

4.32. Even if it had been possible to provide an accurate and precise account of the distributions of income, gross and net of taxation, and even if the potentialities for changing them in any desired direction by means of the taxation system were assessable in a far more clear-cut way than they are, it would still be a problem of the utmost difficulty to decide how much should be done. It is however implied in the Committee's terms of reference and must be broached, though with all the diffidence that befits a non-political Committee offering views on problems that are essentially and acutely political.

4.33. To start with some simple generalities. If asked what the government should do about the distribution of income and property and how taxes should be used in doing it, it seems likely that nearly everyone would agree on certain vague propositions: that taxes should be related to ability to pay, that they should be used to assist the aged, the unemployed, the sick, the economically weak, and those burdened with the upkeep of large families; that while poverty exists some limits should be put upon the passage of growing accumulations of wealth from generation to generation. They would agree, on the other hand, that part at least of the extra rewards given by the market to those who work especially hard or have rare abilities should certainly stay with them. But if pressed to translate such merely qualitative statements into quantitative terms—to indicate the actual level of grants to those requiring help, to specify tax rates and so forth—plainly a welter of divergent answers would be elicited, even from intelligent respondents doing their best to give practicable figures. It is apposite to consider the principal explanations that might be discovered for this variety.

4.34. There would in the first place be the most widespread ignorance of
the statistical facts of the present situation (and of the trends in it) and in consequence all kinds of inconsistent myths and legends and distorted views would be honestly believed. Secondly there would be, among most of those questioned, much ignorance also of the qualitative nature of the lives of people socially remote from themselves. Not many of the well-to-do know what it is to be very poor, and most of us may have strange ideas of the daily lives of the very rich. Finally, and quite separately, there would be the widest divergences in the extent to which people in fact cared very much what happened to the rest of the population, in the extent of their mutual sympathy, in the extent of their exclusive self-interest or group loyalties, in their willingness, in the last resort, to pay up for the good of others.

4.35. It is reasonably to be supposed that were the first kind of ignorance remedied there would be a reduction in the spread of opinions about distribution policy. Such too might be the consequence of remedying the less tangible ignorance that surely exists under the second head. But even then, residually, there would remain the variations in social and political attitudes last mentioned as a cause of different views on this basic issue of social justice. Such variations stem ultimately from the moral—or if you will, immoral—beliefs of individual citizens, which may indeed change over the generations but which are of a kind not amenable to alteration by the expression of ‘expert’ views. It is by reason of the inevitability of these variations that distributional policies must be decided in the political process and cannot be determined on any impartial, scientific, objective basis. But it does not follow that, were ignorance remedied, the dispersion of basic political attitudes would be so great as to make a reasonably settled policy unattainable. Some extreme views will doubtless always persist in small minorities. More importantly, whatever objective is currently being pursued, many may want more done and many less. But the differences among the moderate majority may be, quantitatively, of no great magnitude, no greater than can be accommodated by changes in tax rates, without changes in the whole structure.

4.36. Australia has a very homogeneous society, both economically and socially. It is sometimes abused for over-valuing material well-being, perhaps because it is a country with a very high standard of living, but it is predominantly tolerant and individualistic. Most Australians are self-reliant and indisposed to believe that there exists any kind of exact social scale in which they have their own precise place, still less to identify such a scale and their own place in it by reference to their own and their neighbours’ income or wealth. Hence it seems to the Committee that some such near-consensus as that just suggested may exist here, behind and below, so to
speak, the existing ignorances and myths and despite Australia's tradition of vigorous language in political debate. In recommending a direction of reform in the Australian tax system it is one of the Committee's tasks to attempt to define in general terms what this underlying national unity suggests for fiscal policy.

4.37. In the Committee's judgment there will be almost universal agreement that, overall, taxation should be progressive at the upper end of the scales of income and wealth, and that at the other extreme poverty and threats of poverty reflecting situations of special need should be relieved of taxation or assisted by social service payments. But it is convinced that there will nevertheless long remain debate and disagreement about the exact extent to which it is economically safe, administratively feasible, and socially justifiable to push taxation at these higher levels and to assist poverty and need.

4.38. At the same time and quite consistently with this recognition of sharp disagreements about the extremes, the Committee's belief is that over the middle band of income and wealth, the band in which the great majority of them spend their lives, most Australians will accept as fair and convenient an approximately proportional taxation system. When the estimates are made as best they can, that appears to be the quantitative outcome of the present system, and the Committee sees no reason to depart from it.

The Committee acknowledges with gratitude numerous analyses of this material undertaken for it by Dr N. Podder of the University of New South Wales, with the freely given help of his university colleague, Professor N. C. Kakwani. It has also made use of estimates of the distribution of taxes contained in a paper by three Macquarie University economists—Messrs P. Bentley and D. J. Collins, and Professor N. T. Drane—one of which much further work has been done, with the Committee's assistance, by Messrs Bentley, Collins, and D. J. S. Rutledge.
Chapter 5 The goals of Tax Reform

5.1. When the analyses of the previous two chapters are drawn together it is possible to provide some general discussion of the options open to Australia in the reform of its tax system, and to state, in broad terms, the direction of change recommended by the Committee.

I. The Options

5.2. It will be helpful first to distinguish two quite opposite destinations towards which, if so desired, it might be possible to work. Each would be consistent with whatever level of revenue-raising from time to time may be decided upon. For reasons to be noted neither can be recommended, but both are worth describing briefly as the extremes between which a range of more satisfactory possible destinations can be imagined.

5.3. Were simplicity and efficiency the only objectives, one might aim at a system overwhelmingly dependent for revenue upon a single broad-based tax on goods and services set at a very high rate, with some simple additional taxes on, for example, alcoholic drinks, tobacco, and motoring to serve the specific interventions in the private market needed for efficiency purposes. At the same time simple grants to meet the most obvious differences in individual needs—child endowment, age pensions, sickness and unemployment benefits—would deal, without much administrative complexity, with the most serious problem of equity at the bottom end of the scale. There would be no income or capital taxes at all.

5.4. If this be called the ultra-simple extreme, its polar opposite might be called the ultra-complex. The latter would be a system relying overwhelmingly for its revenue upon an income tax, buttressed in its operation by a capital gains tax and capital taxes, whether estate and gift duties or a wealth tax or even both. Again some efficiency taxes could be incorporated. There would be no place for any broad-based tax on goods and services: the income tax could be put at any desired level. The same set of grants would be included whether separately means-tested or made fully taxable; concessional deductions from income tax would be freely used. It would be a system thoroughly adaptable to the expression of very refined notions of progressivity, involving minute adjustments of relative tax liability from the bottom to the top of the scales of income and wealth, and allowing, if so desired, a very sharp rate of progressivity.

5.5. Certainly the ultra-simple system would have in full measure the attractions of simplicity. Very few individuals would directly pay taxes,
and they and the enterprises on whom the task would chiefly fall would probably be able to handle the accounting without difficulty. Taxes in fact would become as nearly invisible as possible, though everybody would of course know of the level of the broad-based consumption tax. Indeed, taxes might be almost too invisible. There would be a reinforcement of that misunderstanding, already with us, which leads people to believe that what we receive from the government comes from some supra-human Santa Claus from whose bottomless sack ever more can be produced without charge to ourselves. (In a report rendered to a Treasurer it is unnecessary to argue that this myth is troublesome to the right conduct of public finances.) This system too would admirably serve the end of economic growth. With no income tax and no capital tax restraining the savings of the well-to-do, there would be no direct limit on accumulation and inheritance. But this, of course, would be the mere obverse of the fault that would certainly make it wholly unacceptable. The grants would make it a progressive system at the bottom of the scale, but towards the top it would become actually regressive. It would grossly offend universally accepted interpretations of the aim of equity.

5.6. The ultra-complex extreme would have to be rejected for opposite reasons. It would be even more complicated than the system we have now. Everyone would be annually involved in completing elaborate returns. With total income tax higher than at present, the problems of willing compliance would be exacerbated. The costs of enforcement, both monetary and in terms of bureaucratic intrusion into private affairs, would rise. If the one system was drawn towards the Scylla of the fallacy of Santa Claus, this would fall into the Charybdis of the burden fallacy.

5.7. Between these plainly unacceptable extremes a narrower band of alternatives can be imagined between which more serious debate is possible. The cardinal objection to the ultra-simple system, that of its regressivity at high levels of income and wealth, would be largely met by the inclusion of an income tax and a capital tax with high minimum exemption limits that effectively confined their impact to the upper end of the scales of income and wealth, perhaps with measures to improve their coverage of capital gains. The simple though now taxable grants would still deal with vertical and horizontal equity at the other end; the broad-based tax would still secure no more than a simple proportionality to consumption in the middle range; simplicity would only be sacrificed in the interests of equity at the top where, however the dividing line were placed, only a minority of the population would be found. Correspondingly, the prime fault of the ultra-complex system would be quite substantially relieved if a broad-based tax at a moderate level were
added to it, combined with some efficiency taxes, and the proceeds used to increase grants (in compensation for the rise in prices) and to reduce the rates and simplify the structure of personal income tax. As long-term possibilities for a permanent structure neither of these less extreme systems, which might be dubbed the simple and the complex, could reasonably be dismissed out of hand.

5.8. It will at once be noticed that in these alternatives the list of taxes is the same. Where they differ is in the relative weights given in each to the taxes they comprise. When one imagines these weights being changed to exhibit a whole series of intermediate alternatives, one comes upon a continuum. Moving along this continuum from the complex end, the rate of the broad-based tax rises as also do grants, while the income tax is reduced in rate and coverage. Conversely, travelling from the simple end the rate of broad-based tax falls, grants fall, and income tax rises. Efficiency (in the sense of neutrality modified by some specific taxes for specific purposes) is unaffected, but simplicity varies.

5.9. The analysis of Chapter 3 points thus far. That of Chapter 4 enables the Committee to take a further step. Even in a system quite far towards the simple end of the range it is possible by varying the rates of the income and capital taxes to express a greater or less desire to be progressive at the top end of the distribution, and to improve progressivity via grants at the opposite end of the scale. Also, by variation of the rate of the broad-based tax these grants can be raised or lowered at will, to the advantage or disadvantage of those at the bottom (as well as to the advantage or disadvantage of the average level of intra-lifetime transfers for everyone). Thus provided that approximately proportional taxes are accepted as fair in the middle range, a simple system can serve greater or less public ambitions for redistribution at the extremes.

5.10. The analysis in Chapter 4 of such factual information as the Committee has been able to gather suggested two tentative conclusions of prime importance. First, it would appear that when all taxes are taken into account the Australian tax system is already approximately proportional in the middle ranges, though (when grants are reckoned in) progressive at the lower end and, through the impact of personal and company income tax and estate duty, progressive again at high levels. Second, it would also appear that the distribution of income is such that, accepting the need for substantial grants at the bottom end of the scale and significant progressivity at the top, there is not very much scope for change in the progressivity of the tax system in the middle range. Furthermore it was suggested in the later part of that discussion that something like proportionality in the middle range was socially acceptable in Australia,
and that the spread of socio-political views chiefly concerned the extent to which those in need should be assisted through grants and the higher groups taxed more than proportionately.

5.11. If these tentative judgments of fact and value be correct, it follows that a tax system towards the simple end of the spectrum just described would suit the facts and values of the Australian community. The Committee therefore recommends such a system as the long-term target to which Australia should work and would favour a general strategy of tax reform which worked towards it.

II. Immediate and Long-Term Perspectives

5.12. There is of course a world of difference between establishing a long-term target in general and abstract terms and achieving it. Indeed on the way to it much may happen to cast doubt upon the continuing validity of the underlying factual and social judgments.

5.13. Currently, as the Committee sees it, the Australian tax system contains sufficient internal incoherences for the term ‘system’ to be somewhat of a euphemism. As will be argued later, the income tax, both personal and company, on which major dependence is now placed, has considerable defects that require remedy; the lack until now of a capital gains tax is seriously inequitable and renders the system less progressive than was probably intended; estate and gift duties are very faulty as capital taxes; and the existing sales tax and excise duties are defective as efficiency taxes. A number of reforms to deal with these immediate deficiencies will be proposed in later chapters, together with the introduction of a broad-based consumption tax.

5.14. In the immediate result the Committee's recommendations would, it hopes, give Australia a more systematic body of taxation, and one that would be more efficient and equitable. But it would be very much at the complex end of the spectrum just described, and it is questionable whether it could be claimed to be, overall, simpler than the present system especially since two new taxes are proposed. On the other hand, if the Committee's full proposals were accepted it could be argued that at least the complexity of the still dominant income tax would be alleviated and there would be simplifications in the area of estate and gift duties.

5.15. The major opportunities for simplification, in the Committee's judgment, inevitably lie further ahead. Some might be gained quite soon. As and when the Australian taxpayer becomes accustomed to a broad-based tax, it should be quickly practicable (above all if the co-operation of those concerned with the fixing of wages and salaries was forthcoming) to
reduce marginal and average rates of income tax by progressively raising
the level of the broad-based tax. Thereby great gains in terms of reduction
of evasion and avoidance and costs of compliance could be achieved, and
the effect upon incentives to work and save might also be favourable. But
beyond that lie the further goals of gradually replacing the existing means-
tested social service transfers by a simpler system of taxable grants and of
raising the exemption level of income taxation so that at length such grants
were only taxed in the hands of a minority. Were it ever possible to reach
that situation Australia would indeed have attained the simplest taxation of
any advanced country. But its eventual practicability would depend
crucially upon future trends in the level of grants, in the numbers eligible,
in the spread of incomes before tax and in the way social attitudes to this
spread change as average real incomes rise. The Committee would by no
means wish to suggest that much progress to these ultimate goals can be
made in the years just ahead. Perhaps they would always prove
impracticable. But the Committee would not wish to exclude them from
the eventual ideal of a tax system appropriate to a rich democratic and
socially egalitarian country.

5.16. The discussion of this chapter has deliberately been kept at a very
general level and, correspondingly, has had to be somewhat vague. In later
chapters particular taxes will be examined in greater detail and more
concrete content given to the Committee's proposals.
Chapter 6 Inflation and Tax Reform

6.1. The Committee, which began its task of formulating advice in October 1972, has had to do so against the background of an economy in the throes of a continuing serious inflation—inflation at a rate which, at the time this report is presented, threatens to be far beyond anything contemplated during the initial stages of the Committee's deliberations. The rate has increased noticeably since the compilation of the Committee's preliminary report which was completed at the end of May 1974.

6.2. In the period from 1954–55 to 1968–69, the annual rate of increase in consumer prices—customarily treated as the main index of inflation—averaged 2.6 per cent; but over the last five years the annual rate of increase, taking the figures from one June quarter to the next, has sharply accelerated in the following manner:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent</th>
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<tbody>
<tr>
<td>1969–70</td>
<td>3.7</td>
</tr>
<tr>
<td>1970–71</td>
<td>5.4</td>
</tr>
<tr>
<td>1971–72</td>
<td>6.2</td>
</tr>
<tr>
<td>1972–73</td>
<td>8.0</td>
</tr>
<tr>
<td>1973–74</td>
<td>14.4</td>
</tr>
</tbody>
</table>

In the result, prices over the past twenty years have almost exactly doubled. But if the 1973–74 rate of increase persists, they will double again in only six years; while if the annual price rise approaches 20 per cent—the rate at which inflation appears to be running in the first half of 1974–75—the doubling will occur in approximately four years.

6.3. Inflation on the present scale is gravely disturbing. It produces arbitrary changes in the distribution of income and wealth, favouring borrowers at the expense of lenders, the working population at the expense of the retired, and more powerful pressure groups at the expense of less powerful ones. It distorts the composition of production as people seek, not the commodities they most want for consumption and the level and pattern of savings most suited to their real needs, but rather what will give them the best hedge against inflation. It creates uncertainty and frustration over the whole range of the community, and leads to serious breakdown in commercial confidence and great industrial unrest. It may cause balance of payments difficulties. And once the rise in prices is at all rapid, the new
threat emerges of further acceleration, leading if unchecked to hyper-inflation and to the undermining of the whole economic and social fabric.

6.4. There can be no denying, too, that tax arrangements are capable of intensifying or moderating the pace of inflation. In its proposals on tax reform, compiled within its terms of reference of 1972 and spelled out in later chapters of this report, the Committee has given only modest attention to the impact of taxes on inflation. For one thing, tax measures on their own are hardly likely to remove inflation, and it is not within the Committee's competence to pass judgment on policies outside the immediate field of taxation. Furthermore, effective action to deal with inflation may require at least temporary adjustment to the overall level of taxation, and the Committee by its terms of reference is instructed to ‘ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth’. Also the role of taxes in the inflation process is a matter of much controversy and uncertainty: any recommendations would thus have to be somewhat tentative. But with inflation running at an exceptionally high rate and threatening to become a permanent feature of the Australian economy, the Committee might justly be criticised for seeming to be out of touch with reality if it failed to make observations on tax policy in relation to inflation, more especially in view of the variety of anti-inflation schemes now being canvassed that assign a somewhat novel role to the tax system. Section I of this chapter is intended to forestall such criticism.

6.5. Just as taxation has a bearing on the rate of inflation, so inflation impinges on the tax system in important respects, furnishing both grounds for a measure of tax reform and, since it is reasonable to suppose that an undesirable rate of inflation is going to persist for some time, complicating the task of devising reforms that will still be relevant years from now. Some of the main ways in which inflation impinges on the tax system are outlined in Section II of this chapter; the manner in which the Committee has sought to allow for inflation will be explained in later chapters when particular taxes are being reviewed.

6.6. Before proceeding to Section I, brief reference should be made to a further way in which inflation has affected the drafting of this report. With prices rising at rapid but unpredictable speed, it becomes correspondingly more difficult to estimate tax yields a year or two ahead, let alone yields four of five years hence which may prove to be the earliest that at least some of the Committee's recommendations can be implemented. That the Government now has difficulty forecasting revenue accurately even 12 months in advance is fairly apparent when actual tax receipts in 1973–74 are compared with estimates published in August 1973: for instance, sales
tax brought in 9.0 per cent more revenue than anticipated and the pay-as-you-earn component of personal income tax 7.6 per cent more. Understandably, therefore, the Committee has not sought to be precise about the revenue implications of its various tax recommendations. Nor, in most cases, has it attempted to attach particular money values to levels of proposed concessions, rebates and the like, except by the way of indicating rough orders of magnitude and then only on the basis of today's prices.

I. Taxes and Inflation Control

6.7. The causes of inflation are complex and incompletely understood. But broadly two schools of thought can be distinguished, commonly labelled demand-pull and cost-push.

6.8. The former school looks to the behaviour of individuals and groups in the face of excess demand for goods and services over available supply, a rapid expansion in the volume of money, and expectations of changes in prices and earnings. It is recognised too that inflation may stem in part from international factors, and a number of channels by which rising prices may be transmitted from country to country have come to be identified: for example, by overseas demand raising exporters’ incomes or a balance of payments surplus causing the domestic money supply to expand. In general, the emergence of excess demand is considered to be the prime initiating factor, though inflation may continue after excess demand has been eliminated and perhaps even been replaced by a short-fall in demand accompanied by unemployment—what has come to be known as stagflation. Inflation persists because the pursuit of income claims in response to price increases that have already occurred establishes a wage-price spiral which is liable to continue as long as monetary conditions permit, reinforced in some measure no doubt by wage-fixing practices inside and outside the arbitration system. The spiral tends to be accompanied by greater strike activity as wage earners exploit their market power to press their income claims. To control inflation, according to the demand-pull school, the various sections of the community must be induced to alter their behaviour, which can be done by manipulating such conventional economic variables as the money supply, interest rates, the exchange rate, taxes and government spending.

6.9. The second school would acknowledge that the economic factors referred to in the last paragraph may at times be important, but argues that the underlying cause of inflation is more deep-seated and relates to a basic social struggle over the distribution of national income. Unions, firms and other groups use their economic and political power to try to protect or
improve their share of national income, inflation of the cost-push variety being the means by which conflicting income claims find expression. The process is self-sustaining because governments have a strong political commitment to full employment and are therefore prepared to let the money supply expand to accommodate the income claims. This school also accepts that, to control inflation, behaviour must be changed, but the emphasis is less on manipulating conventional economic variables as on fundamental institutional and social reorganisation.

6.10. The explanations of both schools are undoubtedly important for an understanding of the inflationary process and it is misleading to polarise them. The first school points to the tendency for expenditure plans to exceed the capacity of the economy to satisfy them and sees rising prices as the inevitable consequence. The second school focuses on the conflict about income shares and sees rising money incomes as the manifestation of this struggle.

6.11. This latter view may help account for the long-term upward movement in the price level in the post-war period, but a more immediate explanation for the upsurge of inflation in Australia since 1970, and particularly after 1972, would seem to lie in the excessive growth in money supply, the pressure of demand on available resources and the build up of inflationary expectations. These tendencies can be traced to both international and domestic sources. The rapid growth of international reserves contributed in no small degree to the 26 per cent increase in money supply during 1972–73, while the steep rise in world commodity prices has obviously had a significant influence on the growth of Australian prices and incomes. On the domestic front the easy monetary conditions of 1972–73 and early 1973–74 added to the growth of money supply and strengthened the demand for factors of production and final commodities. Budgetary policy was strongly expansionary throughout 1972–73 and only very slightly less so during 1973–74. Under these circumstances expectations of continuing and accelerating inflation led employers and employees to use their market power to maintain or increase their share of national income. The severest wage-price spiral since the wool-boom days of the early 1950s was thereby established.

6.12. It is fairly apparent that a reduction in the rate of inflation is only possible if individuals and groups in society can be induced to modify their behaviour. This is as much a political and social problem as an economic one, requiring common agreement about the extent to which the policy objectives of full employment, appropriate use of resources and a fair distribution of national income should be compromised for the sake of greater price stability. Conflicts inevitably arise in establishing satisfactory
compromises, but until they are resolved an underlying inflationary trend seems unavoidable. Moreover, even if consensus about policy objectives can be achieved, there is still likely to be dispute over the means of ensuring that behaviour is consistent with the objectives chosen.

6.13. Tax increases have traditionally been viewed as one of a number of policies for inclusion in a program to combat inflation. Increases in personal income tax reduced disposable incomes, thereby easing the pressure on resources caused by excessive spending in the private sector. Increases in indirect taxes tend to be shifted forward in varying degrees, producing once-and-for-all increases in the price level; but higher prices involve a cut in real spending power and in this sense such taxes are demand-reducing and therefore, in the absence of corresponding wage increases, anti-inflationary. It is conventionally assumed, when tax increases are to be used in a program to combat inflation, that any additional tax revenue is not in fact spent by the government.

6.14. Recent trends of events have called these views into question. It may be unduly optimistic to assume that government spending will be kept in check as taxes increase. Given the political commitment to full employment and pressures on governments to fulfil electoral promises, increases in tax revenue may have the effect, at least indirectly, of boosting government spending with the result that community spending is not in fact reduced. Such commitments and promises, moreover, make it unlikely that tight monetary policies will be pursued for any length of time. In these circumstances the conventional assumptions may no longer be appropriate: there now seems to be a distinct possibility that personal income tax will in some degree be shifted too, and once-and-for-all price increases associated with tax shifting in general will become cumulative.

6.15. For a number of reasons personal income tax may be a somewhat weaker anti-inflationary device than used to be thought. To the extent that employees, in formulating their wage claims, anticipate the extra income tax that higher wages will attract, personal income tax may contribute in fairly direct fashion to the wage-price spiral. For if attempts to shift the tax through correspondingly higher wage claims prove successful and employers seek to recover their higher expenses by passing on additional labour costs (including those unavoidable costs accompanying a larger wages bill, such as payroll tax, workers’ compensation insurance premiums, and holiday and long-service leave costs), then commodity prices must rise as long as the money supply is allowed to expand. Workers, in deciding their wage demands, appear increasingly to be recognising the fact that personal income tax not only bites heavily into additional income but, because of the graduated rate schedule, does so with
mounting severity the greater the additional income. It is understandable, in these circumstances, that employees should set their wage claims as high as possible, knowing as they do that the real value of their extra pay is going to be eroded not only by the rising prices but also by heavier taxation. Paradoxically, though, the more successful the work force as a whole in securing large wage increases, the more is the real value of extra pay liable to be eaten into by higher marginal tax rates.

6.16. The point is illustrated in Table 6.A. A 25 per cent increase in 1974–75 in the income of the average earner (row 1), if accompanied by similar increases throughout the work force and by a 2.5 per cent growth in national productivity, will mean a rise in consumer prices of the order of 22 per cent. The increase in pre-tax real income will thus be modest (row 2), being confined to growth in productivity. However, because of the considerable expansion in money income, tax payable will rise sharply in the context of an unadjusted rate schedule (rows 3 and 6). Were the 1973–74 schedule still functioning, the real value of the average earner's take-home pay would actually decline (row 5); indeed, had the 1974–75 schedule applied in both years, the decline would be somewhat greater (row 8).

### TABLE 6.A: EFFECT OF RISING MONEY INCOMES AND AN UNALTEDER PROGRESSIVE INCOME TAX SCHEDULE

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<tr>
<td>$6,136</td>
<td>$7,670</td>
<td>$1,534</td>
<td>+25.0</td>
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<tr>
<td>Average earnings per employed adult male unit</td>
<td></td>
<td></td>
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<tr>
<td>Value of average earnings at 1973–74 prices (a)</td>
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<td></td>
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<tr>
<td>Tax payable 761</td>
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<tr>
<td>Take-home pay 5,375</td>
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1973–74 rate schedule and dependant allowance provisions

1974–75 rate schedule and dependant allowance provisions
6.17. It is thus all too clear that tailoring wage demands to allow for the additional tax liability that higher incomes involve, if attempted by all employees, must be self-defeating in the absence of adjustments to the rate schedule or of the acceptance of lower profit margins by business. Nevertheless, particular sections of the work force, viewed in isolation, may be perfectly rational in seeking to maximise their wage demands; for if they are only modest in their demands, while other sections are not, they face the prospect of being made even worse off both absolutely and in relation to the rest of the work force. In the outcome, such inflationary pressures as already exist in the economy tend to be reinforced. Resistance to paying heavier taxation merges with the more basic struggle, adverted to in paragraph 6.9, between different groups in society each seeking a larger share of national income and reacting to the claims of others for a larger share.

6.18. This view of the contribution of personal income tax to the wage-price spiral has intuitive appeal and is beginning to gain many adherents. Empirical studies have yet to establish conclusively that there is a close relationship between changes in income tax, changes in wages, and changes in the general price level: investigations in the United Kingdom and Canada point to a relationship, but the research there is in its early stages and the findings are necessarily tentative. However, the wide publicity now being given to theories of inflation that attach importance to the passing on of personal income tax may in time serve to confirm such theories by bringing home more forcibly to income earners just how significant a bearing high and progressive rates of income tax have on the
real value of take-home pay.

6.19. Doubts of other kinds have also been expressed about the efficacy of personal income tax as an anti-inflation device. Exactly how far work effort is inhibited by personal income tax is a matter of conjecture, but to the extent that it is it may tend to accentuate inflation by curbing the supply of goods at a time when demand is rising strongly. The issue is particularly important in relation to overtime work: it was concern on this account that led New Zealand, in 1974, to introduce a special rebate of tax on overtime earnings.

6.20. There is the further point that if unions are now increasingly bargaining in net of tax terms, high and graduated rates of personal income tax may mean greater industrial unrest and strike action as workers attempt to achieve their wage demands, which again will be reflected in the supply of goods coming on the market as well as in the cost of producing them. Strong claims have been made, on the basis of United Kingdom data, for the existence of a relationship between strike activity and taxes.

6.21. Finally, the demand-reducing effects of personal income tax may be weaker than often thought. An increase in personal income tax expected to be only short-lived may do little to restrain personal consumption spending. To the extent that personal consumption depends upon ‘permanent’ rather than current income, the effect of a temporary increase in rates of personal income tax will be to reduce saving rather than consumption. A counter-cyclical increase in personal income tax may thus be ineffective in restricting demand precisely because it is seen to be a temporary stabilising measure. Moreover, in so far as personal income tax reduces the reward for saving and acts as an inducement to consume now rather than later, its efficacy in curbing demand may be further weakened.

6.22. In the conventional view, company tax reduces demand, and hence inflationary pressure, by diminishing company savings and the income of shareholders and thus reducing the rate of spending in both corporate and household sectors. To the extent that tax is shifted forward to consumers, the spending of companies and their shareholders will be less affected, but purchasers of the company's output will find their disposable incomes reduced in real terms. In the latter case, however, raising company tax is likely to exacerbate the wage-price spiral unless the offsetting demand-reducing effects are substantial.

6.23. It has been customary to argue that increases in rates of indirect tax are passed on as once-and-for-all increases in prices and constitute a deflationary measure because of the accompanying decline in the real spending power of consumers. However, the deflationary impact on the demand side may prove weaker than the initial effect on the general price
level; furthermore, the price level effect may become embodied in expectations and hence in income claims. In these circumstances the tax increase will lead to cumulative shifting forward to consumers through firms raising their prices and backward to firms through employees raising their income claims. Like other taxes, therefore, it is by no means certain that an increase in indirect taxation will be effective in reducing inflation; indeed, it could make things worse in some situations. Payroll tax is particularly open to criticism on this account, directly tied as the levy is to the size of an employer's wages bill.

6.24. Understandably, therefore, the view is now being widely canvassed that stabilisation policy in a period of severe inflation should feature tax cuts rather than tax increases, and the Committee can see some merit in this. Tax cuts, if accompanied by appropriate action in such other areas of policy as government spending, money supply, the exchange rate, tariffs and surveillance of prices and incomes, may have at least three attractions:

(a) Once inflation becomes at all rapid, the appropriate setting of monetary and exchange rate policies and levels of government spending is likely to be associated with long delays before the effects are seen in a reduction of inflation. Tax cuts may fulfil the useful function of breaking into the wage-price spiral and thus of shortening the time-lag involved in applying other more conventional policies.
(b) Tax cuts in effect represent a reduction in the income claims of the government sector, which is one of the major groups involved in the struggle over income shares.
(c) Tax cuts can be made to serve as a quid pro quo for trade union agreement to moderate wage claims. Employing taxes as part of a ‘social compact’ of this kind inevitably merges with the broader issue, now also attracting much attention, of using the tax system to implement some form of income and prices policy. This warrants closer examination.

6.25. Incomes and prices policies have found favour with many overseas countries, at one time or another, as a means of coping with inflation, though the results have been disappointing especially in the longer-term context. These policies usually involve the setting of guidelines for the growth of national and individual prices and incomes, and the adoption of devices to induce employers and employees to behave in a manner consistent with those guidelines. The inducement devices vary considerably, from moral suasion at the one extreme to legal compulsion at the other. In most countries the central government has had the power to pass legislation to regulate prices and incomes directly, but this is not the case in Australia and perhaps goes some way to explaining why, at least in peacetime, such policies have never been tried here. Lately, however, a
number of proposals have been put forward for using the Australian tax system to induce employers and employees to formulate their income claims in conformity with certain national guidelines. This is not the place to debate the merits and shortcomings of incomes and prices policies generally; but it is not inappropriate to comment on particular tax arrangements designed to put pressure on management and labour to behave in certain ways.

6.26. Most of the suggestions in this area involve employing company tax to stiffen the back of the corporate sector in wage negotiations with employees. They include raising the basic company tax rate to, say, 60 per cent and then providing a rebate of perhaps 20 per cent for all companies holding wage increases within prescribed limits; leaving the basic rate unaltered but providing tax relief to firms that keep their wage increases down; and the denial of wage payments, in excess of some norm, as a tax deduction. More sophisticated proposals involve tapering the tax rebates or penalties. An excess profits tax has been canvassed too. Outside the company tax field there has been some support for a penalty rate of personal income tax on all increases in income in excess of a prescribed figure. One suggestion goes so far as setting the penalty rate at 100 per cent.

6.27. There may be constitutional obstacles to tax-penalty schemes of these kinds. Under section 51(ii) of the Constitution, the Commonwealth Parliament has power to make laws ‘with respect to taxation’. It is open to argument that a law purporting to impose differential rates of tax on employers according to their policy on wages or seeking to confiscate wage rises above a certain norm by imposing a marginal tax rate of 100 per cent would not be a law ‘with respect to taxation’ but one imposing wage control.

6.28. As well as constitutional problems, substantial tax shifting might occur, which would defeat the whole purpose of such measures. Indeed, unless the tax penalties were carefully designed, and effective price controls to apply, price might rise even faster than otherwise in circumstances where firms were readily able to shift taxes forward because of the buoyant state of the market and were anxious to avoid becoming embroiled in protracted industrial disputes. The ability to shift tax penalties is likely to vary markedly in different parts of the economy depending, for example, on the degree of competition from overseas suppliers or from domestic producers not subject to the penalty provisions. Such penalties might therefore prove highly inequitable, even as between firms exposed to penalties.

6.29. The use of the company tax system to restrain wage increases has
further shortcomings. It might encourage some companies to assume partnership or trust status to avoid penalties. It might encourage others to change their method of operation, relying more heavily on sub-contractors instead of on their own employees. It could undermine many soundly-based production bonus schemes. It would make it extremely difficult for firms to estimate the effects of the coming into operation of major items of new equipment or the launching of additional products. There would be formidable administrative problems for employers and endless and unproductive argument on the exercise of the many discretions the Commissioner would need to be given to ensure that the scheme will function with some semblance of equity for all taxpayers.

6.30. It is extremely doubtful whether an excess profits tax aimed at inhibiting firms from pushing up their prices would achieve its purpose; it might simply weaken their resolve to hold down costs. Moreover, the problems to be faced in designing a scheme that would be both equitable and administratively feasible are daunting indeed. They were examined in some detail by the Spooner Committee which, in 1950, was asked to look at methods of giving effect to the government's decision, subsequently abandoned, to impose an excess profits tax as an anti-inflation measure.

6.31. There are also likely to be thorny problems in employing a penalty rate of personal income tax to curb wage claims. Persons working overtime or taking on second jobs or securing promotions would have to be accorded special treatment if the system was to be fair and work effort not to be unduly discouraged. Special consideration would also have to be given to persons with fluctuating incomes and to those entering the work force for the first time. There would be a strong inducement to understate income or attribute it to someone else, making the administration of the scheme even more burdensome for the Commissioner. Industrial unrest might intensify.

6.32. In the Committee's view tax penalties of the kinds outlined above are not a feasible proposition. Constitutional difficulties aside, effectively administering such penalties poses many awkward problems and there is no reasonable prospect that the rate of inflation would be held in check.

6.33. As already indicated, however, the Committee is not unsympathetic, in certain circumstances, to employing the opposite technique of tax cuts as part of a properly integrated program to halt inflation. It is particularly relevant in this regard to note the possible introduction soon of a scheme of wage indexation, intended to eliminate the insecurity and uncertainty employees feel about levels of real income and to establish an orderly basis for wage negotiations focusing on changes in productivity. A similar scheme, involving quarterly adjustments of
wages by reference to changes in a price index, operated for many years in this country; it was abandoned in 1953 because it was thought to be inflationary.

6.34. The Committee is not in a position to judge the likely impact that the reintroduction of wage indexation would have on the pace of inflation: much would obviously depend on whether incomes were indexed on a percentage basis or in flat terms and on whatever other concurrent measures were taken. But if nothing were done to counteract price increases already in the pipeline or to moderate wage claims currently under negotiation, wage indexation would almost certainly make inflation worse. This is where tax cuts could perhaps play one useful role. They might serve to reduce the impact on the consumer price index of wage and price increases already in the pipeline, especially if concentrated on excise duties, sales tax and payroll tax which have a fairly immediate impact on the consumer price index. However, any moderating effect that tax cuts might have on the consumer price index, and hence on those wage increases directly tied to consumer prices, would count for little in the longer run if wage indexation failed to exert some downward pressure on wage claims in excess of increases in the cost of living and improvements in productivity. Hence a second function of tax cuts might be to foster a climate more conducive to wage restraint. Thus in so far as employees are increasingly seeking to protect the real value of their take-home pay from the eroding effects of a progressive income tax by bargaining in net-of-tax terms, one might hope that cuts in personal income tax rates would cause employees to moderate their wage demands. But it would be asking too much of the tax system to shore up a wage indexation scheme that was poorly conceived and badly timed.

6.35. In Section II of this chapter, and later in Chapter 14, attention is drawn to the need in times of inflation to adjust tax rates frequently when, in such cases as personal income tax and death duties, rate schedules are progressive. While the case for doing this, at least as far as personal income tax is concerned, may in some measure be to curb wage demands and thus assist in restraining inflation, the main object is to counteract the arbitrary and inequitable restructuring of tax schedules that inflation inevitably produces. In this main object the adjustment may be seen as an attempt not so much to control inflation as to make it more comfortable to live with. In Section II and later chapters attention is also drawn to the way inflation upsets the measurement of the base upon which a tax is levied, and suggestions are put forward for overcoming this problem. These suggestions, too, may be seen as measures to make inflation more comfortable to live with. They are partial expressions of a policy which, in
its widest operation, would extend far beyond the tax system and include linking the number of dollars to be delivered on a contract—whether a wage contract, a sale or loan contract, or a pension entitlement—to changes in some specified price index. The Committee is not competent to determine the feasibility of comprehensive indexing along these lines. It would, however, reject the inference sometimes drawn that if a wide enough range of measures is taken to accommodate personal and business circumstances to rising prices, inflation no longer presents problems. Many problems would in fact remain—not least the prospect that inflation may be allowed to accelerate. The community's top priority, in the view of the Committee, must be to reduce inflation.

II. Effects of Inflation on Taxes

6.36. Whatever views are held about the impact of the tax system on inflation, there can be no question that inflation in its turn exerts a powerful influence on the character of the tax system which must be explicitly allowed for in any program of tax reform. This influence manifests itself in a variety of ways. They may conveniently be dealt with under the three headings of tax payment, tax drift and tax base.

Tax Payment

6.37. With inflation, any appreciable delay between tax liability and actual tax payment may produce a not insignificant reduction in the real burden of tax: tax is, in effect, paid in depreciated currency. Unless such delays can be exploited by all taxpayers, inequities will occur. There is of course always an advantage in postponing tax payments as long as possible, but the advantage may be greater with inflation. Expressed another way, any delay in paying tax confers a benefit on the taxpayer unless a realistic rate of interest is charged on the postponed amount; and since nominal interest rates tend to be higher in times of inflation, the advantage of delaying payment is correspondingly greater. For example, present arrangements for paying company tax involve a noticeable time-lag, and the Committee has recommendations to make in this regard in Chapter 22.

6.38. The other side of the coin, where taxpayers find themselves disadvantaged through initially paying too much tax, is perhaps best illustrated by the system of instalment deductions under personal income tax. Most wage and salary earners are obliged to make interest-free loans to the government by way of excessive instalment deductions which are not
paid back until after the end of the financial year. In a time of rapid inflation, as at present, both the size of these loans and the rates of interest taxpayers are forgoing by not having the money themselves, tend to rise sharply. This too is discussed in Chapter 22.

**Tax Drift**

6.39. Where a tax is levied at progressive rates or involves exemptions and deductions that remain unchanged in money terms over a period of years, substantial increases in prices and incomes have the effect of increasing tax receipts particularly rapidly. One important implication of this phenomenon, perhaps best described as ‘tax drift’, is the possible impetus it gives to inflation as wage earners find it necessary to pitch their income demands ever higher in a vain effort to compensate for the larger tax bite. Some of its other implications must also be considered.

**Total Tax Receipts**

6.40 In so far as tax drift applies to a major segment of the tax system, as in fact it does, it is inevitable that tax receipts will rise in relation to gross national product. As the statistics in Chapter 2 indicate, revenue from taxation has increased from 22.2 per cent of gross national product in 1959–60 to 27.7 per cent in 1973–74—in absolute terms an increase from $3,041 million to $13,768 million. While several factors have contributed to this upward trend, the tendency for inflation to push taxpayers into higher income tax brackets more quickly than otherwise has undoubtedly been responsible in no small measure. The windfall yield of tax drift is not without attractions for governments: extra revenue is obtained without the odium of lifting tax rates by legislation. But such illusions are unlikely to persist. People are already coming to realise that though their incomes before tax may be rising as fast or faster than prices, their incomes after tax are rising less than they had expected.

**Tax Mix**

6.41. Since tax drift mainly concerns personal income tax, a further effect of inflation is to increase the proportion of tax revenue attributable to income tax. As recently as 1963–64 personal income tax raised only $1,271 million, or some 32 per cent of all tax revenue; ten years later, in 1973–74, the figure had reached $5,490 million, which is nearly 40 per cent of tax revenue and puts Australia almost at the top among OECD countries in terms of reliance on personal income tax. It is the Committee's
view, already expounded in Chapter 5, that less, not more, reliance should be placed on personal income tax.

**Income Tax Rates**

6.42 Even were the present trend towards greater reliance on personal income tax thought to be in the right direction, it is unlikely that inflation is achieving the restructuring at the right pace and in the right way. It especially has to be borne in mind that the drift associated with personal income tax does not operate uniformly over the whole income range. The Committee has received numerous submissions on this point and it deserves close examination.

6.43. The 1973–74 rate schedule, now superseded, was a modified version of the one introduced in 1954–55 which, apart from a special levy or rebate in certain years as part of counter-cyclical policy, remained unaltered until 1970–71. In that year, as Table 6.B reveals, reductions of approximately 10 per cent in tax payable on taxable incomes up to $10,000 were made, while reductions in tax payable above that level progressively declined to 4.4 per cent at $20,000 and zero at $32,000. The rate scale was again adjusted in 1972–73 to provide an overall reduction of about 10 per cent in total tax collections but the adjustment was so arranged that the percentage reduction in tax payable decreased as income rose.

**TABLE 6.B: PERSONAL RATE SCHEDULE: MARGINAL TAX RATES**

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<tr>
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<tr>
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6.44. These changes were partly designed to meet the criticism that in periods of inflation when money incomes are rising rapidly the continued use of the same progressive scale, defined as such scales conventionally are on the basis of money income, produces substantial increases in the ‘burden’ of tax as reflected in average rates of tax.

6.45. The simplest way of depicting this increasing ‘burden’—a burden which, it ought to be stressed, derives ultimately not from inflation but from government spending increasing at a faster rate than gross national product—is to compare the average tax payable in different years on the same ‘real’ income, i.e. on an income which remains unchanged when the

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</tr>
<tr>
<td>8,801–10,000</td>
<td>51.7</td>
<td>46.5</td>
<td>44.1</td>
<td>20,001–32,000</td>
</tr>
<tr>
<td>10,001–12,000</td>
<td>55.0</td>
<td>50.6</td>
<td>48.2</td>
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<tr>
<td>12,001–16,000</td>
<td>57.9</td>
<td>56.4</td>
<td>54.6</td>
<td>40,001 and over</td>
</tr>
<tr>
<td>16,001–20,000</td>
<td>60.4</td>
<td>62.4</td>
<td>60.3</td>
<td>60.0</td>
</tr>
<tr>
<td>20,001–32,000</td>
<td>63.3</td>
<td>66.7</td>
<td>64.0</td>
<td>64.0</td>
</tr>
<tr>
<td>32,001–40,000</td>
<td>66.7</td>
<td>66.7</td>
<td>64.0</td>
<td>67.0</td>
</tr>
</tbody>
</table>

(a) Rates for 1954–55 (before the introduction of decimal currency) have been rounded; rates for later years are as published. (b) Excluding 2½ per cent levy. (c) Excluding surcharge on property income.
inflation component is removed. A set of such real incomes is assembled in Table 6.C. As a comparison of column 6 with column 2 indicates, average rates of tax in 1973–74 were somewhat higher than in 1954–55 at all levels of real income, notwithstanding the cuts made in 1970–71 and 1972–73. In terms of the percentage increase in average rates of tax (columns 4 and 7), the taxpayers whose position has changed most by comparison with their predecessors in 1954–55 are those at the bottom of the scale.

### TABLE 6.C: EFFECTS OF INFLATION ON ‘REAL’ INCOME RATE SCHE

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
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<tbody>
<tr>
<td>Taxable income (constant real size)</td>
<td></td>
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<tr>
<td>1.500</td>
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<td>6.1</td>
<td>64.9</td>
<td>2.4</td>
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<td>73.0</td>
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<td>3.7</td>
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<td>2.000</td>
<td>5.4</td>
<td>8.1</td>
<td>50.0</td>
<td>2.8</td>
<td>8.4</td>
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<td>3.2</td>
<td>5.7</td>
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<tr>
<td>3.000</td>
<td>8.3</td>
<td>11.8</td>
<td>42.2</td>
<td>3.8</td>
<td>12.0</td>
<td>44.6</td>
<td>4.1</td>
<td>9.4</td>
<td>13.6</td>
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<td>4.000</td>
<td>10.7</td>
<td>15.0</td>
<td>40.2</td>
<td>4.8</td>
<td>15.2</td>
<td>42.1</td>
<td>5.0</td>
<td>13.1</td>
<td>22.2</td>
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<td>6.000</td>
<td>15.2</td>
<td>20.6</td>
<td>35.5</td>
<td>6.4</td>
<td>21.0</td>
<td>38.2</td>
<td>6.9</td>
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<td>34.7</td>
<td></td>
</tr>
<tr>
<td>8.000</td>
<td>19.0</td>
<td>25.0</td>
<td>31.6</td>
<td>7.5</td>
<td>25.3</td>
<td>33.2</td>
<td>7.8</td>
<td>27.0</td>
<td>42.2</td>
<td></td>
</tr>
<tr>
<td>12.000</td>
<td>25.3</td>
<td>32.0</td>
<td>26.5</td>
<td>9.0</td>
<td>32.1</td>
<td>26.9</td>
<td>9.2</td>
<td>35.7</td>
<td>41.4</td>
<td></td>
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<tr>
<td>16.000</td>
<td>30.1</td>
<td>37.4</td>
<td>24.3</td>
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<td>25.2</td>
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<td>20.000</td>
<td>34.2</td>
<td>41.5</td>
<td>21.3</td>
<td>11.1</td>
<td>42.2</td>
<td>23.4</td>
<td>12.2</td>
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<td>30.000</td>
<td>41.8</td>
<td>48.0</td>
<td>14.8</td>
<td>10.7</td>
<td>49.5</td>
<td>18.4</td>
<td>13.3</td>
<td>51.8</td>
<td>23.9</td>
<td></td>
</tr>
<tr>
<td>50.000</td>
<td>49.7</td>
<td>54.6</td>
<td>9.9</td>
<td>9.7</td>
<td>55.8</td>
<td>12.3</td>
<td>12.2</td>
<td>57.7</td>
<td>16.6</td>
<td></td>
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<tr>
<td>100.000</td>
<td>57.8</td>
<td>60.7</td>
<td>5.0</td>
<td>6.8</td>
<td>61.3</td>
<td>6.1</td>
<td>8.3</td>
<td>62.4</td>
<td>8.0</td>
<td></td>
</tr>
</tbody>
</table>

(a) Excluding 21/2 per cent levy applying in that year. (b) Excluding surcharge
(c) Decrease, but too small to record.
(d) Increase.

**Note:**
The consumer price index rose by 47.8 per cent between 1954–55 and 1969–70, and by 98.1 per cent between 1954–55 and 1973–74. It is assumed that the consumer price index will rise by 20 per cent in 1974–
6.46. A more satisfactory indicator of the change in tax liability resulting from inflation is the percentage reduction in disposable income (i.e. income after tax) resulting from the change in average rates of tax. This variable is shown in columns 5 and 8 of Table 6.C and, except at high levels, presents the contrary impression to columns 4 and 7. Up to a certain income level the effect of inflation is to reduce disposable income by a greater percentage as taxable income rises because under a progressive tax system disposable income increases at a smaller percentage rate than does taxable income. As a result, even though average rates of tax may increase to a greater extent in the lower income ranges, the net effect of inflation as one moves up the income scale is initially to reduce disposable income after tax by increasing percentage amounts. This reflects the fact that at low incomes, where income tax is a small proportion of income, even a large percentage increase in tax takes only a small part of income. Eventually this trend is reversed. At very high levels the percentage reduction in disposable income, for a given rate change, is considerable.

6.47. It follows that criticisms based on percentage increases in the average rates of taxation claiming that the change in tax liability as a result of inflation is inversely related to taxable income are too simplistic. The changes in the distribution of tax liability as a result of inflation are much more complex than this: all taxpayers face increases in average rates of tax and the disposable incomes of taxpayers with higher taxable incomes are in many cases reduced proportionately more than the disposable incomes of those with lower taxable incomes. Much of the confusion about the distributional effects of changes in the effective rates of income tax as a result of inflation can be attributed to the application of an inappropriate summary measure to what is essentially a complex problem. If anything the pattern of changes in after-tax income as inflation proceeds lends support to a view that people well up the income scale, but not at the top, are relatively hardest hit.

6.48. The 1974–75 rate schedule, summarised in Table 6.B and described more fully at the beginning of Chapter 14, will moderate the effects referred to above only to a limited extent. Average rates of tax have been
cut on taxable incomes up to $50,000, the reduction being fairly substantial on taxable incomes below $8,000 but no more than a gesture on taxable incomes above $12,000. Nevertheless, rapid inflation will soon offset these tax advantages, particularly for persons with taxable incomes between $5,500 and $11,000 who now face the prospect of paying noticeably higher marginal rates on any additional income they earn. It is impossible to tell how much tax real incomes of various sizes will attract in 1974–75: it depends on how quickly prices rise in 1974–75. However, Table 6.C has been extended to include figures for 1974–75 showing the tax implications for various levels of real income on the assumption that prices in 1974–75 are 20 per cent higher than in 1973–74. A comparison of the last three columns of the table with those for 1973–74 suggests that, as far as the tax schedule alone is concerned, all real incomes above about $7,000 (in 1973–74 prices) will face heavier income tax in 1974–75 than in 1973–74. Moreover, should a capital gains tax apply in 1974–75, requiring the inclusion in income of half of any realised capital gains, the taxable incomes of some individuals are going to rise rather faster than otherwise and thus accentuate the tax drift.

6.49. If inflation continues at anything like its present rate, it will be a matter of only two or three years before even the average wage earner finds himself paying taxes at marginal rates of 50 per cent or more. In 1954–55, as Table 6.D reveals, the average male wage earner claiming no deductions was subject to marginal tax at 17.5 per cent. In 1973–74 the marginal tax of his counterpart had risen to 35.7 per cent; and in 1974–75, if average earnings increase in the current year by the extremely conservative estimate of 20 per cent, the figure will be as high as 44.0 per cent. Admittedly, as the final column in the table makes clear, the increase in average earnings over the years is only partly due to inflation: growth in real incomes has also occurred. But as the final column indicates too, increases in average earnings in very recent years predominantly reflect inflation: thus, as much as 79 per cent of the $858 addition to average earnings in 1973–74 was matched by higher prices, the largest percentage for many years.

### TABLE 6.D: TAX ON AVERAGE EARNINGS PER EMPLOYED MALE UNIT, 1954–55 TO 1973–74(a)

<table>
<thead>
<tr>
<th>Year</th>
<th>Average earnings</th>
<th>Total tax</th>
<th>Average tax rate</th>
<th>Marginal tax rate</th>
<th>Inflation component of increase in average earnings(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ per annum</td>
<td>$ per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
</tr>
</tbody>
</table>

(a)
<table>
<thead>
<tr>
<th>Year</th>
<th>Number with net income above $6,000</th>
<th>Percentage of taxpayers with net income above $6,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954–55</td>
<td>1,799</td>
<td>9.7</td>
</tr>
<tr>
<td>1955–56</td>
<td>1,924</td>
<td>10.3</td>
</tr>
<tr>
<td>1956–57</td>
<td>2,012</td>
<td>10.7</td>
</tr>
<tr>
<td>1957–58</td>
<td>2,070</td>
<td>11.0</td>
</tr>
<tr>
<td>1958–59</td>
<td>2,132</td>
<td>11.3</td>
</tr>
<tr>
<td>1959–60(c)</td>
<td>2,304</td>
<td>11.5</td>
</tr>
<tr>
<td>1960–61</td>
<td>2,413</td>
<td>12.5</td>
</tr>
<tr>
<td>1961–62(c)</td>
<td>2,475</td>
<td>12.2</td>
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<tr>
<td>1962–63(c)</td>
<td>2,543</td>
<td>12.5</td>
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<tr>
<td>1963–64(c)</td>
<td>2,678</td>
<td>13.0</td>
</tr>
<tr>
<td>1964–65</td>
<td>2,876</td>
<td>14.5</td>
</tr>
<tr>
<td>1965–66(d)</td>
<td>3,011</td>
<td>15.5</td>
</tr>
<tr>
<td>1966–67(d)</td>
<td>3,219</td>
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<td>1967–68(d)</td>
<td>3,406</td>
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<td>1968–69(d)</td>
<td>3,661</td>
<td>18.0</td>
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<td>1969–70(d)</td>
<td>3,968</td>
<td>19.2</td>
</tr>
<tr>
<td>1970–71(e)</td>
<td>4,410</td>
<td>18.8</td>
</tr>
<tr>
<td>1971–72(f)</td>
<td>4,836</td>
<td>20.4</td>
</tr>
<tr>
<td>1972–73(g)</td>
<td>5,278</td>
<td>21.3</td>
</tr>
<tr>
<td>1973–74</td>
<td>6,136</td>
<td>21.3</td>
</tr>
</tbody>
</table>

(a) No concessional deductions. (b) Percentage of increase in average earnings over previous year accounted for by inflation rather than by growth in real income. (c) 5 per cent rebate. (d) 21/2 per cent levy. (e) New tax schedule, plus 21/2 per cent levy. (f) 4.375 per cent levy. (g) New tax schedule. (h) Real value of average earnings in 1956–57 was 1 per cent lower than in the previous year.

6.50. Evidence of a different kind pointing to the same conclusion is presented in Table 6.6. In less than a decade the percentage of taxpayers with net incomes above $6,000 has risen from 4 per cent to nearly 16 per cent. Even within the space of a single year, according to the 1970–71 and 1971–72 figures, the change is striking—and will certainly prove yet more striking in 1972–73 and 1973–74 when statistics for those years become
available.

### TABLE 6.E: PERCENTAGE OF INDIVIDUAL TAXPAYERS WITH NET INCOME IN EXCESS OF $3,000, $6,000 AND $10,000

<table>
<thead>
<tr>
<th>Net income (a) in excess of</th>
<th>1963–64</th>
<th>1970–71</th>
<th>1971–72</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ per annum</td>
<td>Males per cent</td>
<td>Total per cent</td>
<td>Males per cent</td>
</tr>
<tr>
<td>3,000</td>
<td>32.0</td>
<td>24.8</td>
<td>71.6</td>
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<tr>
<td>6,000</td>
<td>4.9</td>
<td>4.0</td>
<td>16.1</td>
</tr>
<tr>
<td>10,000</td>
<td>1.4</td>
<td>1.1</td>
<td>3.1</td>
</tr>
</tbody>
</table>

(a) 1963–64 data relate to ‘actual income’. Source: Taxation Statistics, various issues

6.51. If the rate schedule is to be protected from the distorting and eroding effects of inflation, whether on grounds of fairness or to induce people to moderate their demand for higher incomes, it will need to be adjusted more comprehensively than was done in 1974–75. To ensure that the percentage of taxable income going in tax is properly cushioned against inflation at all income levels, the width of marginal tax brackets must be increased regularly in line with changes in the general price level. Frequent adjustment of the rate schedule and the manner in which it might be done are considered at greater length in Chapter 14.

### Concessional Allowances

6.52. Another aspect of tax drift relates to the complaint that adjustments to dependant allowances under personal income tax have not kept pace with inflation and that, in consequence, the real value of these allowances has been seriously eroded.

6.53. That this is a valid complaint may be illustrated in terms of a taxpayer with wholly dependent wife and two dependent children. In 1954–55 such a taxpayer would have qualified for a $520 deduction from net income for his dependants. Had the size of the deduction been fully adjusted for inflation, it would by 1973–74 have amounted to $1,030—almost exactly twice the earlier figure, the consumer price index having practically doubled in the meantime. In actual fact, the deduction in 1973–74 was $832, only 80.8 per cent of what it would have been if fully hedged against inflation. Table 6.F shows, for selected net incomes, how in 1973–
74 a taxpayer with wife and two children was penalised by the deduction being $832 rather than $1,030.

TABLE 6.F: DEDUCTIONS FOR DEPENDANTS 1973–74: EFFECT OF FAILURE TO ADJUST FULLY FOR INFLATION

<table>
<thead>
<tr>
<th>Net income</th>
<th>$832 deduction</th>
<th>$1,030 deduction</th>
<th>Additional tax saving if deduction $1,030 rather than $832</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,500</td>
<td>4.8</td>
<td>3.7</td>
<td>26</td>
</tr>
<tr>
<td>3,000</td>
<td>6.6</td>
<td>5.4</td>
<td>32</td>
</tr>
<tr>
<td>4,000</td>
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<td>43</td>
</tr>
<tr>
<td>6,000</td>
<td>16.2</td>
<td>15.1</td>
<td>66</td>
</tr>
<tr>
<td>8,000</td>
<td>21.2</td>
<td>20.2</td>
<td>75</td>
</tr>
<tr>
<td>12,000</td>
<td>28.8</td>
<td>28.0</td>
<td>96</td>
</tr>
<tr>
<td>16,000</td>
<td>34.9</td>
<td>34.2</td>
<td>108</td>
</tr>
<tr>
<td>20,000</td>
<td>39.7</td>
<td>39.1</td>
<td>119</td>
</tr>
<tr>
<td>30,000</td>
<td>47.7</td>
<td>47.3</td>
<td>126</td>
</tr>
<tr>
<td>50,000</td>
<td>54.7</td>
<td>54.5</td>
<td>132</td>
</tr>
</tbody>
</table>

(a) Actual deduction in 1973–74 for dependent wife and two children. (b) Amount of deduction equivalent, after allowing for 98.1 per cent rise in prices, to 1954–55 deduction of $520.

6.54. The extent to which the dependant allowance for wife and two children, after adjusting for inflation, has fallen short of the 1954–55 allowance varies considerably from year to year depending on the size and timing of increases in allowances and the rate of inflation. This is apparent from the first column in Table 6.G. Since the late 1950s, however, there has invariably been a substantial short-fall, even in 1967–68 and 1972–73 when dependant allowances were adjusted. Moreover, because inflation has been so severe recently, the short-fall in 1973–74 was almost as great as it has ever been.

6.55. It is clear from the remaining columns of Table 6.G that the several categories of dependant allowances have been affected differently. In
1973–74 the spouse allowance was 70.7 per cent of the adjusted 1954–55 figure, the first-child allowance 84.3 per cent, while the allowance for other children was fully adjusted for inflation. In 1957–58, 1967–68 and 1972–73, all three categories were raised by identical amounts ($26 on the first two occasions and $52 on the last); but since the spouse allowance was the largest to start with and the other-children allowance the smallest, the percentage increases in allowances have inevitably been greatest for other children and least for spouse.


<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of inflation-hedged 1954–55 allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Spouse + 2 children</td>
</tr>
<tr>
<td></td>
<td>per cent</td>
</tr>
<tr>
<td>1955–56</td>
<td>96.1</td>
</tr>
<tr>
<td>1956–57</td>
<td>90.8</td>
</tr>
<tr>
<td>1957–58(a)</td>
<td>103.4</td>
</tr>
<tr>
<td>1958–59</td>
<td>101.8</td>
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<td>1959–60</td>
<td>99.3</td>
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<td>1960–61</td>
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<td>94.8</td>
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<td>1963–64</td>
<td>93.9</td>
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<td>1964–65</td>
<td>90.5</td>
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<td>1965–66</td>
<td>87.4</td>
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<td>1966–67</td>
<td>85.1</td>
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<td>1967–68(a)</td>
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<td>1968–69</td>
<td>90.8</td>
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<td>1969–70</td>
<td>87.9</td>
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<tr>
<td>1970–71</td>
<td>83.9</td>
</tr>
<tr>
<td>1971–72</td>
<td>78.6</td>
</tr>
<tr>
<td>1972–73(a)</td>
<td>91.2</td>
</tr>
<tr>
<td>1973–74</td>
<td>80.8</td>
</tr>
</tbody>
</table>

(a) Size of dependant allowances increased in this year.

6.56. However, the erosion of the real value of the amount deductible from net income must not be confused with the erosion of the real value of
tax saving resulting from deductions. As individuals are pushed into higher marginal tax brackets because of inflation, a dependent deduction of given size means larger tax saving in money terms—perhaps larger in real terms too. At the same time, the more fully are tax schedules adjusted for inflation, the lower still will be the real value of tax savings associated with dependant deductions of given size. It is thus important, if tax schedules are going to be regularly altered, to adjust dependant allowances regularly too—more important, indeed, than if tax rates are not so altered.

6.57. The link between the level of tax rates and the tax saving involved in concessions for dependants would vanish were such concessions to be given as tax rebates rather than as deductions from taxable income. It is thus significant that a special rebate of tax was in fact introduced in the 1974–75 Budget aimed at increasing the value of dependant allowances for persons at the lower end of the income scale. In future a taxpayer whose income is sufficiently low that the tax saving through claiming dependant deductions would be less than 40 per cent of the amount deductible will attract a rebate of tax to bring the tax saving up to 40 per cent. This means that a taxpayer on a marginal rate of, say, 32 per cent who, in the normal course of events, would save $266 in tax as a result of the present $832 concessional deduction for wife and two children, will now also receive a rebate of $66 to lift the tax saving to $332 (40 per cent of $832).

6.58. The rebate will compensate those families most in need for at least some of the recent inflation-induced decline in the value of dependant allowances. It will also tend to cushion the value of dependant allowances, for such families, from the effect of tax cuts—including the cuts introduced in 1974–75 when the rebate comes into effect. But it means that as money incomes continue to expand with inflation, the element of tax saving from moving into a higher tax bracket and thus being able to claim deductions against higher marginal tax will disappear for persons on low incomes.

6.59. The eroding effect of inflation has been less conspicuous with other concessional deductions since the amount deductible is not restricted in the same way as dependant allowances. Some of these other deductions are open-ended; and in the case of one of the main ones that is not—life insurance and superannuation contributions—the maximum limit has gone up faster than inflation: in 1973–74 the real value of the maximum deduction of $1,200 was 50 per cent greater than in 1954–55, though it is true that the real value of this maximum deduction has fallen by nearly 30 per cent since being raised to $1,200 in 1967–68. What was said in paragraph 6.56 applies to these other deductions too: because the concessions are in the form of deductions from taxable income, the real value of the tax saving has in some measure been protected by taxpayers
being pushed into higher tax brackets where the deductions are worth more, and would have been protected even further had tax rates not been cut in 1970–71, 1972–73 and 1974–75.

Estate and gift duties

6.60. Like personal income tax, Federal estate and gift duties are progressive levies. In the absence of offsetting adjustments to the rate scale and to the size of exemptions, duties will bite into estates and gifts with ever increasing severity as rising prices cause money values to become inflated.

6.61. The point is illustrated for estate duty in Table 6.H, though in very oversimplified fashion. No account is taken of death duties levied by the States, which are allowed as a deduction from the value of the estate in computing Federal duty; attention is confined to estates passing wholly to close relatives and unconnected with primary production; and the figures do not reflect the concessional treatment of the matrimonial home introduced in 1974.


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<td>27.9</td>
<td>27.9</td>
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(a) Where the whole estate
6.62. As can be seen by comparing columns 1 and 2 of Table 6.H, had no adjustments of any kind been made to the rate scale or to exemptions since 1954–55, average rates of Federal duty on estates of the same real value would by 1973–74 have been higher right across the board; though in the case of very large fortunes already attracting maximum or near-maximum duties as far back as 1954–55, the increase would have been modest.

6.63. While the 1954–55 rate scale still applies—indeed it was introduced as long ago as 1940—the level of exemptions has been adjusted on two occasions: with estates passing wholly to close relatives, the maximum exemption was raised in 1963 from $10,000 to $20,000, and in 1972 from $20,000 to $40,000. These are sizeable increases that more than compensate for inflation; but the exemptions are vanishing ones conferring no benefit on estates above a certain value (currently $20,000 in the case of estates passing wholly to close relatives). It is thus possible, on the basis of columns 1, 3 and 4 of Table 6.H, to identify three categories of estates:

(a) Smaller estates, up to a value approaching $100,000 at today's prices, are now in fact burdened with proportionately less duty than in 1954–55 because of more generous exemptions.
(b) In the case of very large fortunes (in excess of say $500,000 at today's prices), the fraction going in duty has not been noticeably affected by inflation: in these upper reaches the rate of duty is virtually proportional.
(c) The estates to be hit hardest by inflation are those in the $150,000–$300,000 range (at today's prices), being too large to benefit greatly, if at all, from more generous exemptions, yet low enough to attract higher rates of duty as money values rise.
6.64. If the burden of death duties on all estates, and not merely on smaller ones, is to be cushioned against inflation, it is clearly not enough to adjust vanishing exemptions as was done in 1963 and 1972: the rate brackets themselves must be adjusted for rising prices and, if inflation is rapid, must be adjusted quite frequently. Recommendations are made along these lines in Chapter 24 in the context of an integrated estate and gift duty.

**Tax Base**

6.65. Even in a regime of proportional tax rates or of regularly adjusted progressive schedules, there are still major problems in times of inflation in establishing just what is the proper tax base to which tax rates should apply.

6.66. One of the most important of these problems concerns business income. The effect of inflation on the measurement of business income, more especially for companies engaged in manufacture, has been the subject of intense discussion within the accounting profession and among business management generally for many years now; it has also featured prominently in submissions to the Committee. The fundamental problem is that in periods of inflation profits determined on the basis of conventional historical accounting methods do not reflect ‘true’ profits, which are materially lower. These same methods, when employed in arriving at net income for income tax purposes, can lead to business income being taxed more heavily than intended. When this occurs, the viability of business suffers, ‘true’ retained profits are reduced to below the level needed for continuing operations, and organisations are forced to seek new investment funds which are likely to prove difficult and costly to obtain in a period of tight liquidity.

6.67. For many years certain larger businesses have sought to take some account of inflation in their financial accounts: in arriving at their profits they have deducted charges for the use of their fixed assets calculated by reference to their replacement values and not their historical cost. Also some countries permit methods of valuing trading stocks which allow for the effect of rising prices on profits and on net income for taxation purposes. It is generally agreed that there is urgent need to reconsider financial and tax accounting procedures in periods of high inflation. This is a crucial problem and one for which no generally acceptable solution is currently available. More will be said about it in Chapter 8.

6.68. A further effect of inflation is to highlight the concern felt by many that capital gains should be brought to tax, since such gains become extremely obvious to everyone in periods of rising prices. But inflation
also makes the devising of a way of taxing capital gains that much more difficult. If capital gains are made taxable without adequate recognition of the fact that in a period of inflation a considerable proportion of such gains are not ‘real’ but simply an aspect of the change in the general price level, a large element of capital levy will be involved which may not be intended. Table 6.I illustrates just how heavily a 30 per cent capital gains tax that makes no allowance for changes in the value of money will bite into an asset whose money value has merely risen in step with inflation and whose real value has thus remained unaltered. Yet there are major problems, conceptual and practical, in devising a capital gains tax that takes proper account of the distinction between ‘real’ and ‘fictitious’ gains. In the eyes of some, these problems are sufficiently daunting to make it highly inadvisable to consider introducing such a tax during a period of serious inflation. The Committee generally agrees with this view.

**TABLE 6.I: EFFECT OF IMPOSING 30 PER CENT CAPITAL GAINS TAX WHERE CAPITAL APPRECIATES AT SAME RATE AS INFLATION**

<table>
<thead>
<tr>
<th>Number of years before asset is realised</th>
<th>5 per cent</th>
<th>10 per cent</th>
<th>15 per cent</th>
<th>20 per cent</th>
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<td>18.7</td>
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<td>29.1</td>
</tr>
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</table>

(a) For example, if an asset is acquired for $100 and proceeds to appreciate in value by 10 per cent a year, by the end of ten years it will be worth $259.38. If the owner then disposes of the asset, a capital gain of $159.38 is involved which, on the basis of a 30 per cent levy, means tax of $47.81. This amount of tax represents
6.69. Inflation also has implications for the taxation of income from property, particularly fixed-interest income. When prices are rising but interest rates are held down, the real return on fixed-interest assets declines and the real capital value falls too. This raises problems in establishing an equitable tax base that are closely related to the appropriate treatment of business income and capital gains. These problems are briefly considered in Chapter 9.

6.70. What taxing of business income, capital gains and property income have in common that creates special problems in a time of inflation is the necessity of having to compare values of items of property in different years when the unit of measurement—money—has itself altered in value. Similar kinds of problems arise in relation to the integration of money amounts established at different times and will need to be considered in appropriate context in later chapters of this report. For example, a decline in the value of money means that business losses are worth less later when applied as an offset to income: indeed, most tax provisions for income spreading, of which loss carry-forward is but one, lose much of their conventional rationale in a period of rapid inflation. Again, a decline in the value of money means that gifts made at different times by the one person cannot be regarded as equivalent. The Committee has had to take special account of this in its proposals for an integrated estate and gift duty.

6.71. Where a tax is levied on a base significant components of which do not regularly enter the market and thus require special valuation, inflation poses added problems since values will quickly date. Thus one reason for the Committee's rejection of a wealth tax, as explained in Chapter 26, is the formidable administrative burden and cost to the taxpayer that would be involved in regularly revaluing such assets as freehold property and the inequities that would arise if regular revaluation were not in fact undertaken.

**Need for Further Investigation**

6.72. The variety of distorting and confusing ways in which inflation impinges on the tax system considerably complicates the task of tax reform. The setting up recently of an independent panel to inquire into the
effects of rapid inflation on personal and company taxation payments is some indication of the concern felt by the Government in this regard. While the Committee has had inflation very much in mind in formulating its recommendations in later chapters, it acknowledges the need for intensive study of the implications of inflation for the tax system beyond what it has been possible to attempt in this report.
Chapter 7 Income Tax: The Base

7.1. ‘Income’, as the starting-point for the formal legal structure of income taxation of persons, companies and other entities, is surrounded with problems of definition. The aims of this chapter are to clarify these, to suggest a logical framework into which some of the problems discussed in this and later chapters can be fitted, and to deal with specific issues of definition of general relevance. Specific issues relating peculiarly to business and professional income, and to employment income and investment income are dealt with separately in later chapters.

I. Problems of Definition

7.2. In the language of the present law, income tax is levied on ‘taxable income’, which is income in the meaning of the law (other than exempt income) derived during a period, normally one year, less (i) expenses in deriving that income and (ii) a number of other deductions reflecting equity considerations and particular social and economic policies. The phrase ‘net income’ is here adopted to refer to income less the first of these deductions, but before the second are subtracted.

The Concept of Income

7.3. The legal meaning of income is drawn very largely from judicial decisions—many of them borrowed from the United Kingdom—extended and refined by specific provisions. The primary characteristic of the tax law's approach has been to express what the word may be taken to mean in ordinary English usage. Some basic notions underlie the meaning. One of these is the idea of gains (in some contexts a receipt, in others a profit) from the carrying on of organised activity—an employment, a business or profession, or a business deal—directed to the making of gains. Another is the idea of gains derived from property which leave the property intact—a fruit of the tree as distinct from the tree itself. A third is the idea of compensation which substitutes for gains that would have been income. A fourth is the idea of gains periodically received. None of the ideas is sharp in its outlines, least of all the third and fourth. Thus compensation which substitutes for gains that would have been income must be distinguished from compensation for an asset that would have produced such gains. Gains periodically received must be distinguished from receipts of a fixed sum by instalments.
7.4. For analysis in terms of economic principles in which theory comes first and practicalities are wrestled with later, economists have sought a primary definition of income in any period that is a measure of the flow of an individual's actual and potential satisfactions. One of the most thorough-going efforts to this end is that associated with the American economist Henry Simons whose *Personal Income Taxation*, published in 1938, has had great influence in academic debate. That formulation centres upon ‘increases in economic power’ to command satisfactions.

7.5 The economists' definition would in general include in income all of the gains that the law includes: salary and wages; profits from a business or profession or business deal; interest, rent, dividends; compensation for income; and periodical receipts. But it also covers a great many gains that would probably not be reckoned as income in ordinary English usage, and have not been brought in, or have been brought in only to a very limited extent, by judicial and legislative extensions and refinements of that usage. The comprehensive tax base would include:

(a) capital gains: gains from the realisation of property, when the realisation is not an aspect of the carrying on of a business or a profession, or the carrying out of a business deal;
(b) bequests and gifts received;
(c) lottery and casual gambling winnings;
(d) retirement benefits and compensation for loss of office;
(e) compensation for physical injury to person received in a lump sum or for injury to reputation; and
(f) non-money income.

Some comment on each of these is called for.

7.6. Except to a limited extent resulting from the provisions of sections 26 (a) and 26AAA of the Income Tax Assessment Act, which define the base to include gains from the sale of property acquired for the purpose of profit-making by sale and gains made within a period of twelve months, *capital gains* (as defined in paragraph 7.5) are not included in the present base, though the introduction of a tax on such gains has been announced. The Committee's recommendations for the taxing of capital gains are set out in Chapter 23.

7.7 The present base does not include *bequests and gifts received* except where the receipt is one of a number received periodically, for example an annuity, or where, in the case of a gift, it is included as salary or wages or as a business gain or a gain from a profession. In Chapter 24 the Committee rejects the possible extension of the income tax base to include
all bequests and gifts and proposes the continued taxation of property the
subject of bequests and gifts on a separate basis.

7.8. *Lottery and casual gambling winnings* are not infrequently described
as ‘windfall gains’, though the phrase has no very precise meaning. It
suggests gains that are more or less unexpected. A quality of
unexpectedness also belongs to some capital gains, but the Committee
takes the view that this is not an argument for freeing capital gains from
tax. However, taxing lottery and casual gambling winnings raises awkward
problems, some of them administrative, others concerned with the
deductions that should be allowed. There would be difficulties of enforcing
the law with respect to casual gambling winnings. The problems associated
with the allowance of deductions may be illustrated by asking how one
would deal with the coins fed into a poker-machine. The Committee has no
proposal to extend the tax base to include lottery and casual gambling
winnings.

7.9. *Retirement benefits and compensation for loss of office* which are not
periodically received are by an express provision included in the present
base only to the extent of 5 per cent of the amounts involved. Were it not
for this provision, a retirement benefit would be wholly included as a gain
from an employment, while compensation for loss of office received in a
lump sum—sometimes called a ‘golden handshake’—would be wholly
excluded. Such compensation might be treated as embodying a capital gain
if the notion of ‘property’ for the purpose of bringing capital gains to tax
were broadened to include an office. Alternatively, it might be regarded as
a substitute for salary which would have been earned and thus income. If
any change is to be made in the existing law there is much to be said for
treating retirement benefits and compensation for loss of office in identical
fashion. Moreover, the best way of dealing with these receipts depends
quite crucially on how the tax law treats superannuation benefits and life
insurance proceeds, and the matter is further considered in Chapter 21.

7.10. *Compensation for physical injury to person received in a lump sum
or for injury to reputation* is not at present included in the income base. In
theory the compensation could be regarded as embodying a capital gain if
the notion of property were made wide enough to extend to human capital.
It would, however, be impossible to identify the gain, since the cost of
acquiring human capital cannot readily be ascertained. Some of the
compensation may be in respect of income already lost and in respect of a
loss of capacity to earn income in the future, in which cases it could be
regarded as a substitute for the income that would have been earned. To
this extent, at least, it might be thought appropriate to include it in the base.
If compensation is received in the form of periodical payments, it will be
income as received, whether given for lost income or some other aspect of the taxpayer's loss. These matters are further considered in paragraphs 7.34–7.41.

7.11. The major item of non-money income currently omitted from the income base is imputed rent of the owner-occupied home. This omission is discussed later in paragraphs 7.42–7.57. But houses are not the only form of property that may yield flows of satisfaction to which imputed income might be attached. Works of art and consumer durables in general are other obvious examples. Inclusion in the tax base of imputed income from these latter items of property would of course involve great administrative problems, and is not proposed.

7.12. Goods produced for one's own consumption or services performed for oneself are currently excluded from the income base. Whatever the case in economic theory for their taxation, it would be administratively impracticable and the Committee has no proposals to change the present position.

7.13. Other instances of non-money income that would be included in the comprehensive tax base may be found in the fringe benefits an employee receives from his employer. The gain may be in the form of goods received, services received, relief from an obligation that would ordinarily have been incurred or valuable rights.

7.14. The general rule of the income tax law is that a gain must be valued by reference to the amount of money that could be obtained for it. On this principle of valuation, a made-to-measure suit is likely to be valued at the price it would bring as a second-hand suit. A service one receives from another, such as the use of a motor-car or a residence available only to oneself or free holiday travel as an airline employee, has no value. Similarly the relief from the payment of interest enjoyed by a person who has an interest-free loan has no value; nor has a person's right to take up shares in a company, if not assignable, unless there is a way in which he can make the benefit of the right available to somebody else.

7.15. This general rule is, however, qualified in important respects by section 26 (e) of the Act, but only in relation to income gains that are rewards for services rendered. This provision substitutes ‘the value to the taxpayer’ for the test of value under the general rule. The special rule certainly limits the tax-planning possibilities opened up by the general provision, but its operation is not entirely clear. It has not prevented the offering and accepting of fringe benefits in substitution for cash, under employment contracts. Some of these benefits are certainly taxed; but to the extent that they are valued for income tax purposes below what would be paid for them in cash outside the income-producing relationship, the
equity of the tax system is seriously affected.

There may be a form of collusion between employer and employee by their splitting the saving of tax that attends a full deduction to the employer of the cost of providing the benefit and a lesser amount being included in the income of the employee. There is, however, no easy solution to the problem of making adequate provision. In many instances, the fringe benefit is so interwoven with the normal performance of the services for which the fringe benefit is a reward that the element of gain may be very difficult to identify. The commonplace illustration is the use of a motor-car for both employment and personal purposes. The question of the taxation of fringe benefits is explored in Chapter 9.

Deduction of Expenses

Expenses Incurred in Deriving Income

7.16. Besides questions of what should or should not be included in income, a host of problems arise over the identification and measurement of the expenses incurred in deriving income that have to be deducted before a figure for net income is reached. It is common to both the existing tax law and to the theory of a comprehensive tax base that such deductions be made.

7.17. A prime problem here is to achieve a practical application of the distinction between an expense in deriving income (which gives rise to a deduction) and consumption expenditure (which should not unless by some special concessional provision). Some expenses, such as for entertainment and travel discussed in Chapter 9, often involve elements of both. Drawing the distinction becomes very subtle when, for example, equipment is used which, in its luxuriousness, exceeds the commercial needs of business: as, for example, when an expensive car is employed where a more modest vehicle would serve just as well.

7.18. Very important areas of controversy arise over costs of travel to and from work and child-minding expenses. These are not now regarded as expenses of deriving income, though it is often argued that they should be. They are further examined in paragraphs 7.58–7.75. Extended to its logical conclusion, the argument leads to a notion of expense in deriving income that would include almost all personal expenditure, even that on food and clothing, in which event the income tax base would largely disappear.

7.19. Expenses in deriving income include the depreciation or amortisation of investment expenditure on assets that deteriorate through use. Issues that arise in relation to the deduction of this expenditure are considered in Chapter 8.
7.20. Certain expenses that would not usually be thought of as consumption expenditure or investment expenditure on non-deteriorating assets are denied deduction. Examples are the cost of moving business operations or of moving home to a new place of work: the cost does not relate wholly to current income, and there is no obvious asset to which depreciation might be applied. These expenses are considered in Chapters 8 and 9.

Other Deductible Expenses

7.21. From ‘net income’ as the term is used here the tax law authorises a whole series of further deductions before the taxable income is reached to which the prescribed rate scale is applied and liability determined. These are generally known as concessional deductions and for the most part are so called in the Act. They include dependant allowances, medical and education expenses, zone allowances, life insurance and superannuation premiums, and gifts to charities. They primarily reflect considerations of equity as well as particular social and economic policies. They are discussed in Chapters 12, 21 and 25.

Exempt Income

7.22. The income base is qualified by a number of express exemptions. Some of these are aspects of the taxation of foreign income and of the income of non-resident taxpayers dealt with in Chapter 17. Others may accord special treatment to particular industries and activities and are discussed in Chapters 19, 20 and 25. Questions of equity are raised by the exemption of child endowment and some scholarships and pensions. The possible inclusion in the tax base of child endowment, scholarships and pensions, where they are grants by government, is considered in Chapters 12 and 13. Receipts of alimony are usually exempt. As a correlative of this there is no deduction for their payment: the equity of this arrangement is discussed in Chapter 10.

Annual Accounting

7.23. The income tax base, like the comprehensive tax base, relates to a selected period. For the income tax base the period of account is normally one year and is referred to as the year of income.

7.24. Where the income is that of an individual and the rate structure is progressive, any unevenness, or bunching, of the amounts of income derived in different years will result in more tax being payable than would
be the case if a longer period of account were adopted. The present law has some provisions directed to overcoming the consequences of bunching. Averaging of income is allowed to primary producers and special provisions having a similar effect apply to authors and inventors. These illustrations of averaging are examined in Chapters 14 and 18. There would be administrative and compliance costs in the wider application of averaging; the wider application of averaging is considered in Chapter 14.

7.25. A strict application of annual accounting would work unfairly where a loss has been suffered for a year. Subject to some limitations, the present law allows a loss in one year to be applied to reduce net income of a later year, though not the net income of an earlier year. The treatment of losses is analysed in Chapters 8 and 16.

7.26. Under a system of annual accounting the timing of an income gain or expense in deriving income will affect the amount of net income. The questions, in the language of the law, are when an income gain is ‘derived’ and when an expense is ‘incurred’. Derivation and incurring, in turn, depend on the method of accounting, cash or accruals, held appropriate to the income. Broadly, cash accounting involves actual receipt and actual payment. Accruals accounting involves entitlement to receive and obligation to pay. There are problems as to what is a sufficient right to receive or a sufficient obligation to pay under the accruals method, for example whether a provision for long-service leave in the accounts of a business is an expense. These matters are considered in Chapter 8.

Income of Particular Industries and Activities

7.27. The present law contains a number of special provisions that affect net income arising from the conduct of particular industries and activities or the tax payable in relation to them; and the operation of the general provisions poses special problems in relation to these and other industries and activities. In certain instances, incentives are given through exemption of income receipts and favourable treatment of expenses. Various industries and activities, including primary production, mining, superannuation and life insurance, and general insurance, are examined individually in a series of later chapters.

Income Moving Through Intermediaries

7.28. The determination of net income as explained in this chapter is the primary step in ascertaining the amount of income on which tax is levied, whether the income is that of an individual, a trust estate, a partnership or a company.
7.29. A trust estate has income and may be a taxable entity distinct from its beneficiary. Where there is a beneficiary presently entitled to the income, the income is taxed to the beneficiary; though where the beneficiary is a child, the tax may in effect be paid for him by the trustee. Where, however, there is no beneficiary presently entitled, the income is taxed to the trustee as if it were the income of an individual or, in some circumstances, at a special rate of 50 per cent.

7.30. A partnership has income but the income is treated as income of its members in accordance with their interests in the partnership. A partnership is not a taxable entity distinct from its members.

7.31. The taxation of trusts and partnerships is considered in Chapter 15.

7.32. The income of a company is taxed to the company and is taxed again to shareholders when distributed to them. This system is examined in Chapter 16.

International Aspects

7.33. In general, the bases of Australia's jurisdiction to tax income are residence of the taxpayer and source of the income. Foreign-source income of a non-resident is beyond that jurisdiction. International aspects are referred to in a number of chapters, more especially in Chapter 15 in relation to trusts and partnerships, Chapter 16 in relation to companies, and Chapter 17 where issues of general application are considered.

II. Specific Issues

Compensation for Physical Injury to the Person

7.34. Compensation in a lump sum for personal injury is not included in income. The compensation is a composite receipt of a number of elements. These may include income already lost as a result of the injury, capacity to earn income in the future, pain and suffering and diminished expectation of life. Except perhaps for the first, none of the elements has an income character, whether by virtue of the ordinary usage of the word or the specific provision in section 26 (j) dealing with receipts by way of insurance or indemnity. Compensation for income already lost is income, but it is arguable that there is no such element in the compensation receipt: so far as the amount of compensation takes account of income already lost, this is only for the purpose of determining the amount of the loss of capacity to earn that resulted from the injury. The resolution of the question is, for the present, unlikely, because of the difficulties placed by the present law in the way of dissecting or apportioning composite receipts.
These difficulties are considered later in paragraphs 7.101–7.102.

7.35. So long as compensation received in a lump sum for personal injury is not included in income, the amount of compensation given by the Courts in personal injury cases will continue to be calculated on the basis that what has been lost as a result of the impairment of capacity to earn is the present value of what would have been earned less the present value of the tax that would have been paid on that amount. This results from the application of the principle in *Gourley's Case*. The Court in applying the principle must estimate the deductions and concessions likely to have been available to the injured person and, presumably, what he might have done by way of tax planning to minimise his tax liability. The principle is sometimes criticised on the ground that the person who caused the injury receives a benefit at the expense of all other taxpayers who must make up the loss to revenue. The Committee does not see the matter in these terms, involving as they do notions of ensuring a full penalty for his wrongs on the person who caused the injury which, in the conditions of compulsory insurance of motor vehicle and industrial accident liabilities, are inappropriate. However, the Committee does not regard the application of the principle as sufficient in itself to justify the exemption of lump-sum receipts from tax. It is not intended as a substitute for tax: it is rather a consequence of the absence of tax. Moreover, the application of the principle cannot be precise even when a case comes to trial. There is no way of assessing the significance of the principle in out-of-Court settlements.

7.36. Where compensation for personal injury is received in a series of periodical payments, the amounts received are included in income without regard to whether they are for lost earnings, for loss of earning capacity or for pain and suffering. Thus periodical payments of workers’ compensation are included in income. There are, therefore, important tax implications in the recent proposal of the Committee of Inquiry into Compensation and Rehabilitation in Australia, that injury and sickness compensation be universally paid in periodical amounts. The Bill currently before Parliament preserves to some extent the system of lump-sum awards, but their role in compensation for physical injury has been significantly reduced.

7.37. The continuing exclusion from income of compensation for physical injury must rest primarily on the importance of the element of non-economic loss reflected in the compensation. Whatever the theory of the comprehensive tax base may suggest, it would be a significant departure from accepted ideas to include in income amounts received which are in respect of physical suffering and disability as distinct from
being for the reduced capacity of a person to earn which may attend that suffering and disability.

7.38. If it were sought to separate the element of compensation for non-economic loss and to tax the remainder, this could only be done by some arbitrary apportionment. The award of damages by a Court or the award of a lump sum under workers’ compensation will not show the breakdown; and a lump sum payable under an accident insurance policy is expressed simply as an amount of money.

7.39. The taxing of that part of the compensation apportioned to the element representing a substitute for income would lead, in the case of compensation assessed by a Court or tribunal, to a considerable increase in the level of awards. Gourley's Case would no longer apply and awards would be made on predictions about the gross income of the injured person.

Committee for these reasons does not propose any change in the present tax receipts of compensation for physical injury.

Compensation for Injury to Reputation

compensation for injury to reputation is also a composite receipt covering a of elements. Some of these are concerned with income that would have been with the feelings of the person injured. The compensation is invariably in the form of a lump sum. In the Committee's view there is no ground for distinguishing such compensation from compensation for injury to the person, and it proposes that it too be excluded from income.

Imputed Rent of the Owner-Occupied Home

7.42. At present one very large item of non-money income—imputed rent of the owner-occupied home—is omitted from the income base and thereby escapes tax altogether. This has not always been so. In the earliest years of Federal income tax, from 1915 to 1923, 5 per cent of the capital value of an owner-occupied residence was included in assessable income; deductions were allowed against this amount for expenses by way of repairs, rates and land taxes, and mortgage interest. In 1923, however, the provision for including imputed rent was discontinued; repairs and mortgage interest became non-deductible, but the owner-occupier was still permitted a tax deduction for rates and land taxes. This remains the situation today, with two qualifications. In 1973 a ceiling of $300 was placed on the amount of rates and land taxes an owner-occupier might deduct, and the deduction was henceforth to be confined to a principal place of residence. More recently a scheme has been introduced, restricted
to home-purchasers in the lower and middle income ranges, making some portion of interest paid on home loans tax deductible. Where the combined actual income of husband and wife is $4,000 or less, the whole of interest paid on a principal residence is deductible. On incomes above $4,000 the deduction is reduced by 1 per cent for each $100 of the excess, disappearing altogether when income reaches $14,000.

7.43. Only a few countries, including West Germany and Sweden, treat the rental value of the taxpayer's own home as income for tax purposes. In West Germany, for example, the basis of valuation varies between one-family homes and other types of housing. For one-family homes, 3 or 3 1/2 per cent of the assessed value is used (depending on the date of erection) to determine the rental value; for other types of housing, a rental value is established by comparison with the market rental value of dwellings of equivalent standard. Deductions are allowed for mortgage interest, taxes on real property, depreciation, repairs and maintenance, and insurance.

7.44. The arguments for imputation merit some consideration though, as will appear, the Committee does not propose to recommend that imputed rent be taxed. A substantial inequity between home-owners and tenants is involved under the present Australian system. And though a case can perhaps be made for treating home-ownership specially favourably on the grounds that widespread ownership is socially desirable and good housing benefits the whole community, it is questionable whether exempting imputed rent is an appropriate way of encouraging home-ownership. For one thing, low-income tenants are excluded from the benefits of non-imputation; for another, home-purchasers may in fact be made worse off because of the higher prices they must pay for their homes in the face of greater public demand for housing.

7.45. If imputed rent is to be taxed, the amount subject to tax can be calculated in one of two ways:

(a) The first way involves the determination of the gross rental value of the home. From this repairs, depreciation, and local rates are deducted to arrive at a figure representing net rental value. A further deduction of interest on money borrowed and invested in the home is then made in order to establish the net rental of the owner's equity. This is the amount subject to tax.

(b) The second way avoids some of the complexities of the first, though, in the result, it involves elements of arbitrariness. A percentage of the capital value of the home is assumed to be the net rental value. Interest on money borrowed is then deducted and the residual is the amount subject to tax.

Whichever method is adopted there is the prospect, especially when
borrowing has been made at a high interest rate, that the imputed rent will be a negative figure.

7.46. However the calculation is done the taxing of imputed rent is open to two major criticisms, one concerned with hardship for some taxpayers, the other with administration.

7.47. Where the owner's equity in his home is substantial, a considerable amount of non-cash income could well be involved. In times of high interest rates, annual imputed rent on a house with a capital value of $40,000 may amount to $4,000. If this is added to a retired person's investment income of, say, $6,000 and the total amount of $10,000 is taxed, hardship may result. The inclusion of imputed income in the income tax base will, it is true, make possible some reduction in rates of tax, but the reduction may not be enough to obviate hardship in many cases. One could visualise similar difficulties arising for other classes of taxpayers: for example, a widow with young children may have been left the family home, now freed of mortgage by the proceeds of an insurance policy taken out by her husband, but she may have only modest cash income and few other assets.

7.48. Employee taxpayers with imputed rent, whose employment income is subject to the system of collecting tax by instalment, would not be as conscious of the hardship if the taxing of imputed rent were keyed in some way into the instalment system. There will be administrative problems in doing this; but if it were not done and employees had to pay tax on assessments, the system of collecting tax by instalments would be seriously weakened.

7.49. The adoption of the second way of calculating imputed rent avoids some administrative difficulties at the cost of a certain degree of arbitrariness. But the difficulties inhering in the determination of capital value in the second way are no less than the difficulties of determining gross rental value in the first. Both ways involve defining and applying principles for determining whether money borrowed has been invested in the home.

7.50. Either way poses administrative problems in that it creates a demand for valuation services, a need for a verifiable record of valuation that the taxpayer may quote in his tax return, and a mechanism by which the taxpayer may contest that valuation. The existing State valuation services throughout Australia provide valuation information on a variety of bases. But the information collected is not always relevant or consistent. In New South Wales, for example, the Valuer-General values only the unimproved capital value of residential land: the provision of both improved capital value and assessed annual value was discontinued in
1973. By contrast, the Victorian system employs both net annual value and unimproved capital value. A further problem is the revision of valuations over time—not necessarily annually—to ensure they reflect current market values.

7.51. If the first way of calculating imputed rent is preferred, there would be administrative problems in regard to depreciation allowances and repairs. The problems of depreciation allowances and deductions for repairs are considered in wider context in Chapter 8.

7.52. Difficult problems arise when interest, to be deductible, must be shown to be related to a particular kind of income. Taxing imputed rent would multiply the occasions when these problems have to be resolved. The availability of a deduction of interest would open up avenues of tax planning for the well-advised who will consolidate their debts into the borrowing for home finance.

7.53. The Committee recognises the arguments for including imputed rent in the tax base; but having regard especially to the administrative difficulties it is not prepared to recommend a change in the law to this end.

7.54. The Committee does however propose that the deduction for rates and land taxes, now limited by amendments in 1973, be further reduced and eventually abolished. It is a relic of the time when imputed rent was included in the income tax base. No doubt the availability of the deduction is of some financial benefit to local governments in providing an indirect form of Federal financial assistance. However, the Australian Government is already making direct grants to local governments, and any revenue difficulties for these governments arising from the abolition of the deduction could be dealt with by extending such grants.

7.55. The Committee also proposes that the recently introduced deduction of interest on home loans be discontinued. Allowing such a deduction accentuates the inequity resulting from the failure to tax imputed rent. There is, indeed, some irony in this: the reason given in paragraph 7.52 for not taxing imputed rent is the complexity involved in the allowing of a deduction for interest on a home loan and the opportunities for tax planning to which it gives rise.

7.56. If the deduction for rates and land taxes were abolished, some of the tax advantage owner-occupiers have over tenants would disappear. The advantage might be reduced still further if a deduction were allowed to tenants for some part of the rent they pay. The allowance of such a deduction would be novel: so far as the Committee is aware, a concession of this kind is available only in Columbia. Because of the limit on deductibility, the advantage would generally remain with the owner-occupier; though where because of interest payments imputed rent is a
negative amount, the advantage would move to the tenant.

7.57. The Committee has not explored in detail the administrative feasibility of a rent deduction but considers it worthy of serious examination. The amount of the rent deduction would seek to express the net rent element in what is paid by the taxpayer. It would be necessary of course to proceed by way of allowing a fraction of the rent paid, since the taxpayer would not be in a position to know the expenses incurred by the landlord. A ceiling would need to be placed on the amount deductible, perhaps related to the number of persons dependent on the taxpayer and living with him: the Committee would not wish to encourage the over-consumption of housing further than may be inherent in the continued exemption of imputed rent. There would, it is true, be difficulty in separating out a payment for rent in a composite payment for provision of rent and services: for example, where the accommodation is a serviced flat or where lodging and board are involved. However, the ceiling on the amount deductible might justify ignoring the element of service.

Cost of Travel to and from Work

7.58. The present law, in general, denies a deduction of expenses of travel between home and work. In some circumstances, however, costs of travelling between home and work are regarded as expenses in deriving income and thus deductible. The principle applied in these circumstances requires that the home be in some sense a base of income-earning operations so that the travel can be regarded as travel between bases of operation. The application of the principle is not always clear and consistent, more especially where the bases of operation are aspects of different income-earning activities: the taxpayer may conduct his own business at home and also travel to a base of operations where he is an employee. The application of the principle is obscure where the taxpayer is, for example, a building worker: it is inappropriate to speak of him as having a base of income-earning operations, since his place of work may vary from day to day. The application of the principle may at times appear generous to the self-employed taxpayer where, for instance, he uses his own car in his business or profession. If the denial of a general deduction is to continue, a stricter definition and application of the law as to those costs of travelling between home and work which are to be regarded as expenses in deriving income would seem to be indicated.

7.59. In denying a deduction of expenses of travelling between home and work, the present law treats them as a form of consumption. Arguably they ought not to be so treated, since they are a prerequisite to the earning of
income. But the same could be said of many other expenses whose deduction is currently denied, such as outlay on basic food, clothing and shelter. In the Committee's view a general deduction for expenses of travelling between home and work can only be justified as a concession.

7.60. A general deduction is denied in the United Kingdom and other English-speaking countries. There is however a deduction of general application but limited in several respects in a number of European countries. In Sweden, for example, the expenses are deductible where the taxpayer lives more than 2 kilometres from his place of work. The deduction for the most part covers only the cost of the cheapest means of transportation. A person who drives a car may deduct the cost of a bus or train fare; but should the saving in time resulting from the use of his car be more than 1 1/2 hours a day, a deduction for the actual costs of operating the car is allowed.

7.61. The case for giving a concessional deduction in this area of consumption rests on the circumstances that the incidence of such expenditure, unlike expenditure on basic necessities, varies noticeably between individuals in a way that cannot be wholly explained by personal preference. For some taxpayers, admittedly, there may be a fairly clear choice between more expensive housing plus modest travel expenses and less expensive housing plus considerable travel expenses. But this would be far from generally true.

7.62. Variation in the incidence of travel expenses may arise:

(a) because one taxpayer has to meet his own expenses of travel while another has the means of travel provided for him by his employer; or
(b) because one taxpayer faces high costs of travel while another does not: the former may live a considerable distance from his place of work, or may be forced to use expensive means of transport because public transport is not available at all or not available when he has to travel (e.g. a shift worker), or may require special means of transport because he is disabled.

7.63. The Committee acknowledges the horizontal inequities that may thus arise. In the case of (a) there is clearly also a vertical inequity in that those receiving the benefit of free travel are likely to be concentrated in the higher income groups. But in this instance the inequities will disappear if the Committee's recommendations on the taxing of fringe benefits are implemented. It might be claimed that there is a vertical inequity in relation to (b) because lower income earners tend to live further from their places of work than those with higher incomes. It is doubtful, however, if such a claim can be substantiated. The case for a general deduction must therefore
rest on the horizontal inequity involved in some taxpayers having heavier travel costs than others.

7.64. If a general deduction were allowed, some control would obviously need to be imposed on the amount deductible so as to deny a deduction of extravagant expenditure, for example on a chauffeur-driven limousine. One possibility would be to limit the deduction to expenses in fact incurred in using public transport. This might have a collateral advantage for State and local government finances but would lead to a new set of inequities—between taxpayers who are in a position to use public transport and taxpayers who are not. A way of overcoming this problem would be to allow expenses of other modes of travel where public transport is not available but to limit the deduction to some notional amount that might be thought reasonable in the circumstances. There would of course be administrative problems in fixing such notional amounts, and an inevitable element of arbitrariness. Other administrative problems would be involved in assessing the expenses of the private transport adopted—most often a motor vehicle in respect of which running costs and depreciation would be claimed. In some instances there would be a claim of a composite deduction, involving both private and public transportation, for example where a car is used to reach the nearest railway station. If it were thought that the concession should be extended to those using private transport when public transport is available, the administrative problems associated with assessing the expenses of private transport would be multiplied.

7.65. In the Committee's view the administrative costs of allowing the deduction outweigh any possible equity advantages, and accordingly it does not recommend that a deduction be allowed for costs of travel to and from work. There are special situations, however, for which some other provision might have to be made. Thus under the present sales tax law, tax concessions are available to a disabled person who incurs special expenses by having to use his own car to travel to work. If the continuance of such a concession is not thought appropriate under the value-added tax recommended by the Committee, an alternative form of subsidy—if necessary a direct grant—could be employed. Other special situations, such as the shift worker or the person called on to work in an area remote from any form of public transport, will already have been mitigated to the extent that wages include a loading for time or location of work.

Child-Minding Expenses

7.66. Other illustrations of expenses which, while not expenses of deriving income, are peculiarly prerequisites to the earning of income may
be found in relation to child-minding. There are circumstances where a parent in order to be free to go to work must arrange for the minding of children.

7.67. Under the present law child-minding expenses as such are not deductible. Section 82D involves a related concession. It allows a deduction of $364 when, during the year of income, a housekeeper is engaged wholly in keeping house for a taxpayer and in caring for a dependant of the taxpayer where that dependant is (i) a child of the taxpayer, under 16 years of age; or (ii) any other child under 16, or an invalid relative (narrowly defined), for whom a dependant deduction can be claimed; or (iii) a spouse who is an invalid. A deduction is allowed to a married taxpayer only where the housekeeper is engaged in caring for a spouse in receipt of the invalid pension, except in special circumstances. The Commissioner has a discretionary power to determine these special circumstances. If, for example, a wife has deserted her husband and the husband has engaged a housekeeper who keeps house and also cares for his dependent children, the circumstances will be sufficient for the Commissioner to exercise his discretion and allow the deduction. On the other hand, where a husband and wife both work and engage a full-time housekeeper to care for their dependent children, the Commissioner has taken the view that there are not sufficient grounds to justify a deduction for the housekeeper. It thus appears that while the section may incidentally give a concession in a case where child-minding is a prerequisite to the earning of income, it is not specifically directed to that situation.

7.68. Some countries have provisions that are so directed. For instance, child-minding expenses are deductible in the United States under certain conditions. The main requirement is that the child-minding expenses are necessary for the taxpayer to be employed or to seek employment. The child must be a dependant under 15 years of age for whom the taxpayer is entitled to claim a dependency exemption or, if the dependant is over that age, he must be physically or mentally disabled. The deduction is available to a taxpayer who is raising a child alone, for whatever reason. It is also available to married couples where both are gainfully employed or seeking such employment or where one spouse is disabled. The maximum deduction is $400 per month; however, for services provided outside the home—in a creche, for example—the maximum is $200 per month for one child, $300 for two children, and $400 for three or more children. The deduction is reduced by 50 cents for each dollar of the taxpayer's gross income in excess of $18,000. Expenses are not deductible if paid to a relation of the taxpayer.

7.69. In the Committee's view there should be some concession in the
law, not because of any policy of encouraging persons with responsibilities to children to seek employment, but in order that those who are employed, whether through choice or necessity, might be assisted in meeting the costs of discharging the responsibilities of caring for children when the services of others must be employed. The need for a concession will be the less if the government provides child-minding facilities directly by way of free or subsidised creches and the like. It cannot be anticipated, however, that such facilities will ever be universally available. The need will be the less, too, if generous child-endowment grants are made. But such grants will favour all parents and not provide specially for those who must incur the expenses of child-minding.

7.70. The Committee recommends that the concession be available to a married couple both of whom are working, to a married couple where one works and the other is an invalid, and to the head of a one-parent household who works. A number of other questions arise as to the scope of the concession. These relate to the nature of a qualifying expense, the amount of expense that may be recognised in respect of each child, the age at which the concession ceases, the scaling down of the expense where the earning of income is on a part-time basis or extends to only part of the year, and the protection of the Revenue when the expense involves payment to a relative.

7.71. Where the child-minding is incidental to the provision of education, there is no need to give a concession if there is an appropriate concession available for expenses of education. The question then arises as to the correlation between the child-minding expense concession and the education expense concession. The Committee has, in paragraphs 12.32–12.34, proposed that the present concession for education expenses in respect of dependants be related only to a taxpayer's expenses by way of fees for tuition, be limited by a ceiling of $600 in respect of each dependant, and involve a tax rebate rather than a deduction from income. In the Committee's view the child-minding expense concession ought to be framed as an extension of the education expense concession. Its function is to give a tax concession in respect of the expenses of the pre-school and out-of-school care of a child which a taxpayer is by his employment precluded from providing himself.

7.72. If the child-minding expense concession is framed as an extension of the education expense concession, it follows that the limit of $600 will cover both education and child-minding expenses in respect of the same child where both kinds of expenses are incurred.

7.73. The age at which a child ceases to attract the concession might be set at 14 years. The scaling down will need examination: where a parent is
employed for only part of the year, some scaling down would seem to be called for. Where the person to whom the payment is made is a relative, protection of the Revenue will require provisions of the kind at present applied generally to payments between associated persons (section 65).

7.74. In the Committee's view, in line with its thinking on the education expense concession, the function of the concession proposed should be seen as assistance in meeting special costs of discharging parental responsibilities. The concession should seek to give similar assistance to all taxpayers concerned, whatever their position on the income scale. The expense should therefore be the subject of a rebate of tax at a rate which, like the education rebate, might be set at 40 per cent. This means that somebody incurring $600 in child-minding expenses which qualify for concessional treatment will save $240 in tax.

7.75. There will be need of some provision to determine the correlation between the child-minding concession and the related concession, discussed in paragraph 7.67, provided by section 82D in the case of a housekeeper. An appropriate provision would require that where that concession is given in circumstances involving the care of a child, it be available only as an alternative to the child-minding concession.

Expenses of Income-Earning Activities Carried on at Home

7.76. Considerable administrative difficulties have arisen under the present law in regard to expenses associated with an income-earning activity which is in some degree carried on at the taxpayer's residence. Such expenses are deductible under the general provision allowing deduction of expenses in deriving income.

7.77. The present law, though by no means settled, would appear to draw a distinction between overhead expenses, such as interest and repairs to the residence or rent, and expenses directly connected with the income-earning activity, such as light, heating and depreciation on furniture. In regard to the former, the allowance of a proportion of the overheads requires that the room in which the income-earning activity is conducted should have been used in a manner that could not be described as a domestic use: ‘A study does not cease to be part of a taxpayer's home because it is used by the taxpayer for the pursuit of activities from which he earns his income’. If the study were to be held to change its character from domestic to non-domestic when it is used for such activities, one would have to concede that a bedroom ceases to be part of a home because the taxpayer solves his most difficult business problems in bed. The Committee is conscious of the need to draw a line that involves an objective test and is as determinate as
possible. There is a distinction, it is true, between a barrister who prepares a brief for the next day in his study and a lecturer who reads the latest literature. But the barrister will on occasions read the latest literature and the lecturer may be preparing a lecture for the next day. A test in terms of the activities pursued in the room is unmanageable. The non-domestic-use test appears to the Committee to be the appropriate one.

7.78. Under the latter test, a room devoted to an artist's studio or to a carpenter's workshop will attract a deduction for overheads. So too will a doctor's surgery. If it is thought that there might be doubt in any of these cases, the Act should expressly define non-domestic use.

7.79. In a case such as the doctor's surgery, the allowance could be justified on the ground that the room is used in a way that involves contact with the public. The Committee would, however, prefer the test to depend wholly on non-domestic use. The mere fact that a taxpayer occasionally sees patients, clients or customers at home should not attract the deduction. But where a room is set aside for such contacts, the use will clearly be non-domestic.

7.80. The observations in the last paragraph raise an issue whether exclusive non-domestic use of a room is necessary to attract the deduction. In the Committee's view a test in terms of exclusive use is appropriate. However, the Commissioner should be given a discretion to disregard minor use of the room for a domestic purpose.

7.81. Expenses more directly connected with the earning of income may, under the present law, be deductible even though no part of the home is devoted to a non-domestic use. Expenditure in providing light and heating exclusively for the taxpayer while he is engaged in work from which he derives incomes is, it seems, deductible. Depreciation on domestic furniture, carpets and curtains in a room where the taxpayer engages in work is allowed, subject to apportionment where the room is also used for other purposes. In the Committee's view these principles are unmanageable. The deductibility of expenses for light and heating and depreciation on items of ordinary domestic equipment should be determined by the same principle as applies to overheads. Deduction should be allowed only where the expenses relate to the deriving of income in a room exclusively devoted to a non-domestic use.

7.82. The deductibility of depreciation on items that are not ordinary items of domestic equipment (for example, a typewriter or a filing-cabinet or, more obviously, a lathe), the current expenses associated with such items (for example, electricity charges) and also the expenses associated with the use of a telephone should be left to the operation of the general provision unaffected by the special provisions proposed by the Committee.
7.83. The carrying out of the Committee's proposals will require some statutory amendments to displace, in regard to direct expenses, the interpretation of the general provision. The Committee suggests that the opportunity be taken not only to do this, but to establish a special code which will settle the law in this area in a form that will overcome the present uncertainties.

Subscriptions to Trade and Professional Associations

7.84. The present law contains a special provision (section 73) in regard to subscriptions to trade and professional associations, which draws a distinction between a taxpayer carrying on a business and an employed person. The former may deduct the subscription, without limit on the amount, when membership of the association to which the sum is paid is a pre-condition of the taxpayer carrying on the business.

7.85. The employed person, and a taxpayer carrying on a business whose subscription is not a pre-condition, is entitled to a deduction limited to $42 of any periodical subscriptions paid by him in respect of his membership of any trade, business or professional association. There is a further provision under which an amount greater than $42 in respect of one subscription may be allowed, if the subscription is made to an association that incurs expenses in carrying out any activity on behalf of its members where those expenses would be deductible by the member if incurred by him directly.

7.86. Subscriptions that do not fall within the special provision relating to subscriptions may nonetheless be deductible under the general provision in regard to expenses in deriving income. Deduction under the general provision, while not limited in amount, may in other respects be narrower in its operation.

7.87. The special provision has the advantage of determinateness and, subject to the recommendation made below, should be retained. In cases where the subscription is less than $42, the test will be simply whether the payment has been made to a trade, business or professional association. On the other hand, there is some prospect that what is really private expenditure may attract a deduction: the association may offer some of the amenities of a club. Hence there may be need to protect the Revenue by a more restrictive definition of a qualifying association.

7.88. The limit of $42 may, with a fall in the value of money, be thought to have become too restrictive. That limit, it is true, can be exceeded in the circumstances described above; but except in the case of a taxpayer carrying on a business who is compelled to be a member, the calculation of the amount deductible involves a measure of complexity where the claim
exceeds $42. An increase in the present ceiling of $42 is therefore recommended.

**Income-Protection Insurance Premiums**

7.89. Section 82H of the Act allows a deduction of amounts paid by a taxpayer as premiums for insurance against sickness of, or against personal injury or accident to, the taxpayer or his spouse or child. The amount of the deduction under the section is limited in that the total sum deductible for premiums and payments of the various kinds referred to in the section may not exceed $1,200. These premiums and payments include life insurance premiums and payments made to a superannuation scheme.

7.90. The question has been raised, in cases before Boards of Review, whether a premium for insurance against sickness or accident of the kind referred to in the section may not be deductible as an expense in deriving income. If it is so deductible, there will of course be no limit on the amount that may be deducted. The principles applicable in determining whether an insurance premium is deductible as an expense in deriving income are by no means clear. In some circumstances an expense directed to protecting a capital asset is deductible, though Australian judicial authorities in this respect are less helpful to the taxpayer than United Kingdom authorities. The question to be resolved is whether the expense, even though it relates to a capital asset, is a ‘working expense’. An insurance premium of the kind now considered could be regarded as a working expense of protecting human capital, in this context the capacity to earn income. There seems, however, to be no basis for an assumption that the deductibility of the premium depends under the present law on whether the form of compensation is a lump sum, which will probably not be income, or periodical receipts, which certainly will be.

7.91. Two consequences flow from these views of the operation of the law as to expenses in deriving income. First, it may be easier for a self-employed person to obtain the deduction of the premium. Secondly, there is a prospect of asymmetry in that while a deduction is allowable for the premium a receipt of compensation in a lump sum under the present law may not be income.

7.92. The first consequence involves what might be considered an unfair discrimination between the self-employed and the employee. The second may be thought to involve an unacceptable cost to Revenue.

7.93. The Committee's proposals in relation to deduction under section 82H are dealt with in Chapter 21. Apart from any concession that may be available under provisions replacing section 82H, the Committee considers
that there should be a further specific provision allowing a deduction in circumstances outside the concession. The specific provision should in its terms exclude the operation of the general deduction for expenses in deriving income in relation to premiums on income-protection insurance policies. The premium on such a policy should be made deductible, without limit on its amount, only if the policy provides that the compensation will be paid in periodical amounts during sickness or disability. A sum received in commutation of periodical payments under the policy should be expressly made assessable income.

7.94. To the extent that the new section goes further in allowing a deduction than the general deduction now provides, it will involve a concession that calls for justification. In Chapter 21 the Committee offers, as justification for the deduction of contributions to a superannuation fund, that it is reasonable to allow the postponement of tax on income when expenditure of that income has been demonstrably deferred, provided there is some assurance that it will be brought to tax at a later time. The same justification may be offered for the deductibility of premiums under the Committee's present proposal.

7.95. It will be seen in Chapter 21 that the Committee proposes limits on the deductibility of contributions to a superannuation fund. There might seem, then, to be justification for restricting the amount of the deduction under the provision now proposed by the Committee. However, the availability of insurance will act as a brake. Underwriting practices already set limits on the total cover that an insured person may have: in many cases he will, for example, already be covered to a degree by a superannuation scheme of which he is a member. In the circumstances the Committee does not propose any limit on the deductibility of the premium. Were some limit imposed, there would be a case for allowing a deduction of excess premiums against receipts of compensation under the policy. This would introduce awkward administrative problems.

7.96. Consideration must also be given to payments to sickness and accident funds and to friendly societies that provide benefits by way of periodical payments on the incapacity of a member through sickness or accident. Where the benefits are provided exclusively on a periodical basis, payments and benefits should be given similar treatment to that proposed for income-protection insurance policies.

**Self-Education Expenses**

7.97. Expenses of self-education are in some circumstances deductible as expenses incurred in deriving income. Though the judicial authorities are
not always reconcilable, they suggest a distinction between, on the one hand, the expenses of education undertaken primarily for the purpose of entering on an income-earning activity or a substantial increase in standing in an existing income-earning activity (which are non-deductible) and, on the other, the expenses of maintaining knowledge or skill required for an existing income-earning activity or improving such knowledge or skill (which are deductible). There is an obvious grey area between the two: a doctor who takes a higher degree to enable him to practise as a specialist may be denied a deduction; an employee who undertakes studies to qualify for promotion may not. Expenses that do not relate to any income-earning activity—the pursuit of a general education or a hobby—are not deductible. They are regarded as consumption.

7.98. Those expenses denied deduction as expenses of deriving income because they relate to entry on an income-earning activity or substantial increase in standing could, in principle, be treated as costs of acquiring capital and as generating deductions by way of amortisation against income of the activity in future years. There are, however, no provisions that allow this treatment.

7.99. In 1972 a new section (section 82JAA) allowing a deduction was inserted in the Act intended to cover some of those expenses that are not of a consumption character but are denied deduction as expenses of deriving income because they are undertaken for the purpose of entering on an income-earning activity or a substantial increase in standing. The deduction is limited to expenses for fees, books and equipment in connection with a course of education provided by a school, college, university or other place of education. There is a ceiling on the amount deductible, and the deduction is reduced by any amount allowed under the provisions of section 82J, which relates to education expenses of dependants. Recently the ceiling under both section 82JAA and section 82J was reduced from $400 to $150.

7.100. Reference has already been made to the Committee's recommendations in regard to the education expense deduction for dependants. Under those proposals the ceiling on the concession would be raised to $600 and become a rebate of tax; also, the expenses involved would be confined to fees for tuition. In the Committee's view the self-education expense concession should be retained, with a limit of $400, and it should remain a deduction rather than become a rebate of tax. It is, in effect, the allowance, as a current deduction, of expenses which would in principle be deductible as capital costs subject to amortisation, but which are more conveniently treated in this way. The range of deductible expenses is already narrower than under the existing deduction for
education expenses of dependants; the Committee therefore does not propose a reduction in the range of qualifying expenses as it does in relation to the concession for dependants’ education. To avoid double allowance of the self-education expense deduction and the proposed rebate for dependants' education, there should be provisions of the kind at present appearing in section 82JAA(3).

**Dissection and Apportionment of Composite Receipts and Outgoings**

7.101. An issue of general application arises when a receipt is composed of a number of elements, some of an income character and some not. In certain circumstances, not clearly defined in the legal authorities, the composite receipts may be dissected or apportioned so as to determine what part of the receipt is income. Dissection would appear to require that there has been some acceptance by the taxpayer in the course of the transaction of an amount as referable to the income item. Apportionment, it is said, is appropriate where the amount referable to the income item is ascertainable by calculation, but not, it seems, where the calculation involves a distribution of the receipt between items on the basis of a valuation of each item. The law as it stands might be thought to encourage practices in the settlement of claims to compensation and, in some cases, in the disposal of assets that will defeat the Revenue. Section 36 (relating to trading stock) and section 59 (relating to depreciable property) offer some protection, but more general provisions allowing apportionment on the basis of values would strengthen the law. Even when the parties have made a dissection of the composite amount, the Revenue may still need protection: it should not be open to the parties to make a dissection that is contrary to what would be a fair apportionment, so as to bring about a favourable tax result.

7.102. A similar issue arises when the taxpayer has paid an amount in part for a purpose that would attract deduction as an expense in gaining income and in part for a purpose that would not. The words of the general provision (section 51) purport to allow a dissection or apportionment. An outgoing is allowable ‘to the extent to which’ it is incurred in deriving income. But it is not clear in what circumstances a dissection or apportionment may be made. According to the authorities, it is only when a purpose other than the gaining of income is evident on the face of a transaction that it is proper to deny a deduction for that part of an outgoing incurred for this purpose. Where the transaction is a contract, it must be a part of the contractual arrangement ‘that . . . some advantage not . . . related to the production of assessable income was gained’. The words
quoted are from the judgment of the Privy Council in a New Zealand appeal,¹ but would be thought as well to be a correct statement of the Australian law. The Committee would not wish to make the test of deductibility depend on the subjective purpose of the taxpayer. On the other hand, the character of a transaction should not depend exclusively on its form. It should be expressly provided that the character of a payment may be inferred from all the circumstances of the transaction and, where that character is in part a payment for a purpose which is not the gaining of income, an apportioned amount will be denied deduction. Such apportionment should be made ‘as the facts . . . may seem to make just’.

The words quoted are from a High Court judgment:² they might be made the basis of the drafting of the proposed provision.


Chapter 8 Income Tax: Issues Related to Business and Professional Income

8.1. The broad concepts of income and expenses in deriving income have been dealt with in Chapter 7. These concepts apply in the determination of net income from business and professional activities irrespective of the form in which these activities are conducted, whether as individuals or through trusts, partnerships, or companies. In this chapter, the numerous particular problems which arise in ascertaining the net income of a business or profession are considered.

8.2. The first and overriding principle, in the Committee's view, is that income tax should be levied on true profits flowing from the business or professional activity during its whole period of operations. If this is not achieved the rates of tax, be they progressive as for individuals or proportionate as for companies, become meaningless and misleading as an indication of the weight of tax. The true after-tax profits remaining and available for maintenance or expansion of the activity cease to be readily apparent and become distorted. Further, meaningful international comparison of the incidence of tax on business operations is made very difficult and the results are subject to qualifications which often cannot be quantified. Additionally, if the base is not true profits, ostensible concessions or incentives in specific areas may in fact be excessive or alternatively of less value than the figures suggest.

8.3. The Committee has received, as have previous committees charged with inquiries into income tax, numerous submissions on the ascertainment of net incomes of businesses and professions. Many of the matters now raised have been previously ventilated and pressed without result, some even as far back as the Spooner Committee in the early 1950s. Others have been considered not only by that committee but also by the Hulme Committee (1954–55) and the Ligertwood Committee (1959–61).

8.4. Most submissions point to the failure of income tax legislation to allow deductions for expenses which, under normal commercial practice, are deducted in arriving at profits before income taxation. In some cases a deduction for the expense is not available for income tax purposes; in others it is available in an accounting period other than that in which it is normally charged using generally accepted accounting principles. In the end result, the profits subject to tax tend to be higher than those determined for commercial purposes.

8.5. A further factor, to which brief reference has already been made in Chapter 6, is the overstatement of net income as a result of inflation, and
claims for more equitable treatment on this score increase as the pace of inflation quickens. When the rates of income tax were very much less than they are at present, the consequences of net incomes determined by reference to the income tax legislation being higher than profits before tax arrived at on a commercial basis were not as severe. The overstatement of net income arising from inflation, taken with this increase in rates of tax, is giving rise to growing concern and disquiet.

8.6. It has again been proposed that the overstatement of net income arising from business activities would be avoided if the Income Tax Assessment Act were to be amended to provide that, subject to certain specific provisions, net income for tax purposes should be the profits determined on a commercial basis by applying generally accepted accounting principles.

8.7. At first blush such a scheme may appear to have attractions, but these fade on closer examination. There has, it is true, been considerable progress in recent years towards the acceptance, by companies particularly, of authoritative statements on accounting principles which should be followed in arriving at disclosed profits. However, it is clear that many instances remain within the authoritative standards where alternative procedures continue to be available, and in many types of business organisation the standards accepted generally by the larger publicly-listed companies have yet to be attained.

8.8. In addition, to place the basis for determination of net income on which taxes are to be levied outside the jurisdiction of the revenue-raising authority could not be seriously considered in Australia and has not been adopted, to the Committee's knowledge, in any other country. The proper approach therefore must be to seek to narrow, as far as is possible, the differences between net income as determined under the revenue legislation and as determined by commercial standards.

8.9. The division adopted in this chapter is to deal in Section I with problems which arise in determining the accounting method—cash or accruals—to be followed in computing net income. Section II discusses the appropriateness of the general approach of the Australian law to arriving at net income when the accruals method of tax accounting applies. Attention is drawn to the failure of the law to ensure that, except to a limited extent, matching items of income and expense are brought to account in the same tax year.

8.10. Section III examines a number of the instances of costs or outgoings which are not deductible for income tax purposes in the same accounting period as that in which they fall to be treated as an expense by a business. These instances include provisions or accruals for employee
benefits (long-service leave, holiday pay and sick pay) and provisions for product warranties and doubtful debts.

8.11. Section IV deals with allowances for depreciation and amortisation of fixed assets. Special consideration is given to depreciation of buildings, a subject raised in numerous submissions.

8.12. The special provisions of the Act relating to the valuation of trading stock are examined in Section V, as are also possible extensions of their scope. Section VI is concerned with the offsetting of losses arising in one income year against net income of other years. The existing restrictions on the recoupment of losses have important implications for the overriding principle that income tax should be levied on profits of the whole period of operations of a business.

8.13. Section VII takes up the important subject of the overstatement of net income flowing from the effects of inflation on business income and discusses briefly some of the measures being advanced to arrive at real profits and net income in periods of high inflation.

8.14. Section VIII is concerned with the treatment for tax purposes of a number of costs of business operation, including expenditure on repairs, anti-pollution expenses, and travelling and entertainment expenses.

8.15. This chapter is concerned with the treatment of business and professional income generally. The treatment of several particular industries—mining and primary production, for example—and the special provisions which at present apply in those fields of activity are considered in later chapters.

I. Cash or Accruals Basis

8.16. Income tax law recognises two accounting bases, cash and accruals, for the determination of net income, which broadly correspond with the cash and accruals bases in financial accounting. What is included in ‘income derived’ and in ‘outgoings incurred’ will depend on the basis of tax accounting which is held to apply. If it is the cash basis, income is not derived until an amount has been received: it is not enough that it is receivable. Similarly, an outgoing is not incurred until there has been a payment: it is not enough that the outgoing is payable. On the other hand, where the accruals basis applies, income is derived when an amount is, in the language used in the cases interpreting the law, ‘due’, even though it has not been received and is not immediately receivable. There is an outgoing incurred if there is a ‘definitive commitment’ to pay, even though payment has not been made and there is no immediate liability to pay.

8.17. Accruals tax accounting differs from accruals financial accounting
in ways which are considered in some detail in subsequent sections of the chapter. In theory, both seek to strike a balance for an accounting period between income earned and the costs and expenses incurred in relation thereto which will reflect the true result whether it be a profit or a loss. Cash tax accounting, on the other hand, is concerned with little more than striking the net result of a balance of receipts and payments.

8.18. It would seem to follow, as a matter of general principle, that all businesses and professions should be required to return their net incomes on the basis of accruals accounting. It has been recognised, however, that for some professions and small businesses a cash basis is more appropriate. This may be because most of the income generated flows from the taxpayer's personal labour or effort, because receivables and payables are modest and do not differ greatly in amount, because stock held is small, or because the taxpayer is unlikely to keep the more sophisticated records which will be necessary if he is to return on an accruals basis. The choice of cash rather than accruals in these instances will make little difference to the amount of net income in a tax period; yet the simplicity of the tax system for the taxpayer concerned is so much greater.

8.19. The Committee believes that a cash basis should continue to be available to a large proportion of those currently using it. To impose more sophisticated accounting would have little effect on net income but would add greatly to the compliance costs of those involved in a change from their existing method. The factors detailed in paragraph 8.18 may well be a better guide to the drawing of a dividing line than a general classification based on type of business or professional activity. The fact that most of the income from a business or profession is generated by the taxpayer's own effort might be made the dominant test. This would embrace the majority of doctors, dentists and barristers, as well as many other sole practitioners and small professional partnerships; it would also cover sole traders in the service industries.

8.20. Where the activity includes the employment of tradesmen or professional staff together with supporting administrative staff, the use of a cash basis is clearly inappropriate. In these instances, it is rarely employed in settling interests between partners or in arriving at an appropriate price for the sale of a business. Here, an accruals basis, which brings to account amounts owing and sums payable and a value for work in progress, if any, is needed to assess net income.

8.21. Where the business is carried on by a company, the need to lodge returns on an accruals basis should not impose any added burden as company legislation requires the maintenance of full accounting records.

8.22. The Committee believes that the use of the accruals basis of
accounting should be the general rule in computing the net income of a business or professional activity. Exceptions ought to be specified in the Act or Regulations. The definition of the exceptions should be founded on the extent to which the net income reflects the payment for the individual taxpayer's personal efforts, the scale of operations, the normal level of debts due, debts payable, work in progress and stock in trade. Businesses conducted through a company (except where the company is merely acting as a trustee) should use the accruals basis. No restriction should be placed on any taxpayer adopting an accruals basis if he chooses to do so even though he may qualify for cash-basis treatment.

8.23. The adoption of this general rule will impose a requirement for additional accounting on many taxpayers. However, side-benefit should flow in the way of improved management of the business. And in the event of a broad-based indirect tax being imposed, such as a value-added tax as recommended by the Committee, many small businesses will in any case need to lift the standard of their accounting.

8.24. The question remains as to the special provisions needed to cope with the switch from a cash to an accruals basis, which may arise from a change in law to give effect to the Committee's recommendation or because of an election by a taxpayer to adopt an accruals basis under that law. In most instances the use of the cash basis will have resulted in a lower net income and the accumulated understatement may be a substantial figure for some taxpayers. When many professional firms were required to change from a cash basis to the present quasi-accruals one several years ago following a Court decision, the Commissioner ruled that, in computing net income of the first year under the accruals method, a deduction was to be allowed for the value of debts due to the firm, and a deduction was not allowable for amounts owing to creditors for expenses, as at the commencement of that year. The Committee believes this precedent ought to be followed. It should be provided that a deduction will be allowed in the year of change for the value of debts due and stock in trade, and deduction denied for trade liabilities, as at the commencement of the year, subject to the change to the accruals basis being made prior to a specified date.

8.25. Where a change is made after the specified date, the accumulated understatement of net income should not escape tax. However, it would not be equitable, where progressive rates of income tax apply, to seek to tax the whole of the accumulated income omitted in the year following the change. To do so would also result in serious liquidity problems for most taxpayers. Accordingly, the Committee recommends that when a taxpayer after the specified date is required to or elects to change from a cash to an
accruals basis, the total of net income previously excluded from tax at the commencement of the year of change should be included in his taxable income in the succeeding five to ten years, the actual period depending on the amount involved. A minimum adjustment to income of a succeeding year of $1,000 should be fair in most cases.

8.26. Where the entity changing its basis is a partnership, it will be the interest of each partner in the total net income omitted which will need to be adjusted in the way indicated. A subsequent change in a partner's interest in the partnership should have no effect on his liability to tax on his proportion of the omitted income: its value will normally be reflected in the true worth of his interest in the total net assets of the partnership, whichever tax basis is being used.

II. Accruals Tax Accounting and Financial Accounting

8.27. Many submissions claim that accruals tax accounting under the Australian law is too rigid. It is said that in determining the net income of a business, tax law should take as its starting-point the results of the business for the period determined by generally accepted principles of financial accounting. Tax law should then require adjustments to the results where a particular rule of tax accounting has no parallel in financial accounting, or where the principle of financial accounting that has been adopted differs from the rule of tax accounting.

8.28. The approach suggested would lessen the rigidity of tax accounting only if financial accounting is more flexible in the choices it offers and adjustments are not required by tax accounting. In the Committee's view flexibility in this sense is desirable in some contexts. However, it is for the tax law to define the choices. The law could not resign its function of determining the base of income tax in favour of the professional bodies and business or trade organisations which play a large part in formulating generally accepted principles of financial accounting.

8.29. The criticism of the rigidity of the existing law may be stated in another way. Accruals tax accounting, it is claimed with real justification in some respects, is much less effective than financial accounting in striking a balance which reflects the true profit or loss of a business activity. To the extent that this is true, the Committee would agree that tax accounting rules should adopt the financial accounting principles. However, a difference between a rule of tax accounting and a rule of financial accounting can be no more than a valid reason for re-examining the rule of tax accounting. It cannot dictate a change in the tax rule.

8.30. The change in approach that is being sought would in any case
involve a radical redrafting of the existing law and this should not be contemplated if the purpose of the change can be achieved without it. Old law is, to this extent at least, good law. Overseas experience suggests that a major redrafting of the law would not significantly reduce the complexities of the tax.

8.31. The differences between tax accounting and financial accounting can be overstated. Some of the early pronouncements in legal authorities that tax law is not concerned with the profits from transactions, except where there is some express provision, are contradicted by the treatment the law accords to contracts extending over several years. It has been decided that a charge made to a client of a business, even though it be received, should not be treated as income until the services for which it is the reward have been performed: this is a tax recognition of a principle of financial accounting. The provisions of the Act in regard to the allowance of depreciation and accounting for trading stock are intended to ensure that net income of a business for an accounting period reflects the profits of that business for the same period.

8.32. Attention has tended to focus on those differences between accruals tax accounting and financial accounting that lead to net income being overstated, which is what happens when a deduction for income tax purposes is deferred until an expense is paid while for financial purposes it is brought to account as it accrues. On occasions, however, the law allows a deduction in the year in which the cost or outgoing is met even though, in the particular case, the cost clearly refers to or is connected with an item of income to be derived in a later year. Thus, for example, interest is generally available as a deduction in the year in which it accrues, irrespective of the fact that it may relate to cost of establishing a new industrial complex in course of erection or to development land held for resale. Under financial accounting principles, interest paid in these circumstances will frequently be added to the cost of the asset concerned. A finance institution may in its financial accounts accrue interest on fixed-interest securities; but it is permitted to exclude such amounts from tax accounting on the grounds that the income has not in fact been received. A grazier may purchase a quantity of superphosphate just prior to the end of a financial year and become entitled to deduct the cost from his net income, even though the whole benefit from his expenditure will not fall to be included in his net income until a subsequent period.

8.33. Differences between accruals tax accounting and financial accounting which increase net income subject to tax sometimes arise from legal authority limiting the meaning of a cost or outgoing incurred in deriving income so that an anticipated expense or an expense subject to
some contingency is not allowed as a deduction. Into this category fall accruing costs of employee benefits such as long-service leave and the extension of depreciation allowances to allow for obsolescence of fixed assets. These are examined in detail later in this chapter, as also are several differences of a permanent nature such as depreciation of buildings.

8.34. There is one other difference operating in favour of the taxpayer which must be mentioned because of its fairly general application. It relates to the failure to take to account the value of work in progress in certain professional activities. The professions mainly concerned are those of solicitors, accountants and architects. In those cases where a large staff is employed, the costs incurred in any year will frequently relate in substantial degree to services rendered which have not been billed by the end of the year. Work in progress and unrendered charges and costs may constitute the largest asset of the business and its existence needs to be taken to account to arrive at profits for financial accounting purposes. There is little reason why it should not be similarly taken into account in reaching net income.

8.35. Clearly it is not practicable to seek to eliminate every difference currently arising or to correct the lack of symmetry in every business transaction. Some of the differences spill over to the taxation of income outside the business area. For example, the deduction allowed a finance company for interest accrued but unpaid on debenture loans would require each debenture-holder to include in his net income accrued interest as at the end of a tax year if symmetry were to be achieved. This obviously is not feasible.

8.36. However, several of the differences referred to in this section appear to call for legislative action.

**Holding Charges**

8.37. The Committee recommends that holding charges (in the form of interest, rates, land tax, etc.) on land held for resale, being akin to trading stock, should not be allowable as a deduction to the extent that the charges relate to land held at the end of an income year. The charges so excluded would form part of the value of trading stock.

**Work in Progress**

8.38. The fact that professional firms do not bring to account the value of work in progress or unrendered charges, except where the work performed at a year end has given rise to a recoverable debt, results in their net income being computed on a quasi-accruals method.
8.39. One result is that net income tends to be understated under normal conditions when activities are increasing and costs rising. An associated problem is the considerable room for dispute as to whether the services performed or work carried out at the year end have in fact given rise to a recoverable debt the value of which needs to be included in net income of that year.

8.40. Those professional firms which base their charges to clients on time incurred on the assignment by principals and staff now maintain records from which the value of work in progress is computed at regular intervals for purposes of internal management. There are probably many other firms, however, which do not now find it necessary to keep these additional records. Accordingly, to require all professional persons or firms to bring to account a value for work in progress in determining net income would be onerous and add significantly to administrative costs for at least some taxpayers. But there seems no good reason why a professional person or firm should be debarred from computing net income on a full accruals basis as a matter of choice.

8.41. The Committee recommends that professional persons or firms, whether incorporated or not, be given the right to elect to take account of the value at cost of work in progress at the beginning and end of an income year.

8.42. The Committee proposes that the principle set out in paragraph 8.24 relating to changes prior to a specified date should apply to an election to bring in work in progress.

8.43. This procedure will, it is true, result in the opening value of work in progress escaping tax. But the change in basis for treating work in progress for those firms which elect will tend in most instances to increase their net income and the taxes payable without lifting the cash flow of profits available to taxpayers. Also the change will tend to increase annual taxation revenue, despite the failure to tax the opening value of work in progress.

8.44. Where a firm makes an election to bring in work in progress after the specified date, it is proposed that the opening value of work in progress should fall to be taxed by the spreading procedure, outlined in paragraph 8.25, to be applied when a taxpayer changes from a cash to an accruals basis.

**Tax on Basis of Financial Accounting Principles**

8.45. While the decision in the Arthur Murray Case\(^1\) has led to a more factual approach to the determination of income of a year, there remain
elements of rigidity in the present law. This rigidity has already been referred to, as has also the claim that on occasions accruals tax accounting fails to arrive at a balance reflecting the true result from a business activity.

8.46. While the Committee rejects the proposal that net income be computed using generally accepted accounting principles, it acknowledges that it might well be in the interests of both the Revenue and taxpayers if the Act were more flexible in its requirements both as to computation of gross income and as to deductions for related expenses. In practice, flexibility has been given by administrative decision of the Commissioner and his officers.

8.47. The Committee feels it would be desirable for the Commissioner to have statutory authority to compute the net income from a business activity using one or more of the generally accepted accounting principles approved by recognised Australian professional accounting bodies, where the taxpayer so requests and the Commissioner is of opinion that to do so would be reasonable having regard to all the circumstances.

III. Provisions and Accrued Expenses

8.48. It is under the general heading of provisions and accrued expenses that the major differences arise between net income and results determined under financial accounting: the latter takes to account numerous provisions and accruals that need to be made to match income and expenses which have been incurred or are anticipated in earning that income. These additional charges made against financial results include accrued employee benefits such as long-service leave and holiday pay, provisions necessary to reduce debts receivable to their anticipated realisable value (doubtful debts), and provisions for product warranties and for known contingencies.

8.49. The principle basic to the general deductions section of the Act (now section 51) since its introduction in 1915 is that deductions are allowable for outgoings incurred. But these do not necessarily include provisions for future expenditure.

8.50. One objection raised to relaxing this general deduction provision to eliminate some of the differences which now exist is that the bases of the estimates of provisions and accruals are suspect and tend to err in the taxpayer's favour. This objection may be valid in the case of certain provisions, for example doubtful debts and product warranties. It has no real force, however, in relation to an employee's vested right to long-service leave and holiday pay, where his entitlement is fixed by a governing statute or an industrial award.
Long-service Leave and Holiday Pay

8.51. Both long-service leave and holiday pay are regulated for all employees by either legislation or industrial agreement. There is considerable uniformity in the legislation and awards as to the circumstances in which the leave is payable. The variations between legislation and awards are concerned mainly with the rate at which leave is accumulated and paid. So while the leave requirements are not identical throughout Australia, they are nonetheless uniform to a substantial degree.

8.52. Table 8.A summarises what are understood to be the minimum periods of service to qualify for long-service leave under current State legislation or Federal awards and weeks of leave granted.

8.53. From inquiries made by the Committee it appears that most major employers of labour, and many smaller employers, have established provisions to cover the liability for long-service leave, the liability usually being determined on the basis of the employee's current salary. Inquiries also show that many employers start to make provision after the employee has completed five years' service. Since legislation and industrial awards govern the accrual for long-service leave and require detailed records to be kept of each individual's entitlement to long-service leave, calculation of the provision is made reasonably simple.

**TABLE 8.A: LONG-SERVICE LEAVE ENTITLEMENT**

<table>
<thead>
<tr>
<th></th>
<th>N.S.W.</th>
<th>Vic.</th>
<th>Qld</th>
<th>S.A.</th>
<th>W.A.</th>
<th>Tas.</th>
<th>Federal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. First entitlement, where entitlement flows principally from termination by the employer or sickness, death or domestic reasons of the employee (years of service)</td>
<td>5</td>
<td>10</td>
<td>10</td>
<td>7</td>
<td>10</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>2. First entitlement, where termination by employee (years of service)</td>
<td>10</td>
<td>15</td>
<td>10</td>
<td>7</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>3. Entitlement vests absolutely (years of service)</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>10</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>4. Amount of leave after entitlement vests absolutely (weeks of leave)</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>5. Record of entitlement of each employee required to be kept</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Notes:** (a) There is uniformity in the employee's entitlement of 13 weeks leave after 15 years' service, except for South Australia, and in that after 10 years' service all employees have some entitlement to long-service leave.
The Spooner and Ligertwood Committees, which examined this question, both recommended that provisions for long-service leave be allowable deductions. They had different views, however, on procedure for deductions. The Spooner Committee recommended that a deduction be allowed for the taxpayer's estimate, while the Ligertwood Committee favoured allowing the deduction for employees with ten or more years' service.

The Committee agrees in principle with the recommendations of its predecessors and accepts the equity of the claim made in numerous submissions that a deduction should be allowed for the value of long-service leave entitlements which have accrued to employees at the end of a financial period. The difficulty lies in determining the entitlement to be used in calculating the figure and the transitional safeguards to be provided to protect the Revenue. There are no reliable figures on the probable total value of employees' long-service leave entitlements accrued in the private business sector, but the figure probably exceeds $1,500 million. Clearly a reduction of taxable income of this order in one financial year could not be contemplated. Transitional arrangements are obviously called for.

As Table 8.A shows, an employee working under New South Wales legislation and having his services terminated by his employer is entitled to a pro rata payment of long-service leave if he has completed five years' service, though the more general requirement in Australia is that he must have completed ten years' service to qualify. Where, on the other hand, an employee takes the initiative in terminating his service, he need have served for only seven years under South Australian legislation but more generally for fifteen years. In deciding which entitlement should be accrued, most employers and their advisers would feel that the dominant factor should be the period of service after which the employer would be required to make a payment to an employee in the event of his services being terminated by the employer. To omit to make any provision until an entitlement vested absolutely (in the vast majority of cases after fifteen years' service) would be to fail to match income with costs related to that income.

The Committee believes that, at the very least, a deduction should be allowed for the total amount, at each year end, of the employees'
entitlements to long-service leave which have vested absolutely. This limited deduction would not, however, eliminate the failure to match income with expenditure. Accordingly, the Committee recommends that, subject to transitional provisions, a deduction be allowable for the total amount of employees' entitlements at each year end, calculated according to each employee's entitlement should his services have been terminated by his employer at that date, but only to the extent that a deduction in respect thereof has not been allowed against a taxpayer's income of a prior year. Transitional provisions are considered later.

8.58. An argument commonly made against the kind of proposal being put forward here is that a deduction for a provision calculated by reference to payments in a future year is liable to be excessive unless the provision is calculated by discounting the future payments to their present value. In the Committee's view this discounting is unnecessary. The failure to discount will be offset in part by the calculation of the provision on the basis of the present wages of the employee and not his anticipated remuneration when leave is taken. In most instances promotion and award increases will have lifted his current wages when he takes his leave. For example, a man who at 30 June 1974 had completed ten years' service and whose gross wages at that date were $120 per week would have accrued long-service leave of 8 2/3 weeks—in money terms, $1,040. If, at 30 June 1975, his gross wage rises to $150 per week—a not unlikely occurrence—the value of his long-service leave accrued at this later date will be $1,430, an increase of 37.3 per cent in one year.

8.59. The rights of employees to receive and the liability of their employer to meet holiday pay appear to be more certain and uniform than the conditions relating to long-service leave. Except in the case of some casual workers where a holiday pay loading is incorporated in weekly rates of pay, legislation requires an employee to be granted paid holidays, now generally at the rate of four weeks' leave for each complete year of service, and payment in cash of a pro rata sum in the event of his ceasing employment at any time. Employment for even one day carries an entitlement to pro rata holiday pay.

8.60. From an employer's viewpoint, the cost of meeting the liability for holiday pay of staff is just as much a cost of labour as the wages or salaries paid regularly. Here too the relevant legislation imposes a requirement to maintain records disclosing the holiday pay entitlement of all employees on an individual basis.

8.61. The Ligertwood Committee concluded that a deduction for accrued holiday pay was not warranted, mainly it seems because of the relatively small sums of money involved. Since it reported in 1961, however,
legislation has extended the benefit considerably. Amongst other things, the benefit has increased from two weeks for each year of service to four weeks, and in most cases there is currently a loading of 171/2 per cent. The accrued liabilities of employers is now quite a substantial sum and it has become general practice to take the liability to account in computing financial results.

8.62. This Committee has not been able to locate any reliable statistics on the total estimated value, at a given date, of the accrued holiday pay liability of the private business sector. But the figure may well exceed 50 per cent of the total liability for accrued long-service leave.

8.63. The Committee recommends that, after a transitional period aimed at easing the impact on income tax revenue, a deduction be allowed for the total amount at each year end of the accrued liability for holiday pay entitlements of employees, calculated according to their vested rights under industrial awards or other legislation. In practice, the deduction allowable from the net income of a year would be limited to the increase in the accrued liability at the year end over the figure at the commencement of that year: a decrease in the liability would result in net income of that year being increased to offset the deduction claimed for holiday pay actually met and forming a component of wages and salaries paid in that income year.

8.64. The need for a transitional period for the implementation of the Committee's recommendations in respect of long-service leave and holiday pay has already been referred to. Of the various alternative courses open, it appears that a gradual introduction of allowances over a period of ten years would be the most appropriate. It is therefore recommended that, in the first year of change, the deduction allowable be restricted to 10 per cent of the accrued liability for each benefit, determined as previously recommended, and at the end of the second year to 20 per cent, and so on. It is further recommended that the right to obtain a deduction for these accruals be subject to an election by the taxpayer. For example, a taxpayer may, through omission or having regard to the smallness of his accrued liability for one of these benefits, elect not to claim a deduction for his accrued liability until, say, the third year of the transitional period. The law should provide that in that year he is entitled to a deduction for the full 30 per cent of his total accrued liability and, if further postponement occurs, to the higher percentages applicable to the following years until he becomes entitled to the full 100 per cent allowance against his net income for the tenth year. A taxpayer who does not elect to claim a deduction for his accrued liability should continue to be entitled to a deduction for the actual payments made in each income year.
8.65. Transitional arrangements along the lines suggested would cushion the impact on income tax revenue arising from allowing deductions for these business costs—costs which clearly should be taken to account to arrive at true net income for a tax accounting period. Special provisions will be needed to ensure that no undue benefit is received by either the vendor or purchaser of a business which changes hands.

**Other Provisions for Liabilities**

8.66. A number of submissions have been received requesting allowance of a deduction for provisions for other liabilities made in arriving at commercial profits. Firstly, there is the matter of the provision for a liability arising under a warranty given when a product is sold: for example, a manufacturer may undertake to replace defective parts for a specific period. The major difficulty in the case of provisions for warranty is in determining, in objective fashion, what constitutes a reasonable provision at any year end.

8.67. Several years ago income tax legislation in the United States was amended to allow a deduction for a provision for product warranties. However, the amounts claimed in the first year of operation proved so high and the effect on revenue so great that the deduction had to be abandoned, with retroactive effect. Because of the difficulty of assessing a reasonable provision for any business at each year end, the Committee does not favour an amendment of the law in respect of provisions for warranties. This is in line with the recommendation of the Ligertwood Committee.

8.68. The second liability or contingency for which a deduction has been sought concerns a possible loss under an impending law suit. The legal proceedings may not be resolved for several years and the decision may give rise to a substantial loss. Here too the impossibility of making any objective assessment of the amount that might be claimed as an appropriate provision appears to the Committee sufficient reason for not allowing a deduction.

**Provision for Doubtful Debts**

8.69. Another difference between tax and financial treatment frequently arises in the case of provision for doubtful debts. Business prudence normally demands that adequate provision be made for doubtful debts in determining the results of any period. In addition Australian company legislation requires directors to take reasonable steps to ensure that adequate provision is made for losses which may arise in the recovery of debts owing at the end of a financial period. However, income tax law
permits a deduction only for bad debts written off. The amount of provision necessary to provide for doubtful debts is a matter of judgment, experience with bad debt differing from one industry to another and from year to year.

8.70. It would be possible for the law to prescribe limits, varying from industry to industry, as to the amount of a provision which might be deducted. But inconsistencies could hardly be avoided, and there would inevitably be arguments as to what proportion of the outstanding debts of a company operating in several fields related to each industry classification. For these reasons the Committee does not recommend that a provision for doubtful debts be allowed as a deduction.

IV. Depreciation and Amortisation of Fixed Assets

8.71. If the cost of a fixed asset used to produce income is not fairly spread over the period of use, by allowing deductions each year, the tax base will be distorted by the failure to match expenses with income. Criticisms of the present law relate to the unfairness of the spreading for those assets for which the law does allow depreciation and to the absence of any deduction for certain other fixed assets, principally buildings. In addition allowances have been sought for certain expenditure which, though not wholly falling within the usual definition of fixed assets, is nonetheless of a capital nature. This includes costs of acquiring know-how, of company formation and issues of shares, of feasibility studies; it also includes some expenses of moving the site of business operations. The denial of depreciation deductions to a taxpayer who has incurred expenditure on an asset he does not own—for example, improvements to leasehold property—also has been criticised.

8.72. The depreciation provisions of the Act were examined both by the Spooner Committee and, in rather more detail, by the Commonwealth Committee on Rates of Depreciation (the Hulme Committee). The terms of reference of the Ligertwood Committee did not extend to the matters dealt with by the Hulme Committee; but it examined the lease provisions of the Act, including the question of allowances for expenditure by a lessee on improvements to leasehold property.

8.73. Many of the matters raised in submissions are identical with those brought to the attention of the earlier committees, particularly the Hulme Committee: for despite the recommendation of these committees that allowances be available for the recoupment of the cost of certain assets of a capital nature, the law has remained unchanged. Consequently, the differences between net income and accounting profits which arise in
relation to depreciation and amortisation continue. In the years that have elapsed since the recommendations of the Hulme Committee, the grounds for the criticism of the differences in treatment have not weakened; rather, they have been strengthened by technological progress and by the now almost general acceptance by business that failure to provide adequate depreciation for buildings results in overstatement of profits. The omission to tax capital gains, particularly on land, which it might be thought has mitigated to a degree the absence of depreciation allowances for buildings is now proposed to be rectified.

8.74. The discussion which follows is arranged under four broad categories of assets in respect of which changes in the law are sought. These are plant and equipment, buildings, leasehold improvements and other assets and costs. The questions which arise are considered in relation to the recoupment of the historical cost: the extent to which regard should also be paid to the increased cost of replacement due to inflation is briefly mentioned in Section VII. The special provisions applying to primary production and to the mining and petroleum industries are considered in Chapters 18 and 19.

Plant and Equipment

8.75. Practically all units of property classified in financial accounting as fixed assets and in respect of which depreciation is at present allowed fall under the broad heading of plant and equipment.

8.76. The annual percentage rate of depreciation allowable in respect of each unit of property is determined by the Commissioner on the basis of the estimated effective life of the asset, assuming it is maintained in reasonably good order and condition, and an annual percentage allowance is fixed accordingly. Standard rates of depreciation are determined by the Commissioner in respect of various types of assets. The standard rates make no allowance for obsolescence. Although the Commissioner may allow a variation from the standard rates where special circumstances or conditions relating to a particular unit of property justify such a variation, his determination, it seems, must be made on the physical life of the asset. Australia is one of the few countries which does not have regard for obsolescence in determining rates of depreciation.

8.77. The Hulme Committee considered whether it was practicable and desirable, in determining annual rates of depreciation, to take obsolescence into account and reached the view that it should be recognised as a relevant and material factor. It added, however, that the method of making an allowance for obsolescence and the degree of the allowance had given it
some difficulty and concluded that the only feasible approach was to introduce a degree of flexibility by allowing the taxpayer choice of a rate of depreciation within a band of rates.

8.78. The need to make due allowance for the factor of obsolescence has again been pressed in many submissions to the present Committee, including a number from particular industries in which, owing to the speed of technological advances, the matter is of major concern. Where the period of the estimated effective life of any equipment proves, in practice, to have been excessive, a deduction for the cost not covered by allowances in prior years is available when the equipment is scrapped or abandoned. However, this defers a deduction and does not give an even spread of the recoupment of the capital cost over the effective life of the equipment.

8.79. Complaints about the inflexibility of the standard rates continue, though it may well be that a proportion of these are not soundly based. The Commissioner and his officers permit variation from the standard rates where a taxpayer produces satisfactory evidence that, in his particular case, the specified standard rate is inadequate. Submissions rarely record whether an application has in fact been made for permission to adopt higher than standard rates.

8.80. The essential feature of rates of depreciation is that they are estimates of effective working lives. The allowances flowing from them are in reality estimates also and not precise figures of the portion of an asset's cost relating to a year of income. Considerable clerical recording and effort are frequently involved in computing depreciation allowances, particularly in manufacturing industries, due to the differing rates to be applied to the separate units of property. The clerical effort in checking or reviewing the computations by Departmental officers is also heavy. One method of reducing this would be the adoption of a composite rate to be applied to all depreciable fixed assets of a business, other than motor vehicles and buildings. This method recognises the futility of incurring clerical costs in performing precise calculations of allowances for various categories of property attracting different rates, when approximately the same total allowance can be determined by simple and less expensive procedures and the result under either approach is in any event only an estimate.

8.81. The Committee recommends that the schedules of standard rates of depreciation incorporate composite depreciation rates for specified industries which may be adopted, in lieu of standard rates, for all depreciable assets other than those excluded in fixing the composite rate. It further recommends that, in fixing the composite rate for a particular industry, a loading be added to take account of obsolescence.
8.82. The Act allows deductions for depreciation of ‘plant’ used for income-producing purposes but, with certain limited exceptions, not for depreciation of ‘buildings’. The exceptions are income-producing buildings forming an integral part of plant; buildings used only for scientific research related to the business of the taxpayer; structural improvements on land used for the purpose of agricultural or pastoral pursuits; and buildings erected by mining enterprises as part of the development of a mining property.

8.83. One argument that has been used to support the present situation is that land and buildings appreciate in value rather than depreciate. The Hulme Committee, in observing that the Commonwealth income tax law did not allow depreciation on buildings, stated that the reasons which appeared to have previously weighed against the granting of such an allowance were those to be found in the following extract from the Report of the Ferguson Commission (1932-34):

‘We received many requests that depreciation should be allowed in all cases. There are many buildings, however, which with repairs and maintenance, all of which are of course allowed as deductions, will last for hundreds of years. There is the further consideration that many substantial buildings in good localities have not depreciated in value—on the contrary the property as a whole has appreciated owing to an increase in values of the sites on which the buildings stand . . . We recommend that depreciation on buildings be restricted to buildings forming an integral part of plant . . . ’

8.84. The Hulme Committee reported that in none of the matters which came before it had it encountered more widespread representation, or more unanimity of opinion, than that an allowance should be given for depreciation of buildings. It recommended that depreciation be allowed in respect of the cost of all income-producing buildings but drew attention to the practical problems of including existing buildings.

8.85. It recommended that existing buildings be included where, if depreciation using the prime cost method had been available at the time the building was constructed, there would still be some portion of the construction cost unrecouped. However, to overcome the problem of ascertaining the actual construction costs of older buildings, it devised a complex scheme for calculating the cost of existing buildings where actual construction costs were not known. Construction costs of buildings erected between 1939 and 1955 (the year in which the recommendations were made) could, it was thought, be ascertained. It was proposed that buildings
erected before 1939, which tended to be more standardised than are buildings erected today, should be given a deemed cost of construction calculated by applying a standard cost for that type of building in 1939 to the building’s internal floor area and then relating the result to an index of relative levels of building costs in earlier years. Since the rates of depreciation suggested for brick, stone or concrete buildings assumed a normal life of sixty-seven years, the existing buildings (in 1955) which would still have qualified for depreciation could have been constructed as long ago as 1888.

8.86. Depreciation on industrial and commercial buildings used in the production of income is allowed in many overseas countries including Belgium, Canada, Italy, Japan, Netherlands, New Zealand, South Africa, Sweden, the United States, and West Germany. The United Kingdom is an exception, the deduction being limited to industrial buildings. However, the Millard Tucker Committee on the Taxation of Trading Profits (1951) and the Royal Commission on the Taxation of Profits and Income (1955) both recommended that the depreciation allowance be extended to include commercial buildings.

8.87. In reaching this conclusion, the second of these United Kingdom inquiries reported:

‘380. No doubt commercial buildings involve an ultimate wastage of capital in the same way as industrial buildings do. From that point of view there is no reason to distinguish between them. But we recognise that there are other arguments to be considered. There is an argument that any allowance for capital that is lost in the using up of a fixed asset is anomalous in an income tax system which refrains from treating as taxable a realised capital surplus. This unbalanced treatment, for long confined to plant and machinery, has now been extended to cover other types of assets, in order to stimulate capital investment of a kind desirable in the national interest. It is only in the new context of shortages and high prices combined with a wider range of assets to which capital allowances apply that the anomaly of principle could be of any material importance. But in that context it is not impossible that what is right for industrial buildings is wrong for commercial buildings.

381. The Board are opposed to this recommendation. We summarise their reasons:

(1) Commercial buildings last a very long time; they are not nearly as much subject to obsolescence as factories are.
(2) Over very long periods they tend to appreciate rather than depreciate in value, so
that if allowances were given they would very often have to be withdrawn when a sale took place.

(3) At the present time there is no economic importance in stimulating the construction of commercial buildings.

(4) The proposal would involve drawing a line between commercial buildings and dwelling-houses that would inevitably be regarded as unsatisfactory, particularly in the common case of the house over the shop. Complicated provisions would, moreover, be required to deal with changes of user.

(5) The proposal would add considerably to the work of the Department.

382. Although these arguments must be taken into account we do not believe that in the long run they can be decisive. So far as they are not concerned with administration they amount to saying that businesses would not find it worth while to claim the allowance, or that there would be no economic reason for a Chancellor to implement the recommendation. That may well be so, and we should agree to this extent that we do not regard a change from the present system as in any sense an urgent requirement. But we could find no fiscal justification for distinguishing between commercial and industrial buildings and we think both should get the allowance. Accordingly, we endorse the recommendation of the first Tucker Committee.’

8.88. The Institute of Chartered Accountants in Australia and the Australian Society of Accountants, in a joint statement, ‘Depreciation of Non-current Assets’, issued in April 1974, recommended as follows:

‘Buildings. For the purposes of calculating depreciation, the historical cost of a freehold property (or other value substituted for historical cost in the accounting records) should be apportioned between the land itself and the building(s) erected on the land. The resultant depreciable amount attributable to the building(s) should be written off as an expense by means of periodical depreciation charges over the estimated useful life (lives) of the building(s).’

8.89. The experience of this Committee is very similar to that reported by the Hulme Committee and referred to in paragraph 8.84. Numerous submissions have been received which are unanimous in condemning the present restriction of the allowances to buildings to the extent that they form integral parts of manufacturing plant. The representatives of various kinds of business have urged that at least their own particular class of buildings should qualify for relief.

8.90. The basic arguments in favour of allowing depreciation on buildings as a taxation deduction stem from a recognition that a material asset has a finite useful life which may be shorter than the physical life of the asset. All buildings and other structures on land are just as subject to
the need for eventual replacement as is working plant, and with the rapid rate of technological change the effective working life of these items is becoming shorter. This fact is reflected in a practical manner in the continual demolition of existing buildings to make room for new ones, usually of increased capacity and more suitably designed for modern conditions.

8.91. The argument which persuaded the Ferguson Commission to recommend against an allowance for building depreciation—that any loss in value of a building tends to be offset by appreciation in the value of land—has, in general, long since been rejected. A further argument—that the imposition of a capital gains tax on profits arising from the realisation of real property is a necessary counterpart to the allowance of building depreciation—has also been rejected. The reasons for the rejection of both these arguments were stated in the Hulme Committee report and have been dealt with at some length in pronouncements by the major professional accounting bodies in Australia and overseas. The principal reason is that they overlook the fact that buildings are consumed and replaced in the course of business operations unrelated in any way to changes in the value of the underlying land. Many business activities are conducted on land owned for very long periods. Rarely is industry carried on efficiently in buildings erected more than fifty years previously. Commercial buildings of the same vintage originally used for offices or accommodation are seldom now suitable for that purpose without expenditure of a capital nature on reconstruction.

8.92. In the Committee's view allowances for depreciation of buildings are called for. Their introduction, however, raises certain problems:

(a) For what classes of building should depreciation be allowed?
(b) Should all buildings be included or only those completed after a certain date or after the proposal is introduced?
(c) How should changes in the ownership of depreciating buildings subject to depreciation be treated?
(d) How should the demolition and destruction or damage of buildings be treated?
(e) Is a phasing-in period necessary to cushion the effect on tax revenue?

8.93. Classes of buildings which should qualify. The Committee sees no valid reason for excluding particular classes of buildings from the allowances and therefore recommends that depreciation be allowable in respect of all income-producing buildings whether they be industrial or commercial. In this context commercial would include residential accommodation. While the case for allowances may be stronger for
industrial buildings, which generally have a shorter effective life than other buildings, and possibly also for accommodation buildings such as hotels and motels for the same reason, allowances are justified whenever a building is used in producing income. Moreover, real difficulties would arise in identifying industrial buildings if the allowances were confined to such buildings, or in identifying accommodation buildings if allowances extended only to industrial and accommodation buildings.

8.94. The inclusion of existing buildings. Some restriction on the scope of buildings entitled to allowances, related to time of erection, would seem to be inescapable. The broad alternatives are to give allowances in relation to (i) all existing buildings, together with all new buildings and additions to buildings; or (ii) buildings and additions erected after a specified day (say 1960); or (iii) buildings and additions erected after a very recent date (say 1974). The problems involved in giving allowances in respect of all existing buildings are immense, especially when it is proposed that all income-producing buildings should qualify. On the other hand, the restriction of the allowance to relatively new structures must give rise to inequity: for example, a rented house finished in 1975 would qualify but one next door completed in 1973 would not. The exclusion of existing buildings would also distort the property market.

8.95. Choosing between the alternatives is not easy. The major reason why nothing has been done in this area for so long, despite the recommendations of earlier committees, is probably the administrative difficulties associated with the proposals that have been made. Hence, administrative feasibility must be the major consideration, even though some inequities may result. The Committee therefore recommends that all buildings which were completed, and were used or were available for use, in the production of assessable income after 30 June 1974 (referred to hereafter as the ‘qualifying date’) and any additions to buildings where the additions were completed and used or available for use after that date, should qualify for depreciation. The rates should be based on their estimated effective lives as determined by the Commissioner. Contractual completion date rather than cost incurred to a specified date should be more readily ascertainable in the case of most buildings and a modestly retrospective date, coinciding with the end of a fiscal year, is proposed.

8.96. There will be formidable problems in determining the apportionment of the cost of a building to individual home units, own-your-own units and strata titles to property. An official study will be needed to work out special provisions for these cases, and initially it may be appropriate to defer granting allowances for buildings to which the title is held in one of those forms.
8.97. There is evidence in the published reports of a number of public companies that some taxpayers hold the view that because of the purpose for which a property is held, the value attributed to a building, or some other reason, depreciation of the building does not need recognition. There could be little merit in introducing a difference between tax accounting and financial accounting in these instances. In some overseas countries certain allowances are available only to the extent that the costs concerned have been recognised in a taxpayer's financial records. A similar provision might well be appropriate in relation to allowances for building depreciation proposed by the Committee, at least in respect of companies.

8.98. Treatment on change of ownership. The segregation of the proceeds of the sale of a building from the proceeds of the sale of the land on which it is erected gives rise to special difficulty. This was recognised by the Hulme Committee in its proposal that there be no balancing charge in respect of depreciation on the sale of a building, but not, however, in its proposal that there be a balancing allowance on such a sale.

8.99. In the view of this Committee, the difficulty of ensuring a fair and realistic segregation, within the proceeds from the sale of a property, of that part of those proceeds applicable to a building dictates that there be neither a balancing charge nor a balancing allowance. Segregation within sale proceeds would give rise to added complications if it were necessary to dissect further the sum allocated to buildings, so as to identify that part of the sum applicable to a building erected prior to the qualifying date and that part applicable to additions to it made subsequently.

8.100. Accordingly, the Committee recommends that in the event of the disposal of a building, the new owner should be entitled to depreciation on the basis that he succeeds to the unrecovered amount of the original cost of the structure. His annual allowances would be in accordance with the depreciation schedule for that property applying at the date of purchase. The purchase price of the property would be irrelevant in regard to depreciation allowances, the sale proceeds of the building being deemed to be its written-down value. Where there has been non-income-producing use in any year, the written-down value will have been reduced by a ‘notional’ depreciation allowance in that year.

8.101. Implicit in these proposals is the principle that all proceeds received on the sale of a property which are in excess of the written-down value of the building must represent the value of the land on which the building stands. The total of depreciation previously allowed to the vendor will, however, diminish the cost base of property for capital gains tax purposes. Where property is sold for less than the written-down value of the building—an unlikely event, no doubt—the assumption that the
building was sold for its written-down value is of course contradicted by the facts, and there may be a case in this circumstance for the application of a balancing allowance. The buyer would be treated as having acquired the building at the price he paid for the property. If this is not done, the seller will be allowed only a capital loss in respect of what should be an income deduction.

8.102. It should be noted that these proposals are not intended to vary the present treatment of depreciation of buildings under the special provisions of the Act relating to mining, petroleum, primary production and forestry operations.

8.103. **Demolition and damage.** There would need to be exceptions, in the case of demolition or damage to a depreciated building, to the general rule that balancing adjustments are not made. Problems of segregating amounts received between land and buildings would not arise here (though segregation would need to be made between a building erected prior to the qualifying date and additions made subsequently). In the case of demolition or destruction, the difference between the written-down value of the building and the salvage or insurance proceeds would be allowed as a deduction in the year of demolition. If the proceeds exceeded the written-down value, the excess, up to the sum of the depreciation deductions previously allowed to the taxpayer, would be a balancing charge. Any amount of the excess not then treated as a balancing charge would reduce the cost base of the land for purposes of capital gains tax, unless the taxpayer elected to apply it in reduction of the cost of a building erected in replacement. Where there is only partial damage, any insurance recoveries would be offset against the cost of any restoration not deductible as a repair. Any amount not so absorbed would be treated as a balancing charge to the extent of depreciation previously allowed to the taxpayer and thereafter applied to reduce the cost base of the property for purposes of capital gains tax. Insurance recoveries in respect of restoration amounting to repair are income under existing law and the repair cost deductible. Balancing deductions would not be allowed, since depreciation will continue to be available on the original schedule.

8.104. **Effect on revenue.** The loss of tax revenue that would result if income-producing buildings were to qualify for allowances has been a major factor in postponing the introduction of such allowances. But this factor should not be permitted to override the correction of an inequity in the form of an overstatement of net income by a large body of taxpayers. Some phasing-in of the allowances is nevertheless called for. If, contrary to the Committee's proposal, a major portion of existing buildings were to qualify, phasing-in could be achieved by commencing with a low rate
which would increase to a realistic figure over a period of five to ten years. A phasing-in is automatically achieved under the Committee's proposal that the allowances be restricted to buildings completed after the qualifying date.

**Leasehold Improvements**

8.105. Brief reference is made in Section VIII to leases in general. Here discussion is limited to leasehold improvements carried out by a taxpayer at his own expense in connection with his business activities and for which an allowance, either by way of depreciation or amortisation, is not available. A number of submissions have been received on this point.

8.106. A taxpayer sometimes has no option but to incur costs in erecting buildings on leasehold, and it has been claimed that an allowance should be available which recoups the costs over a reasonable period. Buildings erected at an airport by an airline to service passengers, cargo and aircraft are one example.

8.107. The Ligertwood Committee made a series of recommendations relating to a deduction for part of the cost of improvements carried out by a lessee on leased property used for the production of assessable income and for the inclusion of an equivalent sum in the assessable income of the lessor. The effect of these recommendations would have been to allow the lessee a deduction, spread over the period of the lease subsequent to making the improvements, of an amount agreed by the parties as being the estimated residual value of the improvements at the end of the term of the lease. There would have been corresponding inclusions in the assessable income of the lessor. However, that Committee was mainly concerned with overcoming the abuse of the then provisions of Division 4 of Part III of the Act. The recommendations of the Ligertwood Committee were not acted upon but the abuses were ended by the termination in 1964 of the operation of Division 4 in respect of new improvements. Whatever merit there may have been in the recommendations of the Ligertwood Committee they do not seem to be appropriate in the context of the general allowance of depreciation on buildings which this Committee recommends.

8.108. At least when the lessee has erected the building at his own expense on Crown land or on land of a public authority or a body not subject to taxation, it would be reasonable to deem him to be the owner of the building in question and to provide that he should receive the depreciation allowances. However, this approach would exclude any allowance to a lessee where the leasehold improvements have been carried out on privately owned land and accordingly may be thought to be unduly
restrictive.

8.109. The Committee recommends that, for the purpose of allowances for depreciation of buildings, a lessee should be deemed to be the owner of any leasehold improvements carried out at his own expense if he uses the property for income-producing purposes. He should be entitled, during the period of his possession as lessee, to allowances to recover the costs he has incurred at the same rate as would apply to equivalent expenditure by the owner. It is not proposed that on his ceasing to have possession as a lessee he should obtain a balancing allowance as to do so would possibly open the way for abuse of the allowance. The treatment of any unrecouped cost for capital gains tax purposes would be a matter of detail of that legislation.

Other Assets and Costs of a Capital Nature

8.110. The existing law has been criticised for its failure to make allowances available for the cost of assets not falling within the ambit of the depreciation provisions and for the costs of a capital nature incurred in business operation but having limited enduring value. The items include costs of acquiring know-how and trade rights, some expenses of moving the site of operations, feasibility studies and costs of capital-raising.

8.111. With the introduction of capital gains tax, thought would need to be given to whether some of these costs should qualify for amortisation allowances, similar to those available to primary producers under section 75A (paragraphs 18.23–18.25). Alternatively, losses arising from expenditure of this nature could be made to fall within the definition of capital losses for capital gains tax purposes, though there would often be problems in fixing the time when losses of this nature are to be treated as having been incurred.

8.112. The Committee is inclined to the view that at least some of these costs could be conveniently dealt with by a provision similar to section 75A, which would make the costs allowable, over a period of years, against income.

V. Trading Stock

8.113. The matching of income and expense, which is necessary if net income is to reflect a ‘true’ profit from business operations, requires a method of deferring costs which relate to stock held at the close of a year of income. The present method is set down in the provisions of the Act in respect of trading stock. If net income is to reflect ‘true’ profits, there is also a need for provisions by which an anticipated loss of the sale of stock
may be brought to account. This, too, is met by the trading stock provisions. Those provisions have a third function: they make possible the anticipation of a profit by writing up the value of stock to its market selling value. This anticipation, though not related to the determination of a ‘true’ profit of a year of income, makes possible a spreading of income of a number of years. In this function the trading stock provisions act to support the loss carry-forward provisions and, in the case of individual primary producer taxpayers, to support any provisions relating to the averaging of incomes.

8.114. Trading stock is defined in the Act as including anything produced, manufactured, acquired or purchased for purposes of manufacture, sale or exchange and also includes livestock (section 6 (1)). Other provisions relating to trading stock include the following:

(a) A taxpayer carrying on any business is to bring to account the value of his trading stock on hand as at the beginning and the end of each year of income in order to ascertain his taxable income (section 28).
(b) The value of the stock at the beginning of a year is the value ascertained under the Act at the end of the previous year (section 29).
(c) The value of each item of stock, other than livestock, on hand at the end of the year may be, at the option of the taxpayer, its ‘cost price or market selling value or the price at which it can be replaced’ (section 31 (1)). The latter terms are not defined in the Act. A fourth basis of valuation applies where the taxpayer, on application, satisfies the Commissioner that, by reason of obsolescence or any other special circumstances (e.g., slow turnover items), a value other than one provided by section 31 (1) is appropriate for that item.
(d) Disposals of trading stock otherwise than in the ordinary course of business are to be brought to account at the market value of the trading stock on the date of disposal (section 36).
(e) A notional disposal at market value is deemed to occur where, for any reason, there is a change in ownership of or the interests of persons in trading stock (but specifically including change by reason of formation, dissolution or variation of a partnership) and one or more persons who owned or had an interest in the stock before the change has a continuing ownership interest after the change. There is relief from this requirement, if the parties so request, where a person or persons having an interest in the partnership before the change have at least a 25 per cent interest after the change (section 36A).
(f) A market valuation of trading stock applies on devolution of trading stock on death of a taxpayer; but relief is again given where the trustee of the estate and the beneficiaries (if any) agree and give notice that the valuation should be on the basis of a continuing business (section 37).

8.115. A number of aspects of the trading stock provisions call for
consideration. These relate to the assets to which the provisions might apply, the methods of valuing trading stock and of identifying stock which remain on hand at the end of a year of income, and the operation of those provisions which in some circumstances will deem a disposition of trading stock to have been made at market value.

**Definition of Trading Stock**

8.116. The present definition of trading stock is giving rise to difficulty in determining whether it embraces several classes of assets which are on occasions dealt with as stock in hand for financial accounting purposes. The assets in question generally fall into one of three groups:

(a) land held for resale;
(b) plant spares and consumable stores;
(c) shares, debentures and similar assets.

8.117. *Land held for resale*. In defining trading stock section 6 (1) uses the expression ‘anything . . . ’ and sections 29 and 31 refer to ‘each article’ of trading stock. The question arises, whether land is to be regarded as trading stock. Opinion is divided, though it is understood that in practice the Commissioner treats land purchased by a dealer in land as trading stock. If land does not fall within the definition of trading stock, disposals by a land dealer other than in the ordinary course of business would not have to be valued at market value (section 36). Such a disposal would include, for example, a gift of land by a taxpayer, who might otherwise have been assessable on the sale of the land, to his wife. Where real property is held for resale by a taxpayer who is engaged in a business of trading in real property, the asset should, in the Committee's view, be treated for income tax purposes as trading stock and the definition should be amended to give this result.

8.118. *Plant spares and consumable stores*. The problem of plant spares held in stock for future use is of a different nature. The items do not fall within the present definition of trading stock as they are not acquired or manufactured for the purpose of sale. In addition, they are not articles depreciable as ‘plant’ because they are not ‘installed ready for use’. Thus while the cost of items actually used in repairs during the income year are deductible, any loss on sale or scrapping of spare parts for which the taxpayer has no use is a capital loss and not deductible. Consumable stores such as oils, lubricants, protective clothing, cleaning materials, etc., which are used in manufacture but do not form part of the finished product also
do not constitute trading stock for the purposes of the Act: they may be deductible in full in the year of purchase. In this regard the taxation treatment differs from the accounting treatment where such stock have a significant value. The Committee recommends that provision be inserted in the Act which will permit supplies on hand, including plant spares, to be treated on the same basis as trading stock.

8.119. Shares, debentures and similar assets. Another area of doubt is whether the definition of trading stock extends to shares, debentures and similar assets. This question was considered by the Ligertwood Committee which proposed that the definition should not be extended to include such assets: to do so would permit the deduction of unrealised losses on some of them without regard to unrealised gains on others.

8.120. A decision of the High Court in 1971 has substantially resolved this question in relation to shares, but the Committee believes the position of all these assets needs clarification.

8.121. There are circumstances where the profits on sale of property may be assessable income, even though the taxpayer is not classified as a dealer in such property and the property is not within the definition of trading stock. An example is where the varying of investments and turning them to account is an essential feature of the business: it has been held that the profit on realisation of portfolio investments by banks, life insurance companies and some investment trusts is assessable income under section 25 of the Act. In the Committee's view these assets should be treated as trading stock if they are to be subject to income tax. If they are not treated as trading stock, these profits should be subject to capital gains tax.

8.122. The Committee sees merit in the point raised by the Ligertwood Committee, referred to in paragraph 8.119. When shares, debentures and similar assets are treated as trading stock for income tax purposes, the basis of valuation elected under the trading stock provisions should be applied not to individual assets but to all assets falling within a particular class: for example, to all debentures or to all shares.

Methods of Valuing Trading Stock

8.123. The valuation of trading stock is discussed here in the context of general business. The special provisions of the Act in respect of livestock are dealt with separately in Chapter 18.

8.124. Under the present provisions of the Act each article of trading stock may, at the option of the taxpayer, be valued at its cost price or market selling value or the price at which it can be replaced. There is also provision for valuing trading stock at a lower figure where the taxpayer
requests this and the Commissioner can be satisfied that, due to obsolescence or other special circumstances, a lower value is more appropriate.

8.125. The terms ‘cost price’, ‘market selling value’ and ‘the price at which it can be replaced’ are not defined in the Act and have been the subject of litigation and discussion over the years. It is therefore proposed to consider each term separately and the problems associated with it.

8.126. *Cost price.* Cost is regarded as identifiable or historical cost and the elements which make up cost are:

(a) The purchase price of goods and, in the case of manufactured stock, materials used in manufacture.
(b) Direct expenditure incurred in bringing the stock into its existing condition and location.
(c) Depending upon the circumstances, indirect or overhead expenditure attributable to the stock.

In large businesses it is often either impossible or impracticable for the actual cost of each article of stock on hand to be ascertained. This is recognised by both the accounting profession and the Revenue, and certain methods or formulae have been devised which produce an estimate of the cost of trading stock. These include:

(i) First-in-first-out (FIFO).
(ii) Average cost.
(iii) Standard cost.
(iv) Adjusted selling value.
(v) Last-in-first-out (LIFO).
(vi) Base stock.

The accounting literature on stock valuation is extensive, and it is not therefore proposed to describe each of these methods in detail.

8.127. The Revenue does not accept the LIFO and base stock methods, and, understandably, accepts standard costs only where the standards are reviewed regularly to equate with current prices.

8.128. The major area of disagreement between the taxpayer and the Revenue as regards valuation at cost is the extent and nature of overhead expenses which need to be included in the cost of manufactured products and items in process of manufacture. Other problems include the meaning of ‘cost’ in special situations: for example, in relation to imported goods when foreign exchange rates change in the interval between purchase and
payment; in relation to second-hand cars when discount on a new car is
given by higher trade-in on a second-hand car (recently solved but only by
Commissioner's compromise); and in relation to by-products. These
problems arise out of the many possible interpretations of ‘cost’ when
applied to different businesses.

8.129. In practice there is quite often disagreement of a technical nature
regarding costs to be included. Because of the variety of methods of
valuation applicable to particular types of businesses, it would not be
possible to lay down statutory definitions. This was the view reached by
the Spooner and Ligertwood Committees, and also by the Carter
Commission in Canada.

8.130. A number of submissions have drawn attention to the difficulties
currently being experienced in valuing stocks at cost figures acceptable for
income tax purposes. These are some of the points which have been raised:

(a) There is some inconsistency in the rulings given by departmental officers as to
the extent that overheads are to be included in determining cost.
(b) The appropriate method of calculating manufacturing cost depends on the nature
of the business.
(c) The valuation of trading stock which is in accordance with accepted accounting
standards consistently applied should be acceptable for tax purposes.

8.131. Generally the Commissioner requires, when the basis of valuation
of a taxpayer's stock comes under review, that cost be determined on a full
absorption basis that takes to account all production overhead expenses
whether they be fixed or variable. However, it seems that many taxpayers
for both financial accounting and tax purposes use a direct cost basis which
allows only for production overheads varying according to volume of
production. Direct costing excludes a value for many overhead costs
normally brought to account on a full absorption cost basis. When the basis
adopted is consistently applied from year to year in the case of a continuing
business, the effect of the method used on net income of a year is not
usually significant.

8.132. Having regard to the many and varying factors which need to be
given due weight in determining the appropriate method for arriving at
cost, particularly of manufactured stock, the consistent application of a
generally accepted method of valuation may well be an adequate test of the
reasonableness of the value. It would be most undesirable, from an
efficiency viewpoint, were a large body of taxpayers to find it necessary to
value their stock on two different bases, one for financial accounting and
the other for tax accounting.
8.133. The Committee makes no recommendations for amendment of the present provisions relating to the valuation of trading stock at cost. It believes, however, that many taxpayers in business would benefit were the Commissioner to publish information dealing with the interpretation and operation of the law on stock valuation. This should help to remove some of the uncertainty that now exists.

8.134. It would be helpful if there were a requirement that where the valuation of trading stock has an important bearing on the determination of net income, taxpayers should disclose their methods of valuation and whether or not the method has been consistently applied. This raises the question of special provisions to cope with situations where taxpayers decide it is necessary or appropriate to vary their method of valuation.

8.135. Where a taxpayer changes his method, it has been the practice to require that the new method be also applied to valuation of stock at the commencement of the year of income. Where this results in opening stocks being valued at below the closing value of the previous year, the taxpayer loses a deduction for the amount by which the opening stock value in the year of change is decreased. The Committee recommends that special provision be made so that differences such as these arising from a change in method of valuation will be spread and brought to account over a period of, say, five years. A somewhat similar recommendation has been made in respect of a change in the basis of taxation from cash to accruals (paragraph 8.25).

8.136. Market selling value. By market selling value is meant the price at which the item could be expected to be sold in the market in which the trade of selling by the taxpayer is conducted. It contemplates a sale in the ordinary course of business and not a forced sale. No allowance is made for a possible fall in market price in the future, even when such an eventuality is reasonably anticipated.

8.137. Market selling value ceased to be an acceptable method of stock valuation for financial accounting purposes many years ago when it was replaced by the concept of valuation at ‘net realisable value’, provided it is less than cost. Net realisable value has been defined as the price at which it is estimated that the stock can be realised in the normal course of business, either in its existing condition or as embodied in the product normally sold, after allowing for expenditure to be incurred before and in the process of disposal. In estimating this price, regard is to be had to excess and obsolete stocks, the trend of the market and the prospects of disposal.

8.138. The main ground for rejecting net realisable value as a basis for tax treatment is that it involves estimates which would be difficult for the Revenue to confirm. However, the problems in this area should be no
greater than currently apply in computing net income under the accruals method (for example, in estimating the liability of a general insurance company for outstanding claims). The Committee therefore recommends that the Act be amended to substitute net realisable value for market value as one of the alternative bases of valuation of trading stock.

8.139. Replacement price. Replacement price means the price at which the taxpayer can buy the goods on the last day of the year of income. This basis appears to be a satisfactory alternative and the Committee believes it should be retained.

**Disposal of Trading Stock**

8.140. A number of problems are occurring in the operation of the special provisions of the Act dealing with the disposal of trading stock otherwise than in the ordinary course of business. Where a taxpayer disposes, whether by sale, gift or in some other way, of trading stock which is an asset of his business activity and the disposal is not made in the ordinary course of that business, the value of the asset so disposed of is included in his assessable income at its market value (section 36).

8.141. This provision extends to disposal of trading stock flowing from a change in ownership or of interests following the formation, dissolution or variation of interests of a partnership; but the parties concerned may elect that it shall not apply if the persons holding not less than a 25 per cent interest prior to the change continue to have an interest of not less than 25 per cent after the change has been implemented. Where the parties so elect, the value of the trading stock shall be the figure at which it would have been valued if no disposal had occurred and the year of income had ended on the date of the change (section 36A).

8.142. The major weaknesses in the existing provisions appear to flow from the limitation of their application to assets of a business carried on by the taxpayer.

8.143. For example, a taxpayer who may, on disposal of property, have been liable under section 26 (a) may gift the property to another person. Section 36 will not apply, as the taxpayer was not carrying on a business of which the property was an asset. The other party will not be taxable on the profits on disposal of the property as, having acquired the property as a recipient of an unsolicited and unencumbered gift, he could not be said to have acquired it for resale at a profit.

8.144. The Committee believes that an additional provision is necessary to extend the requirement for bringing to account as assessable income the market value of any asset disposed of, where the profit on disposition is
subject to tax and the asset disposed of was not included in the assets of a business carried on by the taxpayer. A new provision modelled on the existing subsection (4) of section 26AAA would be worth considering.

8.145. It is desirable that there be two exceptions, available at the election of the taxpayer, to the general rule that, on disposal otherwise than in the ordinary course of business, trading stock and other assets should be valued at market price. Firstly, the rule should not apply to transfers of assets between companies forming part of a company group. Secondly, it should not apply when assets are transferred in the course of an amalgamation, reconstruction or merger of one or more companies.

8.146. Consideration also needs to be given to the devolution at death of assets other than trading stock and from which any profit realised prior to death of the taxpayer would have fallen to be taxed. Under the present law trading stock must, on the death of a taxpayer, be brought to account at its market value (section 37); there is a proviso, however, by which the trustees and beneficiaries may give notice of their agreement to the Commissioner that the value of trading stock forming part of the business assets of the deceased shall be their value determined on the basis that the deceased had not died, with the result that any difference between tax value and market value is not brought to account for tax as at the date of death (section 37). This proviso is of considerable assistance to the beneficiaries of a deceased taxpayer who had been carrying on primary production and valuing livestock at average cost values. In the Committee's view, the proviso should be retained.

8.147. The question arises whether there should be a provision, equivalent to section 37, which will bring about a deemed realisation at death for income tax purposes in the case of an asset of the kind referred to in paragraph 8.144, i.e., an asset whose disposition will generate a taxable profit but which is not an asset of a business carried on by the taxpayer. It would be somewhat illogical if there were no provision to this effect when, under the Committee's recommendations, there will be a deemed realisation of other assets at death for capital gains tax purposes.

8.148. The difficulties arising from the operation of the special provision (section 36A) relating to changes in interests of partnerships carrying on business and with assets which include trading stock, growing crops, etc. are somewhat different.

8.149. Section 36A was introduced into the Act in 1952 following a recommendation of the Spooner Committee. The basic rationale was to avoid the inequitable taxation of unrealised profits which arose from the application of section 36 where there was a continuity of interest in the members of a partnership following a variation, dissolution, etc. of an old
partnership. Unfortunately it seems that in addition to correcting the old inequity, section 36A, as at present worded, has also created a ready means of income-splitting.

8.150. For instance, a sole trader disposing of livestock, having a market value far higher than its average cost value as used for income tax purposes, to a family partnership would, but for section 36A, be required to bring the disposal to account at the then market value of the stock. Where the sole trader holds a substantial interest in the new partnership, it is reasonable that he should not be called upon to pay tax on a profit largely unrealised. However, by a two-stage arrangement it has been found possible to transfer the whole interest in the stock to a family partnership or family company without incurring tax on the excess of market value over income tax value. By this method the tax liability on the excess can be transferred from a person paying a high marginal rate of personal income tax to other members of the family paying at lower marginal rates when the profit is realised in the normal course of business.

8.151. The Committee recommends that the principles adopted in New Zealand income tax legislation in relation to the disposition of an interest in trading stock be embodied in the Australian law. In New Zealand the following wording is inserted after sections of the Act dealing with disposals of the entirety of trading stock:

‘The foregoing provisions of this subsection shall with necessary modifications apply in any case where a share or interest in any trading stock is sold or otherwise disposed of by any taxpayer.’

A taxpayer disposing of a share or interest in trading stock is required to bring to account his share of the market value of trading stock so sold or transferred. The purchaser or transferee of the interest is deemed to have purchased the share of the trading stock at the same market value. Problems which might otherwise arise of assessing continuing partners in a partnership on profits which have not been realised are overcome by permitting their interest in trading stock on hand at the balance date following the acquisition to be valued on the same basis as would have applied had there been no change in the constitution of the partnership.

8.152. The following is an example illustrating the operation of the New Zealand principles. A, a grazier, operating as a sole trader enters into partnership with B on 31 August 1973, each having a half-interest in partnership profits and capital. A transfers to the new partnership his livestock which had an average cost value of $10,000 and a market value of $16,000. The provisions operate as follows:
(a) A brings to account his disposal of livestock to the new partnership at market value: $16,000.
(b) The partnership brings to account its opening livestock at 31 August 1973 at the same figure: $16,000.
(c) At the end of the income year, 30 June 1974, the partnership is entitled to value its closing livestock at what would have been A's average cost had he carried on the business for the full year.
(d) The result may be summarised as follows. A's income for the year includes the full profit of $6,000 on the disposal of the partnership. However, his share of partnership income is reduced by the loss on writing down livestock from its market value to his average cost, which virtually eliminates any unrealised profit on livestock flowing from his continuing half-interest in it. B's share of partnership profits is also reduced by the writing down of the value of livestock. He obtains a deduction for the full cost of his interest in this asset of the new partnership.

8.153. The adoption of provisions based on those in force in New Zealand should eliminate a major weakness in the existing provisions. It is appreciated that this new approach will permit a deferral of income arising from the reduction from market value to average cost, for example in respect of B's income in the illustration above. However, any loss to Revenue on this count should be largely offset by tax payable on the profit realised on the interest in trading stock disposed of, which currently is being largely deferred by the operation of section 36A.

8.154. Where a share or interest devolves by the death of a taxpayer, the principles of the present section 37 of the Act considered in paragraph 8.146 should apply.

VI. Recoupment of Losses

8.155. The overriding principle that income tax should be levied on ‘true’ profits from a business during the whole period of its operation is an administratively impossible ideal. Annual tax accounting is clearly necessary if tax is not to be indefinitely deferred and the flow of revenue made uneven. Where a loss is suffered in one year, some expression of the overriding principle will be achieved if the loss is carried forward and applied against income of subsequent years. Carry-forward of losses is allowed by the present law for seven years, and, in the case of primary producers, for an indefinite period. But a full expression of the overriding principle would only be achieved if losses could be indefinitely carried back to earlier years and applied against the income of those years, generating tax refunds to the taxpayer. A workable tax system requires that an assessment must at some time be treated as final: the physical problem of record-keeping is the ultimate control.
Carry-back of Losses

8.156. For many years carry-back of losses has been permitted in a number of overseas countries. In the United States losses may be carried back for three years; in Canada, the Netherlands and the United Kingdom (in effect) for one year. Currently there is no provision for carry-back of losses in New Zealand, France, West Germany or Sweden. In some countries special rules apply on cessation of business operations: in Sweden and the United Kingdom there is provision for carry-back of losses in these circumstances for two and three years respectively.

8.157. Carry-back of losses was considered by the Spooner Committee and again by the Ligertwood Committee. Many submissions requesting an amendment to the Act to permit losses to be dealt with in this way have been made to the present Committee. The Spooner Committee, while acknowledging that loss carry-back had much to commend it, foresaw formidable practical difficulties and recommended against amending the Act. These difficulties were principally the problem of collecting adequate tax revenue in periods of depressed incomes, the prevention of the early finality of assessment due to the increase in amended assessments of prior years resulting from the operation of carry-back provisions, and the inherent complications of amended assessment of private companies and trust estates. The Ligertwood Committee agreed with the findings of the Spooner Committee and again rejected the proposal that carry-back of losses be permitted.

8.158. In the years following the reports of these two committees it seems that the problems of business arising from the absence of any carry-back provisions for losses have increased and this view is supported by the submissions received. To some extent the difficulties flow from the inability to obtain deductions for accrued employee benefits such as long-service leave and holiday pay. In the income year in which a business activity ceases, the profits of that income year are frequently insufficient to meet the deductions which become available from the payment of employee benefits. In addition, an anomalous situation can arise in respect of private companies. For example, a private company may incur a profit for, say, the year ending 30 June 1973, which will give rise to a liability for undistributed profits tax if a sufficient distribution of that profit is not made prior to 30 April 1974. Suppose now that the company incurs heavy losses in the year to 30 June 1974 which make the payment of a dividend imprudent and in breach of company legislation. From a practical viewpoint the company has no profits available to distribute. However, it incurs a liability for undistributed profits tax at the flat rate of 50 per cent.
because it has failed to make a sufficient distribution of its profits for the year ended 30 June 1973. The Act takes no cognisance of the fact that the company is incapable of paying a dividend.

8.159. The Committee's recommendations relating to a deduction for accrued employee benefits will overcome some of the problems arising from the absence of provisions for carry-back of loss, but as a result of the phasing-in proposals it will be some years before a full deduction is available. The recommendation in Chapter 16 on transfer of losses between companies will in some instances also assist in the recoupment of losses.

8.160. The difficulties foreseen by the earlier committees do not appear to be sufficiently formidable to justify the continued absence of any loss carry-back. Loss carry-back will, it is true, involve some dislocation to Revenue; but this dislocation should be comparatively minor having regard to the total revenue from taxation now flowing to the Australian Government. The degree of lack of finality in assessment depends largely on the period for which losses may be carried back: a short carry-back period should not cause undue administrative difficulty.

8.161. Apart from ensuring much greater regard for the overriding principle that the tax base should reflect ‘true’ profits, carry-back has advantages in terms both of the cash-flow of business and of government economic management. The refund of tax which will result from the operation of loss carry-back should provide a business with cash funds at a time when they are most needed. Also where a downturn in the fortunes of the business coincides with a general business recession, the cash funds will provide a source of spending which should assist in stimulating economic recovery.

8.162. The absence of any provisions for carry-back of losses is partly responsible for the practice, described in paragraph 16.142, of selling the shares of ‘loss-companies’. The Committee, in Chapter 16, expresses its agreement with the measures that have been adopted to control this practice. The proposal to allow a carry-back of losses, in removing the unfairness which the practice sought to overcome, strengthens the case for the measures directed against the sale of loss companies.

8.163. The Committee recommends that the law allow a carry-back of losses for all taxpayers other than trust estates and it believes that a period of two years should not cause undue administrative problems. It does not favour these carry-back provisions being made available to trust estates: to do so would require lengthy and complicated special provisions to ensure that the benefit of any loss carried back was in fact received by persons entitled to the benefit.
Carry-forward of Losses

8.164. Currently the Act restricts the allowance of losses to those incurred by a taxpayer in the seven years following the year of income (section 80(2)). There is one exception to this general rule in that primary producers may carry losses forward indefinitely (sections 80AA to 80 AC).

8.165. As a result of representations made to it, the Spooner Committee considered the question of the removal of the seven-year limit and made a qualified recommendation in favour of the indefinite carry-forward of losses. The qualifications were, firstly, that a deduction would not be allowed for a loss incurred in a year of income prior to the year of income ended 30 June 1944; and secondly, that a taxpayer claiming a loss incurred more than seven years before the year of income should be required to establish the amount of any loss and also establish that it had not been allowed as a deduction from assessable income in any intervening year or been offset by exempt income. The point was also considered by the Ligertwood Committee, which dismissed the issue with the brief comment: ‘No evidence was presented to us that the seven year period is generally inequitable or inadequate, and in the absence of cogent reasons to the contrary, we consider the period of seven years now provided should be retained.’

8.166. Overseas practice varies considerably. In the United Kingdom, South Africa and New Zealand losses may be carried forward without restriction; Norway permits ten-year carry-forward, the Netherlands and Sweden six-year; Canada, France, West Germany and the United States allow a five-year period. According to the Carter Commission, the existing five-year period applying in Canada was insufficient for new businesses that required long periods to develop and a liberal carry-forward of losses was essential to overcome limitations of the annual period of measurement. It therefore recommended that losses be allowed to be carried forward indefinitely.

8.167. Numerous submissions have been received by this Committee requesting either that there should be an indefinite carry-forward period or alternatively the existing period should be extended to ten years or more. One reason given was that in the chemical, mining and other capital-intensive industries losses incurred during establishment years and in times of continuous expansion frequently cannot be recouped within the present limited period of seven years. Another reason was that the trend to larger manufacturing operations, combined with the development of new products and processes, are having the effect of extending the period of initial losses. Closely related is the claim by general insurance companies
that in providing the greatly increased total covers required in a growth economy and in an economy experiencing heavy inflation, insurance companies stand to incur substantial losses which require periods in excess of seven years to recoup.

8.168. The Committee recommends that the Act be amended to permit all taxpayers to carry losses forward indefinitely. In implementing this change, it should be provided that losses qualifying for allowance on the indefinite basis be limited to losses incurred subsequent to a date seven years prior to the first year of application.

Exempt Income

8.169. The present law requires that in calculating both the amount of a loss available for carry-forward and the income against which a loss may be applied, exempt income must be brought to account. Bringing to account exempt income in this way has been criticised on the ground that it partly neutralises the concession intended to be given by the exemption.

8.170. In one situation the exemption of income is given not by way of concession but as a means of preventing double taxation of income. There is a general provision whereby income derived from a foreign source which is taxed in the country of source is exempt from Australian tax. The provision is considered in Chapter 17. Bringing this income to account in applying the provisions in regard to carry-forward of losses could be seen as, in effect, taxing the same income a second time without any allowance for the tax already paid. If, of course, the income has only been subject to modest taxation abroad, there may be thought to be reason why it should not be relieved from taxation in Australia; but the loss carry-forward provisions do not differentiate in terms of the amount of tax paid abroad.

8.171. In Chapter 17 the Committee has proposed that the method of preventing double taxation of foreign-source income be replaced by a system under which the Australian resident brings that income to tax but receives credit for the foreign tax. If this system is adopted there can of course be no objection to the income being brought to account in the operation of the loss carry-forward provisions. And the new system will overcome another criticism of the existing system. A loss which has been suffered in operations that would have generated a tax liability abroad had they been profitable, is not available for application against income subject to Australian tax. The existing system thus requires a foreign profit to be brought to account in the operation of loss carry-forward but not a foreign loss. The system proposed by the Committee will allow the bringing in of a foreign loss.
Effect of Dividend Income

8.172. One further point remains to be dealt with. It concerns the provisions of the Act aimed at preventing the double taxation of dividends flowing through intermediate companies. The Act provides (section 46) that a rebate of company tax is allowable in respect of dividends received by one company from another. The section generally operates to render dividends received by one company from another virtually free of tax in the hands of the receiving company. However, the dividends received form part of the net income of the receiving company; and in the event of the receiving company incurring a trading loss, this loss is applied against dividend income and is not available for deduction against trading profits of other periods.

8.173. There are two ways in which the result may be viewed, both of which suggest that the tax payable by the company is excessive. The first view is that to the extent to which the loss is offset against dividend income, the dividends ultimately bear double taxation. The second view is that to the extent to which the losses are so offset, no allowance in made for that proportion of the loss in computing company tax and in fact the loss is never recouped.

8.174. The Committee believes that it ought to be a fundamental principle of company tax that dividends flowing through intermediate companies should not incur double taxation and, further, that the full benefit of trading losses should be available for offsetting against other trading profits. Accordingly, it recommends that in computing the recoupment of losses of companies, amounts representing dividends received from other companies should be excluded from the net income of the relevant years. There would continue, of course, to be need to counter dividend-stripping opportunities.

VII. Implications of Inflation for Business Income

8.175. In the earlier sections of this chapter the discussion has been mainly concerned with the differences which arise between net income and financial accounting profits, both determined using historical cost methods of accounting. In Chapter 6 brief reference has been made to the effect of inflation on business income and the need for the effect to be recognised in levying taxes, particularly in periods when inflation is severe. A number of submissions have requested that the tax law permit depreciation allowances to be based on replacement cost in lieu of historical cost and trading stocks to be valued using bases not now acceptable to the Revenue.
8.176. It is increasingly being recognised, that conventional accounting methods fail to take account of the increased costs of replacement of fixed assets and fail too to exclude stock appreciation in computing profits which form the basis of net income and reported financial results.

8.177. The extent to which conventional accounting methods overstate profits by failing to have regard to depreciation at replacement cost and stock appreciation in periods of high inflation is very significant. On the basis of figures issued by the Commonwealth Statistician for stock appreciation and its own estimate of depreciation at replacement cost, the University of Melbourne's Institute of Applied Economic and Social Research has recently estimated that when allowance is made for these two factors profits before tax of non-finance companies for the year 1973–74 drop from $4,325 million to $2,953 million. Since company tax is assessed on the higher figure, the rate of such tax is in effect equivalent to 66 per cent of the lower figure.

8.178. Accounting methods for adjusting business profits for inflation were discussed in Germany in that country's period of high inflation after the World War I. It was subsequently examined spasmodically in other countries but received increased attention in the early 1950s when the rate of inflation became a worldwide problem.

8.179. Since then, the professional accounting bodies in Canada, the United Kingdom, the United States and Australia have devoted considerable attention to finding an acceptable alternative to historical cost accounting. In June 1969 the Accounting Principles Board of the American Institute of Certified Public Accountants issued a statement entitled ‘Financial Statements Restated for General Price-Level Changes’, which explained the theory and practice of general price level restatement. It sought the presentation of restated accounts as a means of conveying supplementary information not available in historical accounts.

8.180. Early in 1972 the Confederation of British Industry appointed a committee on inflation and accounts under the chairmanship of Sir David Barron. This committee issued an interim report in January 1973 and a final report in September 1973. The following extract from the final report is worth noting:

‘The work of the Committee in the six months since the interim report was published has only strengthened its opinion that financial statements should be adjusted to take account of inflation . . . The longer present historical accounting alone is continued the more will companies and the public be deceiving themselves. The continued erosion of real capital and company earnings while inflation continues at its present pace will almost certainly lead to more critical difficulties to be faced eventually. The
Committee attaches great importance to moving as quickly as possible consistent with allowing sufficient time for the process of education’.

8.181. It is understood that neither the United States nor the Canadian professional accounting bodies have made positive recommendations to date. In January 1973 the Institute of Chartered Accountants in England and Wales, in conjunction with other United Kingdom accounting bodies, issued a draft statement entitled ‘Accounting for Changes in the Purchasing Power of Money’. It proposed that historical cost accounts be restated in terms of pounds of current purchasing power and that the restated accounts be issued as a supplementary statement attached to the conventional financial statements. In May 1974 the draft was adopted as a provisional statement of standard accounting practice.

8.182. In December 1974 the Institute of Chartered Accountants in Australia, together with the Australian Society of Accountants, issued a draft of an accounting standard entitled ‘A Method of Accounting for Changes in the Purchasing Power of Money’, which was almost identical with the provisional standard recommended by the United Kingdom accounting bodies. In issuing the draft, the Australian bodies did not recommend the United Kingdom method of adjusting profits and financial statements for the effects of inflation. Rather, it was published as an initial step in arriving at an acceptable solution.

8.183. A cardinal problem involves tax adjustments to be made where a significant portion of the capital employed in an enterprise is financed by medium-or long-term borrowings. An approach which concentrates on the need of the business entity to make adequate provision from profits for costs of replacement and for stock appreciation will tend to ignore the gains arising from the repayment of borrowings in money which has fallen in value. On the other hand, an approach which concentrates on the interests of the holders of equity capital will have regard also to those gains.

8.184. There appears to have been a tendency for revenue authorities in most countries to remain aloof from the efforts to find an alternative to conventional accounting methods which will produce ‘true’ profits in periods of high inflation. Nevertheless, some concern has recently been shown in the United Kingdom with the appointment in early 1974 of the Committee on Accounting for Inflation (Sandilands Committee) which has not yet issued its report.

8.185. Some recognition of the problems facing business in times of inflation has been given in a number of countries by the introduction of special allowances in respect of depreciation of fixed assets, though frequently these allowances have been employed primarily as a tool of
economic management. The allowances vary in form: in some instances as investment allowances in the year the asset is acquired, in addition to normal depreciation allowances; in other instances in the form of substantial initial depreciation allowances. In the United Kingdom, for example, a taxpayer may claim 100 per cent of the cost of new plant installed.

8.186. For some time now, the need to retain sufficient profits to assist in financing the higher costs of replacing fixed assets has been acknowledged by many of the larger industrial organisations. Some have carried out revaluations of their assets at regular intervals, substituted the higher values for the historical cost values and thereafter provided for depreciation on the written-up figures. However, a tax deduction is not available for the additional depreciation thus set aside in computing financial accounting results. Others have calculated the estimated additional depreciation needed on a replacement values basis and have taken this further sum into account when considering profits available for distribution to shareholders. However, many businesses have largely ignored the problem, with the result that no account has been taken of the increased costs of replacement.

8.187. With inflation at high levels, the effect of stock appreciation forming part of profits falling to be taxed and the related problem of providing funds to finance the increased value of stocks are now matters of major concern. The need to have regard to stock appreciation in computing taxable income has recently been recognised in the United Kingdom where, in November 1974, a special measure was proposed. Broadly, where the increase in value of trading stock and work in progress during the financial year 1974–75 exceeds 10 per cent of a company's profit, the company is permitted to reduce the value of these assets at the close of the year so that the increase in trading stock does not exceed 10 per cent of profits. The measure is confined to companies and to instances where the increase in stocks exceeds £20,000. It results in a deferment of the tax payable on the amount by which the year end stocks are reduced. It is not as yet clear when the deferred tax will fall due for payment, but industry has been assured that it will not be payable in the subsequent income year.

8.188. In the United States where the LIFO method of valuing trading stocks is permitted, it seems that a growing number of companies are adopting this alternative basis which tends to restrict the extent to which stock appreciation arising from inflation forms part of current profits.

8.189. In Australia, at least until very recently, there have been virtually no measures to alleviate either the impact of tax or the pressure on business for finance in the current period of rapid inflation. However, in December
1974 the Australian Government announced the appointment of an independent panel to conduct an inquiry into inflation and taxation and to report by May 1975. The panel's second term of reference is:

‘To examine the effects of rapid inflation on taxation paid by companies and other enterprises and in particular: (a) to examine the various choices available to taxpayers under the provisions of the income tax law relating to the valuation of trading stock and to assess the advantages and disadvantages of providing other bases of stock valuation for income tax purposes; (b) to consider the advantages and disadvantages of alternative methods of providing allowance for income tax purposes for depreciation of plant and equipment, including allowance of deductions for depreciation calculated at flexible or accelerated annual rates; (c) to make recommendations in relation to these matters’.

8.190. A further measure proposed is the introduction of a new depreciation allowance which doubles the depreciation deduction for the current financial year in respect of new plant installed in manufacturing and certain other industries. However, this special allowance is very much less than that available in most overseas countries.

8.191. Further action to bring net income for tax purposes closer to ‘true’ profits in periods of high inflation is now urgent. In view of the inconclusiveness of endeavours by business and the accounting profession to find an acceptable alternative for conventional accounting despite considerable research and exposure of the issues involved, it would be unduly optimistic to expect that the problem will shortly be solved by a change in accounting procedures. In any case, new methods are unlikely to meet the circumstances of the whole range of business activity: though acceptable to many businesses, they may prove to be inappropriate for use in computing net income for tax purposes.

8.192. In the circumstances the appropriate course would appear to be the adoption of measures which operate on a broad scale and which recognise to a degree the overstatement of net income currently occurring. Policies which merely result in a deferment of tax, such as the United Kingdom provision in respect of trading stock and the granting of initial allowances in respect of depreciation on new fixed assets, though helpful, will not be as effective as policies which are more lasting or permanently reduce taxes payable on business income. Measures of the latter type include reductions in rates of income tax, a LIFO method of stock valuation and investment allowances in respect of fixed assets.

8.193. In view of the appointment of the special panel and the detailed studies of which it will have the benefit, this Committee makes no recommendations as to steps which might now be taken. It stresses,
however, the urgency of the need for action.

VIII. Sundry Costs Of Business Operation

8.194. This section discusses the treatment for taxation purposes of a number of costs in conducting business, all of which involve matters raised in submissions.

Lease Transactions

8.195. Division 4 of Part III of the Act contains special provisions dealing with premiums received in relation to the grant, assignment or surrender of a lease and improvements erected by lessees on leased property. However, the application of these provisions was restricted in 1964 and they are no longer generally available. A number of submissions have sought the reintroduction of provisions similar to Division 4 along lines recommended by the Ligertwood Committee.

8.196. In Section IV the Committee has made recommendations for the allowance of depreciation on buildings, including a tentative proposal in relation to allowances in respect of leasehold improvements carried out at a lessee's expense.

8.197. With the introduction of capital gains tax some changes in the law will be necessary in respect of lease transactions generally. Until such time as the Government's proposals in relation to leases under the capital gains tax legislation are known, it would be inappropriate for this Committee to attempt to make detailed recommendations in this area. Clearly the income tax provisions must be blended with those relating to capital gains tax.

Expenditure on Repairs to Income-producing Property

8.198. Two aspects in relation to repair expenditure have been raised. The first relates to what are generally termed initial repairs, being repairs carried out shortly after the acquisition of property. The second refers to the widely accepted practice by business of treating replacement purchases of plant and small tools, of relatively low value, as repair expenditure rather than as items falling to be dealt with by way of depreciation.

8.199. In the case of repairs carried out shortly after the acquisition of property, usually to buildings and to other structural improvements, the practice has developed, in line with a number of legal decisions, of disallowing a deduction for this expenditure where it is apparent that the repairs were necessary at the time of purchase, the general theory being that this would normally be reflected in the purchase price. This practice
has been criticised on the ground that it causes administrative difficulties in the case of minor repairs and some inequity.

8.200. The Committee believes it would be in the interests of taxpayers and the Revenue if a somewhat more flexible approach could be followed, though it is aware that if its recommendations for building depreciation are adopted, some of the complaints will tend to weaken: at present if an allowance is denied for building repairs no deduction is available. The Committee recommends that deductions be allowed for costs of repairs incurred shortly after acquisition, where the expenditure relates to normal maintenance such as painting and minor building repairs. It agrees that major structural repairs, such as the replacement of roof cladding, carried out in the initial period of ownership should continue to be treated as forming, in effect, part of the cost of the property. This is an area in which the issue of guidelines or public information bulletins would be of assistance to taxpayers and their agents.

8.201. A more flexible approach would also be desirable in relation to purchases of plant and tools of small value. Many large business organisations attempt to lessen clerical costs by writing off, in the year of purchase, minor items of plant and maintenance equipment as it is purchased. It is usual to follow this practice of write-off, subject to a limit of, say, $200 for any one item. By so doing, the need for detailed recording of the asset in depreciation schedules is avoided. The Committee recommends that the Commissioner give favourable consideration to requests of taxpayers to be allowed to deal with minor items of a capital nature in this way, within the statutory authority that it is proposed he be given in paragraph 8.47.

Professional Libraries

8.202. A number of requests have been received, mainly from professional bodies, persons and partnerships, for a more realistic deduction for expenditure incurred in respect of the purchase of textbooks and other publications of a professional nature. While a deduction is normally allowable in respect of a subscription to a journal or to a professional body which sometimes carries with it the right to receive periodical publications, other publications, purchased frequently at considerable cost, are deemed to be assets subject to depreciation at the rate of 5 per cent on a fixed instalment basis or 7 1/2 per cent on the reducing balance method. The submissions on this subject complain that these rates are far too low.

8.203. Textbooks and digests are the necessary ‘tools of trade’ of the
professional person. New editions are constantly being published as advances in professional knowledge and methods make existing texts redundant. In the legal profession continual changes in the law brought about by the enactment of statutes and decisions of the Courts have a similar effect. The effective useful life of library texts is therefore limited. In order to cope with these continual changes, modern technical publishing, particularly in the field of law, now often takes the form of loose-leaf services. These are regularly updated by revision sheets which supersede existing parts of the service as they become redundant. The Committee understands that the cost of updating sheets is treated by the Commissioner, in the same way as professional journals, as a revenue expense. This treatment seems reasonable. An ancillary feature of the present provisions for professional library depreciation is the administrative problems of recording depreciation and accounting for disposals and their related balancing adjustments.

8.204. Two methods of simplifying the recoupment of capital expenditure on professional libraries warrant consideration. Texts costing less than, say, $40 could be treated as a revenue expense to be written off in the year of purchase, and the rates of depreciation on other texts might be reviewed in the light of the present limited useful life of publications. Alternatively, the rate of depreciation could be set at a realistic level, say 20 per cent per annum, calculated on the reducing balance method for the whole library; additions would be added to the written down value of the library at cost while the sale proceeds, if any, of disposals would be deducted from the written-down balance. Where the sales proceeds in any year exceed the written-down balance plus additions in the year, a balancing charge would need to be made. Otherwise balancing allowances or charges would automatically be added to or deducted from the written-down balance. This effective absorption of balancing adjustments removes the need to maintain continued records of the cost of individual texts. The Committee prefers the second method since it simplifies the clerical task of keeping depreciation records and prevents any abuse of an arbitrary limit for any one text.

Travelling and Entertainment Expenses

8.205. Reference has been made in Chapter 7 to the interpretation given to the general deduction section (section 51) of the Act. It is there recommended that an apportioned amount of an outgoing should be denied deduction where it can be inferred from all the circumstances that the character of the outgoing is in part a payment for a purpose which is not
the gaining of income. It is not intended, however, that merely because an outgoing such as travelling and entertainment expenses might be said to be extravagant, some part of it must be denied deduction. The proposition asserted in the authorities that the law does not enable the Commissioner to say how much a taxpayer should spend in the gaining of income will continue to be valid. The Committee would not favour provisions, of the kind included in the Canadian law, which would give the Commissioner power to disallow a deduction if he considers that the expenditure involved is unreasonable.

8.206. It may nonetheless be appropriate for the law to specify particular items of expenditure which are likely to involve substantial elements University private consumption by the proprietors of a business and deny them deduction. Recent amendments to the Act deny, for example, deductions of some expenditure on yachts and expenditure on club subscriptions.

Anti-pollution and Ecological Expenditures

8.207. A number of submissions have been received seeking special deductions in respect of expenditure to reduce pollution and to preserve the ecology. Sometimes the expenditure is incurred to prevent pollution of the atmosphere, on other occasions pollution of the soil, streams and ocean, and in yet others to prevent destruction of the environment by its physical alteration. The expenditure may be incurred to comply with legislation, or solely because of the moral obligation of business to avoid inconvenience to the public. The Committee's attention has been drawn to provisions in the United States which allow expenditure of this type to be recouped over five years, and to a similar allowance available in New Zealand.

8.208. The costs are incurred over the broad spectrum of the manufacturing industry and very often in activities connected with mining and other extractive industries. On occasions the costs by way of special equipment, enlarged chimney stacks and treatment of effluent are substantial. Clearly, expenditure in this area warrants encouragement, and special allowances for costs of this kind might be thought justified. However, as what is sought involves an incentive, the Committee merely draws attention to the fact that a number of submissions have been received seeking concessional treatment in this area.

IX. Conclusion

8.209. Many of the recommendations made in the chapter are intended to
eliminate differences between tax accounting and financial accounting and in general to bring them into closer relationship. None of the recommendations involve concessions to business but merely give tax recognition to the fact that the expenses involved are incurred in earning business income.

8.210. Further differences between net income and financial profit will no doubt arise in the course of time as business operations change. A continuing concern with differences between tax accounting and financial accounting should be one of the main areas of responsibility of the independent standing committee on taxation proposed by the Committee in paragraph 22.63.

8.211. Attention is drawn to the Committee's recommendations in Chapter 18 in relation to the restriction of deductions for certain losses incurred in primary production activities. There it is proposed that a deduction be disallowed for a loss where the activity is not being carried on with a view to profit or where there is no reasonable expectation of a profit being achieved. Consideration should be given to the introduction of a provision along similar lines which would have application to business generally, or at least to a number of specific areas in addition to primary production. Motor racing, fishing and the search for minerals might be examples.

8.212. The Committee has not given special consideration to the peculiar problems of small businesses, whether they be problems of income tax, estate duty or other taxes. Shortly after its appointment it accepted a proposal from the Department of Economics at the University of Newcastle that it provide funds for a special survey of the effect of taxation on small businesses in Australia—a survey forming part of a broader investigation into small businesses. This survey was not completed in time for full consideration by the Committee; it is one of the studies listed at the end of this report which the authors have agreed may be published.


Chapter 9 Income Tax: Issues Related to Employment and Investment Income

I. Employment Income

9.1. Chapter 7 contains a discussion of a number of matters which, though not confined to persons deriving employment income, are clearly of interest to them. These include the deductibility of expenses of travel to and from work, child-minding expenses, subscriptions to trade and professional associations, and self-education expenses. The present section of this chapter is concerned with further issues related exclusively to employment income. Most notable among these is fringe benefits. Some attention is also given to salary and wage adjustments, travel and removal expenses, payments to obtain release from employment contracts, and a standard deduction for miscellaneous employment expenses.

Fringe Benefits

9.2. The phrase ‘fringe benefits’ is intended to refer to any benefit, other than salary and wages, derived from an employment. The benefit usually takes the form of non-money income, such as the use of a company car or a home provided by the employer. Sometimes, however, it involves cash, as when a portion of an expense allowance remains unspent, or a cash prize or gift is received from an employer.

9.3. Reference was made in paragraphs 7.13–7.15 to the problems of bringing fringe benefits to tax when they take the form of non-money income. Some further elaboration of these problems is necessary, and also of the related problems of fringe benefits by way of cash. The provision of the Income Tax Assessment Act most relevant to the present discussion is section 26 (e), which requires the inclusion in the taxpayer's income of ‘the value to the taxpayer of all allowances, gratuities, compensations, benefits, bonuses and premiums allowed, given or granted to him in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him, whether so allowed, given or granted in money, goods, land, meals, sustenance, the use of premises or quarters or otherwise . . . ’.

9.4. A number of matters call for examination. The first concerns the adequacy of the present law to cover all those benefits that it is thought should be included in income. Thus it is doubtful whether the law is adequate to cover the case where the benefit is given, not to the employee, but to a member of his family. There is also a question of how far it is
proper to treat as benefits the amenities enjoyed by an employee which are inherent in the performance of his services. In addition, the method of valuing a benefit prescribed by the present law may not be appropriate.

9.5. Secondly, it is proposed to consider the kinds of benefits that would, at least in theory, be within the operation of the amended law and to make observations on how far rules might be laid down that could be applied in the general run of cases to identify benefits and fix their values.

9.6. Thirdly, whether the benefit is one presently subject to tax, or will come within the ambit of reformed provisions, it is necessary to consider the possibility of integrating the taxation of benefits with the system of tax instalment deductions from salary and wages.

Adequacy of Present Law

9.7. Section 26 (e) is concerned with benefits ‘allowed, given or granted’ to the taxpayer, in the present context the employee. It is not uncommon for the employee to be rewarded in some respects by benefits given to members of his family: for example, air travel provided for them by his airline employer, or education expenses in respect of his children paid directly by his employer. It might be possible to argue that the employee receives a benefit in the saving of expense he would otherwise have incurred. And, in some cases, it will be possible to construe the facts so that section 19 applies: that section would include in the income of the employee an amount that has been ‘dealt with’ by the employer ‘on behalf’ of the employee or as the employee ‘directs’. In the Committee's view it is nonetheless necessary, in order that all situations be clearly covered, to provide generally in section 26 (e) that a benefit arising from the employment relationship enjoyed by a member of the employee's family be deemed to be a benefit derived by the employee.

9.8. Another question is whether the section extends in any respect to benefits that are inherent in the performance of the employee's services. In some cases a benefit is a necessary consequence of performing employment duties: for example, attractive office accommodation or the entertainment enjoyed when attending official functions. It may be argued that where the working conditions of employees of one firm are so much more attractive than those of employees of another firm, the benefit of the more favourable conditions should be brought to tax; or, alternatively, that any remuneration reflecting the less attractive environment in which the second group of employees works should be exempt from tax. While the Committee recognises the force of this argument, it believes that law framed in either of the alternative ways would not be feasible to
administer.

9.9. Where the benefit relates only in part to the carrying out of the employment duties, in the sense that it is only in part a necessary consequence, the Committee considers that an appropriate part of the benefit should continue to be brought to tax. Identifying the benefit which is a necessary consequence will always be a matter of judgment. Take, for instance, employer-subsidised housing, which may be a flat in an office building provided for a caretaker who lives in it with his family, or a prestige house provided for a business executive who is expected to entertain clients at home, or a house made available to the local manager of a country branch of a business. In each case the question must be one of how far the employee's use of the house serves his employer's purpose.

9.10. The Committee recommends that section 26 (e) be amended so as to ensure that, even though a benefit is inherent in the carrying out of employment duties, it should be brought to tax except so far as its derivation is a necessary consequence of the performing of those duties.

9.11. Another legal issue relates to the interpretation of the words ‘value to the taxpayer’ in section 26 (e). The intention in the use of these words is clearly to displace the general principle of the income tax law that a benefit must be valued by reference to the amount of money that could be obtained for it. On this principle of valuation, the use of a motor vehicle or a residence available only to the employee has no value; the relief from the payment of interest enjoyed by a person who has an interest-free loan also has no value. But the precise method of valuation required by the words ‘value to the taxpayer’ is unsettled. In the Committee's view the meaning to be given to the words should be what it would cost the employee to provide the taxable benefit for himself.

9.12. It may be contended that the interpretation thus proposed would be too harsh: that it would, for example, require the full rental value of the caretaker's house, in the illustration given in paragraph 9.9, to be brought to tax. It would be made clear in the amended section, however, that the benefit being valued does not include that element which is a necessary consequence of carrying out the employee's duties.

9.13. The employee will in some circumstances be able to argue that the benefit he might have provided for himself would have been something more modest than the benefit he has derived. The argument would be relevant to determining the element of benefit that ought to be brought to tax but not to valuation. An executive should be able to say that he occupies a home which is too large and too expensive for his needs and tastes because his company requires him to live there in the company's interests. But he should not be able to say that a benefit he is free to refuse,
for example an expensive car provided exclusively for his private use, is beyond his needs and tastes.

**Kinds of Benefits**

9.14. Assuming that the law has been amended in the ways proposed by the Committee, issues both of identification and of valuation will arise in relation to various kinds of benefits. These are explored in the following paragraphs. While the legal obligation always rests on the employee to include a benefit in his return of income, there is a question of what the Commissioner should do as a matter of administration to establish rules of identification and valuation. Possible rules of these kinds are also considered in the following paragraphs.

9.15. *Housing*. Many of the problems of identifying and valuing the benefit from employer-provided housing have already been raised in the illustrations of the caretaker's flat and the business executive's house. Where housing is not in a remote area, the Commissioner should be able to frame rules of identification and valuation, and these ought to be made public. (Such rules would not preclude the taxpayer from establishing that he is entitled to different treatment.) In particular classes of situations, for example a vice-chancellor's house on university grounds, the rules of identification could prescribe certain fractions as taxable benefits. The rules of valuation might provide for the adoption of either a percentage of the capital value as determined by a valuation authority or a rental value of comparable accommodation. Any rent paid by the employee would of course be subtracted.

9.16. Problems of identification of a more especially intractable kind arise when the housing has been provided by the employer at a remote location, such as a mine site: some recognition should be given to the fact that while he remains in the employer's service the employee has no real choice of housing. Problems of valuation may also be acute. It would, presumably, be inappropriate to determine value on the basis of what the house cost the employer, which may be a very high figure because of the location; on the other hand, sale price in a remote area might give too low a figure. There is unlikely to be any market in the area by which to determine a rental value. It may not be possible to frame rules: identification and valuation would have to be settled by negotiations between the employer, or an employee organisation, and the Commissioner.

9.17. *Board and lodging*. Where the benefit is board and lodging, the same questions arise as for housing and the same recommendations are appropriate. But one further point is worth noting. Section 51A, considered
later in paragraphs 9.60–9.62, allows a deduction against a living-away-from-home allowance in circumstances where an employee may be said to be required by his employment duties to establish a temporary home away from his normal place of residence. Arguably, there should not be held to be a benefit from board and lodging to the extent that the employee, had he received an allowance, would have been entitled to a deduction under section 51A.

9.18. *Use of motor vehicles.* The use of a motor vehicle provided by the employer is a common fringe benefit. In principle the value of any private use of such a vehicle should be brought to tax. Private use would include travel to and from work except in those circumstances, explored in paragraph 7.58, where such costs, if incurred by the employee, would be deductible outgoings.

9.19. The Commissioner should establish rules for valuation based either on the annual depreciation of the vehicle and running costs referable to the amount of private use or on some assumed rate per kilometer applied to the distance travelled in private use.

9.20. Provisions have recently been inserted in the Act requiring the inclusion in the employee's income of a minimum amount in respect of the private use of a motor vehicle. These provisions may make unnecessary the calculations contemplated in the preceding paragraphs in the not uncommon case where private use is restricted to travel to and from work and occasional week-end travel. Where the vehicle has an original cost of $6,000, the minimum amount will be $720 in a year of income, assuming that the vehicle is available to the employee for private use for some part of each day of the year of income. It will be proportionally less if the vehicle is available for only a part of the year. The new provisions are complex and it is too early to gauge how well they will work. The Committee is aware of criticisms that the legislation is likely to operate unfairly in some cases but has not sought submissions in this regard.

9.21. *Goods or services supplied at a discount.* It is not uncommon for an employee to be permitted to purchase goods from his employer at a discounted price. The amounts of the discounts vary widely. It might be thought appropriate to regard an excessive discount as a benefit if what is excessive could be fairly determined. One difficulty is that the retail price by reference to which the excessiveness of the discount would need to be calculated tends, in competitive business conditions, itself to vary noticeably. Another is the problem of relating the treatment of the employee in a retail store receiving discounts against retail prices with the treatment of an employee of a wholesaler who receives discounts against wholesale prices. Ascertaining that an employee has received a discount
and, indeed, ensuring that the employee keeps a record of such discounts would present great difficulties.

9.22. In the Committee's view it would not be practical for the Commissioner to frame rules in regard to benefits arising from discounts. In a particular case, say a motor vehicle sold at a very substantial discount, it is open to the Commissioner to tax the employee on the undoubted benefit he receives.

9.23. Discounts may also be provided in respect of services supplied to an employee, or services may be supplied without charge. Similar problems to those already considered in regard to goods apply in bringing to tax benefits of these kinds. In the Committee's view it would not be feasible to devise rules for general application. However, there is a case for applying rules to particular industries where expensive services may be provided to employees at a sizeable discount. An obvious example is the airline industry, where substantial fare discounts are given in respect of travel by an employee or members of his family.

9.24. As already conceded, there will be circumstances where the facts and amounts of discounts are unlikely to be known, even to the employee himself. This is especially so when the employer incurs a loss in providing meals in a canteen for his staff. In this case any tax consequence could only be brought about by denying a deduction to the employer, and the Committee would not recommend this. A dining-room restricted to a small group of business executives might be thought to be different from a staff canteen and warrant a more or less arbitrary apportionment of benefits among the business executives concerned.

9.25. Low-interest loans. The practice has existed for many years of granting low-interest loans to employees, primarily for house purchase. This is another conspicuous fringe benefit. In the Committee's view the benefit arising from a loan of this kind should be brought to tax whenever it is derived from the employment relationship. It should not be brought to tax when the making of the loan is solely an act of charity on the employer's part.

9.26. A loan may have been made for a term, at a rate of interest that cannot be varied, at a time when commercial rates were low. Where the rate of interest was not less than the commercial rate, there would not appear to be any benefit to the employee in a later year if, in the meanwhile, commercial rates have risen significantly. Where, however, the rate of interest was less than the commercial rate at the time the loan was made, it could be argued that some benefit is involved. Yet it would not necessarily be appropriate to regard the benefit as the difference between the loan rate and whatever happens to be the commercial rate in the
relevant year of income. In the case of a loan at a rate that cannot be varied, the amount of benefit should probably be restricted to the difference between the loan rate and the commercial rate at the time the loan was made. On the other hand, where the loan rate is variable in the power of the lender, it might indeed be appropriate to treat as a taxable benefit the difference between the loan rate in fact charged and the commercial rate in a particular year.

9.27. Implicit in these propositions is a notion of a commercial rate of interest. Commercial rates tend to vary not only by reference to general financial conditions but also with the kind of loan. It would be necessary in framing a rule to fix some single arbitrary rate—one would think a low rate—to apply in all cases where an examination of individual loans is not made.

9.28. The committee recommends that rules be framed, at least as a beginning, in terms of a single ‘commercial rate’ set for each year by reference to the minimum rate charged by savings banks for long-term housing loans.

9.29. **Prizes and gifts.** Prizes as work incentives are given by some firms. The value of the prize is income of the employee and should be included in his return, though there is a case on administrative grounds for excluding prizes of small value.

9.30. Gifts may be looked at differently where they are in the nature of recognition of the personal esteem in which the employee is held by his employer. There is scope in the legal authorities for the view that gifts of this kind are not income, but this view would be restricted to cases such as the traditional gold watch.

9.31. **Stock options and share purchase schemes.** Until recently, the operation of section 26 (3) 26 (e) that the value of rights which an employee acquired under an employee stock option scheme or share purchase scheme should be brought to tax at the time those rights first arose. The valuing of rights arising under these schemes provided to be inordinately difficult and the employee who paid or was liable to pay tax felt aggrieved on occasions when the rights, in line with the value of the shares on the market, fell substantially in value.

9.32. Provisions have recently been inserted in the Act displacing the operation of section 26 (e). Under these provisions the time of derivation of income under a share option or share purchase scheme will be the time when the option is exercised or shares are transferred to the employee. The benefit will be the amount by which the value of the shares acquired exceeds the consideration the employee has given for them. In the Committee's view this approach is the correct one. Comment on the detail
of these proposals is not attempted in this report.

9.33. **Goods and services supplied by others and paid for directly by the employer.** A wide range of goods and services may be supplied to employees and paid for directly by their employer. It may be helpful to consider some typical situations.

9.34. Where the expense met by the employer relates to the education of the employee's children, there is a simple case of a benefit that should be brought to tax. However, a difficulty arises in regard to the operation of the tax concession for education expenses: that concession is available to the employee only in respect of an expense he himself incurs. Administratively it may be convenient to treat the direct payment by the employer as involving no benefit to the extent that it is within the amount of the concession.

9.35. Where the employer meets the costs of the employee's education, for example in a trade or professional course, an employer purpose is being served. In this case it is possible to conclude that there is no taxable benefit to the employee, in which event there is a prospect of discrimination between one employee whose employer finances his education and another whose employer does not. In some instances, expenses met by the employee will be deductible as employment expenses, and in regard to such expenses discrimination could not arise. But where the employee who meets his own expenses must rely on section 82JAA—the self-education deduction section—such discrimination seems unavoidable where the expenses exceed the limit imposed by that section. The employer's purpose may in some cases be remote: for example, where the course is not related to the employer's business. In such a situation a taxable benefit should arise, except so far as the employee would have been entitled to a deduction under section 82JAA.

9.36. The employer may meet directly the travel and entertainment expenses of his employee: the availability of credit cards facilitates this. The tax consequences of direct payment by the employer should not be different from the consequences considered in paragraphs 9.40–9.42 where the employee pays from an allowance given him by the employer or is reimbursed by the employer.

9.37. The expenses of attending a conference may relate, at least in part, to a benefit that is not simply the necessary consequence of the carrying out of employment duties. The same is true of some club subscriptions paid by the employer.

9.38. In the case of the club subscription a further issue arises. It is provided in legislation recently enacted that certain kinds of expenditure, not thought to serve clear business needs, will be denied deduction
whoever incurs them, and notwithstanding their relevance to the earning of income. The fact that the employer is denied a deduction should not preclude the identifying of a taxable benefit derived by the employee.

9.39. If an employee benefit is to be identified and valued, it will be essential for employers to maintain adequate records showing the purpose and detail of the expenses. In the United States the law requires a substantial degree of detailed recording of the precise nature of travel and entertainment expenditure and the vouching of such expenditure. The Committee recommends that similar provisions be included in the Australian law. In the absence of such recording and vouching, deduction for travel and entertainment expenditure should be denied. The recording of entertainment expenditure would, for example, require specification of the date, place and description of the entertainment, the business purpose of the entertainment and details of the persons being entertained. It would be necessary to set some limit on the amount of any individual expenditure below which vouching would not be required.

9.40. Allowances made available to employees for travel and entertainment expenses. Where an employee is given an allowance which relates to travel, entertainment and similar expenses that do not involve any taxable benefit, or is reimbursed such expenses, there are no tax consequences for the employee unless, in the case of an allowance, some part of it fails to be spent in this way. There may, however, be elements of taxable benefit in the travel and entertainment.

9.41. Over recent years there has been an increasing tendency for employers, in both the private and public sector, to pay their senior staff annual expense allowances of a fixed sum to cover entertainment and other expenses incurred in the performance of their duties. Provided the amount is considered reasonable by the Commissioner, it has become normal procedure to view the allowance as having been fully expended without requiring the employee to substantiate his claim. In many instances the amount of the allowance has been negotiated by employers with the Commissioner. It is rare to treat such allowances in this way in overseas countries. It causes administrative problems in negotiating the amount with the Commissioner—inevitabilities are unavoidable—and it is open to abuses which are difficult to police.

9.42. The Committee recommends that the law should require detailed recording and vouching of expenses met from travel and entertainment allowances and similar expenses reimbursed by the employer. The recording and vouching should be the same as is proposed in regard to travel and entertainment paid directly by an employer. Any part of the allowance or reimbursement not matched by recording and vouching
would be treated as a benefit derived by the employee. Some concession in regard to the recording and vouching required might be allowed in respect of the cost of meals and accommodation where an employee is travelling. The Commissioner might set a *per diem* figure, and recording and vouching of the costs of meals and accommodation would be dispensed with where the allowance or reimbursement given by the employer does not exceed this figure. The employee would nonetheless have to record other details.

**Tax Instalment Deductions**

9.43. Except in cases where an employer provides sustenance and use of quarters, the present law does not require that the calculation of tax instalment deductions take account of non-cash fringe benefits derived by an employee. The amounts attributed to sustenance and use of quarters for purposes of tax instalment deductions may, in any event, be less than their real value. The value of these benefits, and also cash allowances, are shown on the group certificate, but other non-cash benefits are not.

9.44. A fully effective system of taxing fringe benefits would require that all such benefits be included in the amount upon which tax instalment deductions are calculated and be shown in the group certificate in respect of an employee. Such a system is clearly out of the question. It would be unreasonable, for example, to expect the employer to calculate the cash value to each employee of discounts allowed to him.

9.45. However, the Committee favours imposing much wider statutory obligations on employers to disclose fringe benefits in group certificates and to make tax instalment deductions from salary and wages in respect of fringe benefits given to employees. The obligation to disclose should extend to all fringe benefits of which the employee has knowledge. The requirement to make tax instalment deductions should at least apply to regular benefits such as the use of a motor vehicle, housing, board and lodging, low-interest loans and cash allowances. It would always be open to the employee to include in his return an amount different from the value assigned to the benefit by the employer and to substantiate this amount. The Commissioner of course would not be bound by either the employer's or the employee's valuation.

**Other Issues**

**Salary and Wage Adjustments**

9.46. It is not uncommon for an employee to receive an amount of wages
relating to a period of employment during an earlier year: a wage increase may have been made retrospective to a date in the previous year of income. Less frequently, an employee will receive wages in advance: he may be paid a sum, say in June, for a period of long-service leave he is about to take. The consequence of the cash method of tax accounting applying to employment income is that the wages are taxed in the year of receipt without regard to the period of employment to which they relate. Because of the progressive rate structure, this usually results in greater tax than would have been payable had the wages been received at the time of the employment to which they relate.

9.47. In Chapter 8 it was assumed that in determining the income of a business or profession for tax purposes, efforts should be made to relate receipts to the year of income to which they properly belong. The Committee sees force in the argument that the same should be done for employment income.

9.48. However, the administrative costs in reopening earlier returns, and in deferring the inclusion in other cases to later returns, would be very considerable. They might be mitigated if a lower limit were set on the amount which could be taken into the other return, but this would introduce elements of inequity. Because of the wider marginal tax brackets now obtaining, the number of cases where there will be a significant tax disadvantage is not likely to be very great. In some circumstances, the income equalisation scheme proposed in Chapter 14 will assist the employee to defer the inclusion of an amount to a later return.

9.49. On the balance of considerations, the Committee feels that no change in the existing position is warranted.

Travel and Removal Expenses

9.50. In Chapter 7 the appropriate treatment of fares to and from work was considered, and the Committee recommended against extending the law to allow these fares to be deducted. However, it was also explained that expenses of travel between two places of work within an employment are properly allowable as deductions. Where an employee travels within an employment to a place of work away from his normal base, his own travel expenses are deductible whether the movement is necessary for some temporary purpose or involves an employment in the new place of work for a more permanent purpose. Where the purpose is temporary, his travel expenses will include accommodation and sustenance expenses in the new place of work, but where the purpose is more permanent this will not normally be so. In the case of travel for a more permanent purpose, a
question arises whether the travel expenses of his family and the expenses of removal of his home are deductible. When a person accepts a new employment involving his moving to another city, there will be a question of the deductibility of his own expenses of travel and also of the expenses of travel of his family and removal of his home. There are, in addition, two marginal situations requiring separate examination, one concerned with living away from home and the other with study leave.

9.51. *Travel within employment for a temporary purpose.* Travel expenses, including in this case accommodation and sustenance, are deductible by the employee as expenses in deriving income. Where the employee can be said to act on his employer's behalf in incurring the expenses, it is appropriate to treat any allowance or reimbursement provided by the employer as not being the employee's income and any amounts paid by the employee as not being deductible by him. The general practice would be to treat expense allowances and reimbursements in this way. If the employer himself meets the expenses directly, there will be no income derived by the employee.

9.52. There is ordinarily no question of deductibility of the expenses the employee may choose to incur in having his wife or other members of his family travel with him. These expenses are private. The expenses of a member of his family are only deductible in the unusual case where the role of that member is essential for the performance of the employment. If the employee receives a sum of money from his employer in respect of the expenses of his family, this is included in his income.

9.53. *Travel and removal expenses within an employment for a more permanent purpose.* The travel expenses of the employee are deductible: these expenses ordinarily include accommodation and sustenance expenses, though this is not the case if he may be said to have established a home at the new place of work. Where the expenses are the subject of an allowance or reimbursement or are met directly by the employer, there is again ground for the view that the employee is not entitled to any deduction and does not derive any income. The deductibility of the travel expenses of members of his family and of removal expenses raises a somewhat different issue. An employee who is required to move to a new place of work where he will have to stay for any length of time may fairly claim that these expenses are not private but are incurred in deriving income. In this case, however, it would appear that the expenses are not deductible.

9.54. Where the employer meets family travel and removal expenses, either directly or by giving an allowance or reimbursement, there is a question of how the amount involved should be treated. It is at least
arguable that the amount is not income of the employee. It appears to be the Commissioner's practice to treat such an amount in this way, provided it does not exceed the actual expenses and those expenses are reasonable.

9.55. In the result there would appear to be an unfair discrimination between an employee whose employer is prepared to meet the expenses and another whose employer is not. To overcome the unfairness it would be necessary to provide that the reasonable expenses incurred by the employee will be deductible where he is required by his employer to move to a new place of work.

9.56. In the Committee's view the law and practice assumed in paragraph 9.54 should be confirmed. Where the employer meets the reasonable removal costs of an employee, no amount should be included in the employee's income. Where the employee who is required to move meets his own reasonable expenses, he should be entitled to a deduction for those expenses.

9.57. Travel and removal expenses to take up a new employment. The expenses of seeking new employment are currently not deductible: they are akin to the expenses of exploring the possibility of undertaking new business operations. The denial of a deduction, to a person who is unemployed, of expenses in seeking a job may appear unfair. However, the difficulties in defining the expenses to be allowed rule out the possibility of giving a deduction. If the Commonwealth Employment Service provides financial assistance to meet the expenses of seeking a job, this assistance should be excluded from income.

9.58. The expenses of taking up a new employment are, it seems, not deductible. In the view of the Committee, the treatment in paragraph 9.54 should apply in respect to any amount provided by the new employer to cover those expenses.

9.59. Treating a reasonable amount provided by the employer in respect of these expenses as non-taxable could in this case, even more than in the previous one of movement within an employment, be justified as contributing to greater mobility of labour.

9.60. Living away from home. Since 1945 there have been express provisions in section 51A allowing a limited deduction to an employee in receipt of a living-away-from-home allowance, i.e. an allowance paid to him for the additional expenditure he is obliged to incur in meeting living costs in a place of employment away from his home. The deduction is limited to what the Commissioner considers reasonable, but in general it may not be more than the amount by which the allowance exceeds two dollars. Two dollars is supposed to represent the amount by which his permanent household expenses would be increased were he at home; but
clearly, with a decline in the value of money, theory and reality have parted company.

9.61. This deduction does not fit comfortably into any of the situations already considered. In its terms it is intended to cover expenses in deriving income not deductible under the general provisions of the Act. Some element of permanence in being away from home seems to be contemplated, so that the expenses would not necessarily be in the nature of travel expenses in the sense of those words in paragraph 9.53. Travel expenses, deductible under the general provisions, include accommodation and sustenance expenses only when the taxpayer has not established a home in the new place of work. Provided there is an establishment elsewhere which the employee may claim to be his home, there is a prospect of his being permitted deductions against a living-away-from-home allowance even though, in a sense, he has a home in the place where he works.

9.62. The distinction between travel expenses deductible under the general provisions and the expenses to which section 51A applies is not readily apparent. Having regard to the nominal character of two dollars at today's prices, very little turns on whether a deduction is classified as the one or the other. If the sum is increased to a more realistic figure, the classification will become of some consequence. In the Committee's view, section 51A should be regarded as a special provision appropriate to the case of an employee who, because of the limited time he spends in any one place of work or the remoteness of the place of work, does not move his principal home to his place of work.

9.63. Study leave expenses. Another situation that does not fit comfortably into any of those dealt with in paragraphs 9.51–9.59 is that of a person, most often on the staff of a university, who goes abroad on study leave in the course of his employment. The leave may be of varying length, quite commonly twelve months. It is not unusual for the employee to be given allowances by his university intended to cover his own fares and those of his family and extra costs associated with his going abroad.

9.64. The practice of the Commissioner, it would appear, is to treat the employee as a person travelling within his employment for a temporary purpose. He is allowed to deduct his own fares and his accommodation and sustenance expenses; any allowances he receives from his university are taxed as income.

9.65. This practice seems to the Committee appropriate where the employee goes abroad for only a short period of leave. It does not appear appropriate, however, when an extended period of leave is involved, say four months or more. It would not be thought fair in this case to disregard
the necessity for the employee to be accompanied by his wife and dependent children. Yet this appears to be the consequence of the Commissioner's practice. Even though an allowance has been given by the university intended to cover the fares of members of the employee's family, these expenses are not deductible. Moreover, where the employee has taken members of his family with him and has established a temporary home abroad, he may find himself limited in the amount of the deduction for his own accommodation and living expenses he will be allowed: the Commissioner will attribute a substantial proportion of the expenses of the temporary home to the members of his family who have accompanied him.

9.66. In the Committee's view, the amount of a reasonable allowance provided by the employer to cover the fares of the employee, his wife and dependent children, and the extra expenses which fall on the employee in undertaking the study leave and are met by way of a per diem allowance, should not be included in his income when an extended period of leave is involved.

Payments to Obtain Release from Employment Contracts

9.67. It is not uncommon for scholarships and cadetships under which a person undertakes some form of training to provide that he must enter or continue in the employment of the organisation giving him the scholarship or cadetship for a period of years after completing his training. If he does not fulfil this condition, he may be required to pay an amount to the organisation to obtain his release. Under the present law there does not appear to be any basis on which a deduction of an amount so paid might be claimed: it would be regarded as a capital cost of obtaining freedom of action to enter on other employment.

9.68. There is a general principle appropriate at least to business income that moneys received are not income if, under the terms of the receipt, there are outstanding conditions yet to be fulfilled; the moneys will become income only as the conditions are fulfilled. If this principle were applied to moneys received under the scholarship or cadetship, it would bring about a result somewhat different from a deduction of the amount paid to obtain release. Receipts under the scholarship or cadetship would cease to be taxed as received but would become income during the years of service following training, and this would mean a bunching of income which would not be welcomed by the former trainee. The Committee would not, in any event, favour the application of such a principle in the present context.

9.69. If the law is to make any allowance in respect of payment under an
employment contract, it will have to be by way of a special provision permitting a deduction of the whole or some part of the payment at the time it is made. However, the Committee does not favour such special provisions.

**Standard Deduction**

9.70. A number of employment expenses of relatively minor significance for the vast majority of taxpayers are deductible under the general provisions of the Act. These largely relate to tools of trade, special clothing and its maintenance, and professional, technical and trade journals. The administration of the law in this regard involves considerable compliance and administrative costs which might be thought disproportionate to the revenue involved. Some taxpayers who are unaware of the available deductions or are unwilling to submit to the tedium of record-keeping do not obtain deductions to which they are entitled. Claims for deductions put the Commissioner to considerable trouble in verifying the amount of claims and whether they qualify.

9.71. In some countries, for example Canada and New Zealand, a standard deduction in respect of these items is given. The deduction, usually of modest amount, is allowed without proof of actual expenses and any further deduction is denied. In Canada's case the amount is 3 per cent of employment income up to a maximum of $150. There is considerable merit in this approach, though it must cause injustice to some taxpayers for whom the expenses are of more than minor significance. Both Canada and New Zealand have found it necessary to treat some classes of taxpayers more generously.

9.72. Were the Canadian and New Zealand approach adopted, it is likely that some occupations would seek to be excluded. It might be more realistic, therefore, to provide that the standard deduction be available but not obligatory: a taxpayer would still be allowed to itemise his claims. If a taxpayer chose to itemise, he would not be subject to the money limit on deductibility. At least some saving in compliance and administrative costs would be achieved.

9.73. The Committee recommends that an optional standard deduction against employment income be available. The amount of the deduction might be set, as in Canada, at $150 or 3 per cent of employment income, whichever is less. It will be necessary to specify the kinds of claims the standard deduction is intended to cover in addition to those listed in paragraph 9.70. The Committee does not contemplate that the standard deduction, if taken, would preclude the allowance of separate deductions
for such expenses as subscriptions to trade and professional associations.

II. Investment Income

9.74. Ownership of property can give rise to various forms of investment (or property) income, notably rent, interest, dividends and capital gains. Their tax treatment is analysed in a number of places in this report. Imputed rent from owner-occupied dwellings is dealt with in Chapter 7, dividend income in Chapter 16, income from investment in superannuation and life assurance in Chapter 21, and capital gains in Chapter 23. A further aspect, the levying of a special surcharge on property income, is considered in Chapter 14 and there rejected. An issue not taken up in Chapter 14, however, is whether there are grounds not merely for rejecting the surcharge but for actually granting concessional treatment to investment income. This is the issue considered here.

9.75. One possible justification for concessional treatment is to encourage saving, either in general or in particular forms. In Chapter 21 the Committee has commented on the objective as justifying special treatment of superannuation funds and life insurance.

9.76. A second possible justification for concessional treatment is that consumption may be thought a better indicator than income of ability to pay tax. If this is accepted, it follows that imposing an income tax, including tax on income from savings, is horizontally inequitable because individuals are treated differently according to how they spread consumption over their lifetime, the effective rate of tax on postponed consumption being greater than the rate on current consumption. Given the retention of income tax, however, the consumption approach suggests a need to give relief to income saved as distinct from relief to income from saving, and it is this philosophy that underpins much of the discussion on superannuation and life insurance in Chapter 21.

9.77. As already pointed out in Chapter 3 and 6, conventional procedures for establishing income subject to tax under conditions of inflation can result in ‘illusory’ rather than ‘real’ gains being brought to tax. This leads to inequities of a horizontal kind, and perhaps vertical inequities too. The Committee discusses the problem for recipients of business income in Chapter 8, and its proposals in regard to capital gains are spelled out in Chapter 23.

9.78. In times of inflation, recipients of interest income, too, face the prospect of being taxed on ‘illusory’ gains. This is particularly noticeable when interest rates lag behind the rate of inflation, in which case tax is imposed on what are in reality negative gains. For this reason the
Committee considers that some form of concessional treatment should be provided for taxpayers in receipt of interest income.

9.79. One means of providing concessions would be the broad-brush approach of indexing all monetary debts. This is a radical proposal, raising issues beyond the Committee's terms of reference. Were a move to be made in this direction, the initiative would have to come from the government, which might as a first step issue indexed bonds.

9.80. An alternative approach would be to make ad hoc adjustments to the income tax base. Canada has recently introduced legislation to this end. In computing taxable income, an individual in Canada may deduct interest income from securities such as bank and trust company deposits, mortgages and bonds. The deduction is limited to the lesser of (a) $1,000 or (b) the taxpayer's interest income for the year minus the amount, if any, deducted by him in computing his income on account of interest paid on borrowed money for the purpose of earning income from a business or property. New Zealand also has tax concessions for persons receiving interest income, and these have recently been extended. An exemption is given of $100 of interest from any source; in addition, $200 of savings bank interest is exempt. There is also a special exemption of $500 in respect of savings certificates and national development bonds. In the short run at least, ad hoc adjustments such as these appear to be the most appropriate.

9.81. If legislation were to be introduced along these lines, the following general principles should be followed:

(a) The deduction should be available for interest income on as wide a range of securities as possible to avoid introducing new distortions into the capital market. Consideration might be given to making the deduction available in respect of dividends on preference shares which carry no rights to capital beyond the amounts subscribed.
(b) The deduction should be limited to net interest in the sense of interest received less interest that is deductible, whether as costs of deriving income or by a virtue of a concessional deduction provision.
(c) The deduction should be limited in amount and be personal to the individual taxpayer.
Chapter 10 Personal Income Tax : The Taxpaying Unit

10.1. A fundamental characteristic of any system of personal income taxation must be the ‘unit’ chosen for taxation. It can be the individual, or the married couple, or the family, with ‘family’ narrowly or widely defined.

10.2. From the beginning, personal income tax in Australia has been based on individual incomes; along with Canada and New Zealand, Australia is one of the few countries still making this selection. This is not, of course, to assert that in our tax system (or in others with this basic unit) no regard whatever is paid to the family situation of the individual taxpayer. There are allowances for various dependants and numerous concessional deductions applying not only to the taxpayer's expenditure upon himself but also to that made on behalf of family members. It is, however, true that the allowances provided are generally rather small in relation to the total expenditure that the individual will normally make upon his or her family.

10.3. The problem of whether the individual unit system is appropriate or not has been put to the Committee in many submissions and in two main ways. Some have tackled it directly, arguing that the total income of the family is the proper indicator of ability to pay, and that the manner in which that income happens to be divided among the individuals concerned is irrelevant.

10.4. Others have raised the same problem rather less directly. Since under the individual system with a progressive rate scale, family tax will be minimised when incomes are equally divided, it is plainly to the tax advantage of families to rearrange their affairs so as to permit them to return equal or nearly equal incomes. They take measures to this effect, perhaps of a kind they would not take for any other reason. In fact, some people—for example, those in business or with substantial property incomes—can rearrange their affairs to this end fairly readily, and have been doing so in increasing numbers in recent years: other people, wage and salary earners in particular, cannot. The latter naturally have a grievance of the ‘horizontal inequity’ kind and denounce ‘income splitting’ in sharply pejorative terms. But it is often not clear whether their complaint is that others can, or that they themselves cannot, so rearrange their affairs. If the latter (whether or not they have thought the matter through), they are in effect espousing the cause of family unit taxation. If the former, they would seem to be arguing that some ways of arranging division of income
are acceptable while others are not—that existing law, in sanctioning the latter, draws the dividing line in the wrong place.

I. Overseas Experience

10.5. Over the years, the general issue of the taxpaying unit has been dealt with in overseas countries in a wide and changing variety of ways which to a large extent have been influenced by the history of the legal systems of the particular countries concerned. Several examples may be described.

10.6. In 1799 upon initial introduction into the United Kingdom of an income tax, a husband and wife constituted one taxpaying unit because the English common law, unlike the laws of many parts of Europe, rejected the doctrine of community of property between husband and wife on marriage and regarded the legal personality of the wife as merging in that of her husband so that in law they became one person. While in course of time the growth of equitable doctrines modified to some extent the operation of the common law, for a long period this made no practical difference as, in an action to recover the tax levied in respect of the income of a wife living with her husband, he was a necessary party. It was not until towards the end of the nineteenth century that the married women's property legislation began to effect a separation at law between the wife's property and income and her husband's rights thereto. This separation was not finally completed until 1935 but, in the removal of these restrictions upon a married woman's property rights, the income tax legislation did not march in company with the laws of property. It was not until 1950 that the married woman ceased to be classified for the purposes of the income tax legislation as an ‘incapacitated person’ along with infants and various categories of mental defectives. Although from time to time full aggregation of the wife's income with her husband was in some respects departed from, the Income and Corporation Taxes Act 1970 still deems the income of a married woman living with her husband to be his income and not hers. In 1914 the husband was given the right to require separate assessment of their respective incomes and in 1918 provision was made for either husband or wife to make a similar election but, in general, separate assessment did not make the parties liable to pay less tax.

10.7. Originally the separate incomes of husband and wife were added together and this income was taxed as if it were the sole income of one taxpayer. Ultimately concessional deductions were allowed as some means of recognising differences in taxable capacity of different taxpaying units—in addition to deductions for dependent children. The United
Kingdom allows personal deductions which vary according to marital status. If the wife works, a special wife's earned income allowance is also provided in the form of a deduction from taxable income additional to the personal deduction. Since 1971, married couples have been provided, where husband and wife jointly elect, with a limited option of submitting separate income tax returns. Under this option, tax is calculated as if all the income other than the wife's earned income were the husband's, so that for tax purposes the husband receives only the single person's personal deduction, and the wife is taxed as a single person on her earned income, with the single person's personal deduction only. The wife's earned income relief is not available under this option and the allowances for children must be claimed against the husband's income. The new option is described in the following terms in a reference document submitted to the OECD by the United Kingdom Government:

‘Whether this [the new option] will reduce the total tax bill of a married couple will depend upon their personal circumstances; but as a general rule it will not unless their combined income exceeds £6,900, and may not do so even then’.

10.8. In the United States there is another system that can be traced to a legal background of property and income rights. After an earlier abortive attempt to levy an income tax, Congress was given constitutional power in 1913 to impose an Income Tax Act. However, the law with regard to the property and incomes of spouses was not, and still is not, uniform throughout the United States. In eight States, which prior to their accession to the Union had been under the influence of the European community property legal system, property acquired by a husband and wife after marriage is presently regarded as owned by them in community and in equal shares and the income from such property is divisible equally between them. Each of these States has different rules to distinguish between separate income and community income but generally all earned income is community income. All property acquired by either spouse before marriage is his or her separate property and property acquired thereafter is their community property. Income tax returns in these eight States may be filed jointly or separately. In the separate return, half the community income is shown and, in addition, the separate income. Usually the filing of a joint return will result in a tax saving to both spouses. In the remaining States, where there is no community property law, the spouses may file a joint return and this even though one spouse has no income or deductions. Generally the filing of a joint return will result in the saving of tax for the married couple because of the tax rates applicable to the joint return or optional tax tables, the latter being available where the joint
return shows an adjusted gross income from all sources of less than $10,000. The presence in the Union of a number of community property States has no doubt influenced the course of taxation in the remaining States in an attempt to achieve some uniformity in the mode of taxing spouses.

10.9. The split-income provisions, when initially enacted in 1948, gave the couple the option of filing a joint return under a tax rate schedule that provided tax brackets twice as wide as those applying to single people. This in effect resulted in the same taxation burden as if each spouse was taxed separately on half their combined income. Compared with the Australian system, it had much the same effect as legally allowing all married couples to put themselves in the position of those practising what here might be regarded as income-splitting abuses. This rather peculiar, though temporary, arrangement was an outcome of the previous history. However, as the result of criticism of this system by single persons, the rate schedules were changed in 1969 to ensure that in no event did the liability of a single person exceed by more than 20 per cent that of a married couple with the same taxable income. A new head-of-household classification was also introduced to meet the cases of unmarried persons with family responsibilities, providing for rates that fall midway between those of single and married persons. It is now possible for two single persons with equal incomes who are living together to pay less tax than a married couple with the same total income, a situation that was not possible under the pre-1969 legislation which incorporated an underlying tax bias in favour of marriage.

10.10. *South Africa* is a country which, through the influence of its connection with Roman-Dutch law, has a community property legal system. For taxation purposes the income of a woman, married and with or without community property, living with her husband, is deemed to be income accrued to her husband and in such case the husband makes the return and is liable for the tax. If, in the income return of the husband, there is any income earned by the wife not in association with her husband, for example not in a husband-wife partnership or in a private company in which both are interested, the husband is allowed a deduction of R.500 or the actual amount of earned income if it be less than that figure. Either husband or wife may make application to the Secretary for Inland Revenue for the right to submit a separate return and a separate return may be lodged if he considers it to be desirable. The Secretary himself may also require the making of a separate return. However, the total tax payable on the separate assessments must not be less than the total tax payable by the husband alone had the wife's income been assessed as his. In South Africa
a married man's liability to tax is on a much more favourable basis than that of other persons. He enjoys lower rates of taxation. He is also entitled to a much higher primary abatement (deduction) in addition to the earned income deduction and to more advantageous medical deductions.

10.11. While the rule of aggregating the incomes of husband and wife is found in other European countries, the unit of taxation is sometimes the family. Thus, in France not only are the incomes of husband and wife aggregated but also the incomes of children are included in the income of the family unit. Allowance for differences in the composition of families and differences in family size are then made, not by way of deduction but instead by means of a method commonly called the ‘quotient system’. The aggregate income is divided into parts according to the number of adult persons and children in the family and tax is charged separately on each part. For this purpose a child is counted as one-half and an adult as one part. Thus a married couple with two dependent children pays three times the tax of a single person with one-third of the joint family income. This system may provide a more generous treatment of married couples, especially those in higher tax brackets with children, than either the United Kingdom or the Australian system.

10.12. The present United States system is similar in many respects to the Carter Commission proposal for reform in Canada which after lengthy discussion was not accepted by the Canadian Government. This plan provided separate rate schedules for single persons and married couples but also included the incomes of dependent children in family income subject to tax. Dependant allowances were to be granted in recognition of differences in family circumstances; however, unlike the quotient system described above, the variation in tax liability between single persons and families was to be achieved by means of the different rate schedule. But Canada preferred to tax husbands and wives as individual persons.

10.13. Mention should also be made of a recent change in Sweden which reverted from a system that taxed the combined income of husbands and wives (and of single persons living together) to one that now taxes the earned income of wives separately. Property income is still taxed in the hands of the husband as before. A stated purpose of the change was to remove the disincentives for married women to work inherent in the previous system.

II. Review of Possible Reform

10.14. With so many overseas models, old and new, to choose between, and so many compromises that could be devised, it is necessary to make a
systematic review of the arguments before coming to conclusions.

10.15. Broadly there are three directions that reform could take: (i) Australia could stay with its present basis of compulsory individual taxation; (ii) it could go over to a compulsory family unit basis; or (iii) it could retain the individual basis but provide families with the option of taxation on a family unit basis if both spouses so elect.

10.16. The Committee is agreed that the second course, the adoption of a compulsory family unit basis, must be rejected on grounds of general social principle. The right to be taxed as an individual has always been accorded in Australia. At a time when women are playing an ever greater role in the economic and other affairs of society, the withdrawal of this right would certainly be regarded as a retrograde step. And objections would come not only from women: men too might take exception to a universal and compulsory commingling of their tax affairs with those of their wives. This would, in the Committee's view, make a change in this direction politically unacceptable irrespective of whether married women (or married men) paid more or less tax after the change than they do now: social attitudes to the separate status of the sexes, rather than purely economic considerations, are involved here.

10.17. The choice therefore lies between leaving the existing basis of individual taxation unaltered (with or without measures to handle income splitting) and adding an option for married couples to be taxed on some newly devised family unit basis if they elect to do so. The choice, naturally, cannot be resolved until a number of issues about the new basis are settled, but the general argument for family unit taxation can be considered first.

10.18. The proponents of the family as the tax unit rest their case mainly on a proposition about the normal attitudes and practices of married couples in spending and enjoying the fruits of their incomes. It is argued that, however separate, legally and practically, the sources of their two incomes, in practice married couples largely share or pool their expenditure. Much is jointly consumed: one house, one lounge suite, one television set, one refrigerator and (to a diminishing extent) one car suffices. Whichever spouse made the purchase, both enjoy the benefits, and even the purely personal expenditure of each gives the other pleasure. On this view of the matter, it is the total income of the pair that determines their ability to pay rather than the way the total is formally divided between them: it is wrong that families should pay more tax the more unequally their total income is divided, at any rate to the extent shown in Table 10.A.

| TABLE 10.A.: TAXES PAID BY EQUAL-INCOME FAMILIES: |
10.19. It must be agreed that this argument has force. But even those who use it will certainly concede that a high degree of sharing of this kind is by no means universal. In some marriages, and not by any means only unhappy ones, almost completely separate patterns of spending and enjoyment may be the rule. Between the extremes a whole range of intermediate arrangements will be found. At the one extreme a family unit basis would give the fair result, at the other the existing individual basis would. The compulsory family unit would be unfair to some; the compulsory individual unit is unfair to others. A graded set of alternatives being self-evidently impracticable, to give a choice between two bases is at least better than to give none. The Committee agrees with this conclusion; the difficulties lie in settling the details.

Questions Arising over the Taxation of Family Units

10.20. The first question of detail under a family unit system is the rate scale to be used. Under the British system the same scale as for single persons is applied to the aggregate income of the married couple (though with qualifications in the form of allowances to moderate the extreme severity of the result). If this be called ‘pure aggregation’, then ‘pure averaging’ might be the term for the system introduced in the United States in 1948, when a schedule with tax brackets twice as wide as those for single persons was adopted for those electing family treatment. This, as noticed, gave the same arithmetical result as if each spouse was taxed.
separately on half their combined income.

10.21. In terms of economic equity between married and single persons, neither of these very simple solutions to a difficult issue commends itself. Pure aggregation produces the same result as the current Australian individual basis in the special case of one spouse having no income (apart from the effect of the modest dependent spouse allowances). But it would increase the tax paid by the pair in almost any case where both spouses have significant incomes. They would then pay more tax than if they had elected to be taxed as individuals, and the amount by which that tax would increase would be the greater the more equal were their separate incomes. An election system with this rate would ensure no elections. Pure averaging, by contrast, would mean that election saved tax for all married couples except those who happened to have equal incomes. The tax each paid would in no way reflect the additional capacity to pay inherent in the notion of shared enjoyment. Everyone would have a financial inducement to elect, including perhaps those whose relationship was more fairly described as, and felt to be, economically quite separate: the tax result would be the same as if all couples achieved complete income-splitting. The loss of revenue would be so great as to entail, if the income tax revenue were to be maintained, a severe increase in tax on single persons (and those married couples who resisted the tax inducement to represent themselves as a sharing unit). It was for this reason that the pure averaging provisions of the United States tax were abandoned in 1969.

10.22. It is inherent in the equity arguments for an elective family unit system that there should be a distinct family rate somewhere between the extremes of pure averaging and pure aggregation. The former is undoubtedly too kind to electing pairs, too unkind to single persons and couples who require individual treatment; the latter undoubtedly too harsh on electing pairs, too kind to single persons and those who accept individual treatment. The choice of family rate relative to the individual rate is therefore one of nice judgment.

10.23. A further question that has to be dealt with under a family system is the treatment of dependent wives. There are here two distinguishable situations: (i) when the wife's dependence is primarily due to her looking after small children rather than going to work; and (ii) when, without children, she simply prefers to take no paid work (or can obtain none). In the present Australian income tax system they are treated alike. As regards (i), married couples who both work often feel that, because their child-minding and their housework involve more strain than for families where the wife is at home, they are unfairly treated at present. Under a family unit system this situation could be handled by an earned income allowance for
the second working spouse. As regards (ii), under the present system the family in which the wife stays at home may feel over-taxed relative to the family in which both spouses work and receive the same total income, since the dependent spouse allowance is small and the wife will almost certainly be contributing domestic services of value even though they are unmeasurable. But under a family unit system with a rate near the pure averaging end of the range, the situation might be reversed. Examining this problem, the Canadian Royal Commission on the Status of Women (1970) was tempted to propose the abolition of any allowance for dependent wives without dependent children, but concluded against this recommendation because it felt there were inadequate employment opportunities for married women of working age in many places and it was concerned also for the position of elderly wives. The future of the dependent spouse allowance in Australia is further discussed in Chapter 12.

10.24. The treatment of children in a family unit system also requires thought. It is implicit in the concept of a family unit that the income of children is part of that of the family as a whole. Certainly when living at home children have full use of the common equipment of the family and may properly be said to share in much parental expenditure. Considerable scope for tax avoidance would remain if any property income they derived, whether the property came to them by parental gift or otherwise, were left to be wholly taxed on an individual basis. This matter is dealt with in Chapter 11. Income being accumulated in a trust estate to which a child is contingently entitled must also be considered. Indeed there might be income so accumulating to which husband or wife is contingently entitled. These matters are taken up in Chapter 15.

10.25. Concessional deductions for dependent children, and the associated issue of child endowment, appear to be unaffected in principle by the possible adoption, or rejection, of a family unit system and their discussion can be left over to Chapter 12. This would not be so, however, if the French version of the system were selected. That variant, summarised in paragraph 10.11, provides, as there remarked, extremely generous treatment for parents with children and seems to be expressly designed to encourage a high birth rate. The Committee presumes that this is not an objective of Australian Government policy and would therefore not recommend a quotient system.

**Individual Taxation with an Election System**

10.26. The provision of the option to be taxed on a family unit basis would not reduce the necessity, which the Committee regards as urgent, to
remedy tax avoidance by income-splitting within a family which has not exercised the option. It would be necessary, at the least, to deny the tax effects of tax-avoidance transfers of income by parents to children. Furthermore, spouses who were taxed as individuals and who had incomes of unequal magnitude would still have an incentive to make tax-avoidance transfers of income to enable more equal incomes to be returned for taxation purposes. By choosing to be taxed as individuals they would have asserted a claim to behave, in their financial dealings, as if they were at arm's length, and it would be important to ensure that this relationship was reflected in their tax liability. Measures directed against income-splitting are proposed in Chapter 11. Consideration must also be given to the accumulation in a trust estate of income to which a member of a family is contingently entitled. This matter is considered in Chapter 15.

**Restrictions upon the Right of Election**

10.27. During the decades over which a marriage will normally last, the absolute and relative incomes of husband and wife will usually change. There will be years in which to be taxed as a unit would be more advantageous financially, others when separate individual taxation would reduce their tax liability. To provide married couples with an unrestricted right to move in and out of family unit taxation whenever it would save them money to do so would be perilous to the Revenue and inequitable between married persons and single, whether they be bachelors, spinsters, widowers or widows. The proposal to institute an option for taxation as a family unit is not put forward as a mode of reducing taxes for married persons (or raising them for the single); it is, rather, designed to provide a fairer allocation of personal income tax between persons, and in particular between families with different practices and attitudes towards the expenditure of their separate incomes. Some restriction on the right to elect and to cancel past election therefore seems to be imperative.

10.28. Such a restriction would not be easy to define and administer. Provisions for cancelling an election would of course be necessary in the event of formal separation or divorce. In addition it might be provided that married persons who do not elect for family unit treatment within some defined period after the option becomes available or after their marriage may elect thereafter only upon the fulfilment of a condition that guards the revenue from any misuse of the option to elect. Thus the condition might require the payment of the additional tax that the spouses would have paid had they elected in the immediately preceding years.

**De Facto Relationships**
10.29. Where any provision of the present law depends on a marriage relationship, a formal marriage is necessary, although in some circumstances an illegitimate or adopted child may qualify as a dependant. The Committee is conscious of the change in social attitudes that could lessen the significance of formal marriage. An extension of the law so that the status of ‘spouse’ would include a partner in a de facto relationship would, in the Committee's view, be desirable if it were possible to define such a relationship in a manner that would not pose undue problems of interpretation and application. The Committee has, however, concluded that it is not possible to define the relationship in a satisfactory way. One context in which proof of the relationship will be important is the election of family unit treatment. The restrictions on the election could not be conveniently applied. Thus the requirement that an election must be made within a stipulated time after marriage would pose the problem of establishing the commencement of the relationship. The claim for a concession for a dependent spouse made in a previous return would assist; but no such claim would have been made where, because both had income, no tax advantage could have been obtained. Another context is the application of provisions against income-splitting. The Commissioner could not enforce the law in regard to a de facto relationship without what might be thought to be an unacceptable invasion of privacy.

Separated or Divorced Spouses

10.30. The present law (section 23 (1)) exempts income received by way of periodical payments in the nature of alimony or maintenance, by a woman from her husband or former husband. There is a proviso denying the exemption where the husband or former husband has, for the purpose of making such payments, divested himself of any income-producing assets, or diverted from himself income upon which he would otherwise be liable to tax. The husband is not allowed a deduction of the payments made to his wife or former wife.

10.31. In some countries the wife or former wife is taxed on the alimony or maintenance receipts and the husband is allowed a deduction of the payments. A system of this kind was proposed in Australia in 1942 but was rejected by the government of the day largely on the ground that a taxpayer who was separated or divorced from his wife would have been placed in a more advantageous position than a taxpayer who was not. The system, in effect, involves an income split, which would not be open to the latter.

10.32. The Committee would consider it appropriate to allow a husband a deduction for alimony or maintenance payments, whether or not divorced
from his wife, provided there are safeguards against connivance to exploit the potential tax advantages and that the payments are taxed as the income of the wife or former wife. Already the law, in effect, allows a split of income between husband and wife where for the purpose of making payments to his wife the husband has divested himself of income-producing assets or diverted from himself income upon which he would otherwise be liable to tax. As explained in paragraph 11.45 section 102B (4) protects such a split of income from the operation of the short-term assignment provisions. The policy reflected in section 102B (4) should, in the view of the Committee, extend to allow a deduction of the payment where the husband is not in a position to divert income to his wife.

A Proposal for Public Examination

10.33. The provisions of a regime for family unit taxation as an optional alternative to the existing individual basis would be a large departure for Australia, requiring substantial public discussion. The Committee has not suggested a rate scale if only because in this report, given the separate necessity to consider the existing scale and the variety of other proposals being made, no precise figures would be helpful. In any case, statistics of family incomes, and their distribution between individual members, would be required to calculate the effect on revenue. But the Committee emphasises the importance of the choice of scale, and the need, when one is proposed, to explain its effects on families in different situations and its relation to the individual tax scale, in a readily comprehensible manner. The Committee is persuaded of the equity arguments for providing an option that recognises the reality of one large category of family relationship better than does the individual basis, and therefore recommends that the Government prepare a detailed scheme for an elective family unit system for public examination.

Reservation to Chapter 10: Personal Income Tax: The Taxpaying Unit

In paragraphs 7.5–7.33 of its preliminary report (now paragraphs 10.1-10.28 of the full report) the Committee discussed matters concerning the ‘unit’ to be chosen for income taxation, namely, the individual, the married couple, the family, with ‘family’ narrowly or widely defined. After reference to overseas systems of taxation, the difficulties inherent in an elective system for joint returns, and the problems of an appropriate rate scale, the Committee concluded in paragraph 7.34 of its preliminary report:
‘The Committee is persuaded of the equity arguments for providing an option that recognises the reality of one large category of family relationship better than does the individual relationship, and therefore recommends that the government prepare a detailed scheme for an elective family unit system for public examination.’ The ‘large category of family relationship’ was not defined by the Committee and in what sense its ‘reality’ existed for taxation purposes was not specified. This conclusion has been carried over into the full report (see paragraph 10.33) and it is to this that I wish to make a reservation.

The Committee has not overlooked the use of the family relationship for the prevention of income-splitting between the family members (including children) and the avoidance of death duties and has made detailed recommendations elsewhere in this full report (which time did not allow for in the preliminary report) to prevent the exploitation of the procedures which have been employed to these ends. As I have endeavoured to make clear in a paper titled ‘Aggregation of Incomes of Husband and Wife’ which accompanies this full report, the aggregation of the separate incomes of husband and wife never originated as a means of inhibiting schemes for income tax avoidance; and the propriety of aggregation should be considered quite apart from the activities of those who seek to abuse the taxation system for the reasons which I have set forth in the paper above referred to.

Upon much further consideration than I was able to give in the very limited time which was available in getting out the ‘broad brush’ preliminary report, I am firmly convinced that the Committee's conclusion is unsatisfactory and should not have been made. In the paper referred to above I have discussed in some detail the historical basis of the aggregation of the incomes of husband and wife in the United Kingdom and the United States and have pointed out that in Australia, with the exception of a very brief period in the early income taxation period in Tasmania, Australian taxation systems of income tax have consistently rejected the aggregation of the respective incomes of the spouses. I have also opposed their aggregation on the grounds of unfairness and for a number of other reasons which appear in the paper.

I have also observed that the recent Canadian Royal Commission on the Status of Women (1967-70) found against such an aggregation of incomes but recommended an optional system for a joint return which would result in a tax advantage for those married couples who elected to be taxed jointly.

Before the inevitable expenses of any public examination of a detailed scheme for an elective unit system should be seriously contemplated, it
seems to me that a rate system for the taxation of the aggregated incomes of husbands and wives and its consequences both to the taxpayers and to the Revenue would have to be given close consideration. In all taxation systems which embody an optional system of aggregation for the taxation of husbands and wives, everything hinges upon the rate scale and a special rate scale is sometimes devised for optional use. The word ‘elective’ presupposes a choice for the taxpayers not only between the individual and the joint return and assessment but also between different rate scales which could produce monetary results which are, on the one hand, advantageous to the taxpayers and, on the other, disadvantageous to the Revenue.

If a rate system were constructed so as to result in both spouses paying a higher total amount of tax than they do under an individual unit base, this would be not only an unacceptable approach in Australia but also one which, for reasons which I have given, is unjustifiable. If it were to result in the payment of less tax than otherwise would be recoverable if each spouse were individually taxed, naturally it would meet with wide acceptance on the part of the taxpayers but at the same time would bring about a substantial loss to the Revenue. If it were at all possible to ensure that the tax upon the aggregated incomes would not bear more heavily upon each of the taxpayers, husband and wife, than the existing individual unit system, an eventuality which would lead to a great deal of complexity for both the administration and the taxpayers alike, then the change from the existing system would be an expensive exercise in futility.

In my opinion, in the world of today a married woman should be treated both under the general law and in the taxation system as an individual in her own right and, in relation to the income which is both morally and legally her own, she should pay no more and no less tax than if she were a single person.

For these reasons I have come to the conclusion that a public examination of the kind recommended in the preliminary report—and repeated in the full report—should not be embarked upon.

K. W. Asprey

1. A Reservations to conclusions reached in this chapter is appended.
Chapter 11 Income-Splitting

11.1. The phrase ‘tax evasion’ describes an act in contravention of the law whereby a person who derives a taxable income either pays no tax or pays less tax than he would otherwise be bound to pay. Tax evasion includes the failure to make a return of taxable income or the failure to disclose in a return the true amount of income derived. Leaving aside the cases where a person parts with some portion of his income under the dictate of some particular legal or moral obligation, ‘tax avoidance’, on the other hand, usually connotes an act within the law whereby income, which would otherwise be taxed at a rate applicable to the taxpayer who but for that act would have derived it, is distributed to another person or between a number of other persons who do not provide a bona fide and fully adequate consideration; in the result the total tax payable in respect of that income is less than it would have been had no part of the income been distributed and the whole been taxed as the income of that taxpayer. The act which distributes an amount of income for the purpose of achieving that result is usually described as ‘income-splitting’.

11.2. Generally speaking, as salaries and wages cannot be made the subject of income-splitting, the opportunity by that means to order one's affairs so as to reduce the amount of tax otherwise payable is not equally available to all taxpayers. This is inequitable to the taxpayers who do not have that opportunity. A progressive taxation system that seeks to bring to charge the income of each individual upon an ascending scale of tax rates should operate fairly as between all taxpayers and should tax each person upon the amount of income that was truly and realistically his to receive. Fairness to the whole body of taxpayers demands that this principle should have a full application, for the loss to the Revenue in the reduction of taxation effected by income-splitting must be recouped from those who are unable to practise it. Therefore, it behoves the revenue laws to correct the inequity and restore the efficiency and balance of the taxation system.

11.3. Income-splitting is almost universally confined to family relatives: husband and wife, father and child, grandfather and grandchild and so forth. When the word ‘relative’ is mentioned in this chapter, it is intended that it should bear the meaning ascribed to ‘relative’ in section 6 (1) of the Income Tax Assessment Act. The means by which it is accomplished are most frequently to be seen in partnerships, alienation of income, trusts, private company arrangements, loans, gifts and employer and employee relationships. The current legislation contains a number of sections
designed to inhibit some forms of income-splitting; but these have proved to be ineffective in the sense that they leave large areas untouched, and it is necessary that the use of other measures be explored.

11.4. One suggestion to this end has been the adoption, in place of the individual as the unit of taxation, of a family unit which could be comprised of a husband and wife or husband, wife and children. For the reasons given in Chapter 10, the Committee has rejected the compulsory aggregation of family incomes; and in the present context it would not attain its objective where children had reached a given age and in circumstances where the income distribution was effected to children who had ceased to reside in the household of their parents. This chapter proceeds on the footing that any proposal for a family unit basis of taxing income is not being implemented.

11.5. In some other countries, legislation has been enacted for the purpose, amongst other things, of preventing income-splitting. These are sections framed in such extremely wide and general terms and in language so vague and imprecise that interpretation becomes very difficult. This inevitably leads to inconsistency in their application, with the consequence that liability to taxation becomes to a great degree uncertain and causes dissatisfaction to both the taxpayers and the administration. It has been well said that in fiscal legislation, when the choice lies between general provisions and provisions identifying with precision the kind of transaction which is to be struck at and prescribing with corresponding precision the consequences which are to follow, the second course ought to be chosen. The Committee rejects the adoption of general legislation of the type referred to. In so far as it is possible to do so, it prefers to deal with the different areas in which income-splitting is practised by less sweeping means.

11.6. It is, however, not always possible to enact legislation to cope with tax avoidance in language that fulfils the ideals of simplicity and precision. Firstly, most provisions of a taxation statute have an application to so many sets of circumstances of infinite variety that to attain an adequate coverage of all of them necessitates the employment of wording that is correspondingly extensive. Secondly, the ingenuity and complexity of the procedures to be found in the many and varied schemes of tax avoidance compel the use of measures that are sufficiently wide to counter them, and precision usually sits uncomfortably with width of expression. Thirdly, it must also be recognised that in framing legislation sufficiently all-embracing to deter tax avoidance, there is always the danger of penalising those who have a genuine reason for entering into a bona fide transaction which, if carried out by others, has the objective that ought to be prevented.
There is frequently such a very fine line to be drawn between the transaction which offends and the one which merits no condemnation that clear definition in statutory terms cannot always be satisfactorily achieved. In some instances recourse must be had to an administrative discretion as the only practical instrument available to obviate an unjust result. To set forth in detail in the statute all the circumstances and factors that would regulate the discretion's exercise is clearly out of the question. Some guidelines there may be but, as with a judicial discretion, to confine it within rigid limits is in effect to destroy the discretion and to legislate in its place for a number of particular cases the full complement of which could never possibly be foreseen. The safeguard against error in the exercise of the discretion lies in the availability of a satisfactory procedure for its review.

11.7. Before proceeding to discuss the various procedures by which income-splitting may be effected, it is convenient to point out that all transactions between family relatives do not fall within that description. Some may be voluntarily and reasonably entered into in response to a legal or moral obligation and others may be executed in compliance with a Court order. Others again may result from the desire to carry into effect a mutual enterprise or dealing which by its very terms is stamped as genuine and free from criticism as an income-splitting device. The last-mentioned serves to emphasise the importance of what the law describes as ‘valuable consideration’, which for present purposes may be said to be the value received by a person in return for parting with some part of his income to another. Valuable consideration may consist of money or money's worth. For example, if a husband were to take his wife into partnership and the income she receives from the partnership is truly commensurate with the services she renders, or if one relative purchases from another some income-producing asset at a price reflecting its true value, no question of income-splitting arises, since such transactions or others like them are entered into on the same basis as strangers, acting at arm's length, would do. On the other hand, there are those arrangements between relatives under which income arising from the employment of assets owned by one person, or from the exercise by that person of personal skills or business ability, is established wholly or in part as the income of a relative: in reality there is a gift of this income. There are also those cases—inter-family gifts of capital—where assets producing income are the subject of transfer between relatives without adequate valuable consideration.

11.8. In general the Committee has approached this question in terms of three principles. Firstly, minor children are in a special category and tax advantages that might otherwise flow from diversion of income to them
should be denied, by taxing their income at a rate based on parental income. Secondly, husband and wife are a category of relatives requiring special consideration separately from other relatives. But while income arising from arrangements resulting in gifts of income, as referred to in the preceding paragraph, should be assessed at a rate of tax based on notionally aggregated incomes, the Committee, on balance, considers that income arising from gifts of capital between spouses should be assessed in the normal way to the spouse actually deriving the income. And thirdly, there should be denial of income-splitting advantages under arrangements resulting in gifts of income in the case of other relatives; in these cases, however, as with husbands and wives, there should be no assessment on a notionally aggregated basis of income arising from gifts of capital. These matters are considered in more detail in the following paragraphs. The position in relation to minors is first examined; various means of income-splitting between spouses and with other relatives are then dealt with under several headings.

**Income-splitting and Minor Children**

11.9. It would be possible to deal with income-splitting between parents and minor children, i.e. children under 18 years of age, in much the same fashion as is being proposed in relation to income-splitting between other relatives. In the Committee's view, however, it is appropriate that their incomes should in general be taxed at rates that take account of the amount of income of their parents. It is proposed therefore that the unearned income of a minor child be taxed at a rate determined by notionally adding his income to the income of the parent with the higher income. The income thus notionally added would, for the purpose of ascertaining the tax on it, be regarded as the top slice of the parent's income with the amount added. Where there is more than one child involved, the total income of the children would be added for this purpose and the resulting additional tax then spread amongst the respective children on the basis of their incomes.

11.10. As a method of dealing with income-splitting, the proposal would have a wider application than measures specifically directed to that end would be likely to have. Thus unearned income of a minor child derived under a trust established by the will of a deceased grandfather would be taxed by reference to the amount of his parent's income.

11.11. The existing provisions of the Act (section 102 (1) (b)) relating to a trust created by a parent for his minor children would be unnecessary. Those provisions have, in any event, been shown to be defective in a number of respects. It seems that they have no application where the trust
is created by some person other than the parent and the parent later vests assets in the trust. They are defective, too, in not requiring that amounts under all such trusts for the same minor child, and incomes under trusts for several minor children, be added in one calculation to the income of the parent in order to determine the rate of tax to be applied to the amounts.

11.12. A number of detailed aspects of the Committee's proposal require consideration. The Committee has, in framing what follows, derived assistance from the model of the provisions of the United Kingdom Income Tax Act relating to ‘Aggregation of Income—Parent and Child’.

11.13. The system should apply only to income of a minor child who is unmarried and is not working in some occupation in an arm's length arrangement. The system is based on a view that it is appropriate to determine the ability of a child to pay tax on his income, by reference to the ability to pay tax of those on whom he normally depends for support.

11.14. The system will not apply to arm's length earned income derived by a minor child, since this would operate as a disincentive to work effort. But it should apply to earned income from transactions not at arm's length. For the purposes of the operation of the system, the latter income should be treated as income from property (or investment income). A minimum amount of such income might be specified which would not be taxed under the system. The purpose of this exclusion would be to limit compliance and administrative costs.

11.15. The United Kingdom legislation makes an exception of income derived from the investment of compensation for personal injuries and some similar amounts. The Committee considers that a similar exception should be adopted in Australia. There should also be provisions excluding the operation of the system when the child has a disability and is resident in an institution. There may be a case for other exclusions, for example where some grave and permanent incapacity is involved calling for special care for the child. The Committee would propose a general provision giving the Commissioner a discretion to relieve income from the operation of the system where he is of opinion that to tax the income at the parent's rate would cause unreasonable hardship.

**Income from Gifts of Capital**

11.16. There are difficulties in the way of dealing with income-splitting in the area of gifts. Where one person becomes the legal owner of an asset as the result of a gift from another, that asset may be income producing, may be incapable of producing income, or may not have been producing income when given but is capable of producing income when put to
another use. Subject to such exemption or reliefs as the gift duty legislation may allow, gift duty will be payable on the capital value of the asset. Its value may be reflected in the income it produces or is capable of producing. If the subject-matter of the gift is cash, its value for gift duty purposes will be the amount given. But a gift of cash may not have effected any split of the donor's income: it may have been paid out of a credit balance in the donor's bank account. On the other hand, the donor may have sold an income-producing asset (a parcel of shares) or an asset not producing income (his own residence) or one not capable of producing income (jewellery) in order to obtain the cash to give. Ordinarily, in the latter two cases, there would again be no split of the donor's income. These are some only of the aspects of a gift when looked at in the hands of the donor and before he parts with it to a donee.

11.17. The asset when transferred into the possession and ownership of the donee may in turn be given to a third party, sold for a price above or below its value, mortgaged, exchanged, consumed, rendered non-income yielding or made to yield an income greater or less than that obtained by the donor when it was his property. The form and character of the asset may be materially changed by the labor of the donee himself or by the expenditure of his own moneys. By that expenditure the donee may have effected a reduction of his own income. It is unnecessary to list further illustrations. Enough has been said to indicate that the form, character and value of the subject-matter of the gift in the ownership of the donee in a great many instances will be markedly different to the features it exhibited in the ownership of the donor. More importantly, there is no necessary correspondence between either the income-producing qualities of the asset or the income it in fact produces in the ownership of the donor and donee.

11.18. If the donor owns a valuable work of art from which he derives only his own personal enjoyment and makes it the subject of a gift, it would not be a practical course to impute an income to the donor or the donee for the purpose of exacting an income tax from the donee, as the pleasure obtained from its ownership will vary with the personality of the owner and the use to which he puts it. In the genuine case of a gift of non-income-producing assets there is no income splitting by the donor. If the donee converts such assets into income-producing investments or sells them and invests the proceeds so as to produce an income, in either case the net income proceeds will normally be taxed in the usual way by taking into account the deductions allowable in respect of the production of that income.

11.19. The outright gift of income-producing property which confers upon the donee as its absolute owner the unfettered right to do with it as he
wishes presents problems which are difficult to resolve in a manner that is both practical and equitable. If the donor splits his income by giving to the donee an income-producing asset, its income proceeds, whilst the asset remains intact in the donee's hands in the form given to him, could be identified and taxed at a rate equal to the rate of tax that would have been payable by the donor had those proceeds been included in his assessable income. The same objective of income-splitting could be achieved if the donor were to realise an income-producing asset and give the cash proceeds, or a non-income-producing asset acquired with those proceeds, to the donee who thereupon invested the cash proceeds, or the proceeds of the realisation of the asset gifted, in an asset that produced income for him. Whatever course be pursued, the subject-matter of the gift—the asset in specie or the cash—will have borne its appropriate gift duty. Difficulties for income taxation are to be met with in each case. For example, the donee may realise the income-producing or the non-income-producing asset given to him in specie and out of the net proceeds now mixed with his own funds in his bank account may take another investment, or by his own exertions or expenditures the donee may alter the income characteristics of the asset he has retained. Similar problems can be envisaged where the gift takes the form of the cash proceeds.

11.20. In those circumstances the onus should, perhaps, rest on the donee to satisfy the Commissioner either that there is no income derived by him which is attributable to the subject-matter of the gift or that, of the income he does derive from an investment constituted in part by his own funds and in part either by the proceeds of the realisation of the asset originally given or the gift in the form of the cash proceeds, so much is attributable to the subject-matter of the gift to be taxed as if it were the income of the donor, and so much is attributable to his own labours or expenditures.

11.21. A statutory alternative would be to adopt as the income of the donee attributable to the gift an amount determined by applying a rate per cent, say a rate equal to the ruling bank overdraft rate, to the amount of the gift or to some part of it that could reasonably be regarded as producing income. This alternative would be available for adoption by the donee where he found major difficulties in determining the income actually attributable to the gift or by the Commissioner where he is not satisfied with the basis of determination of a lower figure put forward by the donee.

11.22. The view might be taken that, despite the difficulties outlined above, there should be a notional aggregation of the income, arising to a donee from capital transferred by way of gift, with the income of the donor for assessment of tax. This view could enlist greater support where the donor and donee are husband and wife, because such transfers commonly
have saving of income tax as their objective and because in practice some married couples pool their incomes for joint spending. These aspects are considered in more detail in Chapter 10 dealing with the taxing of family units.

11.23. An alternative view is that where a gift of capital has been made by one person to another, including a gift between married couples, the Revenue should be satisfied by payment of any gift duty liability; and income arising from the gift, in the hands of the donee, should be taxed to the donee in the normal way. This view is supported on the grounds of the major difficulties, to both taxpayers and the Commissioner, in satisfactorily identifying, in the hands of the donee, the capital constituting the gift and the income flowing from it, referred to earlier in paragraph 11.19. These difficulties would increase with the passing of time subsequent to the making of the gift and the need to identify further income arising from the investment of earlier income produced by the capital the subject of the gift.

11.24. The Committee, on balance, favours the latter view and accordingly recommends that income derived by a donee from capital received as a gift should in all cases be assessed to income tax in the hands of the donee in the normal manner.

Partnerships, Inter Vivos Trusts and Arrangements Achieving Similar Income-sharing Results

11.25. Under this heading the Committee considers in some detail income-sharing between relatives by means of a partnership, puts forward proposals for denial of tax advantages from income-splitting by this means, and then goes on to apply the principle of those proposals to trusts and other arrangements achieving generally similar income-sharing results. The other arrangements include those under which a business may be in the ownership of one or more persons but the operational skills, work effort and capital are supplied or in part supplied by a relative of the owner or owners in a manner which is not at arm's length; the ownership of income-producing assets is vested in one or more persons and the financing of the purchase has been by interest-free loans by a relative; and substantial property is leased to a relative, at a token rent, to enable the relative to derive the substantial rents from the sub-lessees.

11.26. In considering these income-sharing arrangements, it is necessary to have in mind that the Committee in Chapter 15 recommends a basis of assessment of income of an inter vivos trust to which no beneficiary is presently entitled. Attention here can thus be confined to the taxation treatment of income flowing from such a trust to a beneficiary in
circumstances where the beneficiary is assessable on that income. It is also necessary to have in mind the recommendation earlier in this chapter that income of unmarried minors should be assessed at a rate based on parental income, and the recommendation that income arising from assets transferred between married couples, and others, by way of gift should be taxed to the donee in the normal manner.

11.27. As in most taxation systems, the partnership in Australia, though required to make a return, is not taxed as a single entity (section 91). As set out in more detail in Chapter 15, the partners themselves are taxed in separate assessments and their assessable incomes include their individual interests in the net income of the partnership (section 92). The only measure directed against income-splitting by the use of a partnership is section 94. That section provides that a partner who does not have the real and effective control and disposal of his share of the partnership income is taxed, unless the Commissioner by reason of special circumstances is of the opinion that it would be unreasonable, at a rate of not less than 50 per cent on that share of income (section 94). For this purpose a direct or indirect share of partnership income of a taxpayer under 16 years of age, as reduced by any amount genuinely attributable to remuneration for services rendered, is uncontrolled partnership income.

11.28. The Ferguson Commission (1932-34) recommended that the administration should not be concerned with the purpose for which a partnership is formed or with the relationship of the partners. The only test to be applied ought to be whether the partnership is bona fide or fictitious, and the partnership should be regarded as bona fide if each partner is the real owner of his share of the capital and profits of the partnership. In many instances, the result in practice of such a test is that the mere production of a partnership agreement meets the test and in almost any occupation provides a partner, frequently a wife or child, regardless of qualifications and despite the performance of services of a very minor nature, with a legal entitlement to a substantial share of the partnership profits. The test propounded by the Ferguson Commission is satisfied and the partners are taxed in accordance with section 92, but the reality of the situation is that the income of the effective owner and operator of the business or profession is split.

11.29. With the greatest respect to the Ferguson Commission, the Committee is unable to agree with its recommendation. The taxation treatment of a family partnership should not depend simply on the existence of a document which, as a matter of form, satisfies the requirements of the law of partnership but which readily presents itself as a vehicle for income-splitting by distributing the profits in arbitrarily
determined proportions to relatives whose services (if any) in the partnership activities and/or whose capital or property contributions are not commensurate with the remuneration or share of profits received. The privacy attaching to an inter-familial contract is of itself sufficient to cast an onus upon relatives of displacing the possibility that the transaction they have entered upon is the product of a tax avoidance scheme. This is in keeping with the well-established principle that, where the relevant facts are solely within the keeping of one party, very little is required to change the onus relating to their disclosure. The fact that the partnership comprises family members requires that disclosure. The Commissioner is entitled to be made aware of the whole of the facts surrounding the formation of the partnership.

11.30. The whole of these facts are not necessarily established by the partnership agreement itself. Also relevant are the facts relating to the operation and control of the business, the manner in which its capital and property have been provided, and the relationship between the services performed and the capital and property provided by each of the partners and the remuneration each receives by way of salary and profit-sharing. Neither section 161 (1) of the Act nor Regulations 13 and 14 are sufficient in this regard. The Commissioner should be supplied, in a form accompanying the return of partnership income for the relevant year, with the appropriate information to enable him to be satisfied that the partnership is bona fide and that the individual interests of each partner in the partnership income, when measured in relation to his business or professional activities in the partnership and his provision of capital and property, are such as would reasonably be determined upon in all the circumstances by parties acting at arm's length. If the Commissioner was not so satisfied as to the share of any partner or some part thereof, that share or that part of the share should be taxed at a deterrent rate. Where an assessment was objected to, the issue for determination on appeal would not simply be, as it is at present, whether a partnership existed but whether the distribution of its income to each of its members was genuinely commensurate with their contributions of capital and property and their services to the partnership or whether the partnership agreement was merely a cloak for tax avoidance. The bona fide partnership would have no difficulty in resolving this issue in its favour. However, if the reality of the situation were otherwise, it should be apparent that the partners would be faced with the difficulty of proving the truth of the statements accompanying the return of income as to their respective roles and activities and their provision of capital and property in order to discharge the onus that lies upon them to displace the assessment. For this purpose
the provision of capital and property to a partnership would not only include funds and assets overtly contributed as partnership capital. It would also extend to property, including loan moneys made available for use in the partnership business without recompense or on favourable terms, and any other benefit given or granted to the partnership by one or more partners but not by all partners according to their shares, such as land, livestock, plant, goodwill, etc. owned by one partner but used by the partnership without realistic recompense.

11.31. The determination of the amount of any share of partnership income to be taxed at a deterrent rate in accordance with what is set out above should also apply as the base figure for determining any liability to gift duty. Paragraphs 24.A54-24.A64 and 24.A67 deal with these questions for gift duty purposes. Thus, where in an equal partnership between a husband and his wife deriving income of $15,000 the Commissioner determines that $5,000 of the $7,500 allocated share of the wife is to be subject to a deterrent rate, that figure of $5,000 would be the base figure for gift duty purposes. As stated in paragraph 24.A105, that amount less the income tax payable on it would be treated as a gift.

11.32. Inter vivos trusts—trusts created by the creator or settlor of the trust during his lifetime—are frequently resorted to by a taxpayer to bring about a sharing of income with those of his relatives who are beneficiaries. In fact it is true to say that an inter vivos trust, where the income of the trust is distributed to the beneficiaries and becomes assessable to tax in their hands, can achieve the same purpose and result as the family partnership considered above. In the view of the Committee, distributions of income from trusts of this kind should be accorded the same tax treatment as distributions from family partnerships. Thus the Commissioner would be required to examine the whole of the facts surrounding the setting up of the trust and its operation and control. This examination would disclose whether the shares of income as allocated to beneficiaries, when measured in relation to their beneficial interest in capital and property of the trust and their business and/or professional contributions to the production of the trust income, are such as would reasonably be determined upon in all the circumstances by parties acting at arm's length. To the extent that the Commissioner could not be so satisfied, income or a part of income distributed would be subject to a deterrent rate of tax.

11.33. In relation to the other arrangements achieving income-sharing mentioned in paragraph 11.25, the Committee recommends the same treatment as for partnerships and inter vivos trusts. Thus, in the case of a business owned by one person and conducted and financed by a relative,
including a spouse, the Commissioner would be enabled, in effect, to treat the business as a partnership between the relatives involved. Where the incomes derived by each relative could not be supported on the arm's length tests set out previously, the deterrent rate of assessment would apply. The same results would follow where the ownership of assets or property and certain leasing arrangements have been established and operated on bases not in accord with the arm's length test.

**Excessive Payments for Services or Benefits**

11.34. A common method of income-splitting is the payment by one relative to another of sums for services rendered or in respect of some benefit received and the amount of the payment exceeds what would normally, in an arm's length transaction, be expected to be paid for those services or that benefit. Payments of this kind are encountered in the relationship of employer and employee, hire of equipment, rent of premises and interest on money lent. Partnerships and private companies are areas frequently used for this purpose. The relationship of the person performing the services or affording the benefit to the person making the payment would, if the quantum of the payment were reasonably commensurate with the nature of the services or benefit, be an irrelevant consideration and the payment would be an allowable deduction under section 51 of the Act as an outgoing in gaining or producing the assessable income of the relative making the payment. Section 65 of the Act provides that a payment to an ‘associated person’ or a liability incurred to make such a payment shall be allowable as a deduction only to the extent to which, in the opinion of the Commissioner, it is reasonable. Section 65, broadly speaking, defines an ‘associated person’ as including relatives (as defined in section 6 (1)) of a taxpayer, partnerships in which relatives are involved, and relatives of partners in a partnership making a payment, as well as members of a company and beneficiaries in a trust, and relatives of these people, where a company or a trust is a partner. Provisions are included in the section to cover the position of the recipient of a disallowed payment and also to cover an amount not allowable as a deduction in a partnership in which a private company is a partner. These are of some unavoidable complexity.

11.35. Section 109 of the Act is designed to prevent income-splitting by a private company where excessive payments are made or credited to persons who are or have been its shareholders or directors or their relatives for services rendered or by way of an allowance, gratuity or compensation upon retirement from or termination of office or employment. The amount allowable as a deduction shall not exceed an amount which, in the opinion
of the Commissioner, is reasonable.

11.36. The Committee is of the opinion that the principles of sections 65 and 109 are to be supported but that, as they now stand, these sections are not sufficiently wide in their coverage. There are basically four types of taxation entities that need to be considered in the context of income-splitting by the means envisaged in sections 65 and 109: an individual taxpayer, a partnership, a trust estate and a private company. The Committee recommends that the principles of sections 65 and 109 should apply to all payments flowing from any one of these entities to another entity in such circumstances that the payment, or part of the payment, can ensure directly or indirectly for the benefit of the payer or a member or director of the payer or for the benefit of a relative of such a payer or member or director of a payer. For this purpose a settlor or deemed settlor and a beneficiary of a trust estate are to be included in the term ‘member’ in relation to a trust estate of which they are a settlor, deemed settlor or beneficiary.

**Alienation of Income**

11.37. Alienation of income for short periods is dealt with in Division 6A of Part III of the Act. Generally speaking, a taxpayer is legally entitled to transfer to another, through an inter vivos transaction, the right to receive income from assets owned by the taxpayer without transferring the property in those assets to that other person. Where a taxpayer makes such a transfer for a period of less than seven years, by section 102B, the income transferred will be included in his assessable income from other sources. Sections 434 to 436 of the United Kingdom Income and Corporation Taxes Act 1970 contain provisions with the same objective as Division 6A of the Act, but the period is six years in place of seven. Where family income-splitting is to be prohibited, there appears to be no reason why a much longer period could not be selected—indeed, any period which by the form of the alienation did not transgress the provisions of the general law.

**Family Companies**

11.38. The private company when it is controlled by relatives is one of the most fruitful fields for income-splitting. For the purposes of the Act, a private company is defined as a company that is not a public company (see sections 6 (1), 103A), and it is the company that falls into one of the various categories set forth in the statute which for income taxation
purposes constitutes a public company. Not every company classified for income taxation purposes as a private company is used as a medium for tax avoidance. The private company of the ‘family company’ kind is the usual vehicle employed to attain that objective. Private companies that are not family companies may attract the provisions of section 109 (see paragraphs 11.35–11.36 above), but most frequently it is the private company controlled by relatives in which income-splitting is practised. A family company, in the present context, is a private company controlled directly or indirectly by relatives either by means of a preponderance of its shares or the voting rights attached to them or to classes of them or by means of any other rights conferred by the Articles of Association, whether the person to exercise those rights be a shareholder or simply the holder of some office in the company, or by agreement or covenant. The number of relatives who possess that control is irrelevant: the relevant fact is the control.

11.39. One type of transaction which may constitute an income-splitting device by means of a family company can be seen in the acquisition of shares by a relative of the family which (i) entitle the holder to a share in the distribution of the company’s profits disproportionate to the amount of capital subscribed by him, or (ii) enable those in control of the company to declare dividends in respect of his shares without distributing dividends to other shareholders, or (iii) enable those in control to declare differential dividends to selected shareholders. By these means it becomes possible to regulate the income levels of the various relatives associated with the company in addition to those activities struck at by section 109. It is not necessary, of course, for shareholders in a family company to subscribe substantial sums by way of capital in order to be capable of exercising the contemplated control or to be in a position to benefit from its exercise. It is not uncommon for the proprietor of a prosperous unincorporated business to sell his business to a family company in exchange for shares of a class which, however numerous they may be, will not necessarily return to their owner a share of the company's profits bearing any realistic relation to the amount of capital represented by them. The bulk of the profits will be divided amongst relatives whose shareholdings are nominal, so that the moneys required to take up those shares can be provided by them out of their own funds or by some friend of the family. The variations in the schemes that have been adopted to secure the income-splitting objective are multiple and further description of them would serve no useful purpose. But they all have one characteristic feature. The transactions carried out between the relatives themselves and between them and the company, in conjunction with the structure of the company itself, constitute a ‘settlement’ or an ‘arrangement’ of their affairs which it would be
impossible to say that business people acting at arm’s length in the investment of their own funds and contemplating for that purpose a bona fide commercial transaction would enter upon.

11.40. Apart from definitions of the word for some special statutory purpose, generally speaking a ‘settlement’ may be said to be created by or consist of any transaction operating or contributing to effect a disposition of property, whether real or personal, by means of one or a number of instruments with the intention that the property, whatever its form, may be enjoyed by others. Where other persons join in the transaction at some point in order to benefit or to be capable of benefiting from the property, either in pursuance of some legally enforceable agreement or of some informal understanding with others (including a family company) engaged in the transaction the scheme regarded as a whole may be termed an ‘arrangement’ whereby the income to be derived from the property can be parcelled out amongst those designed to be its putative beneficiaries.

11.41. In the Committee's view, income-splitting by means of settlements or arrangements of this nature effected through the medium of family companies should be prevented. Where the Commissioner is of the opinion that any such settlement or arrangement was effected by means and created rights or obligations that business people acting at arm's length in a bona fide commercial transaction of that nature would not be likely to adopt, he should be enabled at his discretion to tax the dividend income paid or credited to any shareholder at a deterrent rate: for example, at a rate that would have been payable had such shareholder been paid or credited with all the profits distributed by way of dividend in the relevant year of income. Gift duty could also be involved in these cases. The amount determined as subject to the deterrent income tax rate would be the base for the levy of gift duty (see paragraphs 24.A70–24.A90).

Section 260

11.42. The parent of section 260 appears to be section 82 of the New Zealand Land and Income Tax Assessment Act 1900 which, apart from the addition in 1936 to the Australian section of the words ‘as against the Commissioner’ and certain other immaterial differences in wording, is the pattern of the Australian section. The counterpart of section 260 was section 108 of the New Zealand Land and Income Tax Act 1954 as amended by section 16 of the Land and Income Tax Amendment (No. 2) Act 1968. The New Zealand section 108 has been recently repealed and replaced by a section in very wide-reaching terms but is itself now intended to be the subject of further amendment. The present New Zealand
section 108 would be susceptible to the type of criticism referred to in paragraph 11.5. Although in a shortened form to section 260, both that section and the former New Zealand section 108 have the same objective and both have been the subject of considerable judicial criticism and frequent differences of judicial opinion as to their application. As with the New Zealand section, the Revenue has endeavoured to apply section 260, sometimes successfully and sometimes unsuccessfully, to transactions where it has been contended that the feature of income-splitting is involved. The section has been interpreted as meaning that not every transaction having as one of its ingredients some tax-saving feature is caught by its provisions and that, if a bona fide business transaction can be carried through in one of two ways, one involving less liability to tax than the other, the section is not to be applied merely because the way involving less tax is chosen. For the section to have an application, it has been held, it must be able to be shown that it was implemented in that particular way so as to avoid tax; if the transaction is capable of explanation as an ordinary business or family dealing without necessarily being labelled as a means of avoiding tax, the section cannot be applied to the transaction. If tax avoidance is an inessential or incidental feature of the arrangements that may well serve to indicate that the arrangement cannot necessarily be described as a means of avoiding tax (see the various observations collected in Hollyock's Case).  

11.43. It cannot be denied that this test for the section's operation lacks precision and that in many instances there will be strongly opposing points of view as to the necessity of applying the label. Further, as it has been held that section 260 is an annihilating provision—that it operates to destroy but not to supply and contains no power to rectify a transaction or to substitute something new in its place—the consequences which may follow from its application also create many difficulties. A number of these problems are referred to in the dissenting judgments of Lord Donovan in Peate's Case and Mangin's Case. The section provides ample room for uncertainty and for dissatisfaction on the part of the Revenue and the taxpayer alike and has been said to be long overdue for reform.

11.44. The Committee is of the opinion that the criticisms of section 260 to which reference has been made should be heeded and the section be amended to reflect the following principles. If any arrangement had or was calculated to result directly or indirectly in the type of tax advantage described in the lettered sub-clauses of the section, the Commissioner should have the right to disregard it for taxation purposes, unless the arrangement was an ordinary business transaction creating rights or obligations that would normally be created between business people.
dealing at arm's length in a transaction of the nature in question and
effected by means normally employed in such a transaction, or was made
in the ordinary course of making or changing an investment, or was a bona
fide arrangement of a person's or a family's affairs, and the Commissioner
was satisfied that the arrangement was not entered into solely or primarily
for the purpose of obtaining the tax advantage or that one of its main
objectives was to obtain the tax advantage. If the Commissioner did
disregard the transaction, he should be empowered to assess any person
deriving income under or consequent upon the arrangement to income tax
at a deterrent rate: for example, at a rate equal to the maximum marginal
rate or at a rate declared by Parliament for the purposes of the section.
Where the Commissioner acted upon this section, he should supply any
persons affected with his reasons for doing so. It should be made possible
to obtain the Commissioner's ruling upon proposals for any such
arrangement in order to prevent a transaction being irrevocably entered into
with the consequences, amongst others, of expensive litigation. For this
purpose the system of advance rulings by the Commissioner, proposed by
the Committee in Chapter 22, would be available to taxpayers and their
advisers.

Distributions of Income under a Legal Obligation

11.45. A husband has an obligation imposed under the general law to
maintain his wife, and a father has a similar obligation in respect of his
infant children. Such obligations are presently the subject of certain relief
in the nature of concessional deductions from assessable income (see
section 82B) and are discussed elsewhere in this report. No question of
income-splitting arises in connection with payments made in discharge of
these obligations. In certain circumstances a husband may transfer a right
to receive income from property or income-producing property itself to his
wife or to his former wife pursuant to the order of a Court, in which case
the income would be taxable in the hands of the wife and would not be
exempt income under section 23 (1). Section 102B (4) exempts the transfer
by a husband or former husband of a right to receive income from property
for the purpose of alimony or maintenance from the alienation of income
provisions of section 102B, whether made in compliance with a Court
order or not, and the income in question is not taxable as income of the
husband. The Committee is of the opinion that, where the right to receive
income or income-producing property is, by virtue of a Court order,
transferred to a wife or former wife or to the children or to a trustee for her
or the children, by the husband or father, the measures against income-
splitting in this chapter should not apply.

**Distributions of Income under a Moral Obligation**

11.46. Distributions of income under a moral obligation fall into two classes. Firstly, there are cases in which, without the intervention of a Court, the impact of a strong moral obligation will induce a person to make some enduring provision for a relative by the creation of a trust of some part of his income-producing property or by some kindred means. It is impossible to catalogue all the types of instances where particular circumstances may raise the need for the implementation of a transaction of this nature. It will for the present suffice to be reminded of those cases in which grave and permanent incapacity calls for some special institutional care upon a stable income basis. In the Committee's view, the Commissioner should have a discretion to relieve transactions of this class from the provisions of the Act which otherwise would be attracted to them where he is of the opinion that to impose them would create unreasonable hardship. Secondly, there are the transfers of income-producing property to charitable institutions. Such transfers to selected charitable institutions should not be categorised as income-splitting.

**Retrospectivity**

11.47. The provisions that have been suggested to overcome the problems for the Revenue of income-splitting have, of necessity, a wide application. If they are adopted, the consequences of their infringement will be, in many cases, to impose a heavy burden of taxation upon those who fall within their purview. For a long period of years there has been no legislation in the Australian taxation system comparable to what is now being proposed. Accordingly, taxpayers have been lawfully enabled and entitled to order their affairs so that the tax for which they become liable was less than it otherwise would have been. The arrangements they made and the documents they executed breached no provision of the law. A great many of these transactions have been long acted upon and the rights and obligations of third parties, who were not the instigators of these schemes, have been regulated and affected by them, and it would not be unreasonable to suppose that in a great many cases what has been done is irrevocable.

11.48. There is a well-established, fundamental and sound principle that legislation, especially fiscal legislation, should not have a retrospective operation. That which was lawfully done should not, after the completion
of the act by which it was done, be made unlawful and subjected to a penalty. There is a strong presumption against retrospectivity because it manifestly shocks one's sense of justice.\(^1\) It is, for example, because of this principle that section 437 (2) of the United Kingdom Income and Corporation Taxes Act 1970 is framed not to affect an irrevocable settlement made before 22 April 1936, which was the date when section 21 of the Finance Act 1936 came into operation and introduced for the first time provisions similar to those now appearing in the current legislation. In the opinion of the Committee, it will be proper, therefore, to safeguard any legislation that may be introduced on the lines discussed in this chapter from the vice of retrospectivity penalising any bona fide transaction where the rights and obligations of the parties are involved irrevocable.

**Reservation to Chapter 11: Income-Splitting**

**R. W. Parsons**

My reservations relate, in the first place, to the chapter's explanation of the principle that measures directed against transfers of income should serve. The descriptions given in the chapter of unacceptable ‘income-splitting’ transactions fail to identify any such principle except a notion that a course of action is ‘tax avoidance’, and therefore unacceptable, if it is undertaken solely or primarily for the purpose of reducing income tax liability. In my view such a notion is not a satisfactory explanation nor, where it is adopted as such, is it a workable test of the operation of measures intended to deal with transfers of income.

It is true that this notion is at the basis of the interpretation of section 260 of the Act. But, in that context, it has led to the development of a question-begging distinction between cases where a taxpayer is said to have a ‘choice’ to pursue a course of action which will reduce his tax and cases where he has not. And the drawing of an inference of purpose to reduce tax is unpredictable. A gift of property by a husband to his wife is as much open to the construction that he has moved by love for her as it is open to the construction that it was done to reduce tax on the income produced by the property given.

A principle requiring the defeat of a transfer of income to a person, most likely a spouse, who may be expected to share the enjoyment of the income with the transferor may have some merit as the basis of measures directed against transfers of income, though the appropriate measures would, of course, have a significantly narrower operation than those proposed by the Committee. This principle might be seen as some expression of the
philosophy of family unit taxation discussed in Chapter 10. It would be said that the transferor's ability to pay tax should be determined not only by reference to income he himself has derived, but also by reference to income derived by others who may be expected to share that income with him. The income transferred should be taxed to him or taxed at a rate determined by reference to his income.

Clearly the expression given to the family unit philosophy by the principle would be very limited. That philosophy assumes that the ability of an individual to pay tax should reflect not only the benefits he may expect from the expenditure of income by others, but also the benefits he confers on others by sharing his income with them. It requires an aggregation of the incomes of those who share expenditures, and the taxing of that aggregated income at a rate which reflects the fact that the aggregated income supports more than one individual. And the principle would apply only when the shared income had been the subject of transfer. The principle cannot give effect to the philosophy where the shared income enjoyed by one spouse is income derived from property which the other has inherited from a third party.

Moreover, there are very significant practical limitations on how far measures giving effect to the principle can go. Any attempt, otherwise than by the most arbitrary rules, to identify as income transferred income which flows from the investment of money transferred or from property transferred is clearly an impossible undertaking. There may have been movements of money and other property, sometimes in both directions, between husband and wife over a period of years and dealings with that money or other property.

The imperfections and inadequacies of measures against transfers of income as an expression of family unit philosophy suggest that what is really called for is the explicit application of family unit taxation. The Committee has rejected compulsory family unit taxation. I appreciate that it is unlikely to be politically acceptable, though those who would reject it on the ground that it denigrates the status of women curiously assert, at the same time, that a widow should be treated as having been an equal partner in the acquisition of assets which her husband owned at his death. An elective system of family unit taxation could not, however, be said to denigrate the status of women, and it ought to be politically feasible. It should not be too costly to Revenue, nor would it be unfair to unmarried individuals, if the rate structure were carefully framed to offer a limited advantage, over a lifetime, to most married couples, compared with the lifetime operation of individual unit taxation.

An elective system of family unit taxation would not make measures
against transfers of income between husband and wife wholly inappropriate, but it would then be possible to give a satisfactory explanation of the limited measures which practical considerations would allow. Husband and wife who did not elect would be taken to have asserted that family unit philosophy had no application to them because the financial affairs of each were wholly separate from the other's. Transfers of current income made without consideration between husband and wife contradict the assertion of separateness and those who have not elected family unit taxation should not be allowed by such transfers to gain a tax advantage over those who have. The possible tax advantage that they could gain would, in any event, be significantly less than they could gain under an exclusively individual unit system. Put in another way, elective family unit taxation gives some of the advantages to be gained by transfers of income but gives it to all those who elect, whether or not there are techniques of transfer of income open to them.

I accept that, so long as family unit taxation is not applied, or is not available on an elective basis, what can be done should be done to prevent an individual gaining a tax advantage by transferring income in whose enjoyment he continues to share. The opportunities to transfer income which property law and the tests of derivation in tax law afford are unevenly distributed between taxpayers. They are readily available to taxpayers in business and to taxpayers who have substantial property incomes but not to wage and salary earners. Nonetheless, my acceptance of measures to defeat transfers is tempered by the fact that the divisions of income between husband and wife which occur as a result of the good fortune of inheritance or gifts from third parties continue to give tax advantages. It is tempered too by the fact that defeat of the principal technique of transfer of income—outright gift of capital—is beyond the limits of effective legal action.

Having regard to my understanding of their function and what I consider to be administratively feasible, the measures against transfers of income which I think appropriate will have a narrower operation than those proposed by the Committee. The measures would be limited to transfers of income between husband and wife. There are other cases, it is true, where a person who transfers income may be expected to share in the expenditure of the income transferred: a son may transfer income to his aged parent who lives with him. But these other cases are not a serious threat to the equity of the tax system. The measures would not attempt to deal with the income flowing from the investment of money or from other property which has been the subject of an outright transfer. The problems involved are quite unmanageable even if the attempt is confined to income flowing
from capital transfers. And there is no reason in logic why the attempt should not extend to income flowing from the investment of income currently transferred, for example, through a partnership.

The measures should be limited to transfers of income made without full consideration. Where full consideration is given for a transfer there will be an offsetting transfer of income which cannot fairly be ignored, though, in the interests of administrative feasibility, an offsetting transfer involved in a less than full consideration will have to be ignored. Division 6A of Part III, referred to in paragraph 11.37, in its present terms, applies to transfers of income whether or not consideration has been given. I think that its operation should be qualified so that it applies only when there is a transfer for less than full consideration. I would, in any case, limit its operation to transfers of income between husband and wife. The principle expressed in Division 6A is not easily discovered. It applies notwithstanding that there has been a transfer for full consideration, whether or not the transfer was between persons who share the enjoyment of income and whatever might be thought to have been the purpose of the transfer.

I have a number of reservations in regard to the detail of the measures proposed by the Committee. The proposals are not fully integrated, as I think they should be, with the proposals in Appendix A to Chapter 24 as to the operation of gift duty in relation to gifts of income. The references to taxing income transferred at ‘a deterrent rate’, for example in paragraph 11.30, seem to me to be inappropriate. The income transferred should either be taxed to the transferor as if it were his income, or, preferably, be taxed to the transferee at a rate determined by reference to a notional addition to the income of the transferor.

The assumption in paragraphs 11.34–11.36 that sections 65 and 109 are designed to prevent ‘income-splitting’ seems to me to be open to question. While they will in some circumstances defeat transfers of income, their basic purpose is to deny deductions in respect of payments which are not in fact made in the deriving of income. Without such measures tax might be imposed on an amount less than the true net income of a business and, to this extent, income might escape tax altogether. I agree that there is need for such measures and that they should have a wider operation than they have at present.

The proposals made in paragraphs 11.42–11.44 in regard to section 260 do not have my support. I do not agree that they will overcome the uncertainty and dissatisfaction associated with the operation of the section. The proposed express exclusions of ordinary business transactions and bona fide arrangements of a family's affairs have already been written into the section by judicial interpretation. And the Commissioner's proposed
powers to tax any person deriving income consequent upon the arrangement at ‘a deterrent rate’, are too wide. In any case it is my view that section 260 has no place in the Act. Any general provision directed against courses of action described only as ‘tax avoidance’ involves an abdication of Parliament's responsibility to formulate and inform the taxpayer of the principles intended to be expressed in the tax law.

I concur in the proposal to tax the unearned income of a minor child at a rate determined by reference to his parent's incomes. I think it should be made explicit that this is an adoption of the philosophy of family unit taxation. The child's ability to pay tax on his income reflects the fact that he shares in the expenditure of the income of those on whom he is dependent for support. However, as an expression of that philosophy, the proposal in paragraph 11.9, in my opinion, goes too far. It is not appropriate to tax the income of a minor child at a rate which takes account not only of the incomes of his parents but also the incomes of other minor children of the same parents.

R. W. Parsons

Reservation to Chapter 11: Income Splitting

K. Wood

While I am in full agreement with the need to strengthen the income tax law to reduce the loss of revenue from income splitting, I have a number of reservations on the proposals set out in Chapter 11.

I concur with the view of Professor Parsons that the proposals in this chapter are not adequately integrated with the proposals in appendix A to Chapter 24 as to the operation of gift duty in relation to gifts of income. As paragraph 11.1 states, income splitting devices invariably involve the distribution of income to a person who has not provided an adequate consideration for the amount received. The appendix to Chapter 24 contains detailed procedures for identifying and quantifying gifts of this type together with proposals that such gifts should be brought within the ambit of the proposed integrated estate and gift duty. The principal objective of Chapter 11 should be to suggest clear and certain provisions for the method to be followed in taxing income which has been identified as a gift by the operation of provisions which match those proposed in relation to the estate and gift duty.

I support the proposal in paragraph 11.9 that the unearned income of a minor child should be taxed at a rate determined by reference to his parents’ income. However I concur with the reservation of Professor
Parsons that it is not appropriate to tax such income of a minor child at a rate which takes to account not only the income of his parents but also the incomes of other minor children of the same parents.

I do not support the proposal made in various paragraphs of the chapter, that income identified as having been unreasonably diverted to others should be taxed at ‘a deterrent rate’. I concur with the view expressed by Professor Parsons that it is only income diverted to a spouse which need be subject to special taxing measures. In these cases, the tax payable should be such as would have been paid had the income in fact been received by the spouse who has made or is deemed to have made the gift. In cases of other than minor children and a spouse the diverted income should be taxed in the normal way and the sole deterrent to income splitting procedures should be the imposition of gift duty as proposed in Chapter 24.

I reject as impracticable the proposal in paragraph 11.32 that the allocation of income between the beneficiaries of a trust, other than a trust established by will, should fall to be reviewed by the Commissioner in the same way as is proposed in the chapter in respect of allocations of income by a family partnership. The tests proposed in paragraph 11.32 that the Commissioner should apply, such as beneficial interest in capital and property of the trust, business and professional contributions to the production of trust income and the arm's length concept have no place in a review of the distribution of trust income made by a trustee in accordance with the provisions of the trust document, particularly in the case of a discretionary trust. There may well be grounds for empowering the Commissioner to identify partnership income or income of a company flowing through a trust to a spouse to determine tax payable on this income but such a provision should be limited to these instances only. The Committee's proposals in relation to taxing of income of minor children, the imposition of tax at maximum marginal rates on income accumulated by a trustee and the widening of the base of estate and gift duty should adequately protect the Revenue in cases where trusts are used to spread or divert income.

Finally, I do not support the proposed amendment to section 260 of the Act as proposed in paragraph 11.44. I believe it will increase the present uncertainty of the application of this section and is contrary to the Committee's view expressed in paragraph 11.5 of the chapter. I make no suggestion as to the action which should be taken to heed criticisms of this section of the Act as no acceptable proposal, in my view, has emerged from the Committee's researches and discussions in this area.

K. Wood
1 Reservations to conclusions reached in this chapter are appended.


1. *Young v. Adams* (1898) A.C. 469 at p. 476; *Comm. of Stamps (Q)* v. Wienholt 29 C.L.R. 531.
Chapter 12 Personal Income Tax: Dependant Allowances and Other Concessional Deductions

12.1 Fairness between persons who differ from one another in the level of their income involves questions of rate structure to be examined in Chapter 14. Fairness between persons who differ from one another in other relevant respects has to be achieved by alternative means, the chief of which might be concessional deductions as is the case today. Statistical information about the size and composition of these concessional deductions, for the income year 1971–72, is summarised in Table 12.A.

**TABLE 12.A: DEDUCTIONS ALLOWED BY RANGE OF NET INCOME, 1971–72**

<table>
<thead>
<tr>
<th>Income range</th>
<th>Proportion of taxpayers</th>
<th>Average deduction claimed for</th>
<th>Medical and hospital benefits</th>
<th>Net medical (a)</th>
<th>Rates and land taxes (b)</th>
<th>Life and superannuation payments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Per cent</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>$417–1,999</td>
<td>21.9</td>
<td>1,255</td>
<td>23</td>
<td>15</td>
<td>28</td>
<td>7</td>
</tr>
<tr>
<td>2,000–2,999</td>
<td>18.0</td>
<td>2,506</td>
<td>77</td>
<td>30</td>
<td>54</td>
<td>20</td>
</tr>
<tr>
<td>3,000–3,999</td>
<td>18.6</td>
<td>3,493</td>
<td>174</td>
<td>47</td>
<td>76</td>
<td>41</td>
</tr>
<tr>
<td>4,000–5,999</td>
<td>25.9</td>
<td>4,858</td>
<td>302</td>
<td>69</td>
<td>105</td>
<td>74</td>
</tr>
<tr>
<td>6,000–9,999</td>
<td>12.6</td>
<td>7,338</td>
<td>384</td>
<td>81</td>
<td>135</td>
<td>107</td>
</tr>
<tr>
<td>10,000–19,999</td>
<td>2.7</td>
<td>12,797</td>
<td>365</td>
<td>86</td>
<td>183</td>
<td>168</td>
</tr>
<tr>
<td>20,000+</td>
<td>0.4</td>
<td>29,379</td>
<td>290</td>
<td>88</td>
<td>289</td>
<td>302</td>
</tr>
</tbody>
</table>

(a) Gross medical, chemist, dental, optical, funeral expenses, etc., less amounts paid or payable by a government, public authority, society,
association or fund.

(b) It should be noted that subsequent to 1971–72, the year shown in the table, a ceiling of $300 has been placed on the deduction for rates and land taxes, and the ceiling on deduction for education expenses has been reduced from $400 to $150.

(c) Including gifts to charities.

(d) The total deduction claimed in 1971–72 amounted to $3,886 million, out of a total net personal income of
12.2. It is convenient to discuss first the concessions of most universal significance, those for dependants, before turning in Section II to some of the basic issues raised by the whole system of deductions. In Section III attention is focused on deductions for education and medical expenses, and in Section IV on zone allowances.

I. Concessional Deductions: Dependents

12.3. At present, under section 82B of the Income Tax Assessment Act there is a deduction of $364 for a dependent spouse, which is rapidly reduced when the spouse has income of her (or his) own. There are two criticisms of the concession: the first that a poor man's wife is worth less

$22,827
million. Of the amount claimed, 28 per cent was for dependants; 24 per cent for life insurance and superannuation; 12 per cent for net medical expenses; 8 per cent for education; 7 per cent for medical and hospital benefits funds payments; and 7 per cent for rates and land taxes.

Source:
Taxation Statistics 1972–73

12.2. It is convenient to discuss first the concessions of most universal significance, those for dependants, before turning in Section II to some of the basic issues raised by the whole system of deductions. In Section III attention is focused on deductions for education and medical expenses, and in Section IV on zone allowances.

I. Concessional Deductions: Dependents

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than a rich man's, the second that the concession is in any case too modest.

12.4. One view of the spouse deduction would be that at least a basic minimum which one spouse might be expected to spend on the other who is dependent on him should not be taxed. This points to a deduction approach to the concession. However, in lower income ranges, where the marginal rate of tax is less, the tax saving from a deduction is correspondingly smaller. It is questionable whether the effective assistance should be so unequally distributed, and should be least where it will be of most, if never great, real assistance. The Committee suggests that consideration be given to converting the present deduction to a tax rebate diminishing in relation to the income of the spouse. (By rebate in this context is meant an amount subtracted from tax otherwise payable.) The 1974–75 Budget has taken a step in this direction. As explained in paragraph 6.57, the deduction has, in effect, been converted to a rebate for taxpayers with marginal rates below 40 per cent.

12.5. The second criticism, that the concession is too modest, is sometimes expressed by saying that the reduction in tax liability to which it gives rise is far below the total ‘cost’ of the dependent spouse to the income earner. However, such cost considerations do not appear to lie behind the concession, which has never amounted to much more than a token recognition that husbands have a moral and legal duty to support their wives, when dependent, and wives a similar duty when husbands have no income.

12.6. Nonetheless, even as a token recognition the real value of the concession has declined significantly in recent years in the face of rapid inflation, a situation to which attention was drawn in Chapter 6. And while the measures taken in the 1974–75 Budget have gone some way towards restoring the value of the concession for low-income earners, a strong case can undoubtedly be made for increasing the value of the concession more generally. In the Committee's view, a tax rebate of, say, $300 may not be inappropriate: this compares with a tax saving, under the present concession, ranging from $146 for a person paying marginal rates of 40 per cent or less to $244 for somebody in the top tax bracket. The rebate could be phased out by one dollar for every three dollars of income of the spouse over $130. It would thus disappear at $1,030, just below the present minimum taxable income.

12.7. Under the administration of the existing law, a husband whose wife works and earns income, of whatever amount, during part of a year may still claim a pro rata deduction on the basis that his wife was a dependant without income for the remainder of the year. This produces anomalies where the wife works, perhaps only part time, over the whole year, and
also where the wife derives property income (which is treated as being referable to the whole year). In these instances there is unlikely to be any allowance of a deduction even though the income of the wife for the year is less than the income of the wife who works for only part of the year.

12.8. Such anomalies will be largely overcome, in the Committee's view, if contribution to the maintenance of the spouse at any time during the year is treated as sufficient to justify a concession, and it is provided that the income of the spouse which may go to diminish the concession is any income derived during the year. Where the marriage subsists for only part of the year there should be a proportionate concession allowable, diminished by reference to income derived during the period of marriage. The income affecting the concession in this case would be the excess over the appropriate fraction of $130.

12.9. Were the option of family unit taxation available, there would not be any need for a tax rebate for a dependent spouse. The rebate would in effect be absorbed in the fixing of the rate scale.

12.10. It is also to be noted that if and when income tax were reduced or even eliminated for low incomes, a tax rebate would cease to be of help. It would then be necessary to consider whether the rebate ought to be converted into a taxable grant.

12.11. The Act provides, in section 82B, for a group of concessional deductions that would appear to express the same policy as the concessional deduction for a dependent spouse: they are a recognition of what is at least a moral duty to give support to another adult. A concessional deduction is available when the taxpayer contributes to the maintenance of:

(a) a daughter-housekeeper, wholly engaged in keeping house for a taxpayer who is a widower or widow;
(b) a parent of the taxpayer or of his spouse;
(c) an invalid child, brother or sister of the taxpayer, who is over 16 years of age and in receipt of an invalid pension or certified to be permanently incapacitated for work.

The amount of the deduction in all cases diminishes where the dependant has income. The maximum deduction is $364 except in case (c) when, curiously, it is only $260. In the Committee's view these concessions should be retained; but in line with its recommendations in regard to the dependent spouse deduction, they should be converted to tax rebates.

12.12. Another concessional deduction is allowed, under section 82D, where a housekeeper is wholly engaged in keeping house for the taxpayer and in caring for his child, invalid wife or other invalid relative (see
paragraph 7.67). The availability of the deduction does not depend on contribution to the maintenance of the housekeeper and is not diminished by reference to the income of the housekeeper. The amount of the deduction is $364. Normally, the housekeeper deduction is not available where the taxpayer is married, except where the spouse is an invalid and the housekeeper cares for her. The correlation of this deduction with the concession in respect of child-minding expenses proposed by the Committee was considered in paragraphs 7.66–7.75. While the dependant deduction for spouse recognises the obligation to support a spouse and the dependant deductions referred to in paragraph 12.11 recognise the obligation to support other adult persons, section 82D's policy is more difficult to express. It would seem to recognise that the taxpayer has been put to special expense because he does not have the services of a wife to assist him in meeting his legal or moral obligations to support others or because he has been put to special expense in meeting his legal or moral obligations to his invalid wife. In either case, however, the support necessary is something more than financial. In the Committee's view the concession should be retained but be converted into a tax rebate. There should also be some modification of the requirement that the housekeeper be ‘wholly’ engaged in keeping house to make the requirement less rigid. The Committee understands that the practice of the Commissioner is to allow the concession in circumstances that may not strictly satisfy the test.

12.13. Section 82B allows deductions for dependent children under 16 years of age. The deduction is $260 for the first such child and $208 for others. The deduction is diminished dollar for dollar by the child's income over $130. The solution of the equity problem created by the existence of dependent children is complicated, as it is for all the other needs now partially met by tax deductions, by the presence of non-tax devices serving similar ends. In this case there is only one other general aid—child endowment payments through the social service system. One curious difference is noteworthy: while the $260 tax deduction for the first child is larger than that for later children, child endowment rises after the first child. In total value the two kinds of help must normally be well below the total cost of supporting children. Since they can scarcely be put forward as subsidies deliberately designed to increase population, they are presumably intended primarily to enable parents to meet minimum levels of expenditure upon their children's needs without too great a sacrifice to their own.

12.14. It is untidy to have two instruments of policy for the same purpose. The Committee sees advantages in the suggestion made in the Interim Report of the Commission of Inquiry into Poverty (1974) that the
dependent child allowance be abolished and child endowment correspondingly increased.

12.15. At the same time the Committee regards the tax-exempt status of child endowment as anomalous and likely to become more so if social policy towards poverty dictates its increase. There is therefore a good case for making it taxable in the hands of parents. With taxation on the individual unit basis, a teasing problem must be solved: that of choosing which parental income the payments should be added to for tax purposes. There are arguments pointing both ways: some for adding them to the income of the parent in daily charge of the child (to whom the endowment is now paid—usually of course the mother); others for adding them to the larger income. In the Committee's view the former is appropriate where only one parent has the care of the child. Where the child lives with both parents, child endowment should be added to the larger income. Were the family unit option available, this problem would largely disappear.

12.16. The discussion of the dependent child concession has so far been concerned with the concession given under section 82B in respect of a child under 16 years of age. Where the taxpayer contributes to the maintenance of a student not less than 16 years of age but less than 25, a concessional deduction is available under section 82B phased out by reference to the child's income. (‘Student’ is defined to mean a person receiving full-time education at a school, college or university.) The concession, modified in one respect, should be retained but converted to a tax rebate. The modification would make the commencing age 18 instead of 16. In Chapter 11 the Committee has proposed that the unearned income of a minor (a person under 18) be taxed at rates determined by the amount of that income and the income of his parents. It would be convenient if child endowment were made to replace the dependant deduction of any minor child. Thereafter the student child concession would apply. The income of the student child, which would be taxed without reference to his parents’ income, would of course dictate the phasing out of the concession.

II Other Concessional Deductions: Issues of Principle

12.17 Besides the deductions for dependants, existing legislation contains no fewer than twenty-three other deductions from net income. A list will be a reminder of additional complexity they introduce into a tax that must inevitably be complex even without them: net medical (including chemists’) expenses, dental expenses, optical expenses, therapeutic treatment expenses, expenses for artificial limbs and eyes, expenses for hearing aids, expenses for medical and surgical appliances, attendant's
remuneration paid on account of blindness or permanent confinement to a bed or invalid chair, maintenance expenses of a guide dog for a blind person, payments to a medical or hospital benefits fund, funeral or burial or cremation expenses, subscriptions to professional associations or unions, payments of insurance premiums, payments to a superannuation or similar fund, rates and land taxes paid on principal residence, mortgage interest on home purchases, gifts to approved institutions, zone allowances, overseas service allowance, living-away-from-home allowance, education expenses for dependants, self-education expenses, legal and other expenses incurred in the adoption of children. Most of these deductions apply to expenditure made by the taxpayer on behalf of dependants as well as on the taxpayer's own behalf; in some cases, the amount of the deduction is limited.

12.18. Collectively, the deductions for dependants and these deductions are of very great quantitative significance. They reduce the tax base by almost 20 per cent, involving a loss of revenue under the current progressive rate structure equivalent to more than one-third of the sums actually raised. In other words, removal of all concessional deductions would permit a reduction in tax rates over all income levels by a proportion, on average, of more than 25 per cent of the rate currently applying. Figures for the most significant of the concessions available are set out in Table 12.A. for the year 1971–72. As indicated in the footnote to that table, 28 per cent of total deductions claimed in that year was for dependants; a further 24 per cent for life insurance and superannuation payments; 19 per cent for medical expenditure, broadly defined, and medical insurance; 8 per cent for education expenses; and 7 per cent for rates and land taxes. Some general discussion of the issues of principle to which they give rise is essential.

12.19. There are two main reasons in principle why in one form or another such concessions may be considered necessary. As already mentioned, some are introduced for purposes of equity. But they can also be given for efficiency reasons: to encourage individuals to adjust their expenditure in various ways, because increases in expenditure on particular items are held to be socially or economically desirable. Gifts to charity and contributions to superannuation funds and life insurance policies probably come under this head, and so perhaps do the deductions for education and zone allowances, in so far as these are specifically designed to increase sums spent on education or to attract population to remote areas.

12.20. Concessions granted for any one purpose will generally have consequences for others, whether this is desired or not. A deduction of medical, dental and chemists’ expenses designed to achieve horizontal equity will also serve to raise taxpayers’ expenditure in this area. Allowing
mortgage interest as a deduction from assessable income, so as to encourage home-ownership among lower income groups, will incidentally influence the progressivity of the income tax structure; it will also have equity repercussions between home-buyers and others, and between different home-buyers according to the proportion of income spent on housing.

12.21. It cannot be presumed that the benefits of any concession will fully accrue to the taxpayer. When the supply of the commodity or service to which it is directed is unresponsive to price changes, the higher demand stemming from the concession will cause a noticeable rise in price, to the ultimate benefit of suppliers rather than consumers. For example, the aids to home-ownership may evaporate in capital gains to landowners and home-owners, and may reduce the supply and raise the cost of rented accommodation.

12.22. It is important to bear in mind that the particular objectives served by concessional deductions are also served by other kinds of government activity. The dual assistance given on account of children has already been noted. In other cases the range of instruments employed is as great or greater. Provision is made for old age by age pensions, subsidised medical and transport services, and by the tax assistance given to saving through superannuation and life assurance policies; for unemployment not only by social service benefits but also by their exemption from tax; for sickness by tax deductions for medical, dental and pharmaceutical expenses, by the exemption of medical supplies from sales tax, by the provision of public hospitals, by the subsidisation of medical insurance funds, and by sickness benefits and their exemption from income tax. The ends of education are served by various income tax deductions, by the exemption of educational supplies from sales tax, by the public provision of much education at all levels, by the partial subsidisation of private educational institutions, by scholarships and student living allowances and their exemption from income tax. Home-ownership is encouraged by the income tax deduction for local rates and land taxes, and by a new scheme, devised on a family basis, for the deductibility of mortgage interest, as well as by the subsidisation of housing loans, and by home savings grants. Furthermore, the exclusion of imputed rents from the income tax base may not improperly be regarded as an income tax deduction. Doubtless this summary list could be extended.

12.23. It is plain enough that this welter of simultaneously operating aids to areas of need that are partly met through income tax deductions has grown up over the years in a piecemeal way. Some of their cumulative consequences, could they be estimated, might be found to be very far from
what was intended.

12.24. Rationalisation and simplification in the pattern of government intervention in these areas of expenditure are obviously called for. It is not the Committee's function to examine the expenditure side in depth; but the future of the concessional deduction system is nevertheless very much bound up with it. Two directions of change can be distinguished. One is to use the tax system in yet more complicated ways while excising some of the activities on the expenditure side. The other is to adjust the expenditure measures and gradually reduce or eliminate the corresponding tax concessions. A good case can be made for the latter course.

12.25. To take the principal areas involved, government expenditures in the fields of health and education are already substantial and may well increase. Government thereby exerts a powerful influence over the quantity of these services and the price at which they are offered to the public. Any extension of assistance given in these ways need not necessarily entail much expansion of bureaucracy: it might largely be a matter of adjusting the scales of existing subsidies and grants. When tax deductions are the technique adopted, assessors have a task that is essentially retrospective: to check claims made in the light of past expenditures by persons who may well have been uncertain whether or not deductions would be allowed. They have also to establish general rules to cover difficult matters: Is this book educational? Are wigs medically necessary? Concessional deductions are recognised by those who administer income tax as one of the more difficult, uncertain and costly parts of their task. On grounds of efficiency and simplicity alike, greater reliance on carefully administered public expenditure and less on concessional deductions might bring gains.

12.26. The equity problems raised by reform in this direction may not be so serious as at first sight appears. As the figures in Table 12.A bring out, the deductions allowed under the present system tend to favour those with higher incomes. The shift away from tax concessions towards expenditure measures may well reduce the extent to which this is so. If the attendant change in effective progressivity was felt to be undesirable, appropriate adjustments could be made to the rate scale.

12.27. Horizontal equity would not necessarily be diminished. The case on this ground for deductions essentially involves the proposition that when one of two persons with equal incomes spends more on the item in question than does the other, his ‘true’ income is thereby reduced in relation to the other's. Most people, in the case of medicine for example, might agree with this, but putting a number on the difference in ‘true’ incomes is quite another matter. No two people are exactly alike, and we will all rank differently the expenses we consider ‘necessary’ rather than
‘enjoyable’ or ‘satisfying’. Once it is accepted that certain ‘necessary’ but not ‘satisfying’ expenses should be tax deductible, the flood-gates are open for endless pleading; and when a concession is made in one area, there are instant pleas for its extension into neighbouring areas. In the realities of political life, concessions for this are almost irresistibly followed by concessions for that, and then for the other thing. The income tax base, already hard enough to define at the net income level because of the problems of deciding what are expenses of earning income, becomes liable to continual erosion at the taxable income level; and with every erosion rates have to be increased if the revenue is to be maintained.

12.28. Further, it must be remembered that as the income tax is reduced, as it would be if the Committee's recommended strategy were accepted, concessional deductions become less and less capable of giving substantial help.

12.29. Hence on grounds of efficiency, simplicity and equity alike, the Committee considers that the long-term aim should be to replace concessional deductions, wherever possible, with assistance given in other ways to meet the principal needs the deductions now serve. It recognises, however, that at least three qualifications are necessary:

(a) Some concessions, of which those relating to superannuation and life insurance payments are the most conspicuous, are of a kind that have necessarily influenced the lifetime expenditure plans of many who have benefited from them. Considerable transitional problems would have to be attended to in any change in these areas.
(b) In other cases where political issues concerning the freedom of the individual are involved—possible examples of which are the cases of educational and medical expenses—a tax concession has the merit of leaving the citizen with a free choice and of saving the authorities some of the burden of administrative control.
(c) In certain cases, measures on the expenditure side may not be a wholly adequate replacement for tax concessions: there is likely, for example, whatever the form of government expenditure on medical services, to be continuing private expenditure in this area.

III. Concessional Deductions for Education and Medical Expenses

12.30. The previous section has dealt in general terms with the full range of present concessional deductions other than for dependants. The deductions in respect of rates and land taxes, interest on home loans, self-education expenses, contributions to associations, and living-away-from-home allowances have been considered in earlier chapters. Others, more
especially the deductions for contributions to life insurance and superannuation and for gifts to charities, will be considered later in this report. It is intended to deal in this section with the deductions for education and medical expenses.

**Education Expenses**

12.31. The present law allows a deduction, first introduced in 1972, for education expenses incurred by the taxpayer on his own behalf up to a prescribed limit (section 82JAA); and another deduction, dating from 1954, for such expenses incurred by a taxpayer in respect of his own child under 25 or of a person for whom he may claim a dependant deduction if that person is under 25 (section 82J). This latter deduction is also subject to a limit in respect of each person for whom a claim may be made. Until 1974 the limit, under both section 82JAA and section 82J, was $400; this has now been reduced to $150.

12.32. The deduction for self-education expenses was considered in paragraphs 7.97-7.100 and some observations were made about its correlation with the deduction for other education expenses. The Committee thereforeshadowed its recommendation that the deduction for the education expenses of a child or other dependant should be retained and converted into a tax rebate. The amount of the rebate in this case would depend on applying some given percentage to the amount of actual expenditure falling within the limit.

12.33. The case for retaining the concession rests on the importance of preserving freedom of choice of education options and on an argument that it serves an equity purpose. The equity argument makes the assumption that the concession is primarily utilised by parents whose children attend non-government schools and that these schools receive less subsidy per student than government schools. If a subsidy is provided for the child of one parent and a smaller subsidy for the child of another and the parent of the first is not taxed on the difference between the subsidies, there is a case for saying that the parent of the child with the lower subsidy should be given a deduction for what he himself provides in substitution for the difference between the subsidies. The Committee sees some force in this argument and would agree that it points to a deduction rather than to a rebate. However, in so far as the question is one of achieving equity within the group of taxpayers who, in meeting education expenses of their children, provide substitutes for subsidies, a rebate appears more appropriate. The assistance given in the tax system in meeting these expenses should, it is thought, be uniform whatever be the income level of
the taxpayers. The Committee therefore recommends that a rebate apply, at a rate of, say, 40 per cent. It also recommends that the limit on the amount of education expenses qualifying for rebate be set at $600 in respect of each child or other dependant. A taxpayer who spends $600 or more in education expenses of his child will thus save $240 in tax.

12.34. At present the expenses qualifying for deduction are described in the widest terms. There are two reasons for preferring a more limited definition. One is that considerable administrative problems are at present involved in checking claims which may include expenses of such items as clothing and travel. The other is to make it more likely that those who benefit by the concession are the parents whose children are the less subsidised by government expenditure. The definition that the Committee favours would limit qualifying expenses to fees for tuition.

Medical Expenses

12.35. The present provisions relating to medical expenses (in a broad sense of those words) are contained in three sections of the Act:

(a) Section 82HA allows a deduction of amounts paid by the taxpayer in the year of income to a medical or hospital benefits fund for the personal benefit of the taxpayer or his spouse or child. The fact that the spouse or child has income is irrelevant.
(b) Section 82F allows a deduction of an amount paid by the taxpayer as medical expenses (as defined) in respect of himself or in respect of a dependant (again as defined). The amount is net of any sum the taxpayer or any other person is entitled to be paid by a government or public authority or by a fund referred to in section 82HA or any other society, association or fund. The term ‘medical expenses’ as used in the section covers a wide range of payments:

- to a doctor, nurse or chemist or to a hospital;
- to a dentist or to a registered dental mechanic;
- for therapeutic treatment by direction of a doctor;
- in respect of an artificial limb or eye, or a hearing aid;
- in respect of a medical or surgical appliance prescribed by a doctor;
- for optical services and the supply of spectacles under prescription;
- for the services of an attendant for a blind person or a person confined to a bed or an invalid chair;
- for the maintenance of a trained guide dog for a blind person.

‘Dependant’, for purposes of the section, means the spouse of the taxpayer, or his child if less than 21 years of age and a person in respect of whom he is entitled to a deduction under section 82B. The relevant provisions of the latter section are explained above in paragraphs 12.11 and 12.16.
(c) Section 82G allows a deduction, limited to $100, for the funeral expenses of a dependant. A dependant has the same meaning as in section 82F.

12.36. It will be noted that in all instances where the payment is in respect of a spouse or child of the taxpayer, any income of the spouse or child is irrelevant. This might be thought anomalous, having regard to the fact that a payment in respect of any other person will qualify for deduction only when that other person's income is small enough to allow the taxpayer a dependant's deduction under section 82B. On the other hand, it could be argued that the anomaly lies in the qualified nature of the deduction in respect of these other persons. Thus a dollar of income in excess of $390 derived by an invalid relative has the effect of denying the taxpayer a medical expense deduction in respect of that relative. While this may be unavoidable if the medical expense deduction is to be kept within bounds, the Committee would think that in the case of spouse and child it is more appropriate, as now, not to impose any such qualification.

12.37. In the discussion that follows, attention is initially focused on the deductions referred to under (a) in paragraph 12.35, and also under (b) except for the last two items relating to blind persons and the seriously disabled. The remaining two items under (b) are then examined, followed by a brief comment on the funeral expense deduction.

**Payments to Medical and Hospital Benefits Funds and Medical Expenses Generally**

12.38. The possibility needs to be considered of restricting the concession for medical expenses to amounts in excess of a stated limit, the object being to confine the concession to exceptionally heavy expenses. There are good administrative reasons for adopting such an arrangement: the Commissioner would be relieved of a considerable burden of assessment and verification of claims for deductions. The problem is to fix an appropriate floor. One approach would be to set the limit at a figure somewhat above the average of present claims by taxpayers without dependants. These claims are shown in Table 12.A, combined however with claims by persons with dependants. A floor of perhaps $100 might be appropriate, with a somewhat higher figure under a family unit system if one were available. The approach ought to be acceptable in terms of horizontal equity: if the floor is not too far above the average expenses of taxpayers without dependants, substantial numbers of those with dependants would qualify for the concession. The approach would, however, be open to objections in terms of vertical equity, more especially because, as Table 12.A reveals, claims for medical expenses are markedly
correlated with income. Another approach, following Canadian and United States precedents, would be to express the floor as a fraction—say 3 per cent—of taxable income. This might be more equitable vertically but would raise objections in terms of horizontal equity between two taxpayers on the same level of taxable income, one of whom has dependants. It might be possible, however, to lower the floor for the latter taxpayer by adjusting taxable income to allow for dependants.

12.39. The Committee does not express a view as to whether a floor should be adopted. A choice must be made between administrative convenience if there is a floor and a more precise regard for equity if there is not.

12.40. According to one view, medical expenses are non-discretionary in character and therefore should be deducted in determining income subject to tax in the way that expenses in deriving income are deducted. This view, however, pays insufficient regard to the social service character of the concession for medical expenses. The intention is, at least in part, to give assistance to persons who have to meet medical expenses, and it might be thought that assistance should be uniform—as it is when medical services are directly subsidised by government. A compromise solution would be to allow a rebate in respect of expenses qualifying for the concession at a rate of, say, 40 per cent of the amount of the expenses: the high-income taxpayer would receive somewhat less assistance than under the present deduction, the low-income taxpayer somewhat more.

12.41. The Committee does not think that any of the existing claims should be excluded from the concessional treatment, though the precise coverage of some of them calls for comment.

12.42. The item for contributions to medical and hospital benefits funds will become less prominent as a taxpayer expense under the proposed national health insurance scheme. There will, however, be contributions for cover beyond that provided by the proposed health insurance scheme, for example for a higher grade of hospital accommodation or for expenses incurred overseas. The Committee recognises the argument that some of this cover might be thought to be for expenses within the choice of the taxpayer but would not propose to deny the concession. Nor would it propose to deny the concession to the item of payment to doctors and hospitals: while this item will also become less prominent under the new health scheme, there is again a prospect of expenses beyond the cover of the scheme.

12.43. The item of payments to chemists raises a number of problems. A taxpayer can vouch his claim only when he has kept careful records or this has been done for him by a chemist from whom he makes regular
purchases. The compliance cost is thus substantial. The taxpayer may be tempted to estimate a claim, on occasions dishonestly. Another problem concerns the requirement that the purchases in question should have been made from a chemist. It is now commonplace for drugs for the treatment of illness to be available from retailers who are not chemists. A solution to these problems, which has much to commend it, is to retain the restriction that purchases must have been made from a chemist but to limit the purchases attracting the concession to those made on the prescription of a doctor. Here too the choice lies between administrative convenience and a more precise regard for equity, and the Committee does not express a view.

12.44. The limit of the item concerned with payments for medical or surgical appliances prescribed by a doctor has given rise to considerable debate. The principal issue is whether the appliance must be something specific to the taxpayer's treatment, in the sense that it is not useful for any other purpose. Thus a heart pacemaker is specific but an air-conditioner for an asthmatic is not. If it is not necessary for the appliance to be specific, the prospect is open for many ordinary household amenities—even a swimming pool—to attract the concession. The restriction of the concession to appliances that are specific is, in the Committee's view, generally appropriate. If any other appliance is to be brought within the concession, this should be done by express provision. Thus a wig prescribed by a doctor in respect of an illness might be made the subject of such a provision.

12.45. The Committee's attention has been drawn to other expenses which in their purpose have some affinity with those now under consideration. It is not certain under the present law whether contributions to dental insurance funds are deductible in the manner of contributions to medical and hospital benefits funds. Provided the recoupment from the fund is taken into account in determining the net expense attracting the concession, as it is under section 82F in the case of a recoupment from a medical or hospital fund, the Committee sees no reason why a concession should not be available for contributions to dental insurance funds. The terms of the insurance would need to be drafted so that any payment from the fund would be by way of recoupment of a medical expense as defined in the section.

12.46. Payments made to chiropodists, chiropractors, naturopaths and the like in respect of an illness do not at present attract any concession unless for therapeutic treatment by direction of a doctor. Whether payments to any of these practitioners in other circumstances should attract concessions is a matter on which the Committee is not competent to pronounce. It is clear, however, that there would need to be some test of the qualifications
of the practitioner. This might best take the form of recognition of those qualifications under statutory provisions in the place where he practises.

12.47. Expenses involved in being transported in a motor vehicle in order to consult a doctor or attend a hospital fail to qualify for a concession. The Committee does not, in general, favour giving a concession, even though such expenses may be a necessary aspect of medical attention and a payment to a doctor for his expenses in travelling to attend the taxpayer clearly qualifies already. The concession could not be so wide as to cover travel where medical purpose is not the sole, even if it be the predominant, purpose: for example, a visit to a city where one purpose is to seek medical advice. Yet it would be impossible to frame an appropriate test to restrict its scope, in an administratively manageable way, when an ordinary vehicle is used. A sole-purpose test could not be adopted without letting in a multitude of small claims, and the existence of an emergency—another possible test—is a matter of opinion.

12.48. A different view might be taken when the travel is by ambulance. The use of such a vehicle may be thought a sufficient indication of the sole relevance of the travel to medical attention and the seriousness of the occasion; moreover, the cost involved is readily identifiable. The Committee therefore recommends that section 82F be extended to cover the cost of travel in this way. It would also favour the extension of the section to include subscriptions to ambulance insurance funds, provided the same conditions apply as previously proposed in regard to subscriptions to dental insurance funds.

Expenses of blind persons or persons confined to bed or invalid chair

12.49. Medical expenses comprising payments for the services of an attendant for a blind person or a person confined to bed or an invalid chair, and payments for the maintenance of a trained dog for a blind person, call for special attention. These expenses differ from those so far considered in being continuous expenses over the remainder of a life: the condition must be a permanent one. The notion of giving a concession only for exceptional expenses has no application.

12.50. In the Committee's view the concession should be converted to a rebate. However, the expenses are likely to be very considerable and, more especially where the person with the disability is the taxpayer claiming the concession, may be so large in relation to the income of the person making the claim that even a generous rebate of tax will not provide the order of assistance appropriate. Consideration should be given to replacing the tax rebate in due course by further direct government assistance in the form of
the provision of the necessary services or by means of grants.

12.51. Blind persons and persons confined to bed or invalid chair are the most evident cases of need, but there are other cases of continuous expenses arising from serious permanent disability: for example, the person concerned may be mentally retarded or have a congenital physical disability requiring continuous care. If it were sought to extend the tax rebate concession to these other cases, there would be problems in defining the degree of disability attracting the concession and in defining the expenses by way of travel, therapy and supervision to which it would apply. In any event, the Committee does not regard a tax rebate as the most appropriate form of assistance and would propose that in these cases, too, consideration be given to providing further direct assistance.

Funeral expenses

12.52. There is currently a concession for funeral expenses of a dependant, limited to $100. Such expenses have a close affinity with the medical expenses considered in paragraphs 12.38-12.48, and the Committee proposes, subject to the continuance of a limit, that they be treated in similar fashion. The present limit of $100 is, in the Committee's view, too low. An increase in the limit, say to $400, is therefore recommended.

IV. Zone Allowance

12.53. Persons living in more remote parts of the country may qualify for a concessional deduction in the form of a zone allowance. The availability of the deduction depends on residence in one of the specified areas for a minimum period in the year of income.

12.54. As explained in paragraph 12.56, the justification in the Committee's view for the continuance of zone allowances is the need to ensure horizontal equity between persons living in those zones and persons living in other areas: horizontal equity, in this respect, could not be achieved by any feasible measures on the expenditure side of public finance. But this is not to say that present zone allowance arrangements are necessarily satisfactory on all counts. The manner in which the zone boundaries are drawn has attracted criticism; so too have a number of other features, including the use of a deduction rather than rebate of tax, the size of the concession, and the qualifying period of residence.

12.55. Zone boundaries. Any criticism of the existing boundaries must raise questions about the purpose of zone allowances. When the boundaries
were first fixed in 1945, such factors as the high cost of living, uncongenial climatic conditions and isolation were taken into account, and these are still referred to in the Act. Two zones, Zone A and Zone B, were delineated in terms of the degree of severity of these factors, Zone A attracting the greater concession. The zones have been changed only once when, in 1956, some areas of the old Zone B were transferred to Zone A. In broad terms Zone A takes in the area above the 26th parallel (except for the central and eastern parts of Queensland) as well as places like Norfolk Island, Macquarie Island, and the Australian Antarctic Territory. Zone B covers the rest of Western Australia (apart from the south-west corner), the more remote parts of South Australia, New South Wales and Tasmania, and the central region of Queensland.

12.56. While the factors taken into account in fixing the boundaries may suggest that the primary purpose of zone allowances is horizontal equity, the allowances also serve to encourage people to move to specified areas, and this appears to have played some part in the decision to introduce the concession. At the time of introduction, in 1945, decentralisation tended to be judged in terms of ‘developing the outback’, without reference to particular areas of the outback deserving of special attention. To the extent that decentralisation remains a purpose of zone allowances, it might be argued that the boundaries should be drawn in such a way as to encourage population movement to carefully selected areas. However, decentralisation policy is not a matter on which the Committee feels able to comment. And the Committee, in any event, has expressed its view elsewhere in the report that tax incentives should not be used as a method of implementing an economic policy unless it can be established that a better method is not available. Hence, giving effect to horizontal equity must continue to be regarded as the primary purpose of zone allowances.

12.57. The Committee is not qualified to advise on how the present zone boundaries might be redrawn to achieve greater equity. A special inquiry is clearly called for.

12.58. Deduction or rebate. The amount deductible was originally set at $80 for Zone A and $40 for Zone B. The Zone A allowance was increased in 1947 to $240 and in 1956 to $360 when the Zone B allowance was raised to $60. In 1958 the Zone A allowance became $540 and the Zone B $90. At the same time an additional concession was introduced equal to a fraction (one-half in the case of Zone A and one-twelfth in the case of Zone B) of total dependant allowances claimed by the taxpayer. The basic element in the allowance has not been adjusted since 1958; however, the additional element tied to dependant allowances has increased with the liberalisation of dependant allowances. Thus the total zone allowance for a
married man with two dependant children was $839 (Zone A) and $130 (Zone B) in 1958; it is now $956 and $159 respectively.

12.59. In line with the view expressed earlier in this chapter that the value of a concession ought not to vary with the income of the taxpayer, the Committee recommends that the zone allowance be changed from a deduction to a rebate of tax. The present provisions linking the amount of the allowance with concessional deductions for dependants will require some adaptation. There is no difficulty in those cases where the Committee proposes the conversion of the dependant concession to a rebate: here it is simply a matter of a somewhat higher rebate for the person entitled to a zone allowance. The case of minor children is more difficult because it is proposed that the concessional deduction be replaced by an increased amount of child endowment which should be subject to tax. Consistent treatment would require higher child endowment for families qualifying for zone allowances, but this would add to the difficulties of administering child endowment. A higher rebate in recognition of dependent children would be similar in its effect to giving additional child endowment, except that the rebate would not itself be subject to tax.

12.60 The amount of the concession. The amount of the concession depends on the degree of disability associated with living in a zone. The Committee is not competent to measure this disability; but it would point out that, apart from the element tied to dependant deductions, the money amount of zone allowances has not been adjusted since 1958.

12.61. Qualifying period. A zone allowance is available where a person resides in a qualifying area or spends in total more than six months of any year of income in a qualifying area. The primary purpose of the allowance is to give recognition to the disadvantages of uncongenial climate, isolation and high cost of living associated with living in the zone. For this reason, the alternative test in the definition of ‘resident’ of a zone—‘a person who has actually been in that area, whether continuously or not’ for the required period—seems inappropriate: it can apply to a transport worker who permanently resides with his family outside the zone but may in the course of his work be intermittently in the zone for periods which in total amount to the required time. It is therefore recommended that the alternative test be withdrawn.

12.62. Teachers and others, who may reside for ten months in the zone in a calendar year but only for five months in each year of income, are unable to claim the allowance. This unfairness would be lessened by giving a taxpayer the right to elect that his entitlement to a zone allowance be determined by applying the present half-year residence test, not in relation to the year of income, but in relation to a year beginning with the day he
starts residing in the area. Under this elective arrangement, the zone allowance would be claimed in the year of income in which the last day of a half-year's residence falls. Thus a taxpayer who takes up residence in a zone on 8 February 1975, and continues to reside there only until 15 December 1975 would, for purposes of qualifying for zone allowance, elect to substitute the year commencing 8 February 1975 for the income year. He would thus qualify for zone allowance in the 1975–76 income year, since 8 August 1975—the end of his half-year period of residence—falls in that year. A taxpayer who so elects would be required to retain the same qualifying year until the termination of the full period of residence to which the election relates. There would need to be an overall limiting provision to preclude more than one zone allowance in an income year.
Chapter 13 Personal Income Tax: Social Security

13.1. Social security is one of the major areas of government responsibility. And while many features of Australia's social security system fall outside the Committee's terms of reference and are, in any case, currently the subject of investigation by other government-sponsored bodies, personal income tax and the social security system nevertheless have important implications for each other which it would be inappropriate to ignore. The present chapter discusses some of these implications. In Section I attention is focused on the manner of treating social security payments under personal income tax; in Section II some observations are made on social security contributions.

I. Social Security Payments and the Tax System

13.2. If dependant allowances and other concessional deductions are one confused area of tax policy in which rationalisation and simplification should eventually be possible, social security (or social service) payments are another. Here the issues are not already within, but mostly still outside, tax policy as usually conceived. But they are important in the context of long-term possibilities, and they have been raised in submissions to the Committee.

13.3. A social security payment gives rise to a receipt which, in any general sense, must be thought of as income, even though it be received in a way different from that in which other kinds of income are received. Sickness and unemployment benefits as well as many other social service grants are specifically excluded from the base of the income tax, as were age pensions until recently. Such benefits and grants are now paid after two tests: the first is a test of eligibility by an objective criterion: age, sickness, inability to find work; the second is economic: a means test. Many who know that they would pass the first do not apply, knowing that they would not pass the second. Many who pass the first and apply, receive less than the maximum grant because their resources exceed a stated limit.

13.4. Translated into the language of tax the two operations can be differently described. First there is a general provision that all those who pass the objective test have an entitlement to a ‘taxable grant’ at the maximum rate. Secondly this grant is taxed not under normal income tax but in accordance with the provisions of a special progressive ‘tax’ on income (often family income rather than individual income) and on some classes of assets. This is at a rate that rises to the level of 100 per cent of
the grant at and above the point where the grant is refused. In practice both operations are conducted simultaneously in the relevant social service department: only the net payment to the applicant is made, and is exempt from further taxation under the normal income tax.

13.5. What has recently been done to some age pensions can then usefully be represented as, logically, no more than the abolition of the ‘special progressive tax’ and its replacement by the normal income tax. The accompanying decline in ‘tax’ appears as an increase in the net amount of the grant retained by most of those receiving it, and the payment of some net grant to many from whom the whole of it was earlier taxed away.

13.6. Much discussion of the problems of poverty and the future of social services can be represented as discussion of the possibility of extending what has been done to age pensions to some or all other social service payments. Changes in this direction can be advocated on three grounds: administrative simplification, social advantage, and fairness.

13.7. Firstly, the application of a means test is undoubtedly complicated, and the Australian system contains a variety of such tests. They usually involve collecting information about income and assets and often about the affairs of the whole family unit. Their abolition, even in an area not normally thought of as relevant to taxation, would be in line with the Committee's desire to simplify public finances wherever possible. The additional load on the tried machinery of the normal income tax would be trivial.

13.8. Secondly, it is often stated that the present means tests are regarded by those to whom they are applied as a trespass on their privacy. It is not within the Committee's competence to assess this argument, but it has no reason to question its force.

13.9. Thirdly, changes in this area, whether or not they are accompanied by proposals simultaneously to increase the permissible maximum level of the grants made, are advocated as a way of raising the actual payments to those in receipt of partial payments and bringing into receipt of grant many now excluded by the means test. Social service grants are, as has already been shown, a major instrument for the realisation of society's aims for vertical and horizontal equity. This argument amounts to a proposal to increase the amount of income redistribution towards the lower end of the income scale. (The Committee has already recorded its view that the extent of such redistribution must be a matter of general social and political judgment, and it is aware of other public inquiries now collecting relevant detailed information and making proposals about adjustments to existing policies concerning poverty.)

13.10 The Committee accepts that the future of social services is a matter
largely outside its terms of reference. But there is a possible conflict between the trend of reform in the tax structure that the Committee is proposing and the trend of social service reform just described which it feels it can usefully elucidate. The cost of any shift from the means-testing of grants to their taxation as normal income may be large even when calculated by reference to present rates of income tax: the increase in social service payments, net of tax, may entail a substantial increase in tax for the rest of the population. This cost may be judged acceptable and desirable. But if, as the Committee would wish, income tax rates were gradually lowered, the cost would of course become greater still since receipts from tax on the gross benefits would be reduced. Indeed if income tax were effectively removed altogether from low-income earners, the social service payments would move from the position of being theoretically taxed at a rate more severe than present income tax to becoming entirely free of any tax. This might be felt to be altogether too costly. There is apparently a dilemma: to retain complex and unpopular means tests in order that the income tax might be lowered and simplified, or to retain the income tax unchanged in order to permit the abolition of the tests.

13.11 One possible resolution of this difficulty may be worth detailed investigation. The means tests might be abolished, but it could simultaneously be provided that some classes of social service receipts, separately itemised in the income tax return, be taxed on a separate scale superimposed upon the standard scale at some appropriate point. Given any desired level of gross social service payments, by adjustment of the point of entry and the steepness of the special scale, any desired level of recoupment could be achieved. The net cost of social service payments to the rest of the community would then become fully adjustable without either means tests or alterations to the rate structure of income tax. Such an arrangement would of course be a complicating element in the administration of the normal tax system, but it would allow a simplification in the public finances as a whole by the abolition of the existing complicated means tests.

13.12 Such a scheme would seem particularly suitable in the cases of those social service payments that are normally of a short-term character, especially sickness, retraining and unemployment benefits. Here needs may be urgent and substantial, the poverty very great but essentially temporary: the recipient may be well out of it again before long. Over a year in which he had months of acute need, fully meriting assistance on equity grounds, he may prove retrospectively to have had overall an acceptable total income. It is a defect of a system of tax-exempt grants that it cannot handle this kind of situation, even though in general society is
content to consider the broad issues of equity on an annual assessment of relative ability to pay (or need to receive). The community might well be prepared to give temporary assistance more promptly and with a less sparing hand if, when the recipient is subsequently restored to financial comfort, he repays via the tax system some or even all the help. What is at present an outright grant could be increased and in effect become, to some extent, a temporary loan. Though this arrangement might be applied, for example, to students' living allowances, it may not be suitable for benefits, such as age pensions, which relieve needs that are long-lasting, and these could be taxed in the normal fashion.

13.13. Were all or most of the means tests now separately administered to be removed, and social service grants taxed within the taxation system proper, a large measure of rationalisation and simplification in public finance would have been achieved. The objective tests of eligibility for grants, the decision that a person was aged, or unable to find work, or too sick to work, would still of course be administered by officials outside the tax administration, such tests calling for skills other than those in which tax assessors are trained. Grants would still be paid outside the tax system. The grants, in combination with their tax treatment, could properly be described as providing a guaranteed income to those who had passed the objective tests. Moreover, since these would be established to cover the main situations in which society recognises that economic need is likely to arise, it might be concluded that another ideal of social reformers had been achieved: that of ensuring by the supplementation of its private income that every family had a minimum annual income suitable to its size and composition.

13.14. The removal of the separately administered means tests carries with it the need for a simpler method by which the payment of social service benefits can be readily linked with their inclusion in the recipient's income tax return. One procedure by which this may be achieved in most cases would be for each of the individual tax and social service records to show both the income tax and social service reference numbers. In the United States and Canada statement of a taxpayer's social security or insurance number is required on income tax documents. A similar linking in Australia would not weaken in any way the fundamental principle that the normal details shown in an income tax return shall not be divulged by the taxation authorities except in the few special instances now permitted by law. It would probably serve to strengthen both administrations.

13.15. It is logically permissible to think of grants as ‘negative taxes’; and if these grants be taxable under the income tax, a system incorporating them may be described as a ‘negative tax system’, though perhaps, in the
case so far discussed, ‘taxable grant system’ would be a clearer phrase. Many schemes, varying greatly in detail, have been propounded under the former title. Some approach from the income tax end and arrive at proposals for a guaranteed income via the suggestion that tax rebates or tax credits that exceed tax on assessable income be made refundable. Others start from the idea that the guaranteed minimum incomes for particular family sizes and compositions should actually be paid in cash and then subsequently subjected to tax with other income, a break-even point being reached when the tax recoupment brings the income down to the guaranteed minimum. This is indeed a problem that can be presented in a bewildering number of ways.

13.16. The Committee's discussion is offered not as leading to recommendations, but rather as pointing to issues in an area where decisions are perhaps not immediately called for. Equally it does not attempt recommendations on the further problems that would have to be faced were fully-fledged negative income tax schemes seriously contemplated. But it concludes by drawing attention to a point of difference between variants of these schemes that is often overlooked but which in its view is of the greatest significance; that of the primary test of eligibility for receipt of grant. In the kind of evolution of the social service system discussed above, and in many schemes using the term negative income tax, the primary tests of age, unemployment, sickness—tests recognising particular causes of need—are assumed still to be applied. But in others these are discarded, and indeed the whole system of social services to assist the needy is discarded with them. It is replaced by the sole tests of income and family size, with the tax authorities as the sole administrative body. As a necessary corollary, the guaranteed income is paid irrespective of whether the recipients have genuinely sought work and been unable to find it or are genuinely sick or disabled or have any other valid reason for not earning their own livings. In the Committee's view, such schemes seem likely to have consequences for incentives to work and save which make it impossible to consider them seriously.

II. Social Security Contributions

13.17. In the brief comparison between Australia's taxation system and those of other OECD countries in Chapter 2, it was noted that this country is unique among the countries represented in Table 2.E in having no levies entitled to be classified as ‘social security contributions’. The OECD definition of this category confines it to non-voluntary contributions made to ‘general government’ (widely defined) specifically for expenditures
within the ‘social security’ area. Apart from Australia only three member countries had taxes thus classified which amounted to less than 10 per cent of total tax revenues over the years 1965–71 (Canada, Denmark, Ireland), while six had them to the extent of between 30 and 40 per cent (France, Germany, Italy, Luxembourg, Netherlands and Spain). The figure for the United Kingdom was 14 per cent, and for the United States 18 per cent.

13.18. As an indication of the comparative level of the social services in these countries, such statistics are, needless to say, quite valueless. They merely reflect the fact that in Australia government has chosen to finance social services directly out of general revenue and indirectly by concessional deductions, such as those for contributions to medical benefit funds, without tying particular taxes to those services. It is simply a matter of form and presentation.

13.19. An arrangement not unlike those of OECD countries was once used in Australia. A separately named social services contribution existed from 1945 to 1950, in administrative substance an addendum to personal income tax but formally separate and formally not a tax. Furthermore its proceeds were earmarked to the National Welfare Fund for expenditure in the area of social security to which the proceeds of payroll tax, until 1952, were also paid. Though the tax was eventually abolished and the earmarking of payroll tax rescinded, the National Welfare Fund itself still exists, though since it is now wholly financed from Consolidated Revenue Fund and from interest on its unspent balances, it is very little more than a paper archway with a well-sounding name through which tax revenue is channelled to individuals, via appropriations for the Departments of Social Security, Health, and Housing and Construction.

13.20. So long as what was called in Chapter 3 the ‘burden’ fallacy forms part of the attitude of us all to the payment of taxes, there is some truth and good sense in this presentation. Much public expenditure such as that on defence, general administration, law and order and research confers benefits on the community which cannot, in any but an arbitrary way, be traced to individuals quantitatively. But expenditure on, say, hospitals and so of course can cash transfers to individuals. Moreover, in this area all are entitled to receive them when in need, as defined, and though the definition of means will exclude many people, no one can be certain that he will be excluded all his life.

13.21. As a matter of logic it is in general defensible to conceive of the money required to pay for these social services each year as the out-goings of an insurance fund financed by the compulsory contributions of the actual and potential beneficiaries. Quite possibly many of the public do not see it this way and think rather that all their taxes disappear for ever into
the maw of a distant Leviathan. If so, it is arguable that there would be a real gain if it could be done simply by relabelling some specific quantum of existing taxation social security contributions and passing them through explicit national superannuation, medical or unemployment insurance funds or some agglomeration of such funds. The taxpayer might then better understand what he is getting for his money and perhaps the standard of discussion of future policy would be raised. The idea, at first sight, is especially attractive when large increases in benefits of this kind are under discussion, somewhat ahead of their costing.

13.22. There are, however, conditions to be met before this representation of a slice of what are now taxes could be made entirely convincing:

(a) The individual contributions would have to be related to expected benefits. Whether the fund actually existed or was of the ‘notional’ kind, it would have to be demonstrably solvent.
(b) Though age, sex and family situation might be relevant variables, income could not be (except in the case of an income-related superannuation scheme of contributions). Premiums progressively or even proportionately related to income would, as premiums, be indefensible if benefits were equal for everybody. In all but name social security contributions would be poll taxes and thus regressive on income.
(c) As a corollary of (a), the contributions would have to be confined to beneficiaries. In terms of the insurance principle a general medical fund could only be financed by contributions from individuals, not from business employers.

13.23. Though terms such as ‘fund’ and ‘insurance’ abound in the titles of such schemes overseas, these conditions are never, so far as the Committee is aware, in practice met. In the OECD countries the employer contributions are usually larger than the employee, and are generally payroll taxes of such universality that they are probably passed on in prices. And even when the government is not committed to a direct annual contribution when they start, inflation and changes in the desired levels of benefit end by making them dependent on general revenue. When contributions cease to be genuine premiums, it is likely that even the most innocent taxpayer will come to think of them as taxes, if indeed he ever thought otherwise.

13.24. Even if they were not so, a deeper difficulty remains. The basic social issue to which Chapter 4 was devoted, that of the proper degree of progressivity in the taxation system, would not go away. It might be deflected into a debate about the right distribution of the ‘true’ burden
imposed by the finance of the rest of public expenditure. Or it might take the form of questioning the fairness between persons of the social service contributions themselves, as it was in fact questioned in Parliament when Australia's National Welfare Fund was established in 1943.

13.25. The Committee in no way disputes the importance of appropriate names and of the right formal presentation of public accounts. But in this and other areas of taxation policy it believes that the most genuinely urgent and constructive task is to present the citizen with information about public finance in a way that allows him to understand his own personal transactions with the State and to compare them with those of other people.

13.26. It is doubtless true that at the present time normal Australian taxpayers do not clearly identify any part of the tax they pay with the social service benefits to which they are entitled, and that it would be well if they could. But this is only one gap in their understanding. They may know their own income tax payments, though they are likely to know their marginal rate rather than their average. They will not know what they pay in taxes on the goods and services they consume. They may know what cash social service payments they have recently received, but not what, in a prospective lifetime of average health and length, they are likely to receive. They doubtless know that their taxes pay for much of their children's education; but not how much they cost annually or over their childhoods, nor what taxes contribute, say per week, towards the hospital and medical services they and their families may have made use of. The most normal families do not know these elementary facts about themselves and those in their same income group: still less do they know them about other income groups. Still less again do they know how many are in these various groups and what their total contributions are, or could be, to the average finance of the services of the State. It is small wonder that in this vacuum prejudice and myth flourish.

13.27. In the Committee's view detailed and up-to-date estimates of the transactions with the State of all persons and families in normal situations, at different income levels, together with estimates of the distributions of income and wealth, are the necessary foundation for informed debate on tax policy. That they do not now exist has been a handicap to the Committee, and must be one too to those who have to assess the validity of its analysis. The Committee recommends that, as soon as possible, information of this kind be made widely available. It is needed not only by the experts but by every citizen who thinks about the size and fairness of the taxes he pays.
Chapter 14 Personal Income Tax: Rate Structure

14.1 The personal income tax scale in Australia, as set out in the Income Tax Act 1974, has a number of basic characteristics:

(a) The scale is progressive, with increasing marginal rates specified for successive intervals of income, from 1 per cent on the initial $1,000 of taxable income to 67 per cent on income in excess of $40,000.

(b) The progression is achieved using a series of taxable income steps—fourteen in all—which are subject to progressively higher marginal rates. These are shown in Table 14.A. (Marginal rates in earlier years are set out in Table 6.B.)

(c) A surcharge is payable on property income where a property owner's taxable income exceeds $5,000. Subject to shading-in provisions on taxable incomes between $5,000 and $5,500, the rate of surcharge is 10 per cent of the average rate of tax on all taxable income.

(d) Taxable incomes of individuals up to $1,040 are wholly exempted from tax, but incomes above this figure attract tax on the initial $1,040. To obviate what on the present scale would be a tax of $12.80 on the 1,041st dollar earned—a marginal rate of 1,270 per cent—a shading-in clause limits the tax payable on incomes between $1,040 and $1,061 to not more than 66 per cent of the excess of taxable income above $1,040. In other words, the effective marginal rate is zero up to $1,040, 66 per cent from there to $1,061, 7 per cent on the next $939, and then on up, as indicated in Table 14.A, until a rate of approximately two-thirds is reached again at $40,000.

14.2 This tax scale, introduced as recently as November 1974 in place of the revised scale announced in the 1974–75 Budget, differs in significant respects from the scale applying in 1972–73 and 1973–74 at the time the Committee was receiving submissions and beginning to marshal its thoughts on tax reform. The rate schedule of those earlier years had come in for criticism for:

(a) being unnecessarily complicated;

(b) failing to differentiate between income from personal exertion and income from property;

(c) not discriminating in the right degree between high and low incomes;

(d) being too infrequently adjusted for inflation; and

(e) making insufficient provision for the inequity that may arise where individuals have fluctuating incomes.

Each of these criticisms warrants examination, having regard among other things to the latest restructuring of the rate scale.
I. Complexity of Rate Scale

14.3 In its preliminary report the Committee, addressing itself to the situation as it was in 1973–74, drew attention to the fact that Australia's rate scale, with its twenty-nine marginal steps, was by international standards, exceptionally complicated. As Table 14.1 indicates, the United Kingdom employs only ten marginal steps, Canada thirteen, and New Zealand nineteen; the United States employs seventeen, but has eight more for very large investment incomes, mostly well beyond the point at which the Australian scale stops. Two particular aspects of these overseas scales, closely related to their lesser number of steps, were noted in the preliminary report:

(a) (Percentage of taxable income)

<table>
<thead>
<tr>
<th>Australia (b)</th>
<th>United Kingdom (c)</th>
<th>United States of America (d)</th>
<th>Canada</th>
<th>New Zealand</th>
</tr>
</thead>
<tbody>
<tr>
<td>$A</td>
<td>£</td>
<td>$US</td>
<td>$Can</td>
<td>$NZ</td>
</tr>
<tr>
<td>0–1,000</td>
<td>1.0</td>
<td>0–4,500</td>
<td>0–500</td>
<td>12</td>
</tr>
<tr>
<td>1,000–2,000</td>
<td>7.0</td>
<td>4,500–5,000</td>
<td>500–1,000</td>
<td>15</td>
</tr>
<tr>
<td>2,000–3,000</td>
<td>14.0</td>
<td>5,000–6,000</td>
<td>1,000–1,500</td>
<td>16</td>
</tr>
<tr>
<td>3,000–4,000</td>
<td>20.0</td>
<td>6,000–7,000</td>
<td>1,500–2,000</td>
<td>17</td>
</tr>
<tr>
<td>4,000–5,000</td>
<td>26.0</td>
<td>7,000–8,000</td>
<td>2,000–4,000</td>
<td>19</td>
</tr>
<tr>
<td>5,000–6,000</td>
<td>32.0</td>
<td>8,000–10,000</td>
<td>4,000–6,000</td>
<td>21</td>
</tr>
<tr>
<td>6,000–7,000</td>
<td>38.0</td>
<td>10,000–12,000</td>
<td>6,000–9,000</td>
<td>24</td>
</tr>
<tr>
<td>7,000–8,000</td>
<td>44.0</td>
<td>12,000–15,000</td>
<td>8,000–11,000</td>
<td>25</td>
</tr>
<tr>
<td>8,000–10,000</td>
<td>48.0</td>
<td>15,000–20,000</td>
<td>10,000–14,000</td>
<td>27</td>
</tr>
<tr>
<td>10,000–12,000</td>
<td>52.0</td>
<td>20,000+ 24,000–32,000</td>
<td>12,000–22,000</td>
<td>35</td>
</tr>
<tr>
<td>12,000–16,000</td>
<td>55.0</td>
<td>24,000–36,000</td>
<td>14,000–24,000</td>
<td>36</td>
</tr>
<tr>
<td>16,000–20,000</td>
<td>60.0</td>
<td>36,000–48,000</td>
<td>26,000–40,000</td>
<td>37</td>
</tr>
<tr>
<td>20,000–40,000</td>
<td>64.0</td>
<td>48,000+ 70,000–100,000</td>
<td>28,000–42,000</td>
<td>38</td>
</tr>
<tr>
<td>40,000+</td>
<td>67.0</td>
<td>80,000–100,000</td>
<td>30,000–40,000</td>
<td>40</td>
</tr>
</tbody>
</table>
(a) In the United Kingdom, the United States and Canada, taxpayers are entitled to a personal deduction before tax rates become operative. For single persons the deduction is £625 in the United Kingdom, $750 in the United States, and $1,600 in Canada. In New Zealand a taxpayer is entitled to a tax rebate of $125. (b) Excluding surcharge on property income. (c) In respect of so much of the investment income included in an individual's total income as exceeds £1,000, additional tax is levied (for the most part at the rate of 15 per cent). (d) Scale for unmarried
individuals on earned income; on investment income there are eight further steps, a maximum rate of 70 per cent being reached on a taxable income of $100,000.

(a) Rates of tax on the early steps are substantially higher than in the Australian scale. The outstanding example is the United Kingdom where the height of the initial step was until recently 30 per cent and has now been lifted to 33 per cent. Australia's initial step was only 0.2 per cent in 1973–74 and earlier years; it has now been raised to 1 per cent.
(b) There are noticeably fewer, and hence correspondingly much wider, steps over the bottom ranges of income than under the Australian system. Again the United Kingdom stands out, with an initial step extending over the first £4,500 of taxable income. In contrast, twenty of the twenty-nine steps featuring in the Australian rate scale until 1974–75 occurred below a taxable income of $6,000, encompassing the bulk of taxpayers; the number of steps below $6,000 has now been sharply cut back to six.

14.4. The sole defence known to the Committee for the large number of steps that has been traditional in the Australian scale is that it provides a nearly continuously graduated set of rates, and is thus capable of moving nearly continuously with the size of income and hence also with ability to pay, if this in turn be supposed to be continuously related to income. But as has been emphasised in earlier chapters, ‘ability to pay’ in the vertical equity sense is not a quantifiable concept bearing an exact relationship with income. With wider steps average rates would still rise with income, and this is the prime requirement for vertical equity. To require that the average should rise smoothly is to try to be precise about something that is essentially imprecise.

14.5. It could not seriously be argued that as many as twenty-nine marginal steps were ever necessary for practical fairness. So many steps only confuse taxpayers. They lead to inchoate fears of ‘moving into a higher tax bracket’ whenever income increases. They add to the complexity of tax calculations, whether for the taxpayer or the administration. Experience suggests that they make changes in rates
difficult to introduce. Indeed if, as the Committee proposes, the share of income tax revenue be gradually reduced as a broad-based consumption tax is built up, simplification of the scale by a further reduction in the number of the steps on the fourteen applying in 1974–75 would be desirable.

II. Surcharge on Property Income

14.6. There is one respect in which the Australian rate scale in the recent past has, for all its proliferation of steps, tended to be simpler than those applying in the United States and United Kingdom. In those countries, and in others, income from property (or investment income) is subject to heavier tax than income from personal exertion. The United States distinguishes between the two forms of income by limiting the maximum marginal rate of tax on personal exertion income to 50 per cent, even though the nominal rate schedule extends as high as 70 per cent. Property income of persons in the relevant ranges of income is thus subject to higher rates of tax than the maximum rate on personal exertion income. Until 1973 the United Kingdom provided for a deduction of an earned income allowance of two-ninths of personal exertion income up to £4,005 and of 15 per cent of income in excess of that figure. Under the unified income and surtax arrangements now operating, the earned income allowance has been abandoned and a surcharge imposed on investment income. At one stage Canada imposed a special 4 per cent tax on investment income from all sources. In 1961, however, it was withdrawn from investment income from domestic sources.

14.7. For many years a distinction was also drawn in the Australian legislation between personal exertion and property income, both as to rates of tax and as to the level of general exemption from tax. Property income was subject to higher rates of tax until 1953, but the lower level of exemptions was removed in the 1930s. The abolition of the differential rate of tax in 1952 was no doubt influenced by the Spooner Committee which had drawn attention in the previous year to the low revenue yield in relation to the complexity involved and the irksomeness of the differential where taxpayers with personal exertion income also had a small amount of property income. However, the differential was reintroduced in 1974–75 in the manner described in paragraph 14.1.

14.8. A long-standing argument for treating income from personal exertion more kindly is its greater ‘precariousness’, having regard to the fact that such income is confined to the period of a person's working life and its continuity may be interrupted by sickness or unemployment.
However, much property income is precarious too: losses on investments are by no means an unusual occurrence. In any case, government assistance by way of age pensions and sickness and unemployment benefits now affords considerable protection to those who depend heavily on personal exertion income.

14.9. It is also sometimes said that acquiring income through personal exertion involves greater effort than acquiring property income. But assertions of this kind overlook the fact that a taxpayer's property income may derive from his own saving out of earlier years’ personal exertion income: it would clearly not be feasible to distinguish between property income according to source of investment funds and to confine any property surcharge to income from inherited wealth. So far as the point is that income from personal exertion involves a greater variety of expenses than income from property and many of these expenses may be inadequately reflected in the tax deductions allowable, this is a matter to be corrected by a liberalisation of deductions.

14.10. A surcharge on property income has been proposed, too, as a way of moderating income inequalities, the assumption being that persons on high incomes derive a greater proportion of their income from property than do persons on low incomes. At best, however, this will be so only in a broad statistical sense. There are, after all, many individuals of quite modest means, especially retired folk, for whom interest, dividends or rents are the chief component of income: the relief proposed for low incomes in the Government's recent surcharge is recognition of this. In any case, such vertical redistribution as a surcharge on property income achieves tends to be at the cost of serious horizontal inequities. It is difficult to see why, where there is no relief from surcharge, a retired couple living off their past savings should be asked to pay more tax than members of the work force earning the equivalent income.

14.11. The case for differential treatment has also been argued in terms of the special advantages property confers on its owner over and above any income it produces, particularly in providing a reserve of spending power. Those advantages, it is sometimes held, should be taxed through an annual levy on wealth. For reasons to be explained in Chapter 26, the Committee rejects a wealth tax, and a surcharge on property income might be thought to be a suitable proxy. But this the Committee would not accept. As pointed out in Chapter 3, the income tax system already contains an in-built bias against saving, reducing the ratio at which future consumption can be substituted for present consumption. And an additional bias against certain forms of property income is introduced by inflation, a feature also referred to earlier.
14.12. The Committee sees a number of problems in imposing a surcharge on investment income. Taxpayers are not divided neatly into two mutually exclusive categories, those receiving income from personal exertion and those receiving income from property. Most property owners, except perhaps the retired, also receive personal exertion income even though many wage earners may have little if any property income. This raises difficult questions, foreshadowed in paragraph 14.10, when it comes to trying to accommodate a differential rate structure to an overall tax system designed to be fair. Should somebody with investment income of, say, $5,000 and no other income be subject to the same additional tax burden as somebody else with $5,000 investment income and a substantial amount of income from personal exertion? Alternatively, as under the present Australian scheme, should persons with the same total income but different components of personal exertion and investment income be subject to the same rate of surcharge on the investment component of their income? Whichever approach is followed, serious inequities and anomalies are bound to arise.

14.13. The administrative difficulties of levying a special tax on property income or of providing an earned income relief are substantial. When taxpayers are dealing at arm's length with employers, few problems are likely to arise in determining what constitutes salary and wages. But in many situations, especially those involving private companies and small unincorporated businesses, there may be considerable scope for substituting the payment of salary and wages for the payment of investment income. In the case of unincorporated enterprises, such as farms, further awkward problems arise in determining the income from the ownership of, as distinct from the employment in, an unincorporated enterprise. It may be possible to apply distinctions for administering the law, but if such distinctions involve many arbitrary elements, as they inevitably must when it comes to drawing a line between what is a return for labour effort and what is a return on investment, inequities will occur and opportunities are opened up for tax planning. No set of tax reform proposals that takes equity and simplicity seriously can really contemplate these types of arrangements.

14.14. The Committee therefore recommends that the present surcharge on property income be abolished at the earliest opportunity.

**TABLE 14.B: PROPORTION OF TAXPAYERS, PROPORTION OF TAXABLE INCOME, MEAN TAXABLE INCOME, AVERAGE TAX RATE AND PROPORTION OF INCOME TAX RECEIPTS, BY INCOME RANGE, 1971–72**
### III. Shape of Rate Scale

14.15. From submissions to the Committee it is evident that the shape of the rate scale, so far as it determines how much more tax a high income bears than a low, is a subject on which the community holds strong but differing opinions. The appropriate degree of progression in the rate scale of personal income tax is a subordinate aspect of the question of the degree of progressivity proper to the tax structure as a whole. As the analysis of Chapters 3–5 suggested, preoccupation with the progressivity of income tax obscures the realities of the problem. The discussion of progressivity requires an appreciation, virtually impossible on the basis of present

<table>
<thead>
<tr>
<th>Income range (net income)</th>
<th>Proportion of taxpayers</th>
<th>Proportion of taxable income</th>
<th>Average tax rate</th>
<th>Proportion of income tax receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>per cent</td>
<td>per cent</td>
<td>(a) per cent</td>
<td>(b) per cent</td>
</tr>
<tr>
<td>$0–999</td>
<td>7.2</td>
<td>1.5</td>
<td>671</td>
<td>0.3</td>
</tr>
<tr>
<td>1,000–1,999</td>
<td>14.6</td>
<td>6.0</td>
<td>1,353</td>
<td>6.3</td>
</tr>
<tr>
<td>2,000–2,999</td>
<td>18.0</td>
<td>11.9</td>
<td>2,206</td>
<td>9.7</td>
</tr>
<tr>
<td>3,000–3,999</td>
<td>18.6</td>
<td>16.5</td>
<td>2,953</td>
<td>11.8</td>
</tr>
<tr>
<td>4,000–4,999</td>
<td>15.8</td>
<td>17.3</td>
<td>3,645</td>
<td>13.5</td>
</tr>
<tr>
<td>5,000–5,999</td>
<td>10.1</td>
<td>13.3</td>
<td>4,385</td>
<td>15.3</td>
</tr>
<tr>
<td>6,000–6,999</td>
<td>5.9</td>
<td>9.1</td>
<td>5,140</td>
<td>16.9</td>
</tr>
<tr>
<td>7,000–7,999</td>
<td>3.4</td>
<td>6.1</td>
<td>5,924</td>
<td>18.5</td>
</tr>
<tr>
<td>8,000–9,999</td>
<td>3.2</td>
<td>6.9</td>
<td>7,041</td>
<td>20.6</td>
</tr>
<tr>
<td>10,000–14,999</td>
<td>2.2</td>
<td>6.3</td>
<td>9,597</td>
<td>25.2</td>
</tr>
<tr>
<td>15,000–19,999</td>
<td>0.5</td>
<td>2.3</td>
<td>14,368</td>
<td>32.5</td>
</tr>
<tr>
<td>20,000–29,999</td>
<td>0.3</td>
<td>1.7</td>
<td>20,689</td>
<td>40.7</td>
</tr>
<tr>
<td>30,000+</td>
<td>0.1</td>
<td>1.3</td>
<td>40,551</td>
<td>52.8</td>
</tr>
<tr>
<td></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

(a) Percentage of net income.
(b) Percentage of taxable income.


### III. Shape of Rate Scale

14.15. From submissions to the Committee it is evident that the shape of the rate scale, so far as it determines how much more tax a high income bears than a low, is a subject on which the community holds strong but differing opinions. The appropriate degree of progression in the rate scale of personal income tax is a subordinate aspect of the question of the degree of progressivity proper to the tax structure as a whole. As the analysis of Chapters 3–5 suggested, preoccupation with the progressivity of income tax obscures the realities of the problem. The discussion of progressivity requires an appreciation, virtually impossible on the basis of present
statistics, of the impact of all taxes, and not merely of one of them. This becomes a consideration of increasing importance with the imposition of capital gains tax, the restructuring of company tax and estate and gift duties, and the introduction of a broad-based consumption tax—in other words, all the measures later proposed in this report. Underlying the implications for progressivity of the measures taken—or not taken—in these areas are the trends in revenue requirements, the evolution of expenditure policies, and the basic developments in the economy over the years.

14.16 Some consideration of the present rate scale is nonetheless called for. Table 14.B may conveniently serve as a starting-point to identify three ranges of net income:

(a) The low range, up to an income of, say, $3,000. In 1971–72, 39.8 per cent of taxpayers fell within this range, providing 9.4 per cent of total revenue from personal income tax. Because of continued inflation and recent changes in tax rates, the corresponding percentages are likely to be noticeably lower in 1974–75.

(b) The high range, above an income of, say, $20,000. Only 0.4 per cent of taxpayers fell within this range in 1971–72, but they accounted for 7.9 per cent of total revenue. Somewhat higher percentages may be anticipated in 1974–75.

(c) The intermediate range between the two extremities, encompassing the majority of taxpayers (59.8 per cent) in 1971–72 and supplying the bulk of tax revenue (82.7 per cent). A higher percentage of taxpayers is likely to come within this range in 1974–75, but the percentage contribution to revenue may not be greatly different from what it was in 1971–72.

Low Range

14.17. One of the first questions of detail to settle in any analysis of the income tax scale is the level of the initial step. At present this step, at 1 per cent, is effectively abolished, except in a few cases, by the exemption of the first $1,040 of taxable income, so that up to this level there is a marginal (and average) rate of zero. After the shading-in arrangements already described, a marginal rate of 7 per cent resumes at $1,061 where the average rate is 1.3 per cent. As noted, in the United Kingdom system the initial marginal rate now stands at 33 per cent. The contrast is striking.

14.18. The most important advantage of an initial step of some magnitude is not that it raises much tax from the taxpayers whose total income is confined within this step; it is rather that a sizeable minimum average rate is thereby struck for all higher incomes. Without a significant rate on the lower steps, much higher marginal rates than otherwise must be imposed further up the income scale if substantial revenue is to be raised
from the later income brackets with their greater numbers.

14.19. On the other hand, it may seem quite wrong and vertically inequitable to impose any significant income tax on very low incomes, and this points to a near-zero rate on such incomes, whatever the unwelcome implications for marginal rates higher up. In discussion of tax matters it is often suggested that this dilemma can be escaped by one or other of two devices. First, a universal personal allowance can be provided, as a deduction from taxable income, tax only being paid on what remains: as indicated in a footnote to Table 14.A, the United Kingdom, the United States and Canada provide for a universal personal allowance. Or, secondly, a non-reimbursable tax rebate can be given cancelling out the tax that would otherwise be paid at these levels: New Zealand has recently introduced a rebate along these lines. But these are in fact exactly equivalent to making the first step a zero-rate one; and they mostly serve to conceal the abrupt rise in the effective marginal rate when, at the point of exhaustion of the allowance or the rebate, the marginal rate of the tax scale begins to be effective. Universal tax allowances or non-reimbursable tax rebates are merely techniques for altering the actual progressivity of the tax scale. It seems altogether simpler and less confusing to determine the progressivity of the income tax on its merits in the one obvious place: in the scale. The issue of the amount of tax to be levied on low incomes should not be obscured by artificialities.

14.20. It seems essential to the Committee that decisions about the level of the first step, and the general shape of the rate scale for low income earners, should be made in the light of some clear understanding of the kinds of people it is who have these very low taxable incomes. That information is currently not available. But it is reasonable to suppose that they are persons who are realising capital or receiving exempt incomes from social services benefits or scholarships, or have been working part-time or for only part of the year. And many others may be a statistical illusion arising from a person with more than one job preferring to appear as two persons to the Commissioner. At a time when the minimum wage is over $4,000 a year, it is clear that few could in fact survive on these lower incomes if the latter were a true measure of available resources for essential consumption.

14.21. The Committee would not recommend any increase in the exemption limit above the present figure of $1,040. Moreover, it sees considerable merit in an initial marginal step rather higher than at present and extending further up the income scale. The initial step might be set at 20 per cent. In view of the fact that a marginal rate of 20 per cent now applies on increments of taxable incomes between $3,000 and $4,000, this
would mean a first step extending up to a taxable income of $4,000. (The band of taxable income above $1,040 over which there must be shading-in would, of course, have to be rather wider than at present.)

14.22. An increase in the height and width of the initial marginal step in the manner suggested would in itself involve a substantial increase in tax revenue, since the higher marginal rates on initial income would apply to all taxpayers. It would be important to ensure that additional revenue was used, as far as possible, to protect the living standards of specific categories of taxpayers in the low range and at the bottom end of the intermediate range, notably those with families or dependent on social service benefits. This will be especially necessary if, in line with what was recommended in the previous chapter, social service benefits, including child endowment, are made taxable.

14.23. In paragraph 12.6 the Committee has recommended that the dependent spouse allowance be converted to a rebate, which might be set at $300. However, if an initial marginal rate of 20 per cent is introduced, as is proposed here, the spouse rebate will need to be of the order of $600 to ensure that a married person on a taxable income of $4,000 pays no more tax than at present.

14.24. The proposals in paragraphs 14.21–14.23 are addressed to the more immediate future. The Committee has indicated, however, that as a long-run objective it favours placing less reliance on personal income tax. It might therefore be possible to visualise an initial marginal rate on taxable incomes up to $4,000, fixed in the first instance at 20 per cent, being in time gradually reduced. Indeed, there would be considerable merit, if a simpler tax system is to be achieved, in at some stage zero-rating the initial marginal step, so that persons on low incomes pay no income tax at all and persons on high incomes are exempt from tax on the initial increments of income. It would then of course be necessary, as has been indicated earlier, to rely exclusively on taxable grants to assist low-income families.

High Range

14.25. It is sometimes argued that there is considerable scope for redistributing the income tax burden from the lower to the higher income groups. That is to say, tax reductions on lower incomes could be financed by tax increases on higher incomes. However, from the data of the distribution of the tax burden by grade of net income summarised in Table 14.B, it is readily apparent just how little scope there is for such redistribution. The 0.4 per cent of taxpayers in 1971–72 with net incomes
in excess of $20,000 received only 3.0 per cent of taxable income, contributing 7.9 per cent of total tax collected. Given that the average rate of tax on a taxable income of $20,000 was over 40 per cent, further significant increases in revenue could not have been obtained from taxpayers in that range. An increase to 75 per cent in the average tax liability of a taxpayer on $20,000 would have left him with after-tax income of $5,000 and involved a near 100 per cent marginal tax rate. Such a change for all taxpayers with taxable incomes in excess of $20,000 would have added only about 3.5 per cent to total revenue, and then only if the taxpayers concerned had continued to earn the same income as before—a dubious assumption given the confiscatory marginal tax involved.

14.26. Hence in establishing what the maximum income tax rate should be, factors other than simply contribution to revenue must be the chief concern. As already indicated in paragraph 14.15, the question of the income tax scale inevitably merges with the wider issue of the progressivity of the tax system as a whole and the character of other taxes in the system. Within a narrower compass, considerations of some relevance in fixing the top rates of personal income tax include the relationship between the systems of personal and company income taxes, the effect of taxation on incentives to work and save, and the incentives provided by high rates of taxation for tax avoidance and evasion.

14.27. As is pointed out in Chapter 16, there may be some advantage in linking the maximum rates of personal and company income tax. This was, for example, a key element of the proposal of the Carter Commission for full integration of personal and company income tax, and West Germany is considering a scheme to link the maximum marginal rates of both taxes. Such a link affords a means of limiting the purely tax advantages of retaining undistributed profits in the hands of companies: the tax burden on undistributed profits would equal the top marginal rate of income tax and for most taxpayers this rate of tax would exceed the rate of personal income tax. Such a relationship, however, involves setting the maximum rate of tax applied to all personal income in the light of considerations relevant only to dividend income, which might easily lead to inappropriate results.

14.28. In fixing the maximum marginal rate of tax, as well as in framing the rate scale lower down, some account must be taken of possible effects on the incentive to work. A taxpayer's incentive to work is affected by both the ‘income’ and ‘substitution’ effects of income tax. Because income tax reduces a taxpayer's net of tax income, he will to that extent have an incentive to increase his work effort to recoup at least some of the income taken in tax. The extent of this income effect will be determined by the
taxpayer's average rate of tax: the higher the average rate, the greater will be the influence of the income effect. However, the substitution effect works in the other direction. The effect of income tax is also to reduce the return from additional work effort, and the higher the marginal rate of tax the greater will be the incentive to reduce work effort and substitute leisure in view of the increased relative attractiveness of leisure.

14.29. Economic theory is thus inconclusive as to whether high rates of income tax adversely affect incentives to work. Commonsense reasoning suggests that the higher are marginal rates of tax in relationship to average rates the more is the substitution effect likely to outweigh the income effect; but psychological and sociological forces obviously play a major role in determining the work ethics of particular individuals, while the ability of taxpayers to vary the number of hours they work may be limited by such factors as the length of the minimum working week or the state of demand in the labour market. It is little wonder that empirical evidence on the effects of income tax on incentives to work has tended to be inconclusive and of hardly any guidance to policy-makers.

14.30. The implications of income tax for personal saving are clearer, for here the substitution and income effects tend to reinforce each other. High marginal rates of income tax encourage the substitution of immediate consumption for saving; high average rates, especially at the upper end of the income scale where saving features more prominently, mean lower disposable incomes and hence less opportunity to save. But it must not be overlooked that a large part of saving today is undertaken in the business sector and by government; and the Committee has already expressed the view in Chapter 4 that incentives to save, like incentives to work, are important but not crucial in deciding how progressive the tax system ought to be.

14.31. What it is possible to be rather more certain about is the encouragement high marginal rates of income tax give to avoidance and evasion. The large number of professional people who own farms is not necessarily a reflection of a love of the land: tax considerations often loom large. High marginal rates of income tax substantially increase the reward from an activity of this kind, and attempts to avoid the workings of the law pose serious problems for the equitable administration of the tax system. As far as loopholes in the legislation or in the administration of the law are concerned, a frequent criticism of the tax system raised in many countries with high rates of taxation is that the tax system is steeply progressive only in form and that in substance many wealthy taxpayers are able to avoid the full effects of the progressive rate schedule. The Committee has been concerned in various of its recommendations in this report to limit the
scope for tax avoidance.

14.32. Evasion of the law raises separate though to a large extent interrelated issues. Taxpayer compliance is an essential feature of the administration of a comprehensive income tax levied on a large number of taxpayers; and while evasion will always be a problem for tax administration, the problems can be expected to be more severe the lower the willingness of the public to accept that the tax system is a fair and equitable one. Except in special situations such as war-time, a high burden of income tax is unlikely to be favourably received by the population at large. This is a factor of considerable practical relevance to the design of a progressive rate schedule and explains in some measure why the Carter Commission in Canada and tax authorities elsewhere have been attracted by the prospect of a maximum marginal rate of 50 per cent.

14.33. The Committee, too, sees advantages in top marginal rates of tax lower than at present. As a first step it might be possible, in the more immediate future, to lift the points on the income scale, in the top range, where the highest marginal rates start applying: for example, the 64 per cent rate could cut in at a taxable income of $40,000 instead of the present $20,000, and the 67 per cent rate at $80,000 instead of $40,000. But in line with the Committee's view that more reliance should be placed on the taxation of goods and services and less on personal income tax, a reduction in the maximum marginal rate to the region of 50 per cent would be thought an appropriate long-term target.

Intermediate range

14.34. A significant feature of the intermediate range, which encompasses the majority of taxpayers and provides the bulk of revenue, is the high marginal rates of tax applying over the greater part of the range. Thus by the time taxable income reaches $8,000, the marginal rate is already 48 per cent, and by the time it reaches $12,000 the rate is as high as 55 per cent.

14.35. It follows that any attempt to raise substantial additional revenue from this range, if unaccompanied by increases in marginal rates in the low range, would necessarily involve lifting marginal rates over a wide section of the intermediate range to excessively high levels. For example, 10 per cent more income tax revenue, secured exclusively from net incomes in excess of $10,000, would, on the basis of 1971–72 figures, have meant an increase in average tax rates of the order of 50 per cent and a rather steeper increase in marginal tax rates. Instead of paying at a marginal rate of 48 per cent, an individual on a taxable income of $10,000 would have been
subjected to tax at a rate of over 80 per cent on each extra dollar he earned.

14.36. Recent restructuring of the rate scale to relieve the tax burden on
the low range, and on the bottom end of the intermediate range, has
brought the issue into sharp focus. As Table 14.C reveals, taxable incomes
between about $5,500 and $11,000 now face significantly higher marginal
tax rates than in 1973–74: indeed, on a taxable income of $7,000 the
increase is more than 16 per cent.

### TABLE 14.C: AVERAGE AND MARGINAL TAX RATES, 1973–74 AND
1974–75: Selected Incomes

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>Percentage points</td>
</tr>
<tr>
<td>1,500</td>
<td>6.4</td>
<td>12.7</td>
<td>3.0</td>
<td>7.0</td>
<td>-5.7</td>
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<td>4.0</td>
<td>14.0</td>
<td>-3.2</td>
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<td>20.0</td>
<td>-2.0</td>
</tr>
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<td>4,000</td>
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<td>10.5</td>
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<td>-4.3</td>
</tr>
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<td>5,000</td>
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<td>33.3</td>
<td>13.6</td>
<td>32.0</td>
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</tr>
<tr>
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<td>16.7</td>
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</tr>
<tr>
<td>7,000</td>
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<td>37.9</td>
<td>19.7</td>
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<td>+6.1</td>
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<td>41.8</td>
<td>22.8</td>
<td>48.0</td>
<td>+6.2</td>
</tr>
<tr>
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<td>48.2</td>
<td>27.8</td>
<td>52.0</td>
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<tr>
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<td>60.3</td>
<td>37.6</td>
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<td>-0.3</td>
</tr>
<tr>
<td>20,000</td>
<td>42.2</td>
<td>64.0</td>
<td>42.1</td>
<td>64.0</td>
<td>0.0</td>
</tr>
<tr>
<td>40,000</td>
<td>53.1</td>
<td>66.7</td>
<td>53.1</td>
<td>67.0</td>
<td>+0.3</td>
</tr>
</tbody>
</table>

14.37. The upward adjustment of marginal tax rates in this latest
restructuring has a number of disturbing implications. It may well inhibit
work effort in view of the fact that, for many taxpayers, higher marginal
rates have been accompanied by lower average rates: for such taxpayers
both the income and substitution effects referred to in paragraph 14.28 will
exert a depressing effect on work effort. Moreover, to the extent that
marginal tax rates are built into claims for higher incomes in the manner
discussed in Chapter 6, increases in marginal rates over much of the
intermediate range will tend to foster more rapid inflation. Finally, raising
marginal rates to higher levels may encourage avoidance and evasion
among a larger circle of taxpayers.

14.38. It was in some degree because of its concern to keep marginal
rates in the intermediate range as low as possible that the Committee in
earlier paragraphs proposed a higher and wider initial marginal rate bracket
and some modification of marginal rates in the high range. These measures
will permit wider tax brackets and less steeply rising marginal rates over the intermediate range. Any long-run shift towards less reliance on income tax will facilitate further moves in this direction.

14.39. As indicated in Chapter 6, it is taxpayers in the intermediate range, especially in the top half of the range, who have suffered most from the unplanned restructuring of tax liability produced by inflation. In the next section the question of adjusting the rate schedule for the effects of inflation is examined more closely.

IV. Frequency of Adjustment

14.40. The restructuring of the rate scale in 1974–75 has provided a measure of immediate tax relief for lower wage and salary earners, notably those with large families. However, it has provided no relief to those persons in the upper intermediate range particularly hard hit by what was earlier described as tax drift. Moreover, if inflation continues unabated, it will be only a short time—perhaps no more than a year or two—before income earners lower down the scale are subject to higher average rates of income tax than before the latest restructuring.

14.41. The extent of the change over the last twenty years in effective average rates of tax at various levels of real income has already been described in Chapter 6, illustrated with relevant statistics. Notwithstanding the reductions in 1970–71 and 1972–73, average rates of tax at all levels of real income, except the very highest, were significantly greater in 1973–74 than in 1954–55. It is thus hardly surprising that there has been so much complaint recently of heavier tax burdens.

14.42. The general increase in average tax rates over the past twenty years has been accompanied by a change in the distribution of income tax liability. Two aspects of this change were noted in Chapter 6. First, inflation has narrowed the width of tax brackets in real terms and altered the tax liability of individuals depending on the marginal rate applicable in the region of their taxable income. The resulting change in the distribution of tax liabilities has been arbitrary and it would be fortuitous indeed if it corresponded exactly with government intentions. Secondly, dependant allowances have been eroded. To the extent that dependant allowances have failed to keep pace with inflation, the income earner with a larger family has become worse off in relation to somebody with the same income but a smaller family or no family at all. Here, too, the redistribution of tax liabilities has not been deliberately sought, and again it would be surprising if it reflected the wishes of government.

14.43. The Committee is therefore sympathetic to the view, now being
widely canvassed, that the rate schedule and concessional allowances require more frequent adjustment in times of inflation. But there are several important questions to be answered: Should adjustment extend to the component of rising money incomes reflecting growth in real incomes, or should it be confined simply to the inflation component? Should the adjustment be statutory or a matter of discretion? What is the appropriate adjustment procedure?

**Purpose of adjustment**

14.44. It is sometimes argued that the rate schedule should be adjusted for the effects not only of inflation but also of increasing real incomes, implying that once an income tax structure has been established the burden of tax should remain constant over time at each point on the income scale. The radical implications of such a policy may be brought home forcibly by pointing out that the average rate of income tax for the taxpayer with an income equivalent to average weekly earnings would have remained approximately 5 per cent, taking 1954–55 as the starting-point.

14.45. The view that the rate schedule should be adjusted for the effects of changes in real incomes cannot, however, be ignored altogether. Even if there were no inflation, the use of an unchanged rate scale over an extended period would, in a growing economy, eventually result in all taxpayers being subject to the highest marginal rate of income tax.

14.46. Nevertheless, the problems arising from increases in real incomes are less immediate and obvious than those attributable to inflation because the effect of increases in rates of tax stemming solely from inflation is to reduce a taxpayer's real income net of tax whereas those increases in rates reflecting rising real income serve only to reduce the rate of increase of real after-tax income. It thus seems to the Committee appropriate that any policy to adjust the rate scale more regularly to compensate for the effects of rising money incomes on the level and pattern of income tax liability should concentrate on the inflation element.

**Statutory or Discretionary?**

14.47. Given that the income tax schedule should be adjusted more regularly during periods of inflation, the question arises whether the adjustment should be an automatic one based on a formal statutory indexing procedure or merely discretionary.

14.48. The effect of an automatic adjustment mechanism would be to maintain a constant average rate of tax on any given level of real income, and income tax collections in real terms would increase only with increases
in real income and the number of taxpayers in the economy. Since the income tax rate schedule is progressive, income tax collections would in these circumstances still rise more rapidly than gross national product, but not to anywhere near the same extent as would be the case if no automatic adjustments were made. On the assumption that expenditure commitments and corresponding revenue requirements of the government are determined in the light of factors other than growth in revenue, a government that permitted rates of income tax to be adjusted automatically to offset the effect of inflation could more frequently expect to face situations where the anticipated growth in revenue was insufficient to finance the desired level of expenditures.

14.49. In a regime of statutory tax adjustments, a government that was unwilling to introduce discretionary increases in income tax rates would have to meet a short-fall of revenue by cutting back on expenditure. Some of the proponents of the statutory adjustment see the possibility of such an outcome as one of the strongest arguments for automatic procedures. They argue, in effect, that because inflation causes an automatic increase in revenue so long as rates are unaltered, restraints upon the disproportionate growth of government expenditure are diminished, financial discipline is relaxed and the public sector is encouraged to grow too fast. The implicit assumption here is that government and the electorate are insufficiently aware of the alternative possibility of reducing tax rates and in some way fail correctly to estimate the relative attractions to the community of lowering taxes or increasing real expenditure. While it must certainly be agreed that in a complex dynamic economy with a large public sector and many social services, wise choices between the ever-changing options are difficult to make, there nevertheless appears to be a growing awareness throughout the community that the option of lowering taxes does in fact exist and can be made effective through political pressure on the government.

14.50. A formal indexation of income tax scales might be a convenient administrative device if government spending in money terms were rising at the same rate as total national expenditure. In such a situation the automatic tendency of average rates of tax to increase with rising incomes would require regular tax cuts to obviate excessive budget surpluses of a deflationary kind, and the indexation would do much to ensure these cuts being automatically achieved. Even then there would be some complications in finding a statutory formula that took account of other taxes whose yields would be changing in other ways, and more in finding an appropriate index for the purpose.

14.51. Reality, however, is less stable than the conditions just assumed.
As noted in Chapters 1 and 2, the share of the government sector in the national economy has been rising in recent years, and this trend may well continue. Hence even if the initial pattern of the rate structure were accepted as fair, and to be preserved, indexation of income tax rates would not simplify the government's decision-making process. It would do little more than make annual decisions about the mode in which additional finance was to be collected more difficult to explain. The new rates would appear as adjustments to what they would otherwise have been rather than to what they had been the year before. Such a measure might also have a confusing effect upon public opinion if, in line with the Committee's general approach, taxation of goods and services were increasing and the income tax scale being separately adjusted for this also.

14.52. The Committee is not persuaded of the need for statutory indexing: unless preceded by restructuring of rates along the lines suggested earlier in this chapter, it would only serve to perpetuate the unsatisfactory features of the present rate schedule. The Committee accepts, however, that in a period of inflation the rate schedule requires more frequent adjustment. As an aid to regular review and informed debate, it would recommend that a statement be attached to the Budget Papers each year showing how the rate structure would appear in the current year were rates to be fully indexed for changes in the price level over the previous year. There would, of course, be problems in choosing an appropriate price index and of deciding whether or not to allow for the effects on the index of changes in rates of indirect tax. In the absence of any new official index, the present consumer price index might have to be employed—preferably, the Committee would think, with the effects of discretionary changes in indirect taxes removed.

Adjustment Procedure

14.53. Regular adjustment of the tax schedule for inflation, whether statutory or discretionary, involves the choice of an appropriate adjustment procedure. There are several possibilities:

(a) The three-step procedure of converting current year income to its equivalent in base year prices, calculating tax liability at base year rates, and re-expressing this liability in current year prices.
(b) The widening of marginal tax brackets by reference to price increases since an earlier period.
(c) The adjustment of tax rates by reference to price increases since an earlier period.
Methods (a) and (b) can be readily extended to apply to concessional allowances.

14.54. To the Committee's knowledge no country with statutory indexing has yet adopted method (a). However, a number of countries have implemented variants of method (b). Canada, for example, has recently joined Denmark in linking tax rates and income brackets to adjust the income tax rate schedule automatically for inflation. In the Netherlands there is a statutory link, subject to certain discretionary modifications: in both 1971 and 1972, the Netherlands reduced the size of the automatic adjustment index by the prescribed maximum limit of 20 per cent; in 1973 it decided not to apply the automatic adjustment mechanism but to increase exemptions by 5 per cent instead. These actions were taken on demand management grounds and with the revenue needs of the government in mind. In Iceland there is provision for exemptions and brackets of taxable income to be adjusted annually according to a ‘tax index’. Statutory adjustment procedures have also been applied in Brazil and Chile where inflation has featured prominently for many years.

14.55. Method (c) has been used in Sweden, where income tax law provides for rate adjustments to offset inflation but with an element of discretion reserved to the government.

14.56. The basic idea underlying each method is to provide a mechanism preventing individuals moving into higher tax brackets simply because of inflation. Method (a) can be dismissed as unnecessarily complicated: method (b) achieves the same results in much simpler fashion. The choice therefore lies between methods (b) and (c).

14.57. Method (b) has the merit that it reduces the burden of taxation at all levels of income. By stretching each step in the marginal rate schedule over wider ranges of money income, it reduces the steepness of the progression in marginal rates throughout the schedule, relative to money incomes, while maintaining the same steepness relative to real incomes. To do otherwise involves changes over time in the distribution of tax payments between taxpayers with different levels of real income, which is not the object sought in adjusting the rate schedule for inflation.

14.58. It follows that method (c), which adjusts for inflation by changing rates of tax rather than width of tax brackets, will alter the distribution over time of the tax burden on different levels of real income: levels of real income at which the adjusted rates of taxation apply tend to be compressed by inflation, causing the progressivity of the rate schedule to change. For this reason method (c) is inferior to method (b).

14.59. Whether statutory indexing is adopted or, as the Committee would prefer, regular review and frequent discretionary changes, there can be
little question that method (b) is the technically appropriate way of correcting for inflation. It was not the way actually employed in 1974–75, suggesting that the latest restructuring of the rate scale was not intended simply to compensate for the effects of inflation but was in fact designed to achieve more basic changes in income distribution.

V. Income-Averaging

14.60. Income tax law generally adopts an annual accounting period for the purpose of assessing tax liability. The employment of an annual period creates a number of problems, particularly for individuals with an unstable income who may, over a number of years, find themselves paying more tax than other individuals whose income is the same in aggregate but is earned in a steadier stream. This is illustrated in Table 14.D for a three-year period on the basis of the 1974–75 rate schedule.

<table>
<thead>
<tr>
<th>Year</th>
<th>Taxpayer A</th>
<th>Taxpayer B</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Taxable income</td>
<td>Tax payable</td>
</tr>
<tr>
<td>1</td>
<td>4,000</td>
<td>420</td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>3,300</td>
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<tr>
<td>3</td>
<td>7,000</td>
<td>1,380</td>
</tr>
<tr>
<td>1</td>
<td>22,000</td>
<td>5,100</td>
</tr>
</tbody>
</table>

14.61. The imposition of heavier taxes on recipients of fluctuating incomes tends to give rise to a special type of horizontal inequity, sometimes referred to as period inequity. Though period inequity is chiefly identified with a progressive rate structure, it may also be present under a regime of proportional rates as with company tax. When income instability is sufficiently great to result in profits in some years and losses in others, period inequity will occur as long as provisions for carry-forward or carry-back of losses are inadequate. Recommendations on the treatment of losses have been dealt with in Chapter 8. Attention is confined here to a consideration of measures to alleviate the period inequity to which individuals may be subject as a result of progressive income tax.

The Existing Law

14.62. Existing income tax law contains provisions that may be utilised by some classes of individuals to reduce their tax liability when income fluctuates. These provisions fall broadly under three headings: primary
producer averaging; drought bonds; and measures to spread exceptional income (sometimes referred to as ‘anti-bunching’ provisions). On a wide interpretation, each of these could be described as averaging; but to avoid confusion the term ‘averaging’ will be confined to those procedures involving the calculation of tax liability by reference to the average of an individual's income over a number of years.

14.63. The system of primary producer averaging provides for taxable income of the current year to be assessed at the rate applicable to the average income of the five years up to and including the current year. (If, for example, a primary producer has an income stream as shown in Table 14.E, 1974–75 tax liability would be determined by applying to $5,600 the rate of 4.35 per cent referable to $2,068.) Where primary producers have average or taxable incomes over $16,000, the application of averaging is limited. Special rules exist for determining the first year to be taken into account in calculating average income, and there are also provisions to deal with producers whose income is permanently reduced. There are limitations on withdrawing from or re-entering the scheme. For the purpose of averaging, a primary producer is a taxpayer who carries on a business of primary production; but it does not have to be his principal activity or constitute his chief source of income. Averaging is available to beneficiaries presently entitled to a share of income in a trust estate deriving income from a business of primary production.

**TABLE 14.E: ILLUSTRATION OF PRIMARY PRODUCER AVERAGING**

<table>
<thead>
<tr>
<th>Income year</th>
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<tr>
<td>1970–71</td>
<td>$450</td>
</tr>
<tr>
<td>1971–72</td>
<td>$550</td>
</tr>
<tr>
<td>1972–73</td>
<td>$1,040</td>
</tr>
<tr>
<td>1973–74</td>
<td>$2,700</td>
</tr>
<tr>
<td>1974–75</td>
<td>$5,600</td>
</tr>
</tbody>
</table>

(i) Average taxable income = $2,068

(ii) Tax on $2,068 = $90, equivalent to average rate of 4.35 per cent.
14.64. The drought bond scheme is a means by which certain primary producers can postpone tax payments and take steps to spread their incomes. Individuals who derive at least 90 per cent of their gross farm receipts from raising sheep or beef cattle are permitted to deduct from assessable income expenditure on the purchase of government securities issued under the Loan (Drought Bonds) Act of 1969. The deduction is limited to $50,000, and it may not exceed 20 per cent of sheep and beef cattle receipts for the year of income. If the bonds are redeemed due to drought, fire or flood, an amount equal to the deduction is included in assessable income in the redemption year. Redemption for any other reason results in a cancellation of the tax saving, but the individual may have derived a benefit from the deferred payment of tax.

14.65. In addition, the present legislation contains a variety of specific anti-bunching measures designed to reduce the extra tax burden on individuals receiving certain types of lumpy income. The provisions applicable to primary producers, discussed in Chapter 18, include the allowance of a tax rebate when an abnormal profit from the disposal of livestock in the course of putting an end to a business adversely affects the size of the average income calculated for averaging purposes; spreading of insurance recovery on livestock and trees; postponement of assessment of the proceeds of a second wool clip; spreading of income from the forced disposal of livestock; election to treat proceeds of a forced disposal of livestock as a reduction of outgoings otherwise allowable for the cost of replacement stock; and the spreading of compensation for death or compulsory destruction of livestock.

14.66. Other anti-bunching provisions allow the application of concessional rates of tax to specified kinds of income. Under certain circumstances the taxable income, including abnormal income, of authors and inventors is taxed at the rate appropriate to the individual's normal income plus one-third of abnormal income. The concessional rate is not available automatically but must be applied for by the taxpayer. A concessional rate of tax is also available to taxpayers who, upon ceasing business, receive abnormal income from the disposal of plant.
Alternatives to the Existing Law

14.67. The provisions outlined above have been widely criticised. Some favour their extension to provide relief for a wider range of taxpayers. Others advocate moving in the opposite direction: they see the relief as providing an unfair advantage to those who are eligible, particularly under present inflationary conditions. The various alternatives need to be examined.

Averaging

14.68. The instability of primary production is widely acknowledged: much was made of the fact in the recent Green Paper, *The Principles of Rural Policy in Australia. A Discussion Paper* (1974). Such factors as seasonal conditions and the character of the market are responsible for this instability, not the tax system; but tax arrangements may nevertheless serve to cushion the impact on primary producers’ incomes. It has been traditional in Australia to recognise this in the legislation, primary producer averaging having existed since 1921. The Committee would not wish to interfere with longaccepted principles by denying averaging to this group; however, it has reservations about the operation of the existing system.

14.69. While individuals other than primary producers can have unstable incomes too, and between 1921 and 1937 the system of primary producer averaging was available to all taxpayers except companies, the introduction today of a system of averaging involving all taxpayers would present considerable problems. It would not be easy to integrate general averaging with the present PAYE system; calculating tax liability would be more complicated; taxpayers would be much less certain of their tax commitments; and, to the extent that income fluctuation is due to inflation, the introduction of averaging for all might run counter to the objects sought by frequent adjustment of the rate scale. On balance, the Committee remains unconvinced that the possible gains in terms of equity would outweigh the costs and it does not recommend the introduction of averaging for taxpayers who are not primary producers. Alternative arrangements should go some way towards alleviating the problems associated with other fluctuating incomes. They include widening the income tax brackets, discussed earlier in this chapter; changes in methods of tax accounting, referred to in Chapter 8; and the introduction of an income equalisation scheme considered below.

14.70. While the Committee favours the retention of income averaging for primary producers, it recognises that the present system has a number of major shortcomings. When income turns down the effect may be harsh:
tax payable in the downturn year is generally greater than it would be in
the absence of averaging. Taxpayers must accept this or opt out of the
scheme if the law allows. On the other hand, when incomes are rising, the
system is very generous. This provides considerable incentive for
individuals to enter primary production in a small way to gain the
advantages associated with averaging applied to their whole income. The
$16,000 limit serves to some extent as a deterrent, but the figure is
necessarily arbitrary and discriminates against the genuine primary
producer whose average income exceeds the limit but is still liable to
fluctuation.

14.71. One alternative to the present system would be *cumulative
averaging*, which is based on the principle that total taxes paid over the
averaging period should be equal to the total taxes that would have been
paid had the income been received in equal amounts over that period. Tax
liability in the current year is computed by multiplying the cumulative
average income by the tax rate applicable in each year of the averaging
period, adding the separate calculations, and then subtracting the total taxes
already paid. The period for averaging may be lifetime or something
shorter. Cumulative averaging is extremely difficult to administer and is
not favoured by the Committee.

14.72. Another alternative is *block averaging*. Taxes are paid annually in
the normal way on the basis of current income and current rates. At the end
of a block of years, income earned for the period is aggregated and
allocated to each year of the block in equal amounts. Tax liability for each
year is re-calculated on the basis of the rates applying to that year and then
summed. This is compared with the taxes actually paid and a debit or a
refund may result on the assessment for the fifth year. Block averaging is
currently available in Canada on an elective basis to individuals whose
chief source of income is farming or fishing. Although administratively
feasible, it suffers from two major drawbacks that have led the Committee
to reject it. First, relief is delayed: the taxpayer must wait a long time—in
the Canadian case five years—before a refund is received. Second, if the
rate structure is adjusted regularly for inflation, certain anomalies arise: a
taxpayer may actually incur a greater tax liability with averaging than
without it.

14.73. A further alternative is the *marginal adjustment scheme* put
forward in the Green Paper on rural policy referred to in paragraph 14.68.
Like the current system of primary producer averaging, it is based on the
moving average principle. Tax liability on current year income is equal to
(a) tax payable on the moving average income of the five years up to and
including the current year, (b) plus or minus tax payable on an adjustment
factor, which is equal to the difference between current year income and the moving average income multiplied by the marginal rate applicable to the moving average income. When current year income is above the moving average income, the adjustment factor is positive; and when current income is below the average, it is negative. This scheme has one major feature not present in the current averaging system. When income falls less tax would be paid than at present and when income rises tax liability would be greater. There is therefore a general tendency for fluctuations in after-tax incomes to be reduced, whereas the effect of the present system is just the opposite. The marginal adjustment scheme thus warrants serious consideration. However, it has one serious drawback. The rate scale is structured so that marginal tax rates rise in steps, rather than continuously. Hence, under the marginal adjustment scheme a small difference in income can be associated with a comparatively large difference in tax liability. Table 14.F illustrates the position, over a five-year period, of two taxpayers with almost identical income streams. On the basis of the 1974-75 rate schedule, a $6 difference in income in the fifth year results in a $43 difference in tax liability for that year. The only way this boundary anomaly could be avoided is to replace the present stepped marginal rates with continuously rising rates. But this would introduce additional complexities into the rate structure and run counter to the Committee's proposals in Section I of this chapter.

<table>
<thead>
<tr>
<th>Year</th>
<th>Income stream A</th>
<th>Income stream B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>2</td>
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<tr>
<td>3</td>
<td>6,000</td>
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<tr>
<td>4</td>
<td>14,000</td>
<td>14,000</td>
</tr>
<tr>
<td>5</td>
<td>10,995</td>
<td>11,001</td>
</tr>
</tbody>
</table>

(i) Moving average 9,999 10,000
(ii) Excess of income in year 5 over moving average 996 1,001
(iii) Marginal rate of tax in relation to moving average (48 per cent) (52 per cent)
(iv) Tax liability on year 5 income:
    Tax on moving average income 2,779 2,780
    Tax on excess (ii) at marginal rate (iii) 478 520
    Tax payable 3,257 3,300

14.74. The United States system is a further alternative. It is available to all taxpayers whose current year income is in excess of their average ‘base period income’, but only where the excess is greater than $US3,000. It is based on the moving average principle and in effect stretches the rate
brackets for income in excess of the base period moving average. The steps for computing current year tax liability are as follows:

(1) Compute ‘base period income’ by determining the average income of the previous four years and multiplying by 120 per cent.
(2) Subtract ‘base period income’ from current year income. The difference constitutes ‘excess income’: as long as it exceeds $US3,000, this excess amount will be subject to averaging.
(3) Compute tax liability on an amount of income equal to the ‘base period income’ plus one-fifth of ‘excess income’.
(4) Compute tax liability on ‘base period income’.
(5) Compute tax liability on ‘excess income’; it is equal to tax liability in step 3 minus tax liability in step 4 multiplied by 5.
(6) Compute tax liability for current year: it is equal to tax payable on ‘base period income’ (step 4) plus tax payable on ‘excess income’ (step 5).

Assuming 1974-75 Australian rates, a current year income of $13,000 and prior year incomes of $4,000, $11,000, $7,000 and $8,000, the amount of tax payable would be calculated as follows:

Step 1: ‘Base period income’:
$4,000 + $11,000 + $7,000 + $8,000 = $30,000 ÷ 4 = $7,500
$7,500 x 120 per cent = $9,000.
Step 2: ‘Excess income’:
$13,000 - $9,000 = $4,000; therefore averaging applies.
Step 3: Tax on $9,800 (i.e. $9,000 + one-fifth of $4,000) = $2,684.
Step 4: Tax on ‘base period income’ of $9,000 = $2,300.
Step 5: Tax on ‘excess income’ of $4,000: ($2,684 - $2,300) x 5 = $1,920.
Step 6: Tax liability on current year income:

<table>
<thead>
<tr>
<th>Tax calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on ‘base period income’ of $9,000 (step 4)</td>
<td>$2,300</td>
</tr>
<tr>
<td>Tax on ‘excess income’ of $4,000 (step 5)</td>
<td>$1,920</td>
</tr>
<tr>
<td>Tax liability on current year income without averaging</td>
<td>$4,220</td>
</tr>
</tbody>
</table>

14.75. Canada has recently adopted a general averaging system similar to that of the United States. Eligibility depends upon current year income exceeding both 110 per cent of the income of the immediately preceding year and 120 per cent of the average of the incomes of the four preceding years.

14.76. The United States/Canadian schemes tend to reduce tax liability when income is rising, but not to the same extent as the present Australian
system. On the other hand, tax liability is not raised when income is falling. Admittedly, no reduction in tax liability occurs: averaging simply does not apply. The United States/Canadian schemes therefore suffer to some extent from the same basic weakness as the present Australian system, but the instability of after-tax income is not as great. Furthermore, the eligibility tests go some way to excluding those taxpayers whose income instability is caused purely by inflation. On the other hand, the basic United States/Canadian calculation is probably more difficult for the taxpayer to comprehend than the Australian in the general run of cases.

14.77. The choice would therefore seem to lie between retaining the present system which involves substantial tax saving when income is rising but heavier taxes when income is falling, and substituting a United States/Canadian-type scheme which provides less advantage when income rises but no disadvantage when it falls. The Committee is particularly anxious that tax disadvantage when income falls be minimised and that the arbitrary limit of $16,000 be removed. It would therefore propose that the present system be changed. This might be done by allowing primary producers to opt out of the present scheme whenever income falls, but a provision of this kind would be far too generous. The Committee therefore recommends that a United States-type averaging system be available to Australian primary producers. The basic qualification for the proposed system would be that current year income exceeds a figure equal to, say, 120 per cent of the average taxable income of the preceding four years. Averaging would apply to the difference between current year income and 120 per cent of the average income of the preceding four years. This would operate as follows:

Determination of Qualification:

\[
\begin{array}{ll}
\text{Current year income} & 6,500 \\
\text{Average of income of previous four years ($3,000, $3,500, $4,500, $5,000)} & 4,000 \\
120 \text{ per cent of } $4,000 \text{ is } $4,800. \text{ As current year income of } $6,500 \text{ exceeds } $4,800, \text{ the qualification is met} \\
\end{array}
\]

Calculation of tax liability (1974-75 rates)

\[
\begin{array}{ll}
\text{Tax on } $4,800 (4,000 \times 120 \text{ per cent}) & 628 \\
\text{Tax on 'excess income':} & \\
$6,500 \text{ less } $4,800 & $1,700 \\
$1,700 \div 5 & 340 \\
\text{Tax on } $5,140 (4,800 + 340) & 725 \\
\text{Less tax on } $4,800 & 628 \\
\end{array}
\]

97
It will be noted from the above example that, when income is rising, the proposed averaging system is not as favourable to a taxpayer in the lower income range as the present system. If it were considered appropriate for a higher concession to be given, a lower qualifying percentage could be adopted. Thus, had 110 per cent been employed as the qualifying percentage rather than 120 per cent, tax liability in the example given would have been $1,069 instead of $1,113. Further illustrations of the proposed averaging system are included in Appendix A to this chapter.

14.78. Steps would have to be taken to ensure that average years took effect only when the taxpayer had actually commenced as an income earner. There would also need to be built-in safeguards to eliminate, as average years, periods of nonresidence, years when no assessable income is derived, and years when the taxpayer fails to qualify because of the eligibility test discussed in the next paragraph.

14.79. There is the further problem of confining the operation to ‘genuine’ primary producers. Under present law any taxpayer carrying on a business of primary production is eligible for averaging. This allows persons making nominal investment in primary production—for example, students contributing small amounts of capital to a primary producer trust estate—to take advantage of the provisions and secure tax savings that can be quite substantial. The Committee considers that such advantages should not be available and that a more stringent test of eligibility should be applied. There are a number of possibilities. Averaging could be confined to taxpayers whose chief occupation is primary production; however, this would exclude persons who derive wage or salary income but also farm properties. Averaging could be applied to primary production income only; however, this involves the problem of establishing a fine dividing line between sources of income, something to be avoided if possible. The most appropriate test is the Canadian one that applies block averaging to those persons whose ‘chief source of income’ is from farming or fishing. If the taxpayer has two or more sources of income, it is a question of fact which is the chief source during the period concerned: the yardstick is the period as a whole, not each individual year. Although there will always be borderline cases, this test would deny averaging to many persons now taking advantage of the Australian provisions who are involved in only minimal activity of primary production. The Committee therefore recommends that the Canadian ‘chief source of income’ test be adopted to
determine who is entitled to primary producer averaging.

**Income Equalisation Scheme**

14.80. An alternative way of dealing with the problems of fluctuating incomes is by means of an income equalisation scheme. A scheme of this kind permits individuals to spread income at their own discretion by lodging deposits with the government in a particular year, the amount deposited being deductible from that year's taxable income. When the deposit is later withdrawn, the amount is added to taxable income in that year.

14.81. New Zealand, which has no averaging for primary producers, operates a scheme of this type, confined to primary producers. Its main features include:

(a) Deposits of up to 100 per cent of taxable income from primary production in any one year may be made with the taxation authorities up to six months after the end of the taxation year.
(b) The minimum period of deposit is one year and the maximum five.
(c) No interest is paid on deposits.
(d) Withdrawals cannot be taxed at a greater rate than the tax saved when deposited.

Canada has what amounts to an income equalisation scheme under which persons can purchase income-averaging annuities when specified types of income are received. The Australian drought bonds, described in paragraph 14.64, are another variant. However, these drought bonds have not been extensively used, and some of their provisions have afforded opportunities for tax avoidance.

14.82. The concept of an income equalisation scheme is sound: it would be particularly helpful as a smoothing device for taxpayers receiving large amounts of income sporadically; and it would also provide an alternative to hasty expenditures undertaken near the end of the tax year to reduce taxable income. The basic problem with such schemes is that deposits must be made in cash: taxpayers may not have the necessary liquidity, and even when they have they may be reluctant to tie up funds for twelve months or more. Nevertheless, the Committee sees an income equalisation scheme as a potentially useful supplement to primary producer averaging and recommends that the drought bond provisions be replaced by an income equalisation scheme modelled on New Zealand lines. The treatment would differ in a number of respects from the New Zealand scheme: deposits would be limited to a proportion of the net income, not exceeding taxable
income; deposits could only be made up to one month after the end of the taxation year or prior to the lodgement of a return, whichever was the earlier; and interest would be paid on deposits at a rate equal to, say, half the medium-term bond rate. The scheme would be available on election to all primary producers, not just those involved in sheep and beef cattle raising.

14.83. Though the proposal that averaging be extended to other taxpayers has been rejected, the Committee acknowledges that present anti-bunching measures do not adequately cope with the taxation problems of non-primary producers with unstable incomes. Some form of spreading provisions should be available to all taxpayers, and the income equalisation scheme suggested for primary producers might appropriately be called upon to fulfil this role. The Committee therefore recommends that the income equalisation scheme be available to all individual taxpayers. Authors and others, eligible for anti-bunching concessional rates outlined in paragraph 14.66, would be required to choose: it is not envisaged that they would be able to take advantage, in the one year, of both the income equalisation scheme and the antibunching provisions.

Anti-bunching Measures

14.84. The current anti-bunching provisions are designed to cope with the problems of recipients of specific types of lumpy income. The Committee, elsewhere in this report, recommends that these provisions be retained and in some respects extended. For example, in Chapter 23 spreading provisions for capital gains are proposed, and in Chapter 21 there are recommendations for dealing with lump-sum receipts by an employee or self-employed person on retirement.

14.85. Anti-bunching measures need to be considered in conjunction with the averaging proposals and the income equalisation scheme to ensure that unwarranted tax savings do not flow to some taxpayers. The case for anti-bunching measures is weakened when averaging exists. However, it is traditional for primary producers to be eligible for both, and the Committee does not propose to alter this, though with the change in the method of averaging for primary producers it will be necessary to look at the present anti-bunching measures available to primary producers to ensure that there is no conflict.

<table>
<thead>
<tr>
<th>Income stream</th>
<th>Tax payable</th>
<th>Without averaging</th>
<th>Present averaging</th>
<th>Proposed averaging</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Example 1: Prior year incomes: 2,000, 2,500, 3,000, 3,500</td>
<td></td>
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</tr>
<tr>
<td>4,000</td>
<td>420</td>
<td>292</td>
<td>420</td>
<td></td>
</tr>
<tr>
<td>4,500</td>
<td>550</td>
<td>410</td>
<td>525</td>
<td></td>
</tr>
<tr>
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</tr>
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<td>816</td>
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<td></td>
</tr>
<tr>
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<td>8,090</td>
<td>5,942</td>
<td>7,923</td>
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<td>Example 2: Prior year incomes: 12,000, 11,000, 10,000, 9,000</td>
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</tr>
<tr>
<td>9,000</td>
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<td>2,538</td>
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</tr>
<tr>
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<tr>
<td>3,000</td>
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<td>12,140</td>
<td>13,478</td>
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<td>Example 3: Prior year incomes: 11,000 11,000, 10,000, 9,000</td>
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<td>8,000</td>
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Chapter 15 Income Taxation in Relation to Trusts and Partnerships

15.1. In Chapter 7 there is reference to those cases where the determination of net income is made in relation, not to an individual, but to an intermediary through which income moves to individuals. The cases in point are trusts, partnerships and companies. The present chapter is concerned with the manner in which income is dealt with when the intermediary is a trust or a partnership.

15.2. There is a fundamental difference between the manner of taxing trusts and partnerships and the manner of taxing when the intermediary is a company. The determination of net income of a trust or a partnership is made simply as a step in calculating the taxable incomes of the beneficiaries under the trust (though some of the net income may have to be taxed to the trust because there is no appropriate beneficiary) or the taxable incomes of the partners. In the case of a company the determination is made as a step in calculating the taxable income of the company. A shareholder in a company is then taxed on dividends he receives from the company, the income character of those dividends generally being unrelated to the income character of the company profits from which they were paid. The recognition that a company is, nevertheless, only an intermediary lies behind recommendations in Chapter 16 for imputing to its shareholders some of the tax paid by the company.

15.3. Under the Income Tax Assessment Act, the manner of taxing in the case of trusts and partnerships requires a method of allocating the amount of the net income between the beneficiaries or the partners in accordance with the provisions of the trust instrument or partnership agreement. Under Division 6 of Part III (sections 95-102), the net income derived from the assets comprising the trust estate is allocated in accordance with the entitlement of each beneficiary ‘to a share of the income of [the] trust estate’. Under Division 5 of Part III (sections 90-94), partnership net income is allocated in accordance with the ‘individual interest’ of each partner. ‘Share of the income of [the] trust estate’ refers to the entitlement of a beneficiary to participate in the income of the trust estate, in the trust law sense of income: a fraction of the net income—the tax law concept—is allocated to the beneficiary corresponding with the entitlement. ‘Individual interest’ presumably refers to the entitlement of a partner to share in profits, a fraction of the net income being allocated to him corresponding with this entitlement. The method of allocating has not given rise to evident difficulties in the case of partnerships, but as will be seen it
sometimes gives rise to unfairness in the case of trusts.

I. Trusts

15.4. The scheme of the provisions of Division 6 of Part III of the Act, which has parallels in other common law countries, involves the calculation of the ‘net income of a trust estate’ (in general, net income in the sense of those words in Chapter 7) of a year of income and the allocation of that net income, for purposes of determining the incidence of tax on it, between the beneficiaries and the trust estate. The allocations to beneficiaries are made in terms of their ‘present entitlements’ to trust income. There is judicial opinion that at least those parts of Division 6 which depend on the calculation of the net income of the trust estate have no application when income is derived from a foreign source. The discussion in this section of the chapter assumes that no foreign element is involved: in other words, that the income has an Australian source and the trustee and beneficiaries are Australian residents. International aspects are separately considered later.

15.5. If a beneficiary becomes entitled to part of the income of a trust and later that part is distributed to him, the income will be taxed under Division 6 when the entitlement arises, and no further tax will be charged under Division 6 when the income is actually received by the beneficiary. However, if the beneficiary receives an amount, out of the income of the trust, before he becomes entitled to the amount under the terms of the trust, he is, it seems, subject to tax on what he receives by virtue of section 26 (b). This section (a survival of provisions predating those now embodied in Division 6) includes in income for tax purposes ‘beneficial interests in income derived under any . . . trust’. Its effect is, presumably, to tax the amount received, and the manner of taxation intended by Division 6 is thereby defeated. In the Committee's view the legislation should provide that income of a trust to which a beneficiary is entitled or to which he becomes entitled is taxed only under the provisions of Division 6. A provision akin to that in section 101, discussed in paragraph 15.10, will be required to ensure that where an amount is received in advance of the beneficiary becoming entitled, it will enter the calculation of the ‘present entitlement’ of the beneficiary for purposes of allocating net income of the trust to him.

15.6. The allocation of net income to a beneficiary should involve the consequence that the character of any item of that net income is carried through to the beneficiary. The provisions of Division 6 explicitly recognise this as far as exempt income is concerned and it is understood
that the Commissioner follows this principle in regard to other items of income. In the Committee's view, the Commissioner's practice should be followed, and supported by express provisions which will, for example, ensure that entitlement to tax credits in relation to dividends received, under the Committee's company tax proposals in Chapter 16, also carries through to the beneficiary.

15.7. The allocation of net income of the trust between beneficiaries and the trustee involves initially determining how much of the net income is to be taxed as income of the beneficiaries, the remainder, if any, then being taxed as income of the trust. A number of issues arise in applying the concepts used in this allocation. These relate to the meaning of ‘present entitlement’, and the interrelationship in this regard of tax accounting and trust accounting; the meaning of present entitlement where the beneficiary is under a disability; the consequences of differences between net income of the trust estate and trust income; the treatment of distributions from income that has been taxed as income of the trust; the rate of tax applicable to the income taxed as income of the trust; and the treatment of losses suffered by the trust.

Present Entitlement

15.8. The meaning of present entitlement has been the subject of a number of judicial decisions. In general, a beneficiary is presently entitled to trust income when he can claim immediate payment from the trustee. Where there is a right to income of a deceased estate, there cannot be a present entitlement until the administration of the estate has proceeded to the point where the personal representative becomes a trustee. This occurs when the personal representative has completed the performance of his executorial duties of getting in the assets, paying or providing for the debts, funeral and testamentary expenses and legacies and then holds the remainder of the property in the estate in trust for one or more of the beneficiaries. There are unresolved questions as to the manner of taxation when the personal representative becomes a trustee in the course of a tax year of income. Assuming the trust accounting year and the tax accounting year correspond, the question whether the net income of the trust estate prior to the personal representative becoming a trustee is to be taxed as income of the trust or as income of the life tenant may be thought to depend on the appropriateness of a trust account being taken on the change in status of the personal representative. There is no guidance in the Act or the judicial authorities. The matter is further complicated by the fact that the personal representative may complete his executorial duties in relation
to one part of the estate but have further duties to perform in relation to another part. A similar problem arises where a contingent interest in a trust becomes a vested interest during a year of income. The Commissioner's present practice, it is understood, is to assess the beneficiary on the income for the whole of the year of income during which the executor's administration is completed or the interest vests unless the trustee can show, by taking accounts when he completes his duties as executor or when the interest vests, that the income should be divided between the trust and the beneficiary. In the Committee's view, the Act should be changed to follow this practice; however, the requirements as to accounts should be sufficiently flexible to allow for the situation where the administration is completed in relation to part of the estate but not in relation to the balance.

15.9. There are unresolved issues when the trust accounting period, which may for example, end on each anniversary of the death of the testator or the making of the settlement, differs from the tax year of income. Where the trust estate carries on a business, clearly there can be no present entitlement of a person with a right to income until the time for taking the accounts of the business, and it is the person who then has the right to income who will be presently entitled. As the law is now framed, if there is no beneficiary presently entitled to trust income of any period to which net income of the trust estate relates, the relevant net income is taxed as income of the trust. In the Committee's view, there should be provisions requiring that the trust accounting period be treated as a substituted tax accounting period; it might be necessary also to require that the tax payable be adjusted to prevent a trust accounting period that differs from the normal tax accounting period being used as a method of deferring tax.

15.10. The point was made in paragraph 15.5 that an actual receipt of money or a benefit from the trust by a person with a right to income should be treated as a receipt of an amount to which the beneficiary is presently entitled. Another situation also calls for comment. A trustee may have a discretion to pay or apply income for the benefit of a beneficiary. Where he acts in exercise of such a discretion, section 101 provides that the beneficiary is deemed to be presently entitled to the amount so paid or applied. In the result the amount will go to determine the allocation of net income of the trust estate to be taxed to that beneficiary. The trustee's exercise of his discretion may be made at some time after the taking of the trust accounts for a year and will be treated by him as having been made from the trust income of that year. As the law stands, it is not clear whether the effect is to deem the beneficiary presently entitled to a share of the income of the year in question. Clearly in the interests of finality of
assessment it is necessary to control the tax consequences that can flow from the trustee's exercise of his discretion. The Committee recommends that where the discretion is exercised within three months of the end of the trust accounting period and the trustee appropriates income of that period for the payment, the beneficiary should be deemed to be presently entitled to the amount of the income of the period thus paid or applied for his benefit. If the exercise and the appropriation are made more than three months from the end of the trust accounting period, the Commissioner should be given a discretion to treat the amount paid or applied in the same way.

15.11. Where the trustee, in exercising a discretion of the kind just considered, appropriates income of a still earlier period, there are no tax consequences. The net income of the trust estate in that earlier period will already have been taxed either to the beneficiaries or to the trust.

15.12. The meaning of the phrase employed in section 101, ‘pay or apply . . . for the benefit of . . . beneficiaries’, is a matter of some doubt. Similar words used in a trust instrument or a statute giving a discretion to the trustee have been invested with a very wide meaning. The Committee recommends later in this chapter that where income is accumulated in a trust estate, any part of the corresponding net income of the estate that is not taxed to any beneficiary should bear tax at the maximum marginal rate. Section 101 will therefore, even more than now, offer a prospect of escaping tax at a high rate where an effective application for the benefit of a beneficiary on a lower rate is made. If the words of section 101 are given the wide meaning they have been given in other contexts, a resettlement of trust income on trusts under which the beneficiary has only a contingent entitlement to capital and income will serve to take the part of the net income of the trust estate that is resettled out of reach of the maximum marginal rate. In the Committee's view a resettlement of trust income should only be allowed to operate in this way if the terms of the resettlement give the beneficiary an absolute right to the corpus and to the income from it. If any wider meaning is to be attached to the words in section 101, the prospect arises that a beneficiary in the original trust may have a present liability for tax in respect of money to which he has no present entitlement and to which he has no vested right.

15.13. The notion of present entitlement to a share of the income of a trust estate does not depend on the source of moneys in fact used by the trustee in satisfying the rights of a beneficiary. In general, a person receiving an annuity from a trust is taxed on the amount he actually receives, whatever the source of the moneys used by the trustee. Where, however, the annuity is charged on income of the trust it should to this
extent be taxed under the provisions of Division 6. Assume, for example, that the terms of a trust instrument provide for payment of an annuity of a set amount out of income, with a direction to the trustee to resort to corpus if the income is insufficient. If the income proves sufficient, the amount of the annuity should be treated as a share of the income of the trust and taxed under the provision of Division 6. If the annuity is only in part covered by the income, it should to the extent covered be treated as a share of the income of the trust and the balance not covered by income should be taxed as income under the general provisions of the Act.

**Present Entitlement of a Beneficiary under a Disability**

15.14. The interpretation of present entitlement as meaning a right to claim immediate payment from the trustee would appear to prevent a person under a disability (for example, a minor), who cannot enforce payment because he cannot give a valid receipt, from ever being presently entitled except when a deeming provision like section 101 operates. But this consequence would conflict with the evident intention of section 98 which contemplates that a person under a disability may be presently entitled. The interpretation of ‘presently entitled’ as including a situation where a person is prevented only by his disability from claiming immediate payment, which has been adopted in one judicial decision, should, in the view of the Committee, be confirmed.

15.15. Where a person under a disability is presently entitled to income of a trust, tax on his allocation of the net income of the trust estate must be paid by the trustee as the agent of the beneficiary (section 98). The allocation must nonetheless be included in a return by the beneficiary if he has income from any other source. The tax paid by the trustee is a credit against tax assessed on the beneficiary's income from all sources (section 100). However, the tax credit apparently cannot give rise to a refund. A beneficiary may have deductible outgoings exceeding his income from sources other than the trust and may fairly claim to be over-taxed. In the Committee's view, the tax credit in these circumstances should be available as a refund. Alternatively, section 98 should be repealed. Basically it appears to be designed to ensure the collection to tax on income assessable to a minor and, to a limited extent, to other persons under legal disability. There are undoubtedly many cases where minors derive income directly and in their own right from dividends, interest and rent, and the Committee is not aware of any difficulties in collecting tax in these cases. If section 98 is retained there will need to be further provisions to make the refund available and to give effect to the proposal elsewhere in this report for
assessing the unearned income of a minor at a rate of tax based on the income of the parent. The need for these provisions would be avoided and the law simplified if section 98, and consequently section 100, were repealed. In cases of difficulty the special garnishee provisions in section 218 would be available to the Commissioner.

Net Income of the Trust Estate and Trust Income

15.16. The amount of trust income to which a beneficiary is presently entitled determines the fraction of net income of the trust estate on which he is subject to tax. Trust income is a concept of trust law, its amount depending on principles of trust law and the terms of the trust instrument. Net income of the trust estate is a concept of tax law which owes much to the example of trust law, but its elements differ in significant ways.

15.17. Net income for tax purposes may exceed trust law income. Thus bonus shares may not in all cases be trust income; they may nevertheless be income for tax purposes. The value, for tax law purposes, of stock on a grazing property may be less than the value for trust law purposes and this may give rise to an amount of deemed income for tax purposes when the stock is sold. A premium received on the grant of a lease may be trust income, in which event it will be spread over the period of the lease; when such a premium is income for tax purposes, the whole amount is included in income in the year of receipt. Prudent management of a trust may demand more generous depreciation provisions than the tax law allows, and trust law may require a deduction against trust income of the costs of non-permanent improvements which are not deductible in determining net income for tax purposes.

15.18. When net income for tax purposes exceeds trust income, the scheme of Division 6 may be thought to operate unfairly. While generally it may be true that income for tax purposes is simply a figure for calculating tax on the trust law income, there are important respects in which this is not so. To the extent, for instance, that income for tax purposes includes bonus shares which, under the trust instrument, form part of corpus, it seems unfair for the whole of this income to be used to calculate the tax to be paid by the beneficiary entitled to income and who, if he has no interest in corpus, has no claim to those shares. The Committee recommends that where the trust income to which the income beneficiary is presently entitled is less than the net income of the trust estate, he should as a general rule be taxed on an amount equal to his entitlement to trust income and the excess income for tax purposes should be taxed to the trust.

15.19. This rule is clearly appropriate whenever the tax that would thus
be paid by the trust is, on trust accounting principles, charged against corpus and the beneficiary has no interest in corpus. Where the tax is charged against corpus but the income beneficiary has an interest in corpus, the appropriateness of the rule will depend on the extent of his interest. If he has the entire vested interest in corpus, there is good reason to tax him by reference to the whole of his share in the net income of the trust and, indeed, if there is another income beneficiary to tax him by reference to the excess in relation to that beneficiary as well. If he has a less interest in corpus, the reason is not so compelling. The Committee, however, sees administrative difficulties in a qualification of the general rule which would make the taxing of the income beneficiary on the amount of the excess depend on the extent of the beneficiary's interest in corpus and a prediction of how the trustee would charge the tax if the excess were taxed to the estate and not to the beneficiary.

15.20. The appropriateness of the general rule when the tax that would be paid is charged against income also varies with the circumstances. Consider, for example, a lease premium the whole of which is income for tax purposes in the year it is received by the trust but only an apportioned amount of it is, in that year, trust income to which the income beneficiary is presently entitled. In this case, tax on the excess in the year of receipt is clearly not a charge on corpus but a charge on trust income spread over the period of the lease. The appropriateness of the general rule will depend on the way in which trust accounting deals with tax paid on the excess. If it is spread only over the years after the first year, the income beneficiary of the first year will be taxed on an amount undiminished by tax on the excess. In subsequent years the income beneficiary will receive an amount diminished by a part of the tax on the excess but will not be subject to tax on what he receives, his receipt being a distribution from income already taxed. This, on balance, would appear to produce a satisfactory result. If any part of the tax on the excess is charged against income in the first year, there are mathematical complications in determining the amount of the excess, and the income beneficiary in the first year, who will receive no more than the income beneficiaries of later years, is the only one to be subject to tax on what he receives.

15.21. The general rule may be thought less appropriate where the excess results from depreciation being applied in determining the trust income from letting a building and depreciation being denied in determining the income for tax purposes. In the first year the amount to which the income beneficiary is presently entitled will be undiminished by tax to be paid by the trust on the excess. In the following year, however, there will be a smaller amount to which the income beneficiary is presently entitled, since
his entitlement will have been diminished by the tax paid by the trust on the excess. The excess will thus increase each year at a diminishing rate and eventually stabilise. The point of stabilisation will depend on the tax rate applied to the excess. In this illustration the function of spreading the tax liability more fairly between income beneficiaries of different years is not apparent.

15.22. Though the general rule is thus more appropriate in some cases than others, the Committee prefers the certainty of a single rule to a rule which, in the interests of a more refined expression of fairness, is subject to exceptions. There may, however, be justification for allowing the income beneficiary (or in the case of a minor beneficiary, the trustee) an election to be taxed on the excess as part of his income. The election would offer an avenue of escape from what in a particular case might be an unfair rate of tax otherwise applying to the excess. There is of course a possibility of the election being used as a method of avoiding tax, for example where the person ultimately entitled to corpus has a substantial income and the income beneficiary only a modest one or where the income beneficiary has an interest in several trusts. The possibility could be controlled by restrictions on the election: for instance, election might be expressly denied if the income beneficiary has no interest in corpus or an interest in corpus significantly less than his interest in income, and there might be a requirement that the election can be made only in respect of one trust.

15.23. A special situation arises when a deceased estate is taxed on income derived during the course of administration and the assessment is paid by the trustee after the administration is complete and a beneficiary is now presently entitled to income. The Committee proposes that, in general, income derived during the course of administration should be taxed at rates determined on the assumption that the income is that of an individual as under the present section 99. If the trustee has provided for payment of the tax out of the income, no problems arise. If, however, he charges the tax against income of the later year in which the tax is paid, there will be an excess in that year to which the general rule would be applicable. The Committee sees no reason why the tax consequences may not be left to depend in this way on the trust accounting followed by the trustee.

15.24. The difference between trust income and net income of a trust estate due to the trustee having met an assessment to income tax imposed on the trust estate may be thought to have some parallel in the situation arising when the trustee meets an assessment, under section 98, as agent for the beneficiary under a disability. It should be made clear, however, that the general rule proposed in paragraph 15.18 has no application in this situation. Tax is paid by the trustee as agent and is recoverable by him
from the entitlement of the beneficiary; but this should not affect the amount of the entitlement of the beneficiary for purposes of the operation of the scheme of Division 6.

**Accumulating Income**

15.25. The scheme of Division 6 involves taxing the trust on that part of the income of the estate for tax purposes which is not taxed in the hands of a beneficiary or in the hands of the trustee as agent for a beneficiary. The phrases ‘accumulating income’ and ‘accumulated income’ are used in this chapter to refer to such income. They are not intended to extend to income to which a beneficiary is presently entitled that is retained by the trustee.

15.26. There are two questions to be considered in this regard. The first is the appropriate treatment of distributions made from accumulated income already taxed to the trust; the second is the rate of tax to be applied in taxing the trust.

15.27. Although not the subject of an express exemption, it is a clear inference from Division 6 that a distribution from accumulated income which has been taxed to the trust is not subject to tax in the hands of the beneficiary receiving the distribution. The argument in any case would be that income which has been accumulated, more especially when it has been taxed, has ceased to have the quality of income when it is distributed; it is, in effect, received by the beneficiary as capital.

15.28. It would therefore be a radical departure from the scheme of Division 6 to follow the scheme in relation to companies and tax the beneficiary on distribution, with appropriate credit for tax paid by the trust. The Committee does not favour any such change. The giving of credit, which ought in principle to be a full credit, would involve major administrative difficulties.

15.29. If there were a strong case on equity grounds for this radical departure, these administrative difficulties might not be thought too high a price to pay. The basic approach of Division 6 to the taxing of trust income is the allocation of that income to the beneficiaries who alone are taxed on it. The equity question therefore arises only in relation to income that cannot be allocated because there is no beneficiary with a vested claim to it. In the case of company income, there will almost invariably be shareholders with vested interests in the income at the time it is derived by the company; and where they are low-income shareholders, taxing the company on undistributed profits and not taxing the shareholders on later distribution is inequitable. The Committee does not, however, see a similar case in equity for attempting to relate the tax on accumulated income of a
trust to the tax situation of persons who, at the time income was derived, had no more than contingent interests in that income.

15.30. What is a proper rate of tax to apply to the accumulating income? Until 1964 such income was taxed in all cases as if it were the income of an individual. In that year an alternative was introduced whereby the income is in some circumstances subject to tax at a flat rate (currently 50 per cent) unless the Commissioner is of the opinion that it would be unreasonable to tax it in this way. The alternative was introduced to overcome tax avoidance practices to which the Ligertwood Committee drew attention in 1961. Bizarre possibilities in minimising tax are introduced when multiple incomes, each separately taxed, can be created by setting up a multiplicity of trusts, all in the interests of one person.

15.31. As a measure to defeat tax avoidance, the alternative provision has serious shortcomings. For one thing, the rate of 50 per cent which Parliament has set leaves a tax advantage where the marginal rate of the person who it is intended will ultimately receive the income is higher than 50 per cent. For another, the provision has no application to a trust created by a will or resulting from an intestacy. In general the Committee sees no reason for distinguishing between the inter vivos trust and the testamentary trust. A multiplicity of testamentary trusts in the interests of the one person is not unlikely. In any event, the inter vivos vesting of assets in a testamentary trust, which has been held not to give rise to a new trust, defeats whatever purpose might be served by the distinction.

15.32. The Committee recommends that the rate of levy on income taxed to a trust should, in general, be the maximum marginal rate applying to an individual taxpayer. The rate will discourage the setting up of accumulation trusts having tax avoidance as their object; moreover, where there is no beneficiary with a vested interest there is, except in some circumstances which might be the subject of special provisions, no obvious reason for preferring any other rate. Possible special provisions applying another rate are considered in the following paragraphs.

15.33. Where the estate of a deceased person is in course of administration and income is taxed to the estate, it is not unreasonable to regard the estate as a projection of the personality of the deceased. This would involve retaining the present law by which the income in question is taxed as the income of an individual. Similar treatment should continue to be given, too, to moneys received by the estate that would have been income of the deceased person had he received them in his lifetime: these are treated as income of the estate under section 101A.

15.34. It follows from paragraphs 15.16–15.24 that, except where an election is exercised, the excess of income for tax purposes over income
for trust purposes will be taxed as income of the trust. One might be tempted to argue that in situations of this kind there is unlikely to be any need to discourage tax avoidance by the prospect of having to pay the maximum marginal rate. But if a lesser rate of tax is applied to the excess, there would still be scope for tax avoidance, for example through the adoption by the trust instrument of trust accounting rules designed to limit the amount of trust income. There will nevertheless be cases where, as in the illustration in paragraph 15.21 involving the lease premium, the application of the maximum marginal rate to the excess appears unfair. A compromise, in the Committee's view, is for the amount by which the income of the trust calculated in accordance with income tax principles exceeds the income calculated in accordance with trust law principles to be taxed as the income of an individual who is not entitled to any concessional deductions but who is subject to a minimum rate of tax. The minimum rate should be a specified percentage which is less than the rate of 50 per cent at present applied under section 99A. The exception should not be available if the Commissioner reaches the view that the discrepancy between the two amounts of income has been deliberately brought about by a provision in the trust instrument inserted for the purpose of reducing the incidence of income tax.

15.35. The common form of will provides for the accumulation of income and the payment of that income to a child of the testator on the child reaching a certain age or, perhaps, marrying before that age. It seems inappropriate for the income arising from a trust of this sort to be taxed at the maximum marginal rate. The Committee considers that this income should be also taxed as the income of an individual who is not entitled to any concessional deductions but who is subject to a minimum rate of tax. Again, the minimum rate should be a specified percentage which is less than the rate of 50 per cent at present applied under section 99A. This exception should be limited to income arising under a trust created by will to which a child of the testator has a contingent entitlement, being income accumulated during the minority of the child.

**Losses of Previous Years**

15.36. While the scheme of Division 6 goes some distance towards treating income moving through a trust to a beneficiary in the same manner as income derived directly by a beneficiary, there are respects in which this is not so. The treatment of accumulated income is one instance. Another is the treatment of losses.

15.37. The present law, while taxing an income beneficiary on a share of
the income subject to tax by reference to his present entitlement to income of the trust, does not allow him a deduction of an equivalent share of a loss for tax purposes suffered by the trust. Such a loss suffered by the trust is normally carried forward as a deduction against income otherwise subject to tax in a later year in accordance with the general principles for the application of losses established by the Act. Where there has been a loss for tax purposes in a particular year, there will normally have been a trust law loss in that same year. In this case, if the trust law loss is carried forward and charged against the trust law income in the later year in determining the amount of the entitlement of an income beneficiary, the tax law loss will be carried forward in determining the net income of the trust estate in that later year. If, however, the trust law loss is not charged against the trust income in the later year in determining the amount of the entitlement of an income beneficiary, the deduction of the tax loss is denied in determining the net income of the trust estate for purposes of the tax liability of that beneficiary in the later year. There is an exception to the rule denying the carry forward of the tax loss: the rule is not applied where the income beneficiary has an interest, presumably any interest, in the corpus of the trust estate. Where the income is accumulating income, the carry forward of the tax loss is allowed.

15.38. It has been put to the Committee that the law should allow the income beneficiary a current deduction against his other income of a loss suffered by the trust. Where, under trust law, a loss is carried forward against future income, the denial to the income beneficiary of a deduction for the amount of a tax loss incurred by the trust in the current year seems to the Committee generally appropriate. If there is a prospect of a different income beneficiary replacing the present one in a later year, allowing the deduction to the present income beneficiary would not only produce complications but operate unfairly. In the later year the amount of trust income, but not the income of the trust for tax purposes, would be diminished by the trust loss.

15.39. Where, under trust law, a loss is charged against corpus, the denial to the income beneficiary of a current deduction also seems generally appropriate. In this case, too, there is the prospect that the income beneficiary will not be the person who in fact bears the loss.

15.40. It follows from the preceding paragraphs that a tax loss will not be deductible, whether the trust law directs that the loss be charged against corpus or directs that it be made good from future income of the trust, if the trust is terminated before the tax loss is fully absorbed. In the latter instance, the loss, in substance, will be borne by corpus so that in both instances the capital of the trust will have been diminished. Where there is
a tax loss, which is thus not deductible, there is a case for treating it as deductible against the part included in income of any capital gains arising on the termination of the trust. This proposal is again raised in Chapter 23.

II. Partnerships

15.41. The scheme of Division 5 of Part III of the Act involves calculating the ‘net income’ of the partnership (in general, net income in the sense of those words in Chapter 7) of a year of income and the allocation of that net income, for the purpose of determining the incidence of tax on it, between the partners. The allocations are made in terms of the ‘individual interests’ of the partners in the net income. A partner has an individual interest in partnership profits. It is only as a term of speech that he can be said to have an individual interest in net income. Net income is, after all, merely a figure used in determining the liability to tax on partnership profits.

15.42. All the net income is allocated to the partners and taxed in their hands. While the partnership is an intermediary recognised for the purpose of tax accounting, it is not in any circumstances a taxable entity.

15.43. From the judicial opinion that Division 6 has no application to income of a trust derived from a foreign source, it seems a proper inference that Division 5, too, has no application to foreign-source income. The discussion in this section of the chapter assumes that no foreign-source element is involved: in other words, that the income has an Australian source and the partners are Australian residents.

Net Income of a Partnership and Partnership Profits

15.44. The profits of the partnership as determined by partnership law and the partnership agreement will not necessarily be the same as the net income of the partnership. In some situations the partnership profits will be greater than the net income: special tax concessions by way of accelerated depreciation and investment allowances may be available to the business carried on by the partnership. More probably, partnership profits will be less than the net income. The partnership agreement may require that provision be made for contingent liabilities and higher depreciation charged than is allowable in calculating net income. Whatever the amount of partnership profits, only the amount of the net income will be brought to tax in the hands of the partners. The scheme of Division 5 thus ensures that no greater tax is imposed than would have been the case had the income not moved through the intermediary.
15.45. The amount of partnership profits is not, however, irrelevant. It is necessary in many cases to know the amount in order to fix the individual interests of the partners, on the basis of which the net income is allocated to the partners. Where the interests of the partners are simply expressed as fractions of profits, there will be no need to look to the amount of partnership profits. But where the interests of the partners are to some extent expressed as, say, salary or interest on capital contributed, the determination of an individual interest will require a calculation of the amount of profit in order to determine the proportion of the profits of the partnership to which the partner is entitled.

15.46. Division 5 determines exclusively how a partner is to be taxed on the net income of the partnership. Actual distribution to a partner, whenever it occurs, does not involve any derivation of income by the partner.

15.47. The allocation of net income to a partner carries through to the partner the quality of exempt income that may attach to that income. There is an express provision in Division 5 to this effect. Presumably the individual interest of a partner, for this purpose, must depend on the taking of the partnership accounts and any appropriation of profits that distinguishes the income appropriated by reference to its source. It may be necessary to ensure, by express provision, that the quality of being a dividend is carried through in order that the tax credit in respect of dividend income proposed by the Committee in Chapter 16 be available to a partner.

15.48. Where expenditure is incurred by a partnership engaged in prospecting for minerals or in mining development, deductions may be available if there is income from mining or, in some circumstances, any other income to absorb them. The Act does not at present appear to make the deductions available against non-partnership income of the partners. It may be appropriate to remove the doubt by specific provisions for the carrying through of the deductions to the individual partners.

Treatment of Losses

15.49. The treatment of partnership tax losses differs from the treatment of tax losses of a trust. A tax loss is not carried forward by the partnership in determining the net income of the partnership in a subsequent year. It is distributed to the partners in accordance with the individual interests of the partners. ‘Individual interests’, for this purpose, refers to the liability of a partner to share in losses.

15.50. A partnership agreement may provide for the payment of a salary
to a partner. The salary in a particular year may be greater than the net income of the partnership or may be payable though a tax loss has been incurred by the partnership. The application of the individual interests of the partners to determine the allocation of the net income or of the tax loss becomes, in these circumstances, a difficult exercise. The present practice of the Commissioner in accepting an allocation agreed to by the partners, where there is no suggestion that a tax advantage is the objective of the allocation, seems to be satisfactory. The practice may involve a result which, curiously, taxes one partner on an amount of net income and allows the other a loss. However, the principle is preserved that, when the tax consequences for the partners are combined, no more is taxed than the net income of the partnership or no greater loss is allowed than the tax loss.

Payments by Surviving Partners to Retired Partner or to Estate of Deceased Partner

15.51. A professional partnership agreement may provide that payments be made to a retired partner or to the estate of a deceased partner out of fees received after the retirement or death, the amounts of the payments being determined by reference to the individual interest of the former partner in work in progress at the date of his retirement or death. In the Committee's view there should be express provisions making the amounts income of the retired partner or net income of the estate. At the same time it should be made clear that these amounts are not net income of the partnership of the remaining partners.

15.52. Where the partnership agreement or a new agreement provides for payments to a retired partner or to the estate of the deceased partner which amount to a share of profits derived after the date of retirement or death, the share of profits may be taxed twice. It may be taxed as income of the retired partner, or of the estate, as a series of periodical receipts. It will be taxed also as net income of the partnership of the remaining partners. There is a contrast with the consequences that flow where payments of a similar kind are made by a company to a retired executive or to the dependants of a deceased executive. They will be income of the retired executive or the dependants but may be deductible by the company. They will be deductible as a business expense or under section 78(1)(c), in the latter case to the extent to which, in the opinion of the Commissioner, they are sums paid in good faith in consideration of the past services of the employee in business operation carried on by the company. It may appear anomalous that the company is differentially treated. The company may be no more than a partnership that has adopted a different legal form. It will be anomalous if
a company is so treated and a company elects, in accordance with the proposals in Chapter 16, to be taxed as a partnership. In the Committee's view there should be a provision under which a deduction will be allowable to a partnership for payments made to a retired partner. A number of conditions ought to be imposed. One condition would follow the model of section 78(1)(c) and require that the Commissioner form the opinion that the payment was made in good faith in consideration of past services to the partnership. Another would require that the payment be in a form making it income of the person receiving it: in this respect the condition would be more restrictive than that imposed by section 78(1)(c).

15.53. Alternatively, provisions might be adopted that would follow the United States law, whereby the retiring partner continues to be a partner for income tax purposes until all payments to which he is entitled have been received. In this event, there would need to be some provision requiring a re-allocation of partnership income where the payment is excessive having regard to past services.

III. International Aspects

Trusts

15.54. As briefly indicated in Chapter 7, the bases on which Australia asserts jurisdiction to tax income are residence in Australia of the person beneficially deriving income and source in Australia of the income. Residence in Australia of a trustee intermediary is not asserted as a basis of jurisdiction. The provisions of Division 6 are not in their terms founded on any basis of jurisdiction. There is judicial opinion that those provisions of Division 6 depending on the notion of net income of a trust estate apply only to income having an Australian source.

15.55. A number of consequences follow:

(a) Even though the trustee is an Australian resident, foreign-source income to which a non-resident is entitled through a trust is not subject to Australian tax.
(b) Even though the trustee is an Australian resident, foreign-source income accumulating in a trust is not subject to Australian tax.
(c) Foreign-source income to which an Australian resident is entitled through a trust may be subject to Australian tax in his hands but only when he receives that income: entitlement to receive is not a derivation.
(d) Even though foreign-source income has been paid to an Australian resident, it is arguable that it is still not taxable in his hands if it has previously been accumulated by the trust or retained for him because he was under a disability. The argument would be that he has received, not income, but an amount paid to him in satisfaction
of his interest in the trust.
(e) When instead of paying it to him, the trustee has applied foreign-source income for the benefit of a beneficiary, the application may not give rise to a receipt within the meaning in (c) so as to constitute a derivation of income by the beneficiary.

15.56. All except the first of these consequences involve some escape from or deferral of Australian tax, which the Committee considers unacceptable. Australia should assert a wider jurisdiction to tax income moving through a trust intermediary and Division 6 should be adapted to apply to any such income in relation to which jurisdiction is asserted. The following proposals are made:

(a) Where an Australian resident beneficiary is presently entitled to foreign-source income derived by a trust estate, that income should be subject to tax in his hands, in the same manner as Australian-source income is taxed under the present Division 6. Present entitlement for this purpose will include deemed entitlement arising from a payment or application for the benefit of the beneficiary.
(b) Where an Australian resident beneficiary receives a distribution from income of a trust estate that has been accumulated, and the income has not been subject to Australian tax in the hands of the trustee, it should be taxed in the hands of the beneficiary.
(c) Where income is accumulating, and the trustee is an Australian resident, or for other reasons the trust is to be regarded as an Australian trust, the income should be subject to Australian tax in the hands of the trustee. If subsequently such income is distributed to a non-resident beneficiary, there ought to be an appropriate refund of Australian tax. If, on the other hand, it is distributed to an Australian resident there will be no further tax on the income in the hands of the beneficiary.

15.57. It will be necessary to provide against an assignment to a non-resident by an Australian resident beneficiary of the latter's interest in accumulating income. In proposal (b) such an assignment would defeat the taxing provision; in proposal (c) it would generate an unjustified refund. It may also be necessary to provide that a change of residence by an Australian resident beneficiary shall not preclude an assessment under any of the proposals.

15.58. The implementing of these proposals will require extensions to the scheme in Division 6. Net income of the trust estate should include foreign-source income. An Australian resident beneficiary presently entitled, or deemed to be presently entitled, to that income would be taxed in the same manner as any beneficiary is now subject to tax in respect of Australian-source income. A non-resident beneficiary would of course be exempt in respect of foreign-source income. Accumulating foreign-source income would be subject to Australian tax in the hands of the trustee where
the trust is an Australian one. A distribution from accumulated foreign-source income that has not been previously subject to Australian tax would be taxed to an Australian resident beneficiary receiving it. A distribution to a non-resident from accumulated foreign-source income of an Australian trust would not be subject to Australian tax in the hands of the beneficiary and there would be a refund of Australian tax imposed on that income.

15.59. The notion of an Australian trust will have to be defined. Residence in Australia of a sole trustee or a majority of the trustees should be sufficient to make the trust an Australian one. Management and control of the trust in Australia should also be sufficient. The latter aspect is further considered in Chapter 17.

15.60. The Committee's proposals will give rise to a number of problems that are to a degree avoided by the present limited assertion of jurisdiction. Where the foreign-source income has borne foreign tax, relief against double taxation will be necessary. Where Australian tax is imposed on a distribution of accumulated income, there will be difficulties in applying the relief in respect of foreign tax paid some years before, especially if the relief is in the form of a tax credit. The onus that the law imposes on the taxpayer will assume special significance.

15.61. It will be necessary, to a greater extent than at present, to distinguish in the trustee's accounts between Australian-source and foreign-source income. There will be a question whether the character of a beneficiary's entitlement, or the character of a distribution made to him, is to be determined by the law or by an appropriation by the trustee. If the trustee's action governs, he may be able to limit Australian tax by the appropriation of foreign-source income to a non-resident beneficiary. Alternatively, the law could provide a formula by which any income, for purposes of the tax liability of a beneficiary, will include Australian-source and foreign-source elements in proportions reflecting the amounts of these elements held in the trustee's accounts.

15.62. A potential liquidity problem faces a taxpayer whenever a liability to tax is imposed on money that has not been remitted to Australia. The liquidity problem in the present context inheres in a scheme of taxation by reference to present entitlement as distinct from actual receipt. The problem in its wider context is considered in paragraphs 22.60 and 22.61.

**Partnerships**

15.63. The view was expressed in paragraph 15.43 that Division 5 applies only to income with an Australian source. The manner of taxing an Australian resident partner on partnership income with a foreign source
must depend on other provisions of the Act. It is at least arguable that there is no derivation of such income by a partner until the partnership account has in fact been taken and the amount of his entitlement determined. Even then derivation might be doubted when the partner does not have control and disposal of the amount to which he is entitled. In the Committee's view Division 5 should be extended so that the calculation of net income is made in relation to income from all sources. It will be necessary expressly to limit the net income taxable in the hands of a non-resident partner so that it includes only Australian-source income. As in the case of a trust, there will be a question, in this regard, whether the partners should be free to determine, by an appropriation in the partnership accounts, what is the source of a partner's income. Where a partner is an Australian resident, the question will also bear on the entitlement to exemption or tax credit by way of double taxation relief.
Chapter 16 Company Income Tax

16.1. Taxation of company income is an important element of the Australian tax system. As indicated in Chapter 2, it accounts today for nearly one-fifth of total taxes raised in Australia—a larger fraction than in most countries.

16.2. There is a tendency when considering companies and the taxes they pay to think principally of those companies employing large numbers of the work force or those in which investments are held. However, the term ‘companies’ embraces a wide variety of incorporated and unincorporated bodies. Table 16.A shows, for selected years, the number of resident companies lodging taxation returns, the taxes they paid, and the number disclosing taxable incomes of less than $20,000.

16.3. The table reveals a significant growth in the number of private companies—an increase of 349 per cent between 1955–56 and 1971–72 as against 127 per cent for public companies. There is reason to believe that a high proportion of the additional private companies may have been formed with the intention of spreading income, particularly investment income, between members of a family and of reducing death duties and not for normal business purposes.

16.4. The system of taxing company income must accommodate widely differing shareholding structures and business circumstances. Active businesses are the major contributors to tax revenue. Hence, the Committee believes it should formulate its views with active business operations primarily in mind. Special provisions that may be necessary to deal with companies not engaged in active business operations require separate consideration.

TABLE 16.A: NUMBER OF RESIDENT COMPANY RETURNS LODGED AND COMPANY TAX PAID

<table>
<thead>
<tr>
<th>Income year</th>
<th>Total number of companies</th>
<th>Number of dormant and loss companies</th>
<th>Net company tax paid $m.</th>
<th>Companies with less than $20,000 taxable income No.</th>
<th>per cent (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955–56</td>
<td>38 143</td>
<td>10 817</td>
<td>27 326</td>
<td>96</td>
<td>84.3</td>
</tr>
<tr>
<td>1960–61</td>
<td>71 260</td>
<td>23 734</td>
<td>47 526</td>
<td>120</td>
<td>88.3</td>
</tr>
<tr>
<td>1965–66</td>
<td>102 130</td>
<td>36 241</td>
<td>65 889</td>
<td>205</td>
<td>87.3</td>
</tr>
<tr>
<td>1970–71</td>
<td>157 079</td>
<td>61 454</td>
<td>95 625</td>
<td>403</td>
<td>86.0</td>
</tr>
</tbody>
</table>

Private companies (a)
16.5. An initial question of a very fundamental kind is how companies should be regarded for tax purposes. One approach is to consider the company as a taxable entity in its own right, with an ability to pay quite distinct from that of the shareholders. Then, company tax problems would have to be seen largely in terms of securing equity between companies: the concept of fairness in the tax structure would have to be extended to define fair treatment of companies as well as of individuals.

16.6. Many people would argue, however, that it is in principle necessary to go behind the veil of separate legal personality which the company enjoys and translate the tax formally imposed on company income into a set of individual tax ‘burdens’—on shareholders, or on purchasers of the company's product. The fairness of the tax is then related to the capacities to pay of the various individuals whose private disposable incomes are reduced by the tax.

16.7. This latter approach is basically the one adopted by the Committee.
Hence some judgment has to be made about which set of individuals undergoes a reduction in private income. Is it the shareholders, or consumers of the company's product, or both in some proportions? These questions are much debated by economists, with inconclusive results; but if anything, the balance of informed opinion has tended towards the view that the tax is unshifted.

16.8. In many cases, particularly for small family-owned companies, there is very little difference between a tax liability imposed under company income tax and one imposed under personal income tax on company profits as it accrues to the owners of the company. In such cases it seems difficult to justify making any assumptions about the incidence of company income tax that are not made in respect of personal income tax also. Although there is a very real possibility of personal income tax being shifted forward, as was mentioned in Chapters 4 and 6, it is not customary to predicate tax policy on the assumption that the personal income tax is so shifted, and no such assumption has been made in this report. Consistency suggests a similar line with company income tax.

16.9. In terms of abstract analysis it is certainly possible to distinguish the kinds of current economic situations in which firms can or cannot treat all or some tax as a cost, and to work out the factors determining how long shifting could be sustained and what distortion to economic efficiency might ensue. But it seems clear that in the complex and changing circumstances of reality the actual extent and location of such forward-shifting must defy measurement and forbid any attempt to allow for it in the design of a company income tax. At least it permits a more logical planning of this tax to make the general assumption, somewhat simplistic as it may be, that shifting is not significant and that the tax is substantially paid by shareholders.

16.10. The case for taxing individual shareholders through company tax must then rest on the judgment that, in the absence of company tax, shareholders would be taxed inadequately: that elements of the shareholder's capacity to pay would either not be brought to tax at all, or would be taxed too lightly, by the existing personal income tax. There are three distinct reasons why such a view might be taken:

(a) that those who own or operate business conducted under limited liability should pay extra tax for that privilege;
(b) that, unless capital gains were taxed on an accruals basis (whatever allowance is made for inflation), company retentions would not be sufficiently taxed, and scope for tax avoidance would be provided for those accumulating savings behind the
corporate veil;
(c) that taxation of company income provides one of the few available means—from the revenue point of view certainly the most significant means—of levying tax on foreign residents deriving income from operations in Australia.

16.11. In the Committee's view, the first of these reasons is far from convincing. The second and third reasons for company tax are, by contrast, judged to be extremely important, and the ensuing discussion reflects this judgment.

I. Present System of Company Income Taxation

16.12. Company tax systems vary greatly from country to country and are being modified year by year. The present Australian system, which broadly resembles the system in the United States and the one the United Kingdom had between 1965 and 1972, has the prime characteristic of imposing a tax on the company that is quite separate from the further personal income tax shareholders pay on dividends. It is therefore generally known as the ‘separate’ system, though in much of the vast literature on corporate taxation it is termed the ‘classical’ system.

16.13. In Australia companies are classified for income tax purposes as either ‘public’ or ‘private’. The definitions are complex, but generally those companies whose shares are listed on a stock exchange and are consequently available for purchase by the general public (together with their subsidiaries and also Australian subsidiaries of overseas listed companies) are classed as ‘public’ and all other companies as ‘private’. Commencing with the 1973–74 income year, both public and private companies are subject to company tax at 45 per cent; previously, for many years, private companies had been taxed at a lower rate than public companies.

16.14. Dividends received by Australian resident companies normally attract a tax rebate which effectively prevents any further levy of company tax on the profits from which the dividends have been paid. Dividends received by Australian resident individuals are taxed as income without regard to any company tax paid on the profits from which the dividends derive. Dividends paid by Australian resident companies to non-residents are, in general, subject to Australian taxation in the form of a withholding tax at 30 per cent, or at 15 per cent if the non-resident receiving the dividend resides in a country with which Australia has a double taxation agreement.

16.15. The opportunity for high-income shareholders to defer and sometimes avoid personal tax by accumulating income in a private
company in which they have a controlling interest is largely precluded by the imposition of a penal undistributed profits tax. This additional tax is levied at a rate of 50 per cent on the amount by which actual distribution of profits by a private company is less than a specified minimum distribution. In not requiring minimum distributions for public companies the system assumes that the larger spread of shareholdings of public companies will ensure that there is no unreasonable retention of their profits.

**Criticisms of the present system**

16.16. Separate systems are sometimes criticised for involving ‘double taxation’, since shareholders are required to pay personal income tax on company profits that have already borne company tax. But what is basically important is the total amount of levy a particular kind of income bears, not the number of taxes by which that amount is collected.

16.17. Whether the separate system taxes company profits fairly depends upon whether or not it leads to the shareholder paying tax on his share of the profits at the marginal rate of personal income tax appropriate to his income if it included the whole of his share of the profits. The amount of tax paid, by the company and shareholder, in respect of the shareholder's interest in company profits depends upon the proportion of company profits distributed, the rate of company tax, and the shareholder's marginal rate of personal income tax. The manner in which these influences operate is shown in Table 16.B. In this table, assuming a company tax rate of 47 1/2 per cent, the rate of tax paid by a shareholder on company profits can be compared with his marginal tax rate, for various levels of shareholder's income and various levels of retention by the company. In this calculation, all retained profits are presumed to bear tax at 47 1/2 per cent: in the long term these may contribute to a capital gain in the value of the company's shares, and to the extent that they do any such gain will not have incurred personal income tax. Only the distributed portion of profits will bear the personal income tax as well. Thus if a company retains half its profits after payment of company tax, a shareholder on a personal marginal rate of 66.7 per cent will in effect pay only 65 per cent on his proportion of the company's before-tax earnings. But had his marginal rate on personal income been 15.4 per cent, his full share of profits would have been taxed at 51.5 per cent.

**TABLE 16.B: COMBINED RATE OF COMPANY AND PERSONAL INCOME TAX UNDER PRESENT ‘SEPARATE’ SYSTEM, BY SIZE OF SHAREHOLDER’S INCOME AND PROPORTION OF PROFITS RETAINED**
(a) Including an attribution of company profits before tax according to his shareholding. (b) On final increments of income as shown in previous column; 1973–74 rate scale. (c) The company tax rate is taken as 47 1/2 per cent, the 1972–73 public company rate. The personal tax rate is as shown in the second column, implying that the amount of company profits attributable is modest enough to be wholly taxable at the one marginal rate.

16.18. Table 16.B indicates more generally the way in which over-taxation of a shareholder on company profits is related to the shareholder's total income and the retention policy of the company. At all income levels, the effective tax rate is lower the greater the proportion of profits retained, although the tax saving from retention (both relatively and absolutely) is greater the higher the individual's income. At the same time, the amount of over-taxation, for a given retentions policy, is greater (both relatively and absolutely) the lower the individual's income: indeed, for high-income individuals, high retention results in under-taxation.

16.19. Thus the combined company / personal income tax borne by shareholders paying marginal rates of personal income tax of less than 47.5 per cent will in all cases exceed those marginal rates, but whether this is true of higher-income shareholders will depend upon what distributions are made. The system is clearly inequitable. In low income ranges, it discriminates against those who invest relatively more of their savings in equity shares; in very high income ranges, it probably discriminates the other way. It discriminates between individuals on the same incomes with identical savings according to the different distribution policies of the companies whose shares they hold. It substantially defeats the general progressivity of the income tax.

16.20. It fails also, in several distinct ways, when the test of efficiency is applied:

(a) The over-taxation of the profit entitlements of some shareholders creates a bias against their doing business in corporate form, although the under-taxation of other
shareholders creates the opposite bias. Admittedly, the former bias may inhibit the use of company organisation for income splitting purposes; but even if the discouragement of income splitting is proper, the over-taxing of company profits is not an appropriate way of going about it. The Committee believes that tax law should, as far as possible, be neutral in its effect on the choice of a form of business organisation.

(b) The separate system favours retention of profits, as retained profits bear income tax only at the company level. The addition of a capital gains tax, as proposed by the Committee, will not fully correct this distortion, since capital gains tax applies only on realisation and thus may be indefinitely deferred. Whether the distortion is a ground for criticism depends on the view that is taken of company self-financing through retention of profits, compared with financing by resort to the market. In terms of general economic policy and ignoring the financial strain that high rates of inflation can impose on active businesses, a case can be made for companies distributing all their profits over a period and relying upon the market for acquiring more capital, though innumerable reasons can be suggested why it might be thoroughly imprudent for them to distribute fully each year. This would imply that it would be desirable to reconstruct the tax in such a way as to replace its present bias against full distribution with one in its favour. But in view of the great diversity of kinds of business conducted in the company form, the variations in the annual fortunes of companies, the variations in pressure to retain or distribute to which managements are subject and possible large discrepancies between accounting, economic and business definitions of profit, any attempt to do this may create serious problems in practice. On the whole, therefore, the Committee concludes that neutrality is the best practical test.

(c) The separate system is clearly not neutral as between equity and debt financing. Company income going in payment of interest on debt is not taxed at the company level, but only under the personal income tax in the hands of the lender. As indicated in Table 16.B, this produces a bias in favour of investment in debentures and other fixed-interest securities for all low-income shareholders and a bias in favour of equity investment in high-retention companies for high-income shareholders. It creates pressure to increase the gearing of debt finance to equity and fixed-interest capital raising may become more difficult for less well established ventures with few assets that can be offered as security. It tends to divert the savings particularly of low-income individuals away from equity investment, and to create a gap in the flow of Australian funds to developmental enterprises requiring equity capital. The gap may then be filled to a greater extent by overseas investors than is felt desirable on general grounds.

II. Unacceptable Alternatives to the Present System

16.21. It is thus clear that the existing system is in need of reform. Four alternative schemes, all of which have been seriously proposed in various contexts and all involving the outright abolition of one or other of the two taxes now imposed on income arising in companies, have been examined by the Committee. None of them can however be recommended.
Tax the Allocation of Profits

16.22. One system—perhaps the theoretical ideal—would require the company to allocate its annual profits to shareholders in accordance with their interests in those profits, and require shareholders to include the allocations in their incomes. There would be a like allocation of losses.

16.23. ‘Double taxation’ would be avoided, there being no separate company liability for tax. Equity would be served. The tax system would be neutral in all those respects referred to in paragraph 16.20 in which neutrality is at present lacking. In theory, liquidity problems for shareholders could be overcome by the company making cash distributions sufficient to cover personal tax at the maximum marginal rate on the allocation.

16.24. There is scope for such a system where corporate structures are simple enough for the interests of individuals in the company profits to be readily identified. In effect the company is taxed as a partnership. (Proposals enabling shareholders to elect to be taxed as a partnership when defined conditions are met are made later in this chapter.) But an arrangement of this kind could never be universally applied. Even when all shareholders in a company are individuals, it may be impossible to determine a correct allocation because different classes of shareholders may have differential rights to profits and those rights are not definitively expressed. The task of allocation will be that much greater when allocation must be made through a series of company shareholders. There may be additional practical problems.

16.25. There is a method of allocation available under the existing law involving bonus issues of shares from revenue profits. This method can, however, have only limited operation and could not be the general method of allocation. It involves a change in the company's capital structure by converting reserves into share capital. And it is hard to see how the method could be used when allocations have to be made through a number of companies.

16.26. The taxation of non-resident shareholders under this system would probably raise insuperable difficulties. The present system of taxing dividends received by non-residents involves a withholding tax which, with the underlying company tax, imposes what is thought to be an adequate flat rate of tax. The amount of withholding tax which can be imposed is limited to 15 per cent by a number of international agreements to which Australia is a party. Presumably those agreements would be construed so as to allow withholding tax on allocations; however, non-residents would not be taxed sufficiently unless the permitted amount of
withholding tax were multiplied several times over. Double taxation agreements can be renegotiated, but a change of the kind envisaged might not easily be secured.

**Tax Actual Distributions and Accruals in Value of Shares**

16.27. Another system would tax shareholders only, on actual distributions and increases in share values, those increases reflecting, among other things, the profits not distributed. If decreases have occurred in the value of shares, these would need to be taken into account in determining the amount subject to tax. The system would reach undistributed profits only in so far as such profits are reflected in the value of shares. At the same time, it would reach other gains by the company, realised and unrealised, reflected in the value of its shares as well as increases in value due to changes in interest rates and other market factors.

16.28. The system would have many of the advantages of the allocation arrangement. But it is not feasible to tax capital gains from all varieties of assets on an accruals basis; hence this scheme would involve non-neutrality between shares and other assets. Also, while it might be practicable and was once proposed for Canada to tax capital gains on listed shares in this manner, the problems of an annual valuation of all shares would be intolerable. Finally, the implications for taxing non-residents would be akin to those of the allocation system.

**Require Distribution of all Profits and Tax These Distributions**

16.29. The method of requiring distributions would be the imposition of an undistributed profits tax not intended to raise revenue but to penalise a failure to distribute. Equity would be achieved. Neutrality would be restored in all respects except between retention and distribution of profits. This want of neutrality could be mitigated if the system allowed a bonus issue of shares to count as a cash distribution. The difficulties involved in regard to such bonus issues are adverted to in paragraph 16.25. A scheme of this kind, including the mitigation, was proposed in the economists’ study referred to in paragraph 1.5.

16.30. This system would have implications for the taxation of non-residents akin to those of the two systems just dismissed.

**Tax the Company and Exempt Dividends from Personal Income Tax**

16.31. Taxing the company while exempting dividends from personal income tax is clearly unacceptable on equity grounds. If the company was
not to be used as a tax shelter by high-income shareholders, the rate of company tax would have to be the maximum marginal rate of personal tax, in which case it would be absurdly high for the lower-income shareholder. Unless the present maximum marginal rate is substantially reduced, the rate of tax would be out of line with rates of company tax abroad. Foreign portfolio investors would be deterred from making investments in Australian companies and direct investors would seek by various devices or excess reliance on loan capital to ensure that a controlled Australian company had little or no profits.

III. Split-Rate and Imputation Systems

16.32. It is thus clear that income tax must continue to be imposed both on companies and on shareholders, above all for international reasons and to prevent the company from being a tax shelter for high-income shareholders. But the unfair incidence upon the individual shareholder of the existing system needs remedying. To this end consideration must be given to a system that makes some allowance at either the company level or the shareholder level for company tax on distributed profits.

16.33. Where an allowance is made at company level, the system is generally referred to as split-rate. For example, if dividends paid are allowed as a deduction in computing profits subject to company tax, there are in effect two rates of tax: a positive rate on undistributed profits and a zero one on distributed profits. Initially, this was the way the Commonwealth company tax operated. Split-rate systems more often, however, impose a positive rate of company tax on distributed profits, though a rate lower than that on undistributed profits.

16.34. Alternatively, the shareholder may be permitted a credit against personal income tax on dividends received to allow for all or some of the tax paid by the company on the profits distributed. This is generally referred to as the imputation system. The system involves adding to the cash dividend received by the shareholder an amount representing tax paid by the company. The shareholder is taxed on the dividend so ‘grossed up’ and is allowed credit of the amount representing the company tax against his personal income tax liability. The mechanism of imputation is illustrated later in Tables 16.D and 16.E.

16.35. The differences between split-rate and imputation systems are not significant at the domestic level: if a withholding tax on dividends paid to residents is added to a split-rate system, it will be virtually indistinguishable in its consequences from a corresponding imputation system. But the differences are by no means insignificant in the
international field. Thus a split-rate system imposing a zero rate of tax on distributed profits would tax non-resident shareholders only to the amount of withholding tax on such profits—in other words, to a maximum levy of only 15 per cent where the shareholder is resident in a country with which Australia has a double taxation agreement. This difficulty is shared by the split-rate system with all the one-tax systems at the shareholder level.

16.36. It is therefore assumed in what follows that some form of imputation is needed and that this should allow, with as much precision as is administratively possible, for all or some of the company tax on distributed profits.

16.37. The effect on shareholders with various incomes of full imputation is shown in Table 16.C. Clearly, the full imputation system is not wholly neutral between retention and distribution: low-income shareholders will prefer distribution, while high-income shareholders will prefer retention. But this is to be contrasted with the existing ‘separate’ system in which all shareholders, if they consider only tax consequences, have reason to favour retention. However, the full imputation system, coupled with the 1973–74 personal income tax rate schedule, would leave the shareholder on $12,000 a year more or less indifferent between distribution and retention, and in so far as this is the income position of the ‘average’ shareholder neutrality will be very nearly achieved.

| TABLE 16.C: COMBINED RATE OF COMPANY AND PERSONAL INCOME TAX UNDER FULL IMPUTATION (A) AND PRESENT ‘SEPARATE’ SYSTEM (B), BY SIZE OF SHAREHOLDER’S INCOME AND PROPORTION OF PROFITS RETAINED |
| Shareholder's notional income (a) | Shareholder's marginal rate of personal income tax (b) expressed as a percentage of company profits, assuming proportion of profits retained is: (c) | 0 per cent | 25 per cent | 50 per cent | 75 per cent | 100 per cent |
| $ | per cent | 25 per cent | 50 per cent | 75 per cent | 100 per cent |
| 2,000 | A | 15.4 | 15.4 | 23.4 | 31.4 | 39.5 | 47.5 |
| B | 55.6 | 53.6 | 51.5 | 49.5 | 47.5 |
| 5,000 | A | 33.3 | 33.3 | 36.8 | 40.4 | 43.9 | 47.5 |
| B | 65.0 | 60.6 | 56.3 | 51.9 | 47.5 |
| 12,000 | A | 48.2 | 48.2 | 48.0 | 47.8 | 47.6 | 47.5 |
16.38. One conspicuous feature of Table 16.C is that for shareholders on incomes up to $12,000 a year the over-taxation of income derived through the company is substantially reduced vis-a-vis the separate system. On the other hand, shareholders with incomes over $12,000 will continue to be under-taxed to the extent that profits are retained, ignoring for the moment any tax levied on capital gains to which those retained profits give rise. In fact, this latter group of shareholders will be more under-taxed than under the separate system.

16.39. It seems clear that under full imputation (Table 16.C) equity will be better served the higher the proportion of profits distributed. A requirement, were it feasible, of full distribution of profits would thus achieve equity for all domestic shareholders. But such a requirement would offend notions of neutrality. Where the company tax is levied at a rate lower than the maximum marginal rate of personal income tax, it may
nevertheless be desirable in the full imputation case to impose, in the interests of equity, a minimum distribution requirement, thereby limiting the extent to which the company can be used as a tax shelter by high-income shareholders.

**Choice of an Imputation System**

16.40. There are three main kinds of imputation system to choose between:

A. One that taxes the company at the maximum rate of personal tax and allows full imputation.
B. One that taxes the company at a rate less than the maximum marginal rate of personal tax and allows full imputation.
C. One that taxes the company at a rate less than the maximum marginal rate of personal tax and allows partial imputation.

16.41. While the maximum marginal rate of personal tax continues at the present level, system A involves a company tax rate out of line with rates of company tax in other countries. One might, however, envisage in the long term a lowering of the maximum marginal rate of personal tax to a level which, adopted as the company rate, would not be out of line internationally.

16.42. The system would have the advantage that it would no longer be necessary to require minimum distributions by private companies.

16.43. The prospect of capital gains tax on the realisation of shares, together with a rate of tax on retained profits equal to the maximum marginal rate on personal income, would give an incentive for companies to make maximum feasible distributions. This is so because undistributed profits, in so far as they give rise to capital gains, would bear total company and capital gains tax at a higher rate than would apply to distributed profits. The resultant pressure towards maximum distributions would operate in the interests of equity as Table 16.C indicates, but would be far from neutral between retention and distribution.

16.44. To overcome this problem the Canadian Royal Commission, which favoured system A, proposed that there should be means of allocating profits by companies. The profits allocated would be taxed to individual shareholders with credit, and added to the shareholder's cost of his shares for capital gains tax purposes. The Committee has already dismissed universal allocation as impracticable.

16.45. Without such allocations provisions, the lack of neutrality in the
treatment of company retentions would be too severe. The Committee accordingly rejects system A.

16.46. System B, whereby the company is taxed at a rate less than the maximum marginal rate of personal tax and the shareholder is allowed full imputation, need not involve a company rate out of line with other countries and could ensure adequate taxation of non-residents. It would also reduce the extent of non-neutrality in the choice of form of organisation and in the choice between equity and loan capital. It could be neutral, in the sense explained in paragraph 16.37, between retention and distribution.

16.47. If existing levels of company distributions continue, system B will mitigate inequity towards the bottom of the scale. However, it is likely to create a tax shelter for high-income controlling shareholders, a shelter that could not be completely corrected by any minimum-distribution requirement. With anything less than full distribution, the high-income shareholder has the advantage of a tax deferral which would continue until full distribution or realisation of the shares. If full distribution were required, the system would be open to the non-neutrality and impracticality objections already raised to such systems.

16.48. A minimum-distribution requirement would, nevertheless, reduce the tax shelter possibilities of the system, particularly if the gap between the company rate and the maximum marginal rate for individuals were reduced so that it was not more than, say, 10 per cent. Closing the gap between the company rate and the maximum marginal rate for individuals, given a continuance of existing levels of distribution, will mean that the mitigation of inequity towards the bottom end of the scale will be less but there will be a gain in equity at all levels of income compared with the present system. Full imputation and a narrowing of the gap between company tax and the maximum marginal rate of personal tax are likely, as already explained, to cause an increase in distributions. The effect of any increase must be to improve the equity of the company tax system at all levels of income.

16.49. System B might then be regarded as the appropriate long-term target. Admittedly, there would be difficulties stemming from the need to limit the gap between the maximum marginal rate of personal tax and the company tax rate; but in the long term it may be possible to envisage a lowering of the maximum marginal rate of personal tax that will make this feasible. The system would be costly to revenue and would need to be associated with changes in the tax structure generally.

16.50. The changes required, were system B to be implemented, would be considerable. And, as a matter of principle, such a system of company
tax would need to be introduced slowly: if it were not, there would be a distinct danger that much of the benefit of imputation would be capitalised immediately into the value of shares, with haphazard distributional consequences unrelated to the aims of allowing imputation. For these reasons, any such approach to system B should be gradual, for example via a partial imputation system like system C. This system provides a company rate that need not be out of line internationally, yet would ensure adequate taxation of non-residents. It would mitigate the inequity and the non-neutralities of the present system. The extent of mitigation would depend on the rate of company tax adopted, the measure of imputation allowed and the rate of tax on capital gains.

16.51. In the Committee's view, a company tax at less than the maximum marginal rate of personal income tax coupled with a partial imputation of company tax at the shareholder level (system C) is the appropriate immediate step. It therefore recommends a system of this kind.

IV. Proposed Imputation System

16.52. In recommending a partial imputation system the Committee is proposing a system that is in force in several overseas countries and is gaining support in others. It was in use in the United Kingdom up to 1965, and a carefully reconstructed system was reintroduced there in 1972. It is the system introduced in Canada in 1971. It has also been recommended for adoption in Ireland.

16.53. The extent of the effective imputation of company tax fluctuates under most systems as the company tax rises and falls. The method adopted involves allowing a tax credit of a portion of the actual dividend received by a shareholder, the shareholder being required to include in his income subject to tax the amount of the actual dividend and the amount of the tax credit. Thus, in Canada an individual shareholder is entitled to a tax credit of one-third of a dividend received. If one assumes that the company tax rate is 50 per cent, this will involve an imputation of one-third of the company tax. However, some Canadian companies pay a lesser rate of company tax. The one-third dividend-received credit will in the case of these companies involve an imputation of a greater proportion of the company tax.

16.54. The United Kingdom system is intended to ensure that the tax imputed is no more than a specified amount of the United Kingdom tax that has actually been paid by the company. It was felt important to ensure that the United Kingdom revenue did not, by way of credit or refund, remit to shareholders taxes that it had never received. Company distributions in
many cases are made from profits which have been taxed in another
country and relieved from United Kingdom corporation tax by the
operation of a tax credit and also from profits which, because of
accelerated depreciation provisions under the United Kingdom law, have
not been taxed to the company. Canada does not attempt to ensure that
imputation is limited to the Canadian company tax actually paid. In the
United Kingdom the shareholder is entitled to the tax credit and a refund
should the credit exceed his total tax liability. In Canada the credit may be
applied against the total tax liability of the shareholder but it may not result
in a refund to him.

16.55. The Canadian system has the advantage of simplicity. A number
of special procedures are incorporated in the United Kingdom law.
Moreover, under the United Kingdom system a distribution must be
identified as it passes through interposed companies.

16.56. The virtue of the simplicity in the Canadian system may be
purchased at a price in terms of credit for, and refunds of, tax not in fact
paid by the company. Whether this price would be excessive in Australia
depends on the amount of imputation allowed, the extent of the foreign
operations of Australian companies, and the significance of incentive and
other provisions which may reduce company taxable income below a
company's profits. The Committee proposes for the short term the adoption
of the Canadian system of imputation; it also proposes, in the interests of
the low-income shareholder, additional provisions by which a refund of tax
may be made. It is conscious, however, that as one moves towards the
long-term objective the price may become excessive and the need for a
system of the United Kingdom type compelling.

16.57. The revenue consequence of the Committee's recommendations
will depend on the rate of company tax adopted, the measure of imputation
and the level of distribution made by companies. If the present rates of
company tax remain and distributions do not increase, any imputation will
clearly result in a loss of revenue. Some loss is unavoidable, however, if
the inequities of the present system are to be corrected and there will be
some offset arising from the introduction of the capital gains tax proposed
by the Committee.

16.58. Loss of revenue can be averted, in whole or in part, by an increase
in the company tax rates. But the effect on equity would have to be
considered. Retained profits attributable to low-income shareholders will
have been taxed at rates exceeding still further the marginal rates of those
shareholders. A higher rate of company tax indicates the need for greater
distribution, if the low-income shareholder's position is to be restored.

16.59. The proposed system, whatever company rate and imputation rate
are adopted, will not remove the differential tax treatment under the present system between high- and low-income shareholders. Though the difference may be reduced, the system will continue to favour the former.

Amount of Imputation

16.60. The Committee proposes that initially a dividend tax credit in the range from one-quarter to one-third of the dividend received might be contemplated in association with an increase in the company tax rate over the 1972–73 rate, say to 50 per cent. The cost to revenue of an imputation system involving a dividend tax credit of one-quarter on this basis would, on the assumption that it is not allowed to non-residents, life insurance companies and exempt bodies, be minimal. Whether it should be allowed to any of these is not here considered. Clearly, the cost of a one-third credit would be somewhat higher. Tables 16.D and 16.E illustrate the operation of imputation in the taxing of dividends received by shareholders on different marginal rates of personal tax when the dividend tax credits are one-quarter and one-third respectively.

16.61. The introduction of this limited imputation system is unlikely in itself to affect share prices significantly. Any tendency for share prices to rise may well be offset, perhaps more than offset, by the effects of introducing the Committee's proposals for taxing capital gains.

Minimum Distributions by Companies

16.62. The fact that the rate of company tax will be less than the maximum marginal rate of personal tax will leave the prospect of the use of a company as a tax shelter by a high-income shareholder. The present undistributed profits tax on private companies will continue to be necessary to ensure that minimum distributions are made, and its possible extension to all companies is considered later in this chapter.

16.63. The amount of a minimum distribution required of a private company will need to be re-examined. The likely preference of company management for self-finance has to be recognised, but the fixing of a minimum distribution should reflect the level of distribution necessary to ensure that the company is not used as a tax shelter by high-income shareholders. Under an imputation system, the level of a minimum distribution should, prima facie, be higher than under the present system. But this would not take account of any increase in the rate of company tax or the Committee's proposals for the introduction of a capital gains tax.

TABLE 16.D: MECHANICS OF PARTIAL IMPUTATION SYSTEM
WITH DIVIDEND TAX CREDIT OF ONE-QUARTER OF THE DIVIDEND RECEIVED: COMPANY TAX RATE 50 PER CENT AND 50 PER CENT DISTRIBUTION OF AFTER-TAX PROFITS

<table>
<thead>
<tr>
<th>Shareholder's marginal rate</th>
<th>20 per cent</th>
<th>30 per cent</th>
<th>40 per cent</th>
<th>50 per cent</th>
<th>60 per cent</th>
<th>66 2/3 per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>1. Company profit before tax</td>
<td>200.00</td>
<td>200.00</td>
<td>200.00</td>
<td>200.00</td>
<td>200.00</td>
<td>200.00</td>
</tr>
<tr>
<td>2. Company tax (50 per cent)</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>3. Company profit after tax (1–2)</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>4. Retained by company (50 per cent)</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
</tr>
<tr>
<td>5. Dividend to shareholder (3–4)</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
</tr>
<tr>
<td>6. Gross up on dividend (shown in 5) by 1/4</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
</tr>
<tr>
<td>7. Amount shown in shareholder's tax return (5 + 6)</td>
<td>62.50</td>
<td>62.50</td>
<td>62.50</td>
<td>62.50</td>
<td>62.50</td>
<td>62.50</td>
</tr>
<tr>
<td>8. Tax (on 7) at marginal rate</td>
<td>12.50</td>
<td>18.75</td>
<td>25.00</td>
<td>31.25</td>
<td>37.50</td>
<td>41.66</td>
</tr>
<tr>
<td>9. Tax credit (= 6)</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
<td>12.50</td>
</tr>
<tr>
<td>10. Tax payable by shareholder</td>
<td>nil</td>
<td>6.25</td>
<td>12.50</td>
<td>18.75</td>
<td>25.00</td>
<td>29.16</td>
</tr>
<tr>
<td>11. Total tax paid by company and shareholder (2 + 10)</td>
<td>100.00</td>
<td>106.25</td>
<td>112.50</td>
<td>118.75</td>
<td>125.00</td>
<td>129.16</td>
</tr>
<tr>
<td>12. Under a separate system with 50 per cent tax rate and 110.00 50 per cent distribution, the total tax paid by company and shareholder would be:</td>
<td>$115.00</td>
<td>$120.00</td>
<td>$125.00</td>
<td>$130.00</td>
<td>$133.33</td>
<td></td>
</tr>
</tbody>
</table>

13. The net of tax gain to shareholder of one-quarter imputation on this basis would be:

14. Under the 1972–73 public company rate of 47 1/2 per 5.50 cent with a 50 per cent distribution, the profit after tax would be $105 and the retention and dividend each $52.50. Were the assumption made that the absolute sum of retention would remain constant at $52.50 after the tax rate is increased to 50 per cent and one-quarter imputation operated, the dividend would decrease to $47.50. The net of tax gain to shareholder, using these assumptions and despite the reduction in dividend from $52.50 to $47.50, from the adoption of one-quarter imputation coupled with a company tax rate of 50 per cent, would be:

15. If the original profit of $200 were earned directly by an individual, the tax payable would be:

International Implications of the Proposed Imputation System

16.64. The discussion of the proposed imputation system has so far assumed that imputation will be available only to Australian resident shareholders and that, in principle, it should be available only in respect of dividends from profits that have borne Australian tax. But an imputation system also has international implications that cannot be ignored: they concern both investment by non-residents in Australia and investment by Australian residents in other countries.
16.65. *Investment by non-residents.* Australia may expect pressure from other countries, especially those involved in double taxation agreements, to extend to non-residents at least some part of the imputation given to residents. The pressure will of course be greatest from countries already having a system that allows imputation to non-residents.

16.66. There does not appear to be any legal obligation, under existing agreements to which Australia is a party, to extend imputation to non-residents. There is, for example, no clause in these agreements corresponding to the non-discrimination clause in the 1963 OECD draft convention. In any case, the discrimination with which that clause deals is
discrimination against another country's nationals, and this has never been contemplated: if imputation is denied to some shareholders, it would be on the basis of their residence whatever their nationality.

16.67. Agreements to which Australia is a party include provisions imposing, on a reciprocal basis, a ceiling on the tax Australia may levy on dividends paid by an Australian resident company to a resident of the other country. It might be argued that tax on a dividend should be interpreted to include that part of the tax paid by the company which is subject to imputation in the hands of an Australian resident shareholder. The argument would be difficult to sustain in relation to an imputation system of the Canadian type, which does not attempt to correlate the imputation credit available to the shareholder with an amount of tax paid by the company. On the other hand, the argument might be thought to have some force where there is such a correlation, as under the United Kingdom system. Yet in asserting that one should look beyond the tax expressly levied on a dividend to the tax paid by the company in order to find the amount of tax on the dividend, the argument opens up the whole question of the incidence of company tax. It is difficult to see why it should be any more appropriate to treat the imputed tax as a tax on the dividend than to treat the whole of the company tax on the profits from which the dividend is paid as a tax on the dividend.

16.68. Apart from any legal obligation resting on Australia, it might be said that there is an obligation of comity between nations requiring reciprocity in levels of tax that one country imposes on residents of another. This obligation might, for example, require that Australian tax on a resident of the United States should not exceed the tax which, in similar circumstances, the United States imposes on a resident of Australia. Even if company tax is assumed to be paid by the shareholders of the company, the consequence of the suggested obligation would only be that the burden of Australian company tax and tax on dividends paid to a United States resident should be in line with the taxes the United States imposes in relation to dividends paid to an Australian resident. Perhaps there is in the suggested obligation some requirement, if a country's rate of company tax is greater than that imposed in another, to make an adjustment to its rate of tax on dividends flowing to that other country.

16.69. All these requirements, whether in terms of legal obligation or comity between nations, proceed on a notion of fairness to the shareholder that may be thought unreal. Fairness to a non-resident shareholder in relation to a dividend received depends not only on how Australia taxes the dividend but also on how it is taxed, more particularly what credit is allowed, in the country of residence.
16.70. So far as the arguments are made in terms of fairness between the public revenues of countries, it must be borne in mind that Australia is a net capital-importing country. Relatively, a forbearance to tax a non-resident is more expensive for Australia in terms of revenue forgone than is the same forbearance by a net capital-exporting country.

16.71. The Committee is content to express the view that Australia is not under any present obligation to extend imputation to non-residents. Whether or not imputation is extended to residents of any foreign country will depend on the economic policies Australia may wish to pursue as well as on revenue considerations.

16.72. **Investment by Australian residents in foreign countries.** The adoption of an imputation system will have a bearing on the choice for Australian capital between investing in Australia and investing in other countries. The discouragement to investing abroad will be evident enough if Australia follows an imputation system of the United Kingdom type, which would confine imputation to dividends paid by Australian resident companies and would set a limit to the amount of tax subject to imputation so that it cannot exceed Australian tax actually paid by the company. If the Canadian model is followed, an Australian resident company will not be discouraged from investing abroad. The Canadian system allows imputation in respect of dividends paid by a resident company, whether or not the profits from which the dividend has been paid have borne Canadian tax.

16.73. Imputation would not be available to an Australian resident individual against Australian tax on the dividends he receives from a foreign resident company. Therefore whether Australia follows the United Kingdom or the Canadian model, there will be reason for an Australian resident individual to prefer investing in an Australian resident company to investing in a foreign resident company.

16.74. A compromise between the United Kingdom and Canadian systems, which would overcome the discouragement to foreign investment by an Australian company involved in the former system, would in effect allow imputation credit of tax paid abroad but confine the credit so that it was available only against Australian tax on the dividend in the hands of the shareholder. The Committee would not favour such a compromise in its application to dividends paid from profits that had borne Australian tax. In relation to such dividends, the credit should be available against other tax liability of the shareholder or, if necessary, give rise to a refund. The compromise would need to be confined to dividends paid from foreign-source profits that had not borne Australian tax. There would be considerable administrative complications; but one might visualise
companies being required to distinguish in their accounts between profits that have borne Australian tax and those that have not, with the compromise credit treatment applying to dividends from the latter.

V. Imputation and Forward-Shifting

16.75. In recommending a full imputation system as the appropriate long-term target, with a partial imputation as an intermediate step, the Committee carries to its logical conclusion its assumption that company tax is best treated as a levy on the income of shareholders, despite the probability that in cases where competition is weak it may be shifted forward. Others may believe that the frequency of such shifting is, and would be even under an imputation system, so great that company tax should be designed on an assumption of partial shifting (which, since company tax rules must apply universally, would have to be uniform). The Committee, to repeat, rejects this approach, but its logical implications may be briefly noted.

16.76. On this view company tax is partly an indirect tax on consumers and only partly a tax on shareholders. The former part, it would have to be conceded, is non-neutral and probably inequitable; but as long as the company tax itself exists, it seems quite impracticable to remedy this.

16.77. As regards its impact upon shareholders, the crucial consideration would be that the effective company tax rate is below the nominal, and presumably intended, rate. The simple remedy would be to increase the nominal rate above the level that would otherwise be felt appropriate.

16.78. The assumption of shifting would not destroy the general case for imputation. On the assumption that imputation credits are forward-shifted in the same way as the company tax itself—if, in other words, the imputation credit involves a reduction in the amount of gross company tax shifted—the credit should be raised to match the increased nominal company tax rate.

VI. Proposal to Allow an Election to be Taxed as a Partnership

16.79. An alternative to the present system—the allocation by the company of all its profits to its shareholders, the allocation reflecting their interests in those profits, and the taxing of those profits to the shareholders—was dismissed in paragraph 16.24, principally because of the impracticability of applying it to all companies.

16.80. The Committee does, however, consider it appropriate that the
law, whether or not an imputation system is adopted, should specify the conditions of a corporate regime within which an arrangement of this kind is practicable, and should allow the shareholders of a company meeting those conditions to elect to be taxed on allocations in the manner in which partners are taxed.

16.81. The United States has had a system of election for a number of years and is currently considering its reform. A similar system was proposed for Canada, both by the Carter Commission in 1966 and in the subsequent government White Paper of 1969. The proposal has not been implemented, possibly because a similar result to a system allowing an election is achieved in Canada by the provisions described later in paragraph 16.97. Those provisions ensure that smaller companies are taxed in a way which involves payment ultimately of no more tax than would have been paid had the business been carried on in partnership form, and may involve a deferral of tax in the meanwhile. In the United Kingdom the Report of the Committee of Inquiry on Small Firms (Bolton Committee, 1971) recommended that close companies—the equivalent of Australian private companies—should be allowed to elect to be taxed as partnerships. The fact that this recommendation has not been acted on may be because the United Kingdom has now adopted provisions, described in paragraph 16.98, allowing a lower rate of tax on smaller companies.

16.82. As explained in paragraphs 16.100–16.101, the Committee does not favour provisions along Canadian or United Kingdom lines. Its proposal to allow an election to be taxed in the manner of a partnership has therefore a more important function in its overall recommendations for the taxing of company profits.

16.83. It is not proposed to spell out in detail the system Australia might adopt. There are, however, certain issues of principle bearing on the scope of the system to which reference should be made. Some indication will be given, in a general description of a proposed system, of the inevitable complexities involved.

**Eligibility to Elect**

16.84. A number of issues relating to eligibility to elect call for examination. These concern the possibility of confining the election to companies whose profits are below a specified limit and whose income is not investment income; the possibility of confining the election to companies whose income is derived from Australian sources; the restrictions that should be imposed in terms of numbers of shareholders, the kinds of shareholders, and the capital structure of the company.
16.85. *Amount and nature of company profits.* In the United States the election is available whatever the amount of company profits, and in this respect there is no attempt to confine the election to smaller companies. In Canada the Carter Commission would have confined the election to companies with incomes below $200,000. In the Committee's view the election to be taxed in the manner of a partnership is not primarily directed to assisting small companies, but is a means of ensuring that company profits are taxed fairly. It follows that there should be no restriction on the election by reference to the amount of company profits.

16.86. The United States law denies the election to a company deriving 20 per cent or more of its income from investments, though it has been proposed that this restriction be eliminated. The Committee does not think it appropriate to impose such a restriction. The availability of the election to an investment company is consistent with the treatment proposed in paragraphs 16.116–16.117 of investment income of companies that have not elected.

16.87. The United States does not allow an election when more than 80 per cent of a company's income is derived from foreign sources. The only reason for such a restriction would seem to be the administrative complications involved in allowing tax credits to shareholders; but in the Committee's view these are not sufficient to justify discriminating between companies with domestic-source and companies with foreign-source income.

16.88. *Number and nature of shareholders.* The compliance and administrative costs of an election system will be minimised if the election is confined to companies with small numbers of shareholders all of whom are individuals and beneficially entitled. In the United States the number of shareholders may not exceed ten, though it has been proposed that this be raised to fifteen to allow greater flexibility, making it possible, for example, to issue shares to key employees. The Committee favours the maximum number of shareholders being set at ten, at least until the administrative problems involved in an election system have been carefully assessed.

16.89. All shareholders should be individuals who are beneficially entitled. An exception might be made of the administrator of a deceased estate; but the system could not be conveniently applied where a shareholder is another company. All shareholders and the company itself should be resident in Australia.

16.90. *Capital structure of the company.* If the allocation of profits to shareholders is to be made as easy as possible, all shares in the company should carry the same rights to income and capital. In the United States all
shares must be of the same class, though consideration is currently being given to allowing also a class of shareholders without voting rights who have rights to fixed annual distributions and to a fixed amount upon redemption. The Committee would take the view that, at the outset at least, only one class of shares should be allowed.

**Manner and Timing of Election and Manner of Termination of Election**

16.91. The working out of detailed provisions as to the manner and timing of an election and the manner of termination of an election will be assisted by drawing on United States experience. If, as suggested in paragraph 16.93, both profits and losses are allocated to shareholders by reference to their daily holdings of shares throughout the year, it will be necessary to set the time for making an election early in the year of income and to deem a shareholder who signs an election to have been a shareholder from the beginning of the year. A person who acquires shares thereafter should be deemed to have consented to the election unless he gives the Commissioner notice of revocation. Subject to this, the unanimous consent of all shareholders should be required. All shareholders who have consented would need to join in any revocation. A new shareholder who has not consented might, however, bring about a revocation by giving notice to the Commissioner.

16.92. Unanimity of consent, in the view of the Committee, is necessary to prevent prejudice to a minority shareholder who might otherwise be forced to accept liability to tax on profits he has no immediate prospect of receiving.

**Consequences of Election and of Termination of Election**

16.93. When an election applies, the taxable income or allowable loss of the company should be allocated to shareholders in accordance with their daily holdings of shares during the year of income. This will accord with the law as proposed in the United States where, for the present, allocation on daily holdings applies only to losses. Allocations of taxable income to shareholders will bear the same character as the income had in the hands of the company. There will need to be rules by which income of any class, for example dividends carrying an imputation credit, are treated as being spread over the allocations. Capital gains and losses will be allocated.

16.94. Special rules will be necessary to deal with pre-election accumulated income or pre-election losses of the company.

16.95. Allocations taxed to a shareholder will increase the cost of his shares for purposes of tax on any gain made on realisation of the shares.
An actual distribution to a shareholder from allocated profits will not be taxed to the shareholder but will reduce the cost of his shares.

16.96. The revocation of an election in any year should be treated as relating to the whole of that year. To minimise scope for tax planning that might be practised by moving into and out of the election system, and to minimise administrative complications, the right to make a fresh election after a revocation should be restricted. In the United States a fresh election may not be made until five years after the revocation, except with the leave of the Revenue.

VII. Appropriateness of Special Provisions for Small Enterprises

16.97. In Canada, a ‘Canadian-controlled private corporation’—very generally, an unlisted company controlled by Canadian resident individuals—is taxed on its ‘active’ business income at a special rate of 25 per cent on the first $100,000 of such income, provided its accumulated income does not exceed $500,000 and the income accumulated is invested in the business in the form of business assets, cash or short-term securities. The effect of this special treatment, and of the one-third dividend tax credit available to individual shareholders in that country, is that none of the corporation's business income distributed to shareholders need bear any more tax than would have been paid had it been derived directly by the shareholders. It should be noted, moreover, that having regard to the difference between the 25 per cent rate, which may be all the tax payable by the company on business income, and marginal rates higher than this payable by shareholders, the Canadian-controlled private corporation involves substantial tax deferral.

16.98. In the United Kingdom, a ‘small company’ is charged to corporation tax at a lower rate than other companies: while the general rate is 52 per cent, the concessional rate is only 42 per cent. A small company is defined as one with profits in the year in question of up to £25,000; there are tapering provisions for companies with profits between £25,000 and £40,000. Exploitation of the small company provisions by fragmenting an enterprise over several companies is controlled.

16.99. In relation both to public and to private companies, Australia until quite recently imposed a lower rate of company tax on the first $10,000 of company income and a higher rate on subsequent dollars. This may be seen as a very crude way of providing some relief from the burden of over-taxation to shareholders in small enterprises. The lower rate on the first $10,000 was available to all companies however large their income. In the
case of private companies, there was a sliding scale of retention allowance which also might be seen as providing some relief for small enterprises. Both the lower initial rate of tax and the sliding scale of retention allowance encouraged fragmentation.

16.100. If special provisions are to be made for small enterprises, the Committee would prefer the Canadian or United Kingdom model rather than a return to what used to be the Australian law. However, the Committee takes the view that one should not lightly introduce a new element of non-neutrality into the company tax system. There can be no question that the Canadian provisions afford very substantial tax deferral; and although this element of non-neutrality is much less conspicuous in the United Kingdom model, it is nonetheless significant.

16.101. It is noteworthy that neither Canada nor the United Kingdom allows an election by shareholders to be taxed as a partnership. In the Committee's view, this election is sufficient to afford protection to shareholders in a small enterprise from any element of over-taxation. If the furthering of economic growth is thought to justify tax concessions or other financial incentives to small enterprises, they should be offered whatever the form of business organisation adopted. This is also the view of the Bolton Committee which argued that, since so many small enterprises in the United Kingdom are unincorporated, assisting such enterprises through corporate income tax would be highly discriminatory and of only limited effectiveness.

VIII. Aspects of Present Company Taxation

Minimum Distribution Requirements

16.102. Reference has already been made to the distinction drawn in the Act between public and private companies and to the undistributed profits tax intended to compel minimum distributions by private companies.

16.103. At the inception of Commonwealth income taxation in 1915, it was provided that if a company did not make a reasonable distribution a deemed distribution could be made and the distribution assessed as income in the hands of the shareholders; however, the concept of ‘reasonable distribution’ was left undefined. The amending Act of 1922 fixed two-thirds of the taxable income as a reasonable distribution and provided that tax on deemed distributions would be imposed on the company, the tax so imposed being the tax that would have been paid by the shareholders on the amount unreasonably retained had it been distributed to them. The practice of the Commissioner at this time was to limit the application of the
provisions to closely controlled companies, i.e. companies controlled by a few individuals.

16.104. The Ferguson Commission recommended in its first report, in 1932, that the deemed distribution provisions be limited in a way that would give legislative approval to the Commissioner's practice. It was said that:

‘The dividend policy of a public company in which the public are substantially interested, and whose shares are dealt in on the Stock Exchange, is not likely to be affected by consideration of the amount of tax which will be paid by individual shareholders. The influence of shareholders will be exerted to induce the directors to distribute as much and not as little as possible, and its published accounts will show what profit has been earned, and how it has been appropriated.’

The 1934 Amending Bill gave effect to the recommendation. The amended law defined a private company and confined the deemed distribution provisions to such companies.

16.105. The definition of a private company was complex; but it did not cover all closely-controlled companies, and company structures were adopted to escape the definition. In the early 1950s the Spooner Committee recommended a new definition of a private company, intended to prevent such escape; and it also recommended that in place of the tax calculated by reference to deemed distributions, there should be a tax on company profits designed to force distributions. The tax proposed was to be a penalty levy applicable to so much of the profits of the company after payment of company tax and after deduction of a retention allowance as had not been distributed within a defined period. The recommendation of the Committee was adopted by amendment to the Act in 1952.

16.106. The new definition did not succeed in preventing the practice of employing company structures that fell outside the definition though in fact the companies were closely-controlled. Moreover, companies coming within the definition were able formally to satisfy the requirement to make a sufficient distribution by distributing to a series of related companies (known as chains) or around circles of related companies (known as snakes). The profits thus remained in a pipeline of companies forever moving between companies but never being taxed to individual shareholders.

16.107. In 1964, following recommendations of the Ligertwood Committee in 1961, yet another attempt was made to define a private company, this time by defining a public company and providing that all other companies would be private. The provisions allowing a tax rebate on dividends passing between companies were amended at the same time. The
practice of storing profits in a pipeline of companies is now prevented by a partial denial of the rebate when dividends are received by a private company from another private company. However, the Commissioner is given a discretion to allow a full rebate. That discretion will ordinarily be exercised if the Commissioner is satisfied that the dividends will reach the hands of persons, who are not private companies, within 22 months of the end of the year of income in which the dividends were received by the company claiming the full rebate.

16.108. But the new definition of private company, like its predecessors, failed to embrace all closely-controlled companies. Again company structures were adopted by which closely-controlled companies escaped the definition, this time exploiting the provisions making a subsidiary of a public company a public company. Amendments to the definition were made in 1973 with the object of preventing this avenue of escape.

16.109 The history surveyed in the previous paragraphs reflects two assumptions. The first, recognised by the Ferguson Commission, is that because of pressure exerted by their shareholders listed companies in which the public are substantially interested may be expected to distribute sufficient profits, ultimately to individuals, to prevent the company affording a tax shelter. The second is that it is possible to draw a distinction between such companies and others that need to be put under a legal discipline to make adequate distributions.

16.110 Experience over the years tends to belie the latter assumption. But whether or not an effective distinction can be drawn, the question remains whether the first assumption—that listed companies in which the public are substantially interested do not afford tax shelters—is correct.

16.111. Empirical evidence casts some doubt on the correctness of the assumption. Distribution policies of listed companies in which the public are substantially interested may reflect a variety of purposes that management is seeking to further. But if in fact the distribution policy of a company involves substantial retention of profits, it will give tax advantages to high-income shareholders whether or not management has this in mind, though it is true that the retained profits in terms of their value to the shareholders in the market place may be less than the amount retained.

16.112 The Committee has given some consideration to the technical aspects of an extension of minimum distribution requirements to all companies. Apart from the aspect about to be mentioned, the general structure of the present undistributed profits tax presents no problems. In this it contrasts with the earliest provisions requiring minimum distribution: those provisions, though formally applicable to all companies,
could only be effectively administered in relation to closely-controlled companies. However, as a measure to prevent the storing of profits in a pipeline of companies, the present undistributed profits tax could not be applied to all companies, since a company whose shares are widely held cannot know the ultimate destination of distributions it makes to other companies. An alternative to undistributed profits tax would have to be considered.

16.113 Two methods of ensuring that no tax advantage attends the holding of profits in a pipeline of companies deserve some consideration. The first is the method used in the United States and involves denying exemption to a fraction of a dividend received by a company from another company at each point of movement of profits in the pipeline. This method was in fact proposed by the Ligertwood Committee which suggested that the fraction of a dividend denied exemption should be set at 15 per cent—the fraction actually employed in the United States. However, unless dividends moving within a group of companies are accorded special treatment, as in fact they are in the United States, the method involves an arbitrary and wide-ranging cascade tax on company profits. Even if such special treatment is given, there remains an element of cascade taxation where dividends move through companies that are not members of a group.

16.114 The second method involves an adaptation of a Canadian scheme which at present applies in that country only to dividend income received by closely-controlled investment companies. A company receiving a dividend would hold that dividend in a separate account. The dividend would be subject, in the hands of the company, to a refundable tax at a rate reflecting the tax that an individual shareholder on the maximum marginal rate would pay, after making allowance for any tax credit available to him under the prevailing imputation system. When a dividend is paid by the company from the amount in this account, the tax would be refunded to the company. If such distributions are made in a year of income so as to absorb all dividends received by the company in that year of income, there will of course be no net refundable tax payable. The method involves some complications where the company receiving the dividend has suffered a loss in an earlier year or in the year of income; the company might not, in these circumstances, have any immediate prospect of paying a dividend which would generate the refund of tax. In such circumstances the company might be allowed to apply the loss against the dividend received and so avoid payment of the refundable tax; in the result, however, it will have applied the loss to relieve tax at the refundable tax rate, which will be less than the company tax rate.

16.115 These observations suggest that it might be technically feasible to
extend minimum distribution requirements to all companies. The possible
gain in equity must, however, be weighed against the costs involved. These
costs include not only those of administration and compliance but also the
loss of neutrality between retention and distribution of profits. In the
Committee's view, the costs are likely to outweigh the gain in equity, and
therefore the extension of minimum distribution requirements to all
companies is not recommended.

Income of Private Investment Companies

16.116 The present undistributed profits tax applied to private companies
in effect imposes a penalty on the company if it does not distribute what
remains of profits after company tax and after a retention allowance.
Originally the retention allowance was seen as enabling the company to
hold back funds for the maintenance and expansion of its business
operations. Even when the retention allowance had ceased to depend on
any exercise of discretion by the Commissioner as to the amount of a
reasonable retention, this purpose of the allowance continued to be
reflected in the diminishing fractions applied to successive slices of profits
in computing the amount of the allowance. The present law applies one
fraction—50 per cent—to all after-tax profits whatever their amount. There
is in the result very little suggestion of the original purpose: the present
retention allowance is basically no more than a method of fixing how much
of the company's profits should be taxed at shareholders' individual rates.
In one respect, however, the original purpose does find a continuing
expression. The retention allowance on income from property—income not
accompanied by the same degree of commitment to hold back funds for the
continuance of business operations—is fixed at the much lower figure of
10 per cent, or, in the case of private company dividends, at zero.

16.117 As long as the separate system of company taxation remains, and
even under a limited imputation system, there is a general bias against the
use of the corporate form. The result of the less generous retention
allowance on income from property is that such bias is correspondingly
greater where the corporate form is used as a vehicle of investment in
property other than shares. In the Committee's view this additional bias is
unjustified, and it therefore recommends that the retention allowance in
respect of income from property other than shares be brought into line with
that applying to other income.

16.118 In contrast with the special bias against the use of the corporate
form as a vehicle for deriving income from other kinds of property, the
present law gives rise to a significant incentive to use the corporate form as
a vehicle for deriving income from shares. An individual with a portfolio of share investments can secure significant tax saving by vesting the portfolio in a private investment company which will derive the dividends on those shares. Because of the tax rebate on dividends allowed to a company, the dividends will not be taxed in the hands of the investment company. The effect of the retention allowance of 10 per cent of the amount of the dividends (available unless the dividends are from private companies) is that tax on this fraction of the dividends can be indefinitely deferred. The prospect of undistributed profits tax will force a distribution of the remainder; but tax on the individual who vests his portfolio in a company can be delayed for at least one year, and as long as three years, after the derivation of the dividends by the company. (The longer delay is achieved by the interposition of other private companies between the individual and the company holding the portfolio of shares.)

16.119 Where a business is carried on through a private company, a deferral of tax on dividends paid by the company can be obtained by vesting the shares in that company in an interposed private holding company. There will be no retention allowance in this case, but again tax can be deferred for at least a year, and longer if further companies are interposed.

16.120 The Committee recommends that measures be introduced to prevent this deferral of tax. The measures should be applied to a private investment company as defined for this purpose: the definition would be based on income from property being the predominant element in the company's income. The measure would employ the technique of a refundable tax to which reference was made in paragraph 16.114. The company holding the portfolio of shares would be subject to tax at a rate equivalent to the tax an individual on the maximum marginal rate would pay, after making allowance for any tax credit available to him under the prevailing imputation system. There would be corresponding refunds on distribution. The same regime would apply to any interposed company.

16.121. If the Committee's recommendation is adopted, there will need to be either a phasing-in period or adequate notice of its introduction, in order to accommodate liquidity problems that will inevitably arise in some instances.

Assessment of Company Groups

16.122. A number of submissions have drawn attention to the absence of any provisions whereby a loss suffered by one company of a group of companies may be offset against the net income of another company in the
same group.

16.123. It is argued in these submissions that the fact that two companies are legally distinct entities should not prevent their being treated as one entity for income tax purposes when the same persons are beneficially interested in the equity of both companies. Parent and subsidiary companies it is said should be regarded as one taxable entity, and the subsidiary companies as branches or divisions of the parent. This would be in line with the requirements of the Australian Companies Act in relation to the preparation of consolidated accounts for groups of companies in which the results of the operations of the group, as a whole, are reported.

16.124. The point has also been raised that where the companies involved are private companies there are special difficulties. A profitable parent company, engaged in trading, may be required to pay a dividend to avoid undistributed profits tax even though its profits are offset by a loss incurred by its subsidiary company.

16.125. The treatment of company groups in other countries. Overseas the practices adopted are varied. In the United States a group of companies having a certain common ownership is permitted to make a consolidated return of income. The principle thus expressed is that the true income of a single enterprise should be taxed even though the enterprise is carried on through more than one company. The regulations provide extensive and detailed rules covering the preparation of consolidated returns, the basis for computing taxable income of the group and the liability for the tax assessed. The privilege of lodging consolidated returns is denied foreign companies, life insurance companies, exempt companies and a number of others specifically defined. Some conception of the complexity of the rules thought necessary to prevent the provisions being abused may be gained from the fact that the rules and associated comments in one of the standard tax services relating to consolidated returns in the United States cover nearly 400 pages.

16.126. In New Zealand there are provisions requiring the income of related companies to be aggregated, but here the requirement is largely a consequence of the fact that the income of a company is taxed at graduated rates ranging from 20 per cent up to the general rate of company tax of 45 per cent. Requiring aggregation precludes any tax advantages which might otherwise be gained by multiple incorporation. There is provision for the transfer of losses without restriction between companies in a group where they are wholly owned by the same interests. Where minority interests are involved there is provision whereby one company in the group may make up the current loss of another through a payment to it, referred to as a subvention payment. The payment is deductible by the company making it
and is income of the receiving company.

16.127. There is no provision in the Canadian law for the lodging of consolidated income tax returns by company groups. However, there are some provisions in regard to multiple incorporation, which are mainly aimed at ensuring that undue advantage is not taken of the lower rates of tax available on some company income.

16.128. The United Kingdom has no provisions for consolidated returns but the law contains what are termed ‘group relief’ provisions which, like the New Zealand loss transfer provisions, have the effect, in certain respects, of treating a company group as a single taxpayer. Under the United Kingdom provisions a company may, under certain conditions, surrender to any company in the same group which is profitable its own entitlement to relief for trade losses and for certain other amounts eligible for relief from corporation tax—for example, capital allowances and management expenses. The effect is to cancel one company's losses and reduce the profits of others in the group. It is not necessary that there be an actual payment for the surrender but if a payment is made it will not give rise to tax consequences for either party.

16.129. The choice of method of relief. There is little doubt that consolidated return procedures involve some major compliance and administrative difficulties. Moreover, procedures which would have the effect of permitting the extensive offsetting of losses within all company groups could have significant revenue implications.

16.130. Some of the major difficulties which arise in regard to returns concern defining companies which are part of a group, the question of the time at which any relevant ownership tests decided upon should be applied, the treatment of companies with common ownership but differing balance dates, the extent to which overseas income of foreign members should be aggregated with Australian income, assessing difficulties resulting from the necessity for all member companies to lodge their income tax returns at the same tax office, inordinate delays in assessing because one company's return is late in lodgment and the possible need to amend assessments of all group member companies where an adjustment or error arises in respect of one of them. In addition, there would be special problems arising in relation to sufficient distributions and undistributed profits tax in the case of private companies.

16.131. While the Committee accepts in principle that a company and, at least, its wholly-owned subsidiaries should be treated as one entity for income tax assessment purposes, it does not favour the adoption of group assessment procedures. It recommends that group relief procedures modelled on those currently in force in the United Kingdom should be
available in Australia, though subject to conditions which would be more restrictive than under the United Kingdom law.

16.132. Holding and subsidiary companies. Relief should only be available when:

(a) the companies concerned are resident in Australia;
(b) one company is a wholly-owned subsidiary of the other or both are wholly-owned subsidiaries of a third company for the whole of the year of income;
(c) both companies have the same year of income;
(d) the loss surrendered by one company was incurred in the same year of income as that in which it is claimed by the other company;
(e) the surrender of the loss is evidenced by a written agreement, nominating the amount surrendered, made and notified to the Commissioner within three months of the end of the year of income in which it was incurred.

The adoption of this restriction basis would avoid a number of difficulties and possible abuses and should minimise the effect on revenue.

16.133. The Committee does not think it necessary for the tax law to require that the surrendering company should be paid any amount by the claimant company for the loss transferred. It is apparent, however, that there will be circumstances where commercial reasons, and perhaps company law reasons, require that a payment be made. Under the Committee's proposals there will not be any minority interests in a company which could be prejudiced by the surrender of the loss, but a creditor of the surrendering company might be prejudiced if no payment is received by that company for the loss surrendered. There should be provisions whereby a payment which is in fact made will not be treated as income of the surrendering company or as a deductible outgoing by the claimant company.

16.134. Trading and consortium companies. The United Kingdom extends its group relief provisions so that they are available where the surrendering company carries on business and is owned by a consortium of companies and is not a 75 per cent subsidiary of any company, and the claimant company is a member of that consortium; or where the surrendering company is a 90 per cent subsidiary of a holding company which is in turn owned by a consortium of companies and the claimant company is a member of that consortium; or where the surrendering company is the holding company owned by the consortium of companies and the claimant company is a member of that consortium. A company is owned by a consortium of companies if it is owned by five or fewer companies. These latter companies are the members of the consortium.
Relief is only available in favour of the member of the consortium in respect of the loss of the company carrying on the business, or of the holding company. A member of the consortium cannot surrender a loss to another member of the consortium nor can a member surrender a loss to the holding company or to the company carrying on the business.

16.135. A company owned by a consortium, in the language of the United Kingdom provisions, is sometimes described in Australia as a ‘joint venture company’. In the Committee's view there should be provisions allowing the surrender of losses by a joint venture company to its owners modelled on the United Kingdom provisions. Where there is a surrender of part of a loss in favour of one member of the consortium but no surrendering in favour of another—the latter may have no net income to absorb it—a payment by the member of the consortium receiving the surrender will be commercially appropriate. A payment in these circumstances, like the payments referred to in paragraph 16.133 should not attract any tax consequences.

Restrictions on Carry-forward of Company Losses

16.136. The general provisions of the law in regard to the carry-forward of losses has been explained in Chapter 8.

16.137. Until 1944 no restrictions were imposed on the carry-forward of losses by companies. In that year provisions were inserted in the Act denying the carry-forward of losses by a private company unless shares having not less than 25 per cent of the voting power in the company were beneficially held by the same persons in both the year of loss and the year in which it was sought to apply the loss.

16.138. The reason for adopting these provisions was explained by the Ligertwood Committee in the terms of the Treasurer's speech when introducing the Bill. The Treasurer referred to a practice by persons who had been refused Capital Issues Board permission to form companies ‘of buying up shares in practically defunct companies and then operating those companies for purposes other than those for which they were originally registered’.

16.139. After the war-time capital issues controls had ceased to function, the provisions continued to be part of the law as a means of limiting the carry-forward by private companies of losses of previous years. In this they were designed to control the practice of buying the shares in a company that has suffered losses in order to be able to take advantage of those losses by applying them against future profits of the company. But they proved quite ineffective. Schemes were devised by which they were easily avoided.
and they became no more than traps for the unwary.

16.140. The Ligertwood Committee considered the policy of limiting the allowance of company losses of previous years by reference to the need for continuity of shareholding in the company and questioned whether the principle of limiting, for taxation purposes, ‘the allowance of losses of previous years incurred by companies which have substantially changed their shareholders, is soundly based’. In recommending the repeal of the provisions inserted in 1944, the Ligertwood Committee referred to its view that a company, in fact as well as in law, is a legal entity separate from its shareholders and concluded that a company's losses should be treated for fiscal purposes without regard to the identity of its shareholders.

16.141. The Ligertwood Committee's conclusion was not adopted. In 1964 new provisions were inserted in the Act limiting the carry-forward of losses by companies, whether private or public. A continuity of ownership of shares carrying 40 per cent of voting and dividend rights and rights to capital was now required. In 1965 these provisions were qualified to some extent by further provisions under which a failure of the required continuity could be disregarded if the company continued the same business. The qualification was so strictly drafted that it did not significantly modify such effect as there was in the continuity of ownership provisions.

16.142. However, the continuity of ownership provisions enacted in 1964, like the 1944 provisions, proved ineffective in preventing the practice of acquiring the shares in companies that had suffered losses in order to exploit the potential tax savings to be gained by the application of the losses when carried forward. Arrangements were adopted whereby the continuity of ownership required by the law was satisfied even though, in substance, there was no continuity. Further provisions were inserted in the Act in 1973 to defeat such arrangements, as a result of which a more than 50 per cent continuity of ownership is now required.

16.143. The Committee agrees with the policy of these provisions limiting the carry-forward of company losses and is not persuaded by the reasoning of the Ligertwood Committee. In the taxation of companies it is necessary to go behind the veil of separate legal personality. An individual carrying on business as a sole proprietor or partner who suffers losses has no means open to him of obtaining their equivalent in tax relief except by subsequently making profits against which those losses will be deductible. Moreover, he is limited in thus taking advantage of the losses by the span of his life: losses suffered by an individual cannot be applied against profits made by his personal representative after his death. If there were no restrictions, by reference to continuity of ownership, on the carry-forward
of losses by companies, an individual who conducts business through a company would have an unfair advantage: by selling his shares he would obtain immediately the tax equivalent of the losses suffered by the company; and the value of the losses could be turned to advantage after his death.

16.144. The objective that the seller of shares in a loss company seeks to further is to obtain the tax equivalent of those losses immediately. Other ways of doing this which do not involve any unfair advantage will be available if recommendations of the Committee in regard to carry-back of losses and transfer of losses are adopted. The Committee has recommended in Chapter 8 that carry-back of losses be allowed. It has also recommended in this chapter that the law allow a loss to be moved from one company in a group to another in the same group. In addition, it has suggested that losses of companies electing to be taxed as partnerships be allocated to shareholders.

Loan Capital and Share Capital

16.145. In the discussion of the present separate system of taxing company profits, attention was drawn to the fact that the system is not neutral as between equity finance and debt finance. This want of neutrality will be less if the partial imputation system proposed by the Committee is adopted; it will virtually disappear under full imputation.

16.146. However, even under partial imputation it would be possible to achieve neutrality if the treatment of loan capital were brought into line with the treatment of share capital. Interest on loan capital would be denied deduction, and imputation would be allowed of part of the resulting increase in company tax. The debenture-holder would be given a credit for the tax imputed against the tax on the interest he receives, in the same manner as credit is given to a shareholder against tax on dividends he receives. It would obviously not be appropriate to extend the treatment to all interest. A company engaged in, for example, banking could hardly be denied a deduction for interest paid on deposits, nor could a company which was a customer of the bank be denied a deduction for interest paid to the bank on its overdraft. There would be a question of how one should treat payments under hire-purchase agreements or under leasing arrangements, which at least in part have the same character as interest. It might be possible to draw a distinction between short-term and long-term loan capital and to deny a deduction of interest on the latter, but the line of ratio would necessarily be arbitrary. The Committee considers that in general the present method of taxing loan capital should be retained.
However, there are two situations—one relating to convertible notes, the other to the high gearing of loan to share capital—where it may not be inappropriate, for tax purposes, to treat loan capital like share capital.

16.147. Convertible notes. The present tax treats certain loan capital, generally referred to as convertible notes, in the same manner as share capital. In 1960 interest on notes carrying an option of conversion into shares was made non-deductible in determining the taxable income of the company. In 1970 deductibility of interest on some convertible notes was restored. Deduction is allowed only if the convertible notes meet strictly defined statutory tests intended to ensure that they serve the commercial purposes for which they are ostensibly issued. Thus the option to convert must rest with the note-holder so that, pending conversion, he has the income yield and security of investment that the note provides.

16.148. If deduction were allowed of interest paid on all convertible notes, the operation of the system of taxing company profits would be undermined. That system, where no undistributed profits tax applies, depends for its operation on pressure by those who have an interest in accumulated profits for some measure of current distribution. In the case of a high-income shareholder, the under-taxation of undistributed profits is compensated for by the over-taxation, at company and shareholder levels, of distributed profits. In the case of a holder of convertible notes, whose security gives him a potential claim on a portion of undistributed profits, the pressure for current distribution is satisfied by the interest he receives. This interest will not, however, have borne tax at the company level if the convertible notes are treated as loan capital. The Committee therefore considers that the general denial of deduction of interest on convertible notes should remain.

16.149. Where, however, there are safeguards against defeat of the general operation of the system of taxing company profits, the deduction may be appropriate. The Committee thus does not question the statutory code under which interest on convertible notes is deductible in defined circumstances. Those circumstances are defined so as to ensure that the commercial purposes of the convertible note issue predominate over any tax advantages which may flow.

16.150. High gearing. Where interest is paid by a resident company to a resident, the Committee does not consider that a high gearing of loan to share capital should affect deductibility. The fact that the gearing of loan to share capital may be too high, as a matter of commercial judgment, is a concern of the tax law only so far as it points to the need to overcome the want of neutrality in the treatment of share and loan capital which may have encouraged the high gearing. It does not justify, in the case of a
particular company, the denial of deduction of interest on some part of the loan capital.

16.151. However, the Committee would take a rather different view in regard to some loan capital held by a non-resident in an Australian resident company. The taxation of non-residents is considered in Chapter 17. For present purposes it is enough to refer to the fact that Australian tax on profits distributed as dividends to non-residents amounts to company tax, currently 45 per cent, plus a 30 per cent dividend withholding tax (15 per cent if a double taxation agreement limits the rate of tax); on the other hand, Australian tax on profits going in payment of interest to a non-resident is confined to a withholding tax of 10 per cent of the amount of interest so paid. Thus the tax on $100 of profits distributed as dividends (assuming a 30 per cent withholding tax rate) is $63.33; the tax on $100 of profits distributed as interest is only $10. While the Committee does not wish to pronounce generally on the appropriateness of the rate of withholding tax on interest, it is apparent that the low rate may lead a foreign resident investor who controls an Australian resident company to provide an undue proportion of the capital of the company in the form of loan finance. The inducement to do so will depend on the level of tax in the country of the investor's residence and the credit for foreign tax that country may allow. The inducement will be at its greatest when the foreign investor is resident in a low-tax, sometimes called a tax-haven, country. Canada has recently adopted provisions which may deny a deduction of a portion of interest payable to a non-resident by a resident company where, either alone or in combination with others, the non-resident owns more than 25 per cent of the shares of the company. The denial depends on the ratio of the loan capital held by the non-resident to the share capital of the company. In the Committee's view, provisions along the lines of the Canadian model should be adopted in Australia. It is realised, of course, that such provisions will operate subject to any double taxation agreement to which Australia is, or may become, a party.

16.152. Alternatively to contributing an undue proportion of capital by way of loan finance, subject to the provisions of the exchange control law a non-resident may lend a smaller amount at a high rate of interest, calculated to have the same effect. Provisions intended to enable what would amount to treating the loan capital on which the interest is paid as share capital are proposed in the next chapter.
Chapter 17 International Aspects of Income Taxation

17.1. Australia asserts jurisdiction to tax income on the bases of residence of the tax-payer in Australia and origin of the income in Australia. Origin is determined by general principles and statutory provisions defining ‘source’ of income in Australia. It is also determined by statutory provisions which, for purposes of imposing a withholding tax on dividends and interest, give an Australian origin to payments by Australian residents and, in the case of interest, by non-residents carrying on business in Australia.

17.2. When it first imposed an income tax, Australia exercised jurisdiction to tax income only if the income had a source in Australia. In 1930, concerned at the decline in revenue resulting from the depression, Australia began to exercise a limited jurisdiction to tax the foreign-source income of Australian residents. The jurisdiction did not extend to foreign-source dividend income. Nor did it extend to other foreign-source income if that income was subject to income tax in another country.

17.3. In 1941 foreign-source dividends of Australian residents were made subject to Australian income tax, whether or not they were subject to income tax in another country. An allowance for foreign tax paid on the dividends, where they were derived by an individual, was at first given by way of a deduction of the amount of that tax in determining the amount of the dividends subject to Australian tax. This deduction was replaced in 1947 by a credit of the amount of the foreign tax, the credit being available against Australian tax on the dividends. This credit continues to be available under the present law.

17.4. Where the dividends were derived by an Australian resident company, the foreign-source dividends, though technically subject to Australian tax, remained in substance exempt because of a rebate of tax allowed to the company of the amount of the Australian tax on the dividends. They are still exempt in this way.

17.5. The exercise of jurisdiction based on residence has been extended in relation to foreign-source royalties and interest which, under the provisions of double taxation agreements to which Australia is a party, cannot be taxed in the foreign country at a rate exceeding 10 per cent of the gross amount of the royalties or interest (or 15 per cent in the case of royalties having a source in New Zealand). Since 1967 such royalties and interest are subject to Australian tax, even though taxed in the foreign country, credit being given for the foreign tax against Australian tax on the royalties or interest.
17.6. In 1959 Australia extended its jurisdiction based on origin of income in Australia so that dividends from whatever source became subject to Australian tax, in the form of a withholding tax, when paid to non-residents by Australian resident companies. In 1968 a further extension of jurisdiction resulted from the application of the withholding tax to interest paid to non-residents, where it was paid by Australian residents or by non-residents carrying on business in Australia. This withholding tax continues to apply to these dividends and interest.

17.7. The exercise by Australia of jurisdiction based on origin and, to a lesser extent, on residence is limited by a number of double taxation agreements to which Australia is a party. Typically, an agreement denies jurisdiction to one country to tax profits having their origin in that country, if they are ‘industrial or commercial profits’ derived by a resident of the other country, unless they result from business operations amounting to a ‘permanent establishment’ in the country of origin. Where such a permanent establishment is involved and the country of origin is therefore not denied jurisdiction to tax, the country of residence is required to give credit for tax imposed by the country of origin. The country of origin may be denied jurisdiction to tax other specified kinds of income. Where jurisdiction is not denied and the country of origin taxes the income, the country of residence is required to give credit.

17.8. A double taxation agreement in seeking to regulate the exercise of jurisdiction by two countries inevitably becomes involved in problems of definition. The agreements to which Australia is a party use the language of ‘residence’ and ‘source’, but do not always define these terms for purposes of the agreement. Where the terms are not defined, their meaning is left to the law of the country applying the agreement. In the result both countries may be the country of residence or the country of source, and the operation of the agreement substantially defeated.

17.9. It is proposed in Section I of this chapter to consider the exercise by Australia of jurisdiction to tax on the basis of residence. Attention will be given to the definition of residence and to the limitation on the exercise of jurisdiction which is involved in the continuing exemption of some foreign-source income that has been taxed in the country of source. Attention will also be directed to what is, in substance, the exemption of dividends from a foreign source received by an Australian resident company, more especially to the implications of the exemption in regard to operations by ‘tax-haven’ companies abroad. A ‘tax-haven company’ is one incorporated in a country with no income tax or low rates of income tax, in which Australian residents, or trusts created or controlled by them, have substantial interests.
17.10. It is proposed in Section II to consider the exercise by Australia of jurisdiction on the basis of origin of income in Australia. The meaning of source in different contexts is examined. Attention is directed to the scope for a non-resident to ensure that the amount of income arising in circumstances that would give it an Australian source is minimised. Attention is also directed to the scope for a non-resident to ensure that profits which would otherwise have been derived by an Australian resident with whom he is in some way associated are diverted to himself and do not have an Australian source. In this connection, attention is again directed to the operations of tax-haven companies abroad.

17.11. In Section III some general observations are made in relation to double taxation agreements. It is thought that a brief comment on the drafting of such agreements, concerned with structure and technique, may be appropriate.

I. The Taxation of Foreign-Source Income of Australian Residents

Concept of Resident of Australia

17.12. The Income Tax Assessment Act defines resident of Australia, in relation to an individual, so as to adopt the meaning of the word in ordinary usage and to extend that meaning in ways which depend on the domicile of the person concerned or his presence in Australia for more than half the year of income. The definition, even without the extensions, is likely to include persons who are held also to be resident in another country under that country's concept of residence. In the Committee's view, the resulting competition of jurisdiction to tax must be accepted and adjusted where possible by appropriately drafted provisions of double taxation agreements. The matter of appropriate provisions is explored in paragraph 17.98.

17.13. A resident of Australia in relation to a company is defined by exclusively statutory tests, though one of these—central management and control in Australia—uses the language of judicial decisions that adopts the notion of residence of a company under United Kingdom law. Incorporation in Australia is sufficient to give a company a residence in Australia. So too is central management and control in Australia wherever the company is incorporated. A third test, again sufficient, is carrying on business in Australia and having voting power controlled by shareholders who are residents of Australia.

17.14. Although the definition of resident in relation to a company is wide and may include companies that are resident in another country under
that country's law, the Committee does not consider that a narrower
definition would be appropriate. In a number of respects, however, the
definition might be clarified. The second test requires that a company both
has its central management and control in Australia and be carrying on
business in this country. As the test has been interpreted, the reference to
carrying on business in Australia is unnecessary: central management and
control, it is said, involves the carrying on of business. In any event, in the
Committee's view it should be enough to give a company a residence in
Australia that its central management and control is here.

17.15. The meaning of central management and control calls for
clarification. It would bring some tax-haven companies within the
jurisdiction of Australian tax if these words were held to be wide enough to
include the exercise of control and direction of the company's affairs
otherwise than in the formal proceedings of the board-room. It might be
thought to be enough to give a residence in Australia that the board of
directors habitually responds to instructions formulated in Australia, even
though the board meets elsewhere. This wide meaning would, however,
increase the likelihood of a company being resident both in Australia and
in a foreign country to a degree that might be regarded as unacceptable:
many wholly-owned subsidiaries of Australian resident companies, though
incorporated in foreign countries and resident there, could become
Australian resident companies. On the other hand, the objective of bringing
tax-haven companies within the jurisdiction of Australian tax should not be
lightly abandoned. Some compromise might be possible which would
involve identifying tax-haven countries, either in the Act or, preferably, in
regulations, and would provide that a company incorporated in such a
country would be deemed to have an Australian residence if effective
control and direction of the company's affairs are exercised in Australia,
regardless of where the board of directors meets or other formal corporate
proceedings take place.

17.16. In Chapter 15 the Committee has proposed that the law should
define a concept of an ‘Australian trust’, parallel with the concept of an
Australian resident company. The purpose of this concept would be to
provide a basis of jurisdiction to tax the accumulating income of the trust.
The concept, as there explained, would in part depend on the management
and control of the trust being in Australia. Where the trust is administered
in a tax-haven country, the same wide meaning of management and control
should apply as proposed in relation to companies incorporated in tax-
haven countries.

Foreign-source Income Not Subject to Australian Tax
17.17. The effect of two provisions of the Australian law, noted briefly at the beginning of this chapter, is to exclude from Australian tax a very considerable part of foreign-source income of Australian residents. One of these provisions is section 23(q) which, subject to a number of exceptions, exempts from Australian tax foreign-source income that is subject to tax in the country of source. The other is section 46 which, by allowing a rebate at the Australian rate of tax, in effect exempts foreign-source dividends received by a company, whether or not the profits from which the dividends were paid, or the dividends themselves, have been subject to foreign tax.

17.18. The exclusion from Australian tax by these provisions avoids the need to give relief from the double taxation that would result were the income subject to Australian tax. In this respect they may be regarded as a method of giving relief from double taxation and can be compared with other provisions of the Act that give relief by allowing credit for foreign tax on foreign-source income subject to Australian tax. The discussion that follows is cast in the frame of such a comparison.

Credit for Foreign Tax on Foreign-source Income Subject to Australian Tax

17.19. Section 23 (q) of the Act has no application to a foreign-source dividend received by an Australian resident: such a dividend is subject to Australian tax. But section 45 allows a credit to an Australian resident who receives a foreign-source dividend in respect of income tax imposed on that dividend by the country in which the company paying the dividend is resident, if the Australian resident was personally liable for that tax. The credit is the lesser of the foreign tax or the Australian tax on the dividend, calculated by applying the average rate. By its terms section 45 is applicable both to an individual and to a company. In fact, however, it is relevant only to a dividend received by a resident individual: as indicated in 17.17, no Australian tax against which credit might be given is imposed on a foreign-source dividend received by an Australian resident company.

17.20. Section 23 (q) has no application to income derived by an Australian resident from sources in Papua New Guinea. Such income is subject to Australian tax. However, Division 18 of Part III of the Act allows the Australian resident a credit for Papua New Guinea tax against his Australian tax. The credit is the lesser of the Papua New Guinea tax and the Australian tax. For the reason explained in the last paragraph, the credit has no relevance to a dividend with a Papua New Guinea source received by an Australian resident company.

17.21. Section 23 (q) has no application to royalties or interest received
by an Australian resident when the source of the royalties or interest is in a foreign country with which Australia has a double taxation agreement and when, in addition, that agreement has the effect of limiting the rate of tax the foreign country may impose on the gross amount of the royalties or interest. The foreign countries involved are United Kingdom, Singapore, Japan and New Zealand. The rate as limited by these agreements, if the agreement applies to the particular royalties or interest, 10 per cent in all cases except royalties having a New Zealand source, in which case the rate is 15 per cent. By section 12 of the Income Tax (International Agreements) Act, a credit against Australian tax is given, the amount of the credit being limited to the amount of Australian tax on the royalties or interest.

Exemption and Credit as Methods of Giving Relief against Double Taxation

17.22. A comparison between exemption and credit as methods of affording double taxation relief may assist a decision on whether Australia should extend further its exercise of jurisdiction to tax foreign-source income. The comparison is made in terms of the criteria of equity, efficiency and simplicity.

17.23. Equity. Sections 23 (q) and 46 discriminate between a resident individual who derives all his income from Australian sources and a resident individual who has some foreign-source income that is exempt, or has an interest in a resident company deriving foreign-source income that is exempt, under one of those sections. These provisions thus defeat the equity objective which is one of the justifications for taxing on the basis of residence.

17.24. In the case of exemption under section 23 (q), the equity objective is defeated principally because it involves a taxpayer's income being split and the graduated Australian rates being applied to the Australian-source income and not to the whole of the taxpayer's income. Admittedly, this aspect could be overcome by provisions which, while continuing to exempt foreign-source income, would require it to be aggregated with Australian-source income to determine a rate on the latter. However, the inequity that arises from exemption when the foreign tax is less than the Australian tax would remain.

17.25. Sections 23 (q) and 46 create inequities between shareholders in a company deriving all its income from Australian sources, and shareholders in a company some or all of whose income is exempt under one of those sections.

17.26. An aspect of the inequities arising from section 46 is that the section significantly increases the advantages of using tax-haven
companies as the means through which foreign-source income is derived. Section 46 allows tax-haven company profits to be repatriated without generating any liability to Australian company tax. This would not be possible under a credit system, though profits accumulated in the tax-haven company enjoy an immunity from Australian tax under a credit system as well as under the exemption system. This immunity could only be taken away by a system imposing Australian tax on the profits of the tax-haven company when they are derived by that company, either by taxing the company or the shareholders in the company. The matter is further considered in paragraphs 17.46–17.55.

17.27. A credit system of the kind now applying to dividend income derived by individuals (section 45), to income with a Papua New Guinea source (Division 18) and to some royalties and interest (section 12 of the Income Tax (International Agreements) Act) offers the prospect of ensuring a substantial degree of equity and, in this respect, contrasts with the exemption system. One limitation on its success is apparent when the foreign tax for which credit would otherwise be available exceeds the Australian tax on the income in question. In this situation the credit system avoids the inequity of the exemption system arising from non-aggregation with Australian-source income to determine the rate of tax on the latter; but it does not overcome the inequity involved in the foreign-source income having borne a greater tax than would be imposed on an equivalent amount of Australian-source income. The credit system could be made to overcome this inequity if the excess tax were allowed to generate a credit and, if necessary, a refund. No country in fact has a credit system of this kind. To adopt it would be to give to foreign countries an unacceptable degree of control over Australian taxation revenue.

17.28. Other limitations on the success of the credit system in ensuring equity are inherent in the difficulties of relating foreign tax to the income in respect of which credit is to be given. These difficulties are referred to later in paragraphs 17.36–17.40.

17.29. Efficiency. The Committee has taken the view that economic efficiency is generally best served by a neutral tax system. A neutral tax system, in the present context, is one that does not affect the choice between operations directed to deriving Australian-source income and operations directed to deriving foreign-source income. And the ‘tax system’ must be understood to refer to all the taxes, Australian and overseas, that bear on the operations.

17.30. Equity and efficiency run closely parallel in their implications: a more equitable way of taxing foreign-source income is likely to be more efficient. But the emphasis in considering equity is on income taxation
viewed in isolation from other taxes, whereas an appraisal in terms of efficiency must be made of the tax system as a whole. It is thus not enough in judging efficiency to look only at the impact of income tax in Australia and in the foreign country. Even though the same amount of income tax is paid on income from Australian sources as on income from foreign sources, efficiency will be compromised if the profitability of operating abroad, rather than at home, is affected by other international tax differences—not least those in the area of customs duties.

17.31. It is clearly not within the competence of the Australian tax system to ensure complete efficiency in regard to the effect of Australian and foreign taxes on the activities of Australian residents. This is a matter requiring the widest international co-operation.

17.32. Where efficiency requires a deliberate non-neutrality, as sometimes it may, equity and efficiency will not run parallel, and the exemption system may be preferred as furthering the ends of non-neutrality more effectively. If, for example, Australia wishes to encourage its residents to operate abroad, it can do so by applying an exemption system to foreign-source income rather than a credit system. An exemption system allows the Australian resident to operate, at least so far as income tax is concerned, in equal competition with residents of other countries.

17.33. The exemption system may also be thought to offer an attraction to foreign companies, in countries operating a credit system, to establish subsidiaries in Australia as bases for operating in other countries with low rates of income tax. The Australian Government may desire to encourage this.

17.34. A number of developing countries give special income tax incentives to attract investments. Under an exemption system the value of such incentives to an Australian investor is fully preserved. Australia, in the language that has become current in this context, ‘spares’ the Australian investor the amount of tax the developing country has forgone. This, too, may reflect an aspect of Australian Government policy.

17.35. But in the Committee's view, as indicated in paragraph 3.25, encouragement for a field of activity should be given through the tax system only if other means of encouragement are likely to prove less effective. And where it is thought appropriate to act through the tax system, this should be done by explicit provision. Section 44A is a provision of this kind: even though a credit system otherwise operates, tax sparing in regard to Papua New Guinea is achieved by this section through the exemption of dividends paid from profits with a Papua New Guinea source when those profits are exempt in that country under its Industrial Development (Incentives to Pioneer Industries) Ordinance. Encouragement
to a field of activity by across-the-board exemptions such as are given by sections 23 (q) and 46 is clearly unwarranted.

17.36. Simplicity. An exemption system is unquestionably simpler to administer than a credit system, though some of the simplicity of section 23 (q) would be lost if it were amended to require aggregation of the foreign-source income with Australian income to determine the rate of tax on the latter.

17.37. The complexities of a credit system are at their greatest when credit is being given for tax on profits derived in a foreign country by an Australian resident who himself carries out business operations there. For one thing, the Australian tax accounting period may differ from that applying in the foreign country. For another, the tax base of the foreign country's tax may not be the same as Australia's. The difference in the base may result from the fact that the foreign country includes capital gains in its base. Until Australia adopts a capital gains tax the foreign tax will need to be dissected if credit is to be confined to tax on income. The difference in the base may be because the foreign country adopts a different method of valuing closing stock or different rates of depreciation. Because of the differences in the base there may be a spread of profits over a period of years in the foreign country different from the spread in Australia. The experience of countries with a credit system, more particularly the United Kingdom and United States, will suggest rules by which the differences in accounting periods can be handled. The problem of excess tax for which credit is sought, which may arise because of the way profits are spread over a period of years, can be dealt with by a carry-forward and carry-back of excess credits on the model of the United States provisions. Australia has had some experience in operating a tax credit system in relation to income derived from sources in Papua New Guinea; but because of the substantial similarity between the tax systems of Papua New Guinea and Australia, the complexities referred to in this paragraph have yet to be faced.

17.38. The complexities of a credit system may be less when credit is to be given against Australian tax on a dividend received from a foreign source. Australia already has long experience of such credits where dividends are derived by an individual. If jurisdiction is extended so that the credit system applies to dividends derived by a company, there will be a new problem in the allowing of credit for the underlying tax paid by the foreign company on the profits from which the dividends have been paid. Where the foreign company's profits themselves include dividends received from subsidiary companies, the problem will be compounded if the credit for underlying tax is extended to include tax on the profits of
those companies. Again it will be necessary to turn to the experience of other countries: the tax credit system Australia already employs in relation to income from sources in Papua New Guinea does not offer any relevant experience, since section 46 applies.

17.39. Credit for underlying tax could at best be available only to a limited degree. It would be administratively impossible to extend such credit, on a general basis, to dividends derived by an individual. Where a company derives a dividend from a foreign source, credit for underlying tax would need to be confined to cases involving a substantial shareholding in the foreign company paying the dividend. Double taxation agreements commonly impose an obligation to give credit for underlying tax where there is a 10 per cent holding.

17.40. To the extent that administrative feasibility imposes limitations on the availability of credit for underlying tax, the equity and efficiency of the credit system will be compromised and the advantages of moving to such a system will be less.

17.41. It may be appropriate here to draw attention to the revenue implications of a change to a credit system. The change is unlikely to involve any loss of tax revenue to Australia, assuming that the credit available is limited to the amount of Australian tax. It is implicit in a credit system that where a profit from foreign operations would be included in the net income of the Australian resident, a loss made in the same operations is deductible. Only in this respect could a credit system result in the Australian tax paid being less than under an exemption system. Indeed, a credit system might involve a significant increase in revenue, particularly if Australian investment abroad continues to grow as rapidly as it has done over the past decade.

Committee's Proposals

17.42. In the Committee's view, the comparison in the previous paragraphs establishes a case for extending the exercise of jurisdiction to tax on the basis of residence so that all foreign-source income is subject to Australian tax and credit, so far as administratively feasible, is given for foreign tax on that income. Equity and efficiency considerations point strongly to this conclusion and outweigh the loss in simplicity likely to result.

17.43. The Committee would, however, wish to leave open the possibility of making specific exceptions to the general regime to retain some of the simplicity of the exemption system. Where an Australian resident company receives dividends from a foreign resident company in
which it has a substantial shareholding and that company is resident in a
country which imposes a rate of company tax comparable with the
Australian rate, it may not be inappropriate to continue the exemption
given by section 46. In these circumstances the credit system and the
present exemption system will bring about much the same result. But it
would be necessary to confine section 46 treatment to dividends from
profits having a source in the foreign country: a wider exemption would
open up the prospect of defeat of the purpose of the general regime where
the foreign country applies an exemption system to income from sources
outside that country.

17.44. It might also be thought appropriate to continue exempting profits
derived by an Australian resident company from sources in a foreign
country if the foreign country imposes a rate of company tax comparable to
the Australian rate. It would be necessary to confine the exemption to
profits bearing the foreign company tax. Where royalties and interest with
a source in the foreign country bear tax at a lesser rate, for example by way
of a withholding tax, the exemption should be denied. The denial of the
exemption would follow the precedent set by section 12 of the Income Tax
(International Agreements) Act in relation to royalties and interest which,
because of a provision in an international agreement, are taxed in the
country of source at a low rate.

17.45. With regard to salary and wages, equity considerations would
clearly favour the application of a credit system to foreign-source income.
There may, however, be reason to exempt such income where it relates to a
substantial period of service abroad.

17.46. The adoption of a credit system will take away some of the tax
advantages to be gained from establishing tax-haven companies in foreign
countries. When income which may have borne no foreign tax is
repatriated as dividends to an Australian resident company, it will be no
longer be freed from Australian company tax by section 46, but will be
taxed in full. However, the advantages of indefinite deferral of tax on
income accumulated by the tax-haven company will remain.

17.47. Similar advantages can at present be obtained by the use of what
might be called a ‘tax-haven’ trust: that is, a trust created or controlled by
Australian residents but which has foreign trustees and is administered in a
tax-haven country. If a trust has foreign-source income that is
accumulating, no Australian tax is payable even though the persons who it
may be expected will ultimately receive the income are Australian
residents.

17.48. The tax advantages to be obtained from establishing tax-haven
companies could be removed by provisions of the kind adopted by the
United States in Subpart F of its 1954 Code. The accumulating income of a tax-haven company would be taxed currently to its Australian resident shareholders by reference to some apportionment to them of that income. The tax advantages of tax-haven trusts could be removed by similar provisions, though in this case it would be necessary to seek to tax the trust estate on a proportion of its income in some way related to the extent of the contingent interests held by Australian residents. It would not be appropriate to attempt to tax those Australian beneficiaries without vested interests.

17.49. The complexities and problems of administration which such provisions would involve should not be underestimated. In the case of a company there is a question of defining the persons whose interests would make them subject to current taxation on the company's profits. Rules of constructive ownership would be necessary.

17.50. It would be necessary to define the income to which the provisions apply. It may not be thought appropriate to include income from active business operations in the tax-haven country itself. And it may not be thought appropriate to include income that has its origin in third countries. To include such income would be to put Australian companies using tax-haven subsidiaries for their foreign operations at a competitive disadvantage. On the other hand, it would be of the first importance to ensure that any income that has an Australian origin is included, where present Australian law does not tax that income on the basis of such origin. Income from operations involving ‘invoicing-on’ of goods that move from or to Australia but are at no time physically present in the tax-haven country is the most likely illustration.

17.51. United States experience has not been encouraging. Its provisions are extremely complex and pose great difficulties in enforcing compliance. Canada has adopted similar provisions but there has been some delay in bringing them into operation.

17.52. Apart from the complexities and administrative difficulties involved, the observations made in paragraph 17.50 in relation to the income to which the provisions would be applied may suggest some doubt about their policy. Deferral of tax on foreign-origin income of a foreign subsidiary of an Australian resident company or of foreign-origin income of a foreign resident trust will in the normal case, under the Committee's proposals, be allowed until the income is remitted to Australia as dividends or distributed to Australian resident beneficiaries. It may fairly be asked whether it should make any difference that the foreign-origin income has, because of the tax-haven residence of the company or trust, been subject to foreign tax only at low rates. If it is thought that the policy should be
simply to ensure that Australian-origin income be adequately taxed, it is possible to achieve this by other means.

17.53. At present Australian-origin income may be inadequately taxed for a number of reasons. A tax-haven company or trust will commonly enter into transactions with Australian residents which give rise to income with an Australian origin that is not subject to Australian tax because it does not come within the scope of the jurisdiction Australia exercises in taxing Australian-origin income. The meaning of source in relation to Australia's jurisdiction to tax on the basis of origin needs to be clarified and extended in certain respects. When the scope of the jurisdiction Australia exercises does extend, the amount of income brought to tax may be thought too little because of expenses claimed by the tax-haven company or trust; the amount of tax may be thought too little because a withholding tax is the only tax applicable. Broader reconstruction provisions might be made available which will enable the Commissioner to deny the deductibility of expenses in appropriate cases. Special rates of withholding tax might be applied to income going to a tax-haven company or trust.

17.54. Australian-origin income may be inadequately taxed because it has been diverted by an Australian resident to a tax-haven company or trust in whose hands it is exempt because it does not have an Australian source or is subject only to Australian interest withholding tax. Broader reconstruction provisions would enable the Commissioner to prevent this diversion of income and tax the Australian resident.

17.55. The Committee is not persuaded that it is an appropriate policy to seek to tax foreign-origin income of tax-haven companies and trusts and is very conscious of the complexities and administrative and compliance costs of attempting to do so. It prefers to ensure that the general provisions of the Australian law as to source of income in Australia are effective; that there are adequate provisions in regard to the reconstruction of Australian-origin income of non-residents; and that there are also adequate provisions to prevent the diversion of income by Australian residents to non-residents. There may, in addition, be room for special provisions whereby some income of a tax-haven company or trust that has an origin in Australia is made subject to a special rate of tax, and whereby procedures are established to ensure collection of Australian tax payable by tax-haven companies and trusts. These matters are taken up in Section II.

II. Australian-Origin Income of Non-Residents

17.56. Since income tax was first imposed, Australia has asserted a jurisdiction to tax the income of non-residents on the basis of its origin in
Australia. Initially the scope of the jurisdiction based on origin was wholly determined by ‘source’ in Australia, within the meaning of that word in our law. More recently, Australia has exercised jurisdiction to tax some dividends and interest on the basis of an origin in this country that may differ from their source.

17.57. In the earlier history, dividends were taxed to non-residents only if they had a source in Australia. Where it was a matter of taxing a shareholder in the company, Australian-source dividends referred at that time, as now, to dividends paid from profits of the company with a source in Australia. The meaning of source in relation to dividends paid by one company (company A) which form part of the profits of another company (company B) which in turn has paid a dividend has been debated over the years. On one view the source of the dividends forming part of the profits of company B is simply the place of residence of company B. But there are alternative views which would consider other factors to be relevant, such as the place of the share register of company A or the residence of company A. Tracing the dividends back to the operating profits derived by company A, or by some earlier company, and treating those dividends as having the same source as those operating profits would now appear to be rejected.

17.58. A non-resident shareholder, whether an individual or a company, who was subject to tax on Australian-source dividends was entitled, in the earlier years of the Australian income tax, to a rebate of tax in recognition of the tax that had been paid by the company on the profits from which the dividends came. The rebate, in the case of an individual shareholder, was at the lesser of the company rate of tax or the shareholder's rate. In the case of a company the rebate was at the company rate, with the result that the dividends bore no tax. At this time, then, a non-resident company enjoyed the same exemption from tax on dividends as did a resident company.

17.59. Where a non-resident company received Australian-source dividends and thereafter paid dividends to its non-resident shareholders out of these Australian-source dividends, the shareholders were in theory subject to Australian tax on the dividends. The difficulty of enforcing this liability led to a change in the law in 1939. The rebate of tax that until then had been available to the non-resident company was withdrawn, and the company became liable to pay tax on the dividends at the company rate.

17.60. In 1940 the rebate of tax was withdrawn from all individuals, resident and non-resident.

17.61. In 1959 some dividends paid to non-residents became subject to withholding tax. The tax applied to dividends paid to a non-resident by a company resident in Australia, except where the non-resident receiving the
dividend was engaged in business through a ‘permanent establishment’ in Australia. The person subject to the tax might elect to be taxed by assessment. In 1967 the election was abolished and the tax became a final one. The tax continues to apply. The rate is 30 per cent, except where a double taxation agreement to which Australia is a party provides for a lesser rate. A dividend may be subject to withholding tax even though paid from profits that do not have an Australian source. In this respect withholding tax involves an extension of Australia’s exercise of jurisdiction to tax non-residents beyond the taxing of income with an Australian source.

17.62. In 1968 withholding tax was extended, subject to some qualifications, to interest paid by residents to non-residents and in certain circumstances to payments by non-residents to non-residents. In the latter case the origin of the interest in Australia relied on to justify the exercise of jurisdiction was that the interest is an outgoing incurred by the non-resident in carrying on a business in Australia through a permanent establishment. The tax continues to apply, at the rate of 10 per cent. Like withholding tax on dividends, it is a final tax. Interest may be subject to withholding tax even though it would not be regarded as having a source in Australia as the word is understood in Australian law.

**Justification for Taxing Income of Non-residents on the Basis of Origin in Australia**

17.63. There are obvious reasons why a country will wish to exercise jurisdiction on the basis of origin. More especially where it is a debtor country—an importer rather than an exporter of capital—income will be generated by economic activity within the country which, if not taxed on the basis of origin, would be excluded from the total base of income tax. The tax on the remaining base will need to be so much the greater, or other means of taxation used. Whatever the immediate incidence of any other tax, it will for the most part be borne by Australian residents, more particularly in their capacity as consumers. Indeed, income tax on non-residents may have to be retained at existing levels even if the movement away from income tax towards commodity taxation, favoured by the Committee, occurs in the taxing of residents.

17.64. Revenue considerations aside, the justification for imposing income tax on non-residents on the basis of origin in Australia rests on the ‘benefit’ principle referred to earlier in paragraph 3.7. The non-resident's income has been generated by economic activity conducted under the protection of the country of origin and relying on facilities provided, at least in part, at public expense. This is equally true whether the income has
been produced by the activity of the non-resident himself, as by manufacturing operations in Australia conducted by him through a branch, or by a resident who pays what would otherwise have been his profit to the non-resident, by way of interest or royalties.

17.65. The benefit principle is an aspect of equity. More refined notions of equity, deriving from the principle of ‘ability to pay’, have no obvious relevance in the present context. Australia taxes a non-resident on a base representing only part of his total income, and does not attempt to concern itself with the remainder of his income. Ensuring that the non-resident's tax liability reflects his ability to pay must rest with his country of residence.

17.66. The equity reflected in the application of the benefit principle will to some extent run parallel with the objective of efficiency in the sense of neutrality. It will be apparent, though, from observations made in paragraphs 17.29–17.31 that no provisions of the Australian tax system standing alone can ensure neutrality. Whether a non-resident chooses to invest in his own country, in another foreign country or in Australia will depend, in terms of tax, on the whole range of taxes in each of those countries.

17.67. If it is thought that efficiency requires a deliberate non-neutrality—the encouragement or perhaps the discouragement of foreign investment—the Committee would take the view, in line with its observations in paragraphs 17.32–17.35, that this should be done as far as possible outside the tax system. If the tax system is used, explicit provisions directed to the specific non-neutrality are to be preferred to any general provision. Sections 128F and 128G of the Act, which exempt certain interest from withholding tax, are illustrations of such specific provisions.

17.68. Because it need not concern itself with ability to pay aspects of equity, income tax on Australian-origin income of non-residents can, to this extent, be a simple tax. Tax is imposed, for the most part, at the flat rates associated with company tax and withholding tax. In the case of withholding tax there is also an element of simplicity in the collection of the tax by withholding rather than by assessment.

**Taxation on the Basis of Source in Australia**

17.69. Except where the income is dividends or interest and withholding tax applies, origin of income in Australia is tested by judicially established principles, and by a few statutory provisions, which are concerned with the interpretation of the word ‘source’ in section 25. That section subjects income of non-residents to Australian tax where the income has a source in
Australia. The judicially established principles, for the most part, yield no determinate rules. Indeed, it has often been asserted by the Courts that source refers to ‘something which a practical man would regard as a real source of income and that the ascertainment of the actual source of a given income is a practical hard matter of fact’. The matters that the Courts have tended to think important, as indicating a source in Australia, rather emphasise formal aspects of a transaction than the place of the economic activity generating the income. In this there is some conflict with the assertion of the importance of the view the ‘practical man’ would take. The matters thought important by the Courts in determining the source of income received in respect of the use of industrial or commercial information are the place of the contract to supply the information and the place where the information is handed over, not the place where the knowledge is used. The matters thought important in determining the source of interest are the place of the contract of loan and the place where the loan moneys were provided, not the place where the moneys are used.

17.70. In the Committee's view, determinate rules are desirable in this area of the law. The rules, where possible, should seek to identify income as having a source in Australia where it can be seen to be the product of economic activity in this country. Proposals in regard to the appropriate rules are made in Appendix A to this chapter.

Tax on Australian-origin Income by Withholding

17.71. The provisions applying withholding tax to certain dividends and interest have been explained in paragraphs 17.61–17.62; and for the reasons expressed in paragraph 17.68, the Committee would approve of the use of withholding tax where such a tax can be conveniently administered. Some comment is appropriate here on the problems of setting the spheres of operation of withholding tax and tax by assessment on Australian-source income. Where withholding tax applies, the person receiving the dividends or interest is not subject to tax by assessment. This is expressly provided in section 128D. But tax by assessment on the basis of source in Australia is not excluded when that person makes a payment of dividends or interest to another. It would make for certainty, in the Committee's view, if the occasions when tax by assessment applies were expressly defined in the Act. Thus tax by assessment—as proposed in paragraph 17.A23 of Appendix A—on interest paid by a permanent establishment abroad of an Australian resident might be expressed to apply only when the interest is received by a tax-haven company or a tax-haven trust. Where dividends or interest have borne Australian tax by withholding when paid to a non-
resident company, subsequent distributions of dividends by the company from those dividends or interest will, under the present law, be subject to tax by assessment to the extent that the dividends or interest are from an Australian source. Tax by assessment in these circumstances might be confined to dividends received by a tax-haven company or a tax-haven trust. Tax by assessment is already excluded by a number of double taxation agreements where a non-resident company pays dividends that might have been subject to tax on the basis of Australian source.

17.72. Rates of withholding tax appear modest. The rate on dividends is 30 per cent, unless a lower rate applies under a double taxation agreement. The rate on interest is 10 per cent. Some double taxation agreements preclude a higher rate being imposed on interest in the circumstances specified in the agreements. However, withholding tax is imposed on the gross amount of dividends or interest and may result in higher tax than would be payable if tax by assessment applied and the tax were imposed after deduction of interest paid or other costs of deriving the dividends or interest.

17.73. The rate of withholding tax on interest affords opportunities for tax planning through a tax-haven company or a tax-haven trust lending to a related company in Australia whose profits, which bear company tax, are made less by the amount of the interest paid. There is some discouragement to such planning in provisions excluding withholding tax and applying tax by assessment where income received by a trust would attract tax under section 99A (explained in Chapter 15). However, these provisions are only in part effective since they cannot apply to interest that does not have an Australian source. There is some correction possible in the reconstruction of the profits of the Australian resident paying the interest. This is considered in paragraphs 17.84–17.90. In addition the Committee would recommend that a special rate of withholding tax be applied to interest paid to a tax-haven company or trust. An appropriate rate might be the prevailing company tax rate. The tax would be collected from any payment of interest to a company or trust in the tax-haven country. It would be necessary for any such company or trust that is not, within the meanings in paragraphs 17.9 and 17.47, a tax-haven company or trust to obtain prior permission to have the normal rate of withholding tax applied or to seek repayment of the excess withholding tax collected.

17.74. The rate of withholding tax on interest encourages loan capital in preference to share capital as a means of providing finance for an Australian resident subsidiary company. The scope for reconstruction of the profits of the subsidiary when an undue emphasis has been given to loan capital is the subject of observations in Chapter 16.
17.75. The 30 per cent rate of withholding tax on dividends might appear attractive if the dividends paid to a tax-haven company or a tax-haven trust were to satisfy the obligation of an Australian resident private company to make a sufficient distribution so as to avoid undistributed profits tax. The present law, through provisions preventing the distribution being treated as a sufficient distribution, adequately discourages the use of a tax-haven company in this way.

17.76. There is much to be said for extending the withholding tax provisions to cover the gross amount of payments in respect of the use of commercial and industrial property and know-how with an Australian source on the tests proposed in paragraphs 17.A15, 17.A17–17.A18 of Appendix A. There are very real difficulties in determining the deductions allowable in calculating the net income arising from these payments. If a withholding tax on royalties is introduced, it would be appropriate to provide for a special rate on payments to tax-haven companies and trusts in accordance with the provisions in paragraph 17.73.

Tests of Foreign Origin of Income

17.77. The present exemption and credit provisions explained in Section I of this chapter, whereby relief is given against double taxation of income that has its origin outside Australia, impose Australian law tests of foreign origin. Any new credit provisions may be expected to do the same. In the Committee's view, the tests of foreign origin ought to mirror the tests of Australian origin. It is hardly appropriate that Australia should, for example, apply the tests in section 6C in determining that royalties have a source in Australia but adopt the principle in the United Aircraft Case so as to hold that royalties paid by a resident in another country have a source in Australia. To do so would mean allowing no exemption or credit in respect of the tax paid in the foreign country.

Reconstruction of Australian-source Income of Non-residents

17.78. A non-resident subject to tax by assessment may be able to control the amount of his income liable to Australian tax by incurring inflated costs that will limit his net income from Australian sources. His costs may involve payments to an associated person, who is a non-resident, for goods or services, for money borrowed or for the supply of information. As at present interpreted, the general deduction section (section 51) requires the Commissioner to allow deduction of the actual costs.

17.79. A non-resident with a branch in Australia, where he manufactures or assembles goods, may sell those goods to an associated person in a foreign country at a price calculated to ensure that no profit arises from the branch operations. Section 42, referred to later in paragraph 17.A5 of Appendix A, enables the Commissioner to apportion the profit between the manufacturing operations in Australia and the selling of the goods. But he can apportion only the actual profit. Section 36, which deems a disposition of trading stock made otherwise than in the ordinary course of business to be a disposition at market value, may be helpful: there is some authority that a sale to an associated person may in some circumstances be regarded as a sale outside the ordinary course of business. However, the assistance it can give to the Commissioner is much less than required.

17.80. The Commissioner should, in the Committee's view, have adequate general power to reconstruct the Australian-source income of a non-resident so as to bring to tax an amount of income that would have been derived had the non-resident's costs been incurred in arm's length transactions and had his receipts been such as might have been expected in arm's length transactions.

17.81. Section 136 of the Act is intended to give the Commissioner such power. It provides:

‘Where any business carried on in Australia—

(a) is controlled principally by non-residents;
(b) is carried on by a company a majority of the shares in which is held by or on behalf of non-residents; or
(c) is carried on by a company which holds or on behalf of which other persons hold a majority of the shares in a non-resident company,

and it appears to the Commissioner that the business produces either no taxable income or less than the amount of taxable income which might be expected to arise from that business, the person carrying on the business in Australia shall, notwithstanding any other provisions of this Act, be liable to pay income tax on a taxable income of such amount of the total receipts (whether cash or credit) of the business as the Commissioner determines.’

In the Committee's view, however, the section does not give the Commissioner adequate power.

17.82. The operation of section 136 in the situations of the kind described in paragraph 17.78, involving inflated costs incurred by the non-resident, is limited by the condition that there must be a business carried on in Australia. The section does not enable the Commissioner to increase the amount of net royalties derived by a tax-haven company. The tax-haven
company may have paid, to an associated tax-haven company, an amount in royalties for the information in turn supplied to an Australian resident such as to ensure that the net royalties from an Australian source are zero.

17.83. The operation of the section in situations of the kind described in paragraph 17.79, involving deflated receipts by the non-resident, is probably limited by the condition that the Commissioner must tax an ‘amount of the total receipts . . . of the business’, which would appear to deny him power to substitute for the actual receipts those receipts that would have been derived in an arm's length transaction.

Reconstruction of Income of Australian Residents from Transactions with Non-residents

17.84. Income may be diverted by an Australian resident to a non-resident in whose hands it either escapes Australian tax altogether, because it does not have an Australian source, or is subject to tax at a rate less than it would have borne in the hands of the Australian resident.

17.85. Thus an Australian resident company may buy goods at an inflated price from an associated non-resident company or pay an inflated commission to that company in a transaction which will ensure that the non-resident company's profit does not have an Australian source. Furthermore, the profits of the resident company, subject to company tax, may be the less because of an interest payment to the non-resident subject only to withholding tax at 10 per cent. The non-resident company may be a tax-haven company.

17.86. The diversion of income may take the form of a sale of goods by a resident company to an associated non-resident company at a price which ensures that the resident company makes no profit. The non-resident company may be a tax-haven company that simply ‘invoices-on’ to a foreign buyer. The resident company may pay a commission to an associated non-resident company for making a sale abroad. Again the non-resident company may be a tax-haven company.

17.87. Sections 51, 42 and 36 are no more helpful in enabling reconstruction in these situations than they are in enabling reconstruction of the incomes of non-residents in the situations considered in paragraphs 17.78–17.83. And here, too, section 136, which can apply to income derived by a resident, is inadequate. The resident company will be carrying on business in Australia, but in the deflated receipts situation described in paragraph 17.86 the Commissioner's power to substitute notional receipts in a non-arm's length transaction is doubtful. Both in this situation and in the inflated cost one described in paragraph 17.85, the Commissioner may
have no power to reconstruct because the resident company does not come within any of the clauses of section 136 identifying the persons to whom the section may apply. Clause (b) can be avoided if a majority of the shares is vested in residents, even though those shares carry only a small fraction of rights to dividends or distribution of capital and have no voting rights. Since a company holding shares in another company does not hold those shares on behalf of its shareholders, clauses (b) and (c) can be avoided by interposing a second company incorporated in Australia to hold the shares in the resident company and, in the case of clause (b), in the non-resident company. The control contemplated by clause (a), in the case of a company, probably refers to director control. It may be inferred from judicial authorities on the meaning of central management and control in the definition of residence in relation to a company that it will be enough to prevent the operation of clause (a) if a majority of the directors are Australian residents. In any event, where tax-haven operations are involved, the persons who have the real interests in and control of the resident company are likely to be Australian resident individuals: thus, unless the tax-haven company is its subsidiary, section 136 will not be applicable.

17.88. In the Committee's view section 136 should be replaced by a new section empowering the Commissioner to reconstruct the profits of non-residents derived from sources in Australia and the profits of residents dealing with associated non-residents. The models of reconstruction provisions in double taxation agreements, such as articles 5 and 7 of the United Kingdom agreement, may be helpful.

17.89. The effectiveness of a redrafted section 136 will depend on the Commissioner coming to know facts which persons liable to pay tax may have sought, sometimes with the co-operation of governments in other countries, to keep from him. And it will depend on there being assets in Australia that may be taken in payment of tax. These limitations on effectiveness are inevitable, but they do not justify denying power to do what can be done.

17.90. Special measures may be necessary to assist the enforcement of provisions intended to ensure adequate taxation of Australian-origin income when tax-haven operations are involved. The existing provisions of the Act, in particular sections 254–257, may not be adequate. The Committee has noted the recent amendments to the Banking Act and the Taxation Administration Act relating to the tax screening of proposed transactions with persons in tax-haven countries, and the notice issued by the Treasurer specifying the acts or things to which section 39B of the Banking Act applies. Experience with these new provisions will doubtless
indicate whether further measures will be needed to ensure adequate taxation of Australian-origin income.

**Taxation of Branch Operations in Australia**

17.91. Where a foreign company has a branch operation in Australia it will, subject to the provisions of any double taxation agreement, be subject to Australian company tax on its Australian-source profits. When it makes a distribution to its shareholders from those profits, the shareholders will, again subject to any double taxation agreement, be subject to Australian tax on the dividends they receive. But this is generally only a theoretical liability which the Commissioner will not be able to enforce. When the foreign company has a subsidiary company carrying on the operations in Australia, there will be company tax on the subsidiary company's profits and withholding tax at 30 per cent (or 15 per cent if a double taxation agreement applies) on profits distributed to the company by way of dividends. The result is a discrimination in favour of the branch operation.

17.92. In some countries a special tax is imposed on profits of branch operations to remove the discrimination. The Committee would favour the introduction of a branch earnings tax in the form of an additional tax on a proportion of a non-resident company's Australian taxable income after the deduction of company tax. Tax on half the after-tax income is proposed. The rate of tax should be the normal dividend withholding tax rate of 30 per cent; but where a company establishes that it is a resident of a country that has a double tax agreement with Australia under which the withholding tax rate is reduced to 15 per cent, the rate should be 15 per cent.

17.93. Dividends paid by a non-resident company to non-resident shareholders after the commencement of the proposed provision should be made exempt from Australian tax. In addition, the requirement that a non-resident private company make a sufficient distribution to avoid the imposition of Division 7 tax should be dispensed with. However, neither of these two proposed measures ought to have application if the company is a tax-haven company.

17.94. The branch earnings tax should not be applied to income of the branch which takes the form of dividends. These dividends under the present law will have been taxed in the hands of the branch by assessment at corporate rates as the section 46 rebate does not operate; withholding tax does not apply. The treatment of dividends received by a non-resident company which has a branch operation in Australia involves a discrimination against a branch operation. If the non-resident company
operates through a subsidiary the dividends received by the subsidiary will be relieved from tax by the operation of the inter-corporate rebate (section 46) and when distributed as dividends paid to the non-resident company they will attract only withholding tax.

17.95. Submissions have been made to the Committee that the discrimination against branch operations in relation to dividend income should be removed by extending the inter-corporate rebate to dividends received by a non-resident company which has a branch operation in Australia. In the Committee's view this treatment would be too generous since, for reasons already explained, there is unlikely to be any further Australian tax when the non-resident company distributes to its shareholders. There is, however, in the Committee's view a case for applying withholding tax to dividends received by a non-resident company which has a branch operation in Australia. The dividends would then not be subject to tax by assessment and would in effect bear the same Australian tax as would apply to dividends received by an Australian subsidiary which are the subject of a distribution to the non-resident parent company. The rate of withholding tax should be the same as would apply to distributions by an Australian subsidiary of the non-resident company.

III. Double Taxation Agreements

17.96. Australia has entered into double taxation agreements with a number of countries. The first of these was with the United Kingdom in 1946. Agreements with the United States, Canada and New Zealand were signed in 1953, 1957 and 1960 respectively. The original agreement with the United Kingdom was negotiated in 1968. The new agreement with that country owes much to the model OECD convention issued in 1963. This is true also of the agreements with Japan and Singapore signed in 1969, and of the one renegotiated with New Zealand in 1966. An agreement with West Germany was signed in 1972 but has yet to come into force. Australia has also entered into limited agreements with France and Italy in relation to airline profits.

17.97. Double taxation agreements reflect the revenue interests of the parties, their economic and social policies and, of course, their respective bargaining strength. They also reflect the concern of the parties to prevent injustice and discouragement of trade, investment and other contact between their residents which tend to result when the same income is subject to unrelieved double taxation.

17.98. The Committee does not propose to examine the compromises reached in particular treaties. It is concerned, however, to make some
general observations on the structures and techniques of agreements that
will be most effective in preventing double taxation. This of course is not
to imply that the failure of an agreement to adopt these structures and
techniques is a matter of inadequate expertise. Thus the failure to define
the source of some kind of income may simply reflect the inability of the
parties to agree to a compromise of revenue interests. The failure to define
cloaks the problem of double taxation, it does not resolve it.

17.99. Those agreements subsequent to the OECD model convention of
1963 are distinctly sounder in structure and technique than earlier ones.
The observations which follow, for the most part, express objectives that
are already reflected in the OECD draft.

17.100. A double taxation agreement should resolve the conflicts of
claims to tax that arise when a taxpayer is, by the law of each of the
participating countries, resident in that country. The method of resolving
the conflict involves adopting a notion of residence which will ensure that
a person who is a dual resident has, for purposes of the agreement, only
one residence. The country of residence, in the agreement sense, should be
given the sole jurisdiction to tax the person's income from sources outside
both countries. The other country should be denied jurisdiction to tax the
person's income from sources in the country of residence.

17.101. These limitations on jurisdiction should also apply where there is
no dual residence. The person may be resident by the law of only one
country, which is thus the country of residence for purposes of the
agreement. The jurisdiction of the other country should be limited so that it
may not tax income having a source in a third country or in the country of
residence. The United States claims to tax certain income of a foreign
resident, even though it does not have a source in the United States, if that
income is effectively connected with a trade or business which the foreign
resident carries on in the United States. There is no express provision of
the present double taxation agreement with the United States to prevent the
United States from exercising this jurisdiction. Curiously, the United
Kingdom agreement denies such jurisdiction to the country that is not the
country of residence for purposes of the agreement in a dual residence
situation, but not otherwise.

17.102. A double taxation agreement should define the meaning of
source in relation to different kinds of income in ways which will ensure
that the same income cannot be held to have a source in both countries.
The definitions should apply to determine the meaning of source when
jurisdiction to tax depends on source, and also in relation to the obligation
of the country of residence to give credit for tax imposed in the country of
source. The tendency in earlier agreements was to leave definitions of
source to the operation of a provision in the agreement that ‘any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the law of the country applying the agreement’. There are wide divergencies of meaning of source in relation to different kinds of income in the laws of different countries. Dual source situations and unresolved double taxation problems must result if the matter is simply left to the law of the country applying the agreement. Moreover, the prospect is raised that the country applying the agreement may, in effect, rewrite the agreement unilaterally by changing a definition of source in its own law. There may be some justification for saying that the enactment by Australia of section 6C, defining the source of royalties, was a unilateral rewriting of the double taxation agreement with the United States.

17.103. The United Kingdom agreement, in relation to the obligation of the country of residence to give credit for tax imposed in the country of source requires, in some instances, that the country of residence accept the meaning of source given by the law of the country of source. This is some advance on an agreement leaving the matter to the country applying the agreement, but it is nonetheless unsatisfactory. The agreement should include its own definitions and not definitions imported by reference.

17.104. A double taxation agreement fixes the limits of each country's jurisdiction to tax in relation to different kinds of income. Here too it is of great importance that the agreement should contain its own definitions of terms. The United States agreement uses the term ‘royalties’ without its own definition of the term. The question has been raised whether Australia effectively extended the jurisdiction to tax given it by the agreement when, in 1968, it inserted a very wide definition of ‘royalties’ in the Act.

Chapter 17: Appendix A: Rules for Determining Source of Income of Non-Residents

17.A1. Income from sale of goods imported into Australia. Where goods are manufactured abroad by a non-resident and imported into Australia or bought abroad and imported, the test of source of any profit arising on their sale is whether something was done in Australia by the non-resident personally, or by his agent or representative, which was instrumental in bringing about the sale. The relevant sections of the Act (sections 38–41) appear under a heading ‘Business Carried on Partly in and Partly out of Australia’. Unless the heading is taken to control the interpretation of the sections, the profit from a casual sale may be held to have a source in Australia. In the Committee's view Australian law should be brought closer
to the law of the United States and the United Kingdom so as to require that there be a place of operations in Australia through which the action to bring about the sale has been taken. The place of operations might be constituted by an agent or representative of the non-resident. The notion of action instrumental in bringing about a sale should nevertheless be preserved. To require that contracts be concluded at the place of operations in Australia is to give undue weight to a factor depending on legal forms.

17.A2. Where the goods have been manufactured abroad by the non-resident, it is only the selling profit that is subject to Australian tax. The calculation of the selling profit, under section 38, involves subtracting from the proceeds of sale of the goods ‘the amount for which . . . goods of the same nature and quality could be purchased by a wholesale buyer in the country of manufacture, and the expenses incurred in transporting them to and selling them in Australia’. Under this provision there is the prospect of a reconstruction of the Australian-source profit where the manufacturer's costs have been inflated, by prices he has paid to related persons, so as to prevent any profit arising. However, the calculation of the selling profit under section 39, where goods have been bought by the non-resident and then imported into Australia, does not allow of any reconstruction. The Commissioner has only such powers of reconstruction as may be given him by section 136. The need to increase his powers under that section was considered in paragraphs 17.80–17.89.

17.A3. Income from purchase and sale of goods that are at all times in Australia. The Committee's view is that a place of operations in Australia should be necessary to give an Australian source to a profit from the sale of goods imported into Australia. A casual act of purchase and sale should, however, be sufficient to give a profit an Australian source if the goods are at all times in Australia and acts done in Australia by the non-resident personally, or by his agent or representative, were instrumental in bringing about both the purchase and the sale.

17.A4. Income from purchase of goods in Australia and their sale abroad. An act done in Australia by the non-resident personally, or by his agent or representative, which is instrumental in bringing about the purchase of goods might be thought to justify giving a source to at least part of a profit resulting from the sale of those goods in an export transaction. There is some support for this view in judicial decisions. However, the Committee would prefer that the emphasis be placed on the place of selling. If an act done in Australia by the non-resident, or by his agent or representative, is instrumental in bringing about the sale, the profit should be treated as having an Australian source. It should not otherwise be treated in this fashion.
17.A5. *Income from manufacturing operations in Australia.* Where manufacturing operations are carried on in Australia by a non-resident using materials or components he has imported into Australia, the determination of the amount of profit from the sale of the goods having a source in Australia will be made by the Commissioner under section 42. The Committee considers that section 42 is an appropriate provision. It is noted, however, that the Commissioner under the section must accept the profit: his function is only to determine how much of the profit has an Australian source. Here, too, any power of reconstruction must be found in section 136.

17.A6. *Income from sales of Australian real property.* There is no definitive decision on the source of a profit from the sale of Australian real property. Such a profit should, in the Committee's view, be treated as having a source in Australia even though the purchase and sale of the property took place abroad. While the increase in value reflected in the profit may have been generated by selling activity in the foreign country, it is more likely to have been the result of factors at work in the Australian economy. The suggestion is sometimes made, based on a judicial decision concerning shares in companies, that a profit has a foreign source when it results from the sale abroad of an option over land in Australia. In the Committee's view, the sale of an option should not be distinguished from the sale of the land to which it relates. Option should be given a wide meaning for this purpose. It should not be necessary to attract the operation of the source rule that the option has conferred an interest in the land in Australia.

17.A7. *Income from sale of shares.* The judicial decision referred to in paragraph 17.A6 may be taken to reject any general principle that the source of a profit made on the sale of shares is the place where the shares are situated. The Committee is not disposed to disagree. A share is situated in the place where the register of the share is kept. To make this the source of the profit would be to allow form to govern the matter. It might be suggested by analogy with real property that the source of the profit on the sale of shares should be taken to be the country where the company derives its profits. While a related test referred to in paragraph 17.57 applies in determining the source of a dividend paid by a company, the Committee does not see this as the appropriate test in the present context. The test is unworkable, requiring information about company affairs that would not be available when an assessment is to be made. A profit on the realisation of shares acquired by a non-resident abroad and sold in the Australian market should, in the Committee's view, be regarded as having a source in Australia if the non-resident has a place of operations in Australia and
action through that place of operations was instrumental in bringing about the sale. Where, however, the shares have been both purchased and sold in the Australian market in the sense that acts by the non-resident personally, or by his agent or representative, in Australia were instrumental in bringing about both the purchase and the sale, the resulting profit should be regarded as having a source in Australia. In this case whether or not the non-resident has a place of operations in Australia will be irrelevant.

17.A8. Under these principles many stock exchange transactions would generate profits which would have an Australian source. Where a number of sales are made on an Australian exchange the stock broker or agent instructing the sale of the shares may constitute a place of operations sufficient to give an Australian source. Where the taxpayer buys and sells on an Australian exchange there will be an Australian source. The Committee understands that the law is not at present administered so as to bring all profits of non-residents to tax where they arise from transactions on Australian stock exchanges. There is, of course, great difficulty in establishing that a non-resident has engaged in transactions which, either because he is a trader or by the operation of section 26 (a) and 26AAA, give rise to profits which are income. This is especially so when the non-resident has given instructions through a broker or agent in the foreign country, who has in turn instructed an Australian broker. In many cases a non-resident operates through a nominee company and his identity is not known to the broker or agent acting in Australia. In addition, he may buy through one broker and use another for the sale of the securities. If a liability to tax can be established the Commissioner will very likely have to rely on the agency provisions (referred to in paragraph 17.90) to collect the tax, at some inconvenience and risk of loss to the Australian broker, or other agent, who is constituted the agent for the non-resident under those provisions.

17.A9. The difficulties for the Revenue in ascertaining and enforcing the liability of the non-resident to tax and the related difficulties for the stock broker or other agent could only be overcome by a general provision exempting from tax all profits by non-residents arising from stock-exchange transactions in Australia. The Committee would not support such an exemption as a way of dealing with these difficulties, though it could understand an exemption in these terms, or even wider terms, as a way of attracting to Australia financial operations by non-residents. The Committee would regard recommending an exemption for the latter purpose as outside its functions.

17.A10. Income from services performed as an employee. Judicial decisions suggest a somewhat elusive distinction between the wages or
salary of an artisan in relation to which the place of performance tends to be an important factor in determining source, and the wages or salary of an employee whose services may be called professional, especially one holding an ‘office’, in relation to which the place of performance tends to be less important. In the Committee's view, place of performance should be the sole test of source of wages or salary. It may be appropriate, though, on grounds of administrative simplicity, to exempt the wages or salary of a non-resident if the services were performed for a non-resident and did not exceed a certain number of days—say sixty—in any year of income. In some double taxation agreements to which Australia is a party, an exemption of this kind is given in respect of a longer period of service. It may be appropriate to restrict the exemption so that it does not apply to services performed for a non-resident in connection with a place of operations the non-resident has in Australia. In another respect, however, it may be appropriate to extend the exemption so that it applies to services performed for a resident in connection with a place of operations the resident has outside Australia.

17.A11. Whether the exemption should be restricted so that it will not apply to the income derived in Australia by public entertainers and professional sportsmen, who may earn substantial rewards for very short periods of service, will need to be considered.

17.A12. Income from services performed otherwise than as an employee. Judicial decisions suggest that factors other than place of performance will determine the source of income from independent performance of services, such as the conducting of a geological survey or the giving of professional advice. The place of performance of service should, in the Commission's view, be adopted as the test of source, whether the services are performed as an employee or independently. It may be appropriate to allow an exemption parallel to that suggested in relation to wage and salary income. Here too it will be necessary to consider whether there should be some kinds of services in relation to which the exemption will not apply. It should be made clear that the test extends to services performed by a company through its employee or other agent.

17.A13. Income in the form of rentals in respect of real property. Rentals in respect of real property in Australia should be regarded as having a source in Australia. They are probably so regarded by the present law.

17.A14. Income in the form of rentals of chattels. The present law does not give any clear directive as to the source of rentals of chattels, for example payments for the hire of computer equipment. One factor that might be thought important is the location of the chattel at the time of rental payment. But to adopt this as the test means that the source of the
rentals would alter with any change in the location of the chattel. Clearly the test would be unworkable where the item is a ship or an aircraft. In the Committee's view, the appropriate tests of source are those adopted by section 6C of the Act, which already applies where the chattel is an item of 'industrial, commercial or scientific equipment'. Section 6C defines the source of 'royalties' for purposes of the Act and the definition of royalties in that section includes payments for the use of these items. The tests depend on the connection of the rentals with economic activity carried on in Australia. There is a source in Australia where the payment is made by an Australian resident to a non-resident, except to the extent that the payment was an outgoing incurred in carrying on business in a country outside Australia through a permanent establishment of the Australian resident in that country. And there is a source in Australia where the payment is made by a non-resident, to the extent that it is an outgoing incurred by that non-resident through a permanent establishment he has in Australia.

17.A15. In one respect the tests may be defective in their presumed object of ensuring that gains resulting from economic activity in Australia are treated as having an Australian source. A permanent establishment abroad of an Australian resident may pay rentals for chattels to a non-resident and receive matching rentals in respect of the same chattels from another Australian resident who uses the chattels in Australia. The rentals paid by the permanent establishment will not have an Australian source under section 6C. However, they will be deductible by the Australian resident, in computing his profits, against the rentals received from the other Australian resident. The latter will be entitled to a deduction for the rentals he pays. A similar defect in the provisions imposing withholding tax on interest paid to a non-resident has been overcome by an amendment to those provisions to which reference is made in paragraph 17.A23. An amendment may be thought appropriate to section 6C, which would give an Australian source to a payment by a resident representing an expense of a permanent establishment abroad, if payment for the use of the same property has been received from another Australian resident.

17.A16. Where the person making the payment is a resident, and the exception relating to a permanent establishment abroad does not apply, the tests assume that the resources from which the payment is made will be generated by economic activity of the resident in Australia. The assumption may not always be correct, but in the Committee's view it is justified for the sake of a workable rule. It would be possible to adopt a test making the extent of the Australian source of the rentals depend on the amount of Australian-source income compared with foreign-source income.
derived by the resident undertaking the payment. But the Committee would not favour introducing a complexity of this kind.

17.A17. **Income in the form of payments for the use of commercial or industrial property.** Payments for the use of commercial or industrial property in Australia should be regarded as having a source in Australia. There is support for such a view in judicial decisions and in the effect of section 6C of the Act, though that section does not in its terms make the source depend on the location of the property. Reference is made to section 6C in paragraph 17.A12 above. The definition of royalties in section 6, for purposes of that section, includes payments made ‘as consideration for the use of, or the right to use, any copyright, patent, design, . . . trade mark, or other like property or right’.

17.A18. **Income arising from payments for commercial or industrial property.** A profit from the sale of Australian commercial or industrial property should be treated as having a source in Australia. The treatment of such a profit ought to parallel the treatment of a profit on the sale of real property in Australia. In each case the existence of the property depends on rights given by Australian law.

17.A19. **Income arising from payments for scientific, technical, industrial or commercial knowledge or information.** The source of income arising from payments for know-how—scientific, technical, industrial or commercial knowledge or information—is the subject of judicial decision in the *United Aircraft Case* and of statutory provision in section 6C of the Act already referred to in paragraphs 17.A12–17.A13. The *United Aircraft Case* is authority that income will have a foreign source if the contract under which the information is supplied and the actual supply of the information take place abroad. The inference is that the income will have a source in Australia if both the contract and the supply take place in Australia. The case is unhelpful where only one of these elements takes place in Australia. Section 6C is not concerned with either element. Source, it was seen in paragraphs 17.A12–17.A13, depends on the payment being a ‘royalty’ as defined and on its having been made by an Australian resident or, in some circumstances, by a non-resident. The definition of ‘royalties’ in section 6 includes ‘payments . . . for the supply of scientific, technical, industrial or commercial knowledge[or] information’. In the Committee's view, both the *United Aircraft Case* principle and section 6C are unsatisfactory. The principle over-emphasises form; the section imposes tests in terms of connection with the Australian economy that may be too wide.

17.A20. The approach taken by section 6C is to be preferred but its operation in the present context should be restricted. Where the total
amount of the payments for the know-how is in any way dependent on the extent of use of the know-how or the productivity of the business using it, section 6C should apply. But the section should not apply to payments that are not dependent on use or productivity. A payment for a machine should not be treated differently from a payment for plans and specifications for building the machine. The test of source in Australia should, in this case, be whether the sale of the know-how was made through a place of operations in Australia that was instrumental in bringing about the sale.

17.A21. While the operation of section 6C should be restricted in this way, it ought to be extended in the manner already considered in paragraph 17.A13. The purpose of section 6C, as at present drafted, may be defeated by an arrangement involving the supply of know-how to a permanent establishment of an Australian resident who then supplies the know-how to another Australian resident.

17.A22. *Income in the form of dividends.* Dividends and interest, as has already been explained, are taxed by withholding on a basis of their origin in Australia that may differ from their source. Where withholding tax applies, section 128D excludes tax by assessment so that source in Australia has no immediate consequences. There are occasions, however, in relation both to dividends and to interest when source in Australia continues to have consequences. Some of these occasions were explained in paragraphs 17.71–17.75.

17.A23. The source of a dividend for the purpose of taxing a non-resident receiving the dividend is determined by section 44. The test is the source of the profits from which the dividend has been paid. But the source of a dividend, where it is part of the profits from which a dividend is paid to a non-resident is not determined by the Act. If regard is to be paid to the principle that origin in Australia should depend upon economic activity in Australia, the source ought perhaps to be determined by tracing back to active business profits in Australia. However, such an assertion of jurisdiction could not generally be enforced. For this reason the Committee favours the place of residence of the company (A), from which another company (B) receives a dividend out of which it pays a dividend to a non-resident (C), as being the source of the dividend profits received by B for the purpose of determining the source, under the statutory test, of the dividend received by C.

17.A24. *Income in the form of interest.* The source of interest has been considered in a number of judicial decisions and there are statutory provisions in section 25(2) giving an Australian source to interest in some circumstances and perhaps denying it in others. The judicial decisions tend to emphasise elements of form—where the contract of loan was made or
the loan moneys were provided. The provisions of section 25(2) give a source in Australia to interest upon money secured by mortgage of any property in Australia. There is an exception to the operation of the provision when interest is paid outside Australia to a non-resident on debentures issued outside Australia by a company. It is not clear whether the exception, by preventing a deemed source arising under section 25(2), requires that the interest be treated as not having a source in Australia.

17.A25. In the Committee's view, the tests of origin for purposes of withholding tax should in general be adopted as the tests of source for purposes of tax by assessment. Those tests express the basic notion that source depends on whether the income has been produced by economic activity in Australia. The tests are payment by a resident, except where it is an expense incurred by the resident in relation to a permanent establishment he has abroad, or payment by a non-resident where it is an expense incurred by him in relation to a permanent establishment he has in Australia. A recent amendment has sought to give more effective expression to the basic notion by imposing withholding tax on a payment of interest by a resident to the permanent establishment abroad of another resident. The intention is to ensure that where the permanent establishment has borrowed in order to lend to an Australian resident, withholding tax is paid at some stage. It would have been impossible, however, to apply a provision making the liability to withholding tax on the interest paid by the resident's permanent establishment depend on the tracing of the moneys borrowed into loans made by the permanent establishment to Australian residents. But where tax is imposed by assessment, a provision making the determination of an Australian source for the interest paid by the permanent establishment depend on a tracing may be feasible. The tracing might be done by applying to the interest paid that fraction of the total interest received by the permanent establishment which was received from Australian residents. It would be necessary, however, to confine the liability to tax by assessment in ways proposed in paragraph 17.71.


Chapter 18 Income Taxation in Relation to Particular Industries: Primary Production

18.1. The Income Tax Assessment Act contains a number of provisions that relate only to income from primary production. The relevant sections or divisions may be grouped as follows:

(a) The definition provisions, for example those of ‘primary production’ and ‘forest operations’: section 6 (1).
(b) Provisions dealing with the valuation of livestock: sections 32, 33 and 34.
(c) Provisions allowing for a spreading or averaging of income for the purpose of counteracting either the bunching of income or the effect of substantial variations in annual income due to seasonal conditions and instability of commodity prices: section 26B (insurance recoveries on losses of livestock and trees); section 26BA (double wool clips); section 36 (disposal of trading stock in consequence of the resumption of land, fire, flood, drought or the lease of land for tick eradication purposes); section 36AAA (forced disposal of livestock—alternative election); section 36AA (compensation for death or compulsory destruction of livestock); Division 16 (averaging of incomes); Division 16B (drought bonds); section 160 (rebate in case of disposal of the assets of a business of primary production).
(d) Provisions allowing for depreciation on plant and structural improvements and a write-off of certain capital expenditure: sections 54, 70 and 75A.
(e) A provision allowing for writing off over an indefinite period of previous years’ losses incurred in carrying on a business of primary production: section 80AA.
(f) A provision of now very limited application enabling Crown leases used for primary production to be treated for taxation purposes as though they are free-hold property: section 88A.

18.2. Since the Committee commenced its review, significant changes have been made to the law affecting the determination of net income from primary production: sections 57AA, 57AB, 62AB, 75 and 76 have been terminated and section 75A enacted. All the terminated provisions were regarded as involving concessions and not as being necessary for the determination of true net income. Sections 57AA and 57AB allowed an accelerated write-off, over five years, of the cost of plant and certain structural improvements; section 62AB provided for an investment allowance of 20 per cent of the cost of new units of depreciable property acquired after 14 August 1963; and sections 75 and 76 allowed a full deduction in the year of income for specified capital expenditure on certain improvements to land. The new provision, section 75A, allows deductions over ten years for certain capital expenditure formerly allowed in full under section 75 in the year in which it was incurred.
18.3. To be eligible for the application of some of the primary production provisions, a taxpayer during a year of income must have carried on a business of primary production. Other sections contain a similar requirement stated in slightly different terms; but in the case of depreciation on structural improvements, the test is whether the land upon which the improvements are situated was used for certain of the pursuits defined by the Act as constituting ‘primary production’.

18.4. Eligibility for the application of these provisions is not dependent, however, on primary production being the principal activity of the taxpayer. This has led taxpayers with income from other sources to engage in primary production on a very small scale to obtain the benefits of the primary production provisions and has even encouraged taxpayers to undertake activities involving income losses but offering prospects of capital gains.

The Definition Provisions

18.5. Production of timber from tree farming was regarded as primary production prior to 1963, when the definition of ‘primary production’ in section 6 (1) was amended to include ‘production resulting from . . . forest operations’. However, the definition of ‘forest operations’, also inserted in section 6 (1) in 1963, in addition to describing tree farming operations extends to the activities of persons who merely fell trees in a forest.

18.6. The inclusion of the activity of felling trees in the definition of ‘primary production’ has the consequence that persons who, in a business operation, fell trees in a forest carry on the business of primary production and are thus entitled to the benefit of the averaging provisions, even though they own no forests or plantations but obtain their timber supplies through rights or licences to cut timber given to them by other persons. And it might also have the consequence that logging contractors who do not become the owners of the fallen timber are to be regarded as persons carrying on the business of primary production entitled to the benefit of averaging.

18.7. The introduction of the definition of ‘forest operations’ into the Act was accompanied by an amendment to section 54, which provided for the allowance of depreciation on structural improvements used in forest operations. Thus in so far as the definition of forest operations describes activities additional to tree farming, it extends the scope of allowance of depreciation.

18.8. The Committee can see no reason why persons who carry on a business of felling timber but who do not plant or tend trees in a forest or
plantation for the purpose of felling should be regarded as primary producers entitled to the benefit of the averaging provisions: it does not appear to the Committee that they are especially subject to income fluctuation. It accordingly recommends that in so far as the definition of forest operations extends beyond the concept of tree farming it should expressly apply only for the purpose of allowance of depreciation.

Valuation of Livestock

18.9. As explained in paragraph 8.124 trading stock other than livestock may be valued at its cost price, market selling value or replacement cost. In the case of livestock a primary producer must elect to adopt either a cost price or market selling basis of valuation, but the Commissioner may give a taxpayer leave to adopt some other basis for the whole or part of the livestock, and in fact does so where valuable stud animals are acquired.

18.10. Once having adopted either a cost price or market selling basis of valuation, a primary producer is prohibited from changing that basis except with the leave of the Commissioner.

18.11. Where the cost price basis is adopted, a primary producer is required at the end of a year of income to value natural increase born during that year at a cost price selected by him, which must not be less than the minimum value prescribed in Regulation 5 of the income tax regulations.

18.12. The minimum values now contained in Regulation 5 have remained unchanged since 1935. Prior to 30 June 1961, maximum values were also prescribed but were excluded by amendment of the regulation in that year. Minimum values are prescribed as follows for the undermentioned classes of livestock only:

- Sheep $0.40
- Cattle $2.00
- Horses $2.00
- Pigs $0.50

18.13. All livestock in a business of primary production are treated by the Act as trading stock even though some animals are not acquired for the purpose of sale. Although animals not acquired for the purpose of sale (for example, stud stock) could be regarded as more akin to plant than trading stock, there is no provision in the Act for writing off annual amounts of depreciation from their cost. But what is tantamount to depreciation may be written off in other ways: (i) by adopting a market selling value basis of valuation, which will allow for true depreciation; or (ii) by seeking leave of
the Commissioner, where the cost price basis of valuation has been adopted, to value stud stock at the end of a year of income at values that will reflect depreciation of original cost values.

18.14. The cost price basis of valuation tends to place values on livestock on hand which are less than cost. Under this method in practice, values are generally determined on the average cost of animals in a herd or flock. In calculating average cost, the purchased stock are brought to account at their cost price and natural increase at values that are somewhat arbitrary but may not be less than the minimum values. In the case of those graziers who prefer to build up or maintain their stock numbers by breeding rather than by purchasing, the adoption of low values for natural increase tends to lead to a fall in the average cost of their stock. Over a period of years during which relatively small numbers are purchased, the average cost of stock tends to approach the minimum value used for natural increase. Under normal conditions these average cost values, which are employed for computing net income, are substantially lower than market values. The cost price system thus contains a bias in favour of bred stock as against purchased stock.

18.15. Another consequence of the cost price system of valuation is that it permits a deferment of tax when animals are bred for sale or immature animals are purchased for ultimate sale. This arises from the fact that the cost of maintaining animals until they reach maturity does not form part of the cost value. To some extent the deferment can be justified on the ground that primary producers are not in a position to pay tax until sales are made. However, where a build-up of numbers from breeding is prolonged over a period, there will be an inevitable accumulation of unrealised profits.

18.16. It has been claimed that the present system of permitting only one basis of valuing livestock to be adopted at the end of a year of income is unfair to primary producers because section 31 allows other taxpayers a choice of bases. However, the two situations are not comparable: the cost price basis to which section 31 applies takes into account all costs of production incurred to the time of valuation, whereas the cost price basis for valuing livestock excludes the cost of maintenance during the livestock's growth and conditioning periods. To allow primary producers to exercise a free choice of bases in these circumstances would lead to the possibility of wide fluctuations in net income from year to year. In the United States primary producers are permitted to adopt either a cost price or a market selling basis of valuing livestock at the end of a year of income. But the cost price of livestock must include the cost of maintaining animals until they reach maturity.

18.17. Systems of valuing livestock vary from country to country and no
wholly satisfactory system has been evolved. Ideally, livestock should be treated as though they constitute work-in-progress and maintenance costs should be added to the value of animals year by year until they reach maturity; but the introduction of such a system would create complications not inherent in the present system. The United States system, which does provide for this, has proved to be unsatisfactory in practice with the result that an alternative system has been instituted in that country, under which a switching of bases at the end of the year of income is not permitted without leave of the Tax Commissioner. The alternative cost price basis provides for standard costs of animals according to age to be taken into account.

18.18. While the Australian system contains the defects mentioned in paragraphs 18.14–18.15, it is easily understood and is administratively simple. The Committee is not disposed to recommend any significant alteration; but it considers that the bias in favour of breeding stock, and the accumulation of unrealised profits, would be mitigated if minimum cost values of natural increase were periodically reviewed with regard for increases in costs of production, and it therefore recommends that such periodical reviews be undertaken.

**Spreading and Averaging Provisions**

18.19. No less than four of the provisions referred to in paragraph 18.1 deal with the spreading of profits arising from the forced disposal of livestock. These provisions give relief against the bunching of income that occurs when income from the disposal (or loss) of a substantial number of livestock has to be brought to account. As indicated previously, two of the main causes of bunching of livestock profit are the adoption of minimum cost values for natural increase and the failure to include maintenance costs in the cost price valuation of livestock on hand at the end of the year of income. While adoption of higher cost values for natural increase, as recommended above, will remove one of these causes, the continued presence of other causes appears to the Committee to justify the retention of the provisions.

18.20. The spreading allowed by section 26BA where advance shearing is made because of flood, fire or drought and two wool clips are sold in one year would appear to be justified, and the Committee therefore recommends the retention of this section.

18.21. Consideration is given in Chapter 14 to the question of the averaging of incomes, and recommendations on this matter and on the use of drought bonds are made. If, as recommended, an averaging system that is not limited by a ceiling of incomes is adopted, section 160 can be
repealed. The section ensures that a taxpayer who is entitled to be assessed by reference to an average income and whose taxable income exceeds $16,000 will be allowed the benefit of his average rate of tax in respect of that part of his income representing profit from the disposal of livestock made in the course of putting an end to his business. But if the present averaging system is retained, this provision should also be retained for reasons similar to those given in paragraph 18.19.

Capital Expenditure and Depreciation

18.22. Section 56 allows depreciation on plant to taxpayers generally, on the basis specified in section 55 which requires the rate of depreciation to accord with the effective life of a depreciable unit. Primary producers are in a special position inasmuch as the word ‘plant’ in section 54 is defined to include structural improvements on land used for agricultural or pastoral pursuits. Certain structural improvements in forest and pearling operations also come within the definition.

18.23. Primary producers also incur capital expenditure that does not result in any unit of property within the definition of ‘plant’ in section 54 coming into existence. Some items of capital expenditure of this nature are subject to the special provisions of section 75A. These are:

(a) the eradication or extermination of animal or vegetable pests from the land;
(b) the destruction and removal of timber, scrub or undergrowth indigenous to the land;
(c) the destruction of weed or plant growth detrimental to the land;
(d) the preparation of the land for agriculture;
(e) ploughing and grassing the land for grazing purposes;
(f) the draining of swamp or low-lying lands where that operation improves the agricultural or grazing value of the land;
(g) preventing or combating soil erosion or flooding on the land; or
(h) conserving or conveying water for use in carrying on primary production on the land.

18.24. The section allows deduction for the cost of these items over ten years. Such expenditure is distinguishable from expenditure of a similar description incurred in ploughing agricultural fields, maintaining pastures and keeping down the incidence of plant and animal pests. The latter is ordinary revenue expenditure which is deductible in full under section 51 in the year in which it is incurred.

18.25. Although it is acknowledged that some of the expenditures qualifying for capital allowances under section 75A may be of benefit for
periods exceeding ten years, overall this section and the provision regarding depreciation on structural improvements are considered to be a reasonable compromise in providing allowances appropriate to the determination of true net income.

18.26. Prior to the termination of the provisions of section 75, the Committee received a great number of submissions protesting against the concessions allowed under that section. For the most part they were made by persons or organisations concerned with the protection of the environment and were directed mainly at subsection (1) (b) of section 75, which allowed deductions for the destruction and removal of timber, scrub or undergrowth indigenous to the land.

18.27. The deductions now allowed under section 75A over a period of ten years were previously allowed (in respect of expenditure incurred before 21 August 1973) in full under section 75 in the year in which the expenditure was incurred. Where a taxpayer improved a farm for sale as part of a profit-making undertaking and at the same time carried on a business on that farm, when the farm was sold he was able by virtue of section 82 (3) (a) to obtain a deduction for expenses already deducted under section 75 in computing any profit subject to tax. In no longer allowing a full deduction for capital expenditure described in section 75 or a double deduction for such expenditure (when allowable under section 75A), amendments to the Act have removed the tax assistance aspect of the provisions in regard to the cost of clearing land. In the Committee's view, therefore, no further amendment to meet the case for protection of the environment is called for.

18.28. Another type of capital expenditure for which a deduction has been sought in submissions is the cost of extending power lines incurred by primary producers. At present the cost of extending telephone lines is allowable as a deduction in ten equal instalments. The cost will contain elements of both private expenditure and business capital expenditure. In the latter aspect, deduction seems appropriate whether for telephone lines or power lines: such costs would normally have been deductible if the expenditure had been incurred by the relevant authority and recouped by way of additional current charges for the service. In the private expenditure aspect, deduction can in the Committee's view be justified on the ground of remoteness of the place of living, which dictates that the additional cost be incurred.

**Losses of Previous Years**

18.29. Under the present law primary production losses may be carried
forward for an unlimited period. In Chapter 8 the Committee has proposed that unlimited carry-forward of losses be allowable to all taxpayers.

**Restriction of Benefit of Primary Production Provisions**

18.30. A number of submissions to the Committee have suggested that the only persons who should receive the benefit of the application of the primary production provisions are those whose principal activity is engagement in primary production. Other submissions indicate that the benefit of the averaging provisions should be extended only to those persons whose income from primary production is more than 50 per cent of their total income.

18.31. The question of whether a person engaged in primary production should be entitled to the benefit of the averaging provisions would, under the Committee's recommendations proposed in Chapter 14, require the application of the further test that the activity should provide his chief source of income.

18.32. In general the primary production provisions of the Act are available only to a person who carries on a business of primary production. The question of whether an activity is carried on as a business or as a hobby poses problems in the administration of income tax. It is often difficult for the Commissioner to refute a claim by a taxpayer that his activities constitute a business even though there is little likelihood of any profit being derived. The High Court in *Tweddle's Case*\(^1\) has held that a profit motive is not essential in carrying on a business and it is not for the Courts or the Commissioner to say how much a taxpayer should spend in earning his income. Thus, even though a taxpayer carries on no more than minimal activities on a farming property, which can only result in losses (for example, when the activity involves hobby or pleasure farming), the losses will in all probability be deductible from other income derived by him.

18.33. This problem has been recognised in overseas countries. In the United Kingdom, Canada and the United States special provisions have been enacted to deal with losses from hobby or pleasure farming. In West Germany, too, losses from hobby farms are not deductible unless profits arise over several years. In the United Kingdom a loss is not allowable as a set-off against other income if it arises from carrying on a trade, profession or vocation in respect of which there is not a reasonable expectation of profit. The provision, though aimed at hobby farmers, applies to other kinds of hobby businesses. In the United States deduction is similarly denied for losses arising from an activity not engaged in for profit.
18.34. In Canada farm losses, which are not necessarily hobby losses, are allowed on a restricted basis as deductions from other income where the taxpayer's chief source of income is not farming. This compares with the recommendation of the Carter Commission which proposed that, if business losses have been incurred in three years out of a five-year period, the loss for the latest year should not be deductible from other income: losses would again be deductible, in the year the business again became profitable. The Commission made this recommendation because it found difficulty in defining what constitutes a hobby business.

18.35. Of the alternative methods for dealing with the problem of hobby or pleasure farming suggested by the experience of these countries, those used by the United Kingdom and the United States would seem the most appropriate. Accordingly, the Committee recommends that a loss arising from a primary production activity should not be allowable as a set-off against income from other sources nor should it be available for set-off against the income of any other year, unless the inference can be drawn from the extent and manner of the activity that it was engaged in for profit and in fact there was a reasonable expectation that a profit would result.

Chapter 19 Income Taxation in Relation to Particular Industries: Mining

19.1. This chapter deals with the taxation of income derived from mining which, in non-technical language, may be described as the extraction of substances from their natural site. It considers a number of differences between net income for tax purposes and profits before tax as arrived at for financial accounting purposes—differences beyond those examined in Chapter 8 in the context of business and professional income. Some discussion is also included on those provisions of the Act which might be regarded as extending concessional treatment to the mining industry.

19.2. Part III of the Income Tax Assessment Act contains three Divisions relating to mining. Section 6 (1) of the Act defines ‘minerals’ as including petroleum; it also contains a definition of ‘petroleum’ as meaning, among other things, any naturally occurring hydrocarbon whether in a gaseous, liquid or solid state. Division 10 (Sections 122 to 122T) bears the heading ‘General Mining’, Division 10AA (Sections 124 to 124AR) the heading ‘Prospecting and Mining for Petroleum’, and Division 10AAA (sections 123 to 123F) the heading ‘Transport of Certain Minerals’. The provisions contained in these Divisions are concerned with ‘mining’ which, in the absence of any definition in the Act, has been expounded by judicial interpretation. Such interpretation has, as a rule, excluded quarrying operations which have, accordingly, been considered as not coming within the ambit of these Divisions. Section 77D (1) for its own purposes contains a definition of a ‘mining company’ as meaning a company that carries on, or that the Commissioner is satisfied proposes to carry on, eligible operations in Australia as its principal business, ‘eligible operations’ in turn being described as one or more of exploration, prospecting, and mining for minerals. Section 77D (1) also contains its own definition of minerals. Section 77D, which relates to moneys paid on shares in companies engaged in certain mining activities, has, as the result of amendments to the Act in 1973, in general no application to such moneys paid after 7 May 1973; but the definition of a ‘mining company’ is adopted in the new Division 10AA for the purposes of section 124AR as the result of the amendments to the Act effected in December 1974. In various places in the Act there are other sections relating to mining and these will be referred to later. The Committee draws attention to the diverse placement in the Act of its various mining provisions and recommends that all such provisions (including the various definitions) be drawn together more conveniently in the legislation.
19.3. In Section I of this chapter, dealing with general mining, references to ‘a miner’, ‘a mining company’ and ‘mining’ are intended to refer, respectively, to the person, company and activity engaged in mining, other than petroleum mining and quarrying; these latter activities are examined separately in Sections III and IV. Section II considers some of the recent amendments to the mining provisions of the Act.

I. General Mining

19.4. The profits constituting the taxable income of a taxpayer engaged in the business of mining in Australia are ascertained substantially in the same way as those of any other trading concern in that its ordinary revenue expenditures incurred in the extraction, treatment and sale of the product mined by it, and in the management of those activities, are deductible from the income derived from the carrying on of its business. In addition, the legislation provides for the application of certain special provisions in the computation of a taxpayer's net income from mining operations. The question whether these provisions involve concessional treatment has provoked considerable discussion.

19.5. The present state of the Commonwealth taxation legislation in relation to mining and the recent amendments to it have been dealt with in submissions to the Committee. It is understood that the Industries Assistance Commission has been requested by the Government to examine and report upon the mining industry in Australia, but the taxation of the mining industry also plainly falls within the Committee's own terms of reference.

19.6. It does not follow that, because special provisions apply to a particular business activity, such activity is given preferential treatment. Various businesses and industries in Australia have been dealt with under the fiscal laws in a particular way in order to pay regard to the special problems peculiar to them. The legislation abounds with differences in its application to taxpayers falling into different categories, whether industrial or otherwise. The moulding of tax laws to distinct situations is not a novelty: in many countries mining has always been acknowledged to be an industry of a special kind presenting unique problems when it comes to determining true net income. Most important is the fact that the product which is mined at a particular location, and which is the sole justification for the business being carried on there, is not readily found in commercial quantities; and on the product's depletion to a level making continuation of the mining unprofitable, the assets of and associated with the business at or adjacent to that site are correspondingly reduced in value. Mining involves
costs of production of a type not encountered in other business activities: most important are the expenditures on prospecting and exploration which are frequently abortive and on development of a mine which has no value when the deposit is exhausted. Continuity of mining is essential to the industry; and the investment made at one location must be recovered before the deposit is exhausted to enable the discovery of further resources and the bringing of them into production. Economically-recoverable reserves of many mineral products are limited.

19.7. Reference will be made below to these aspects as well as to the manner in which they have been recognised and dealt with in overseas countries. The mining industry has always been susceptible to changes brought about by governmental requirements to satisfy needs occasioned by current political events and economic conditions. In a study entitled ‘Historical Survey of the Mining Provisions of Commonwealth Income Tax Legislation’, prepared in connection with this report, it can be seen that at different stages the advent of war and other conditions have brought about alterations in the impact of taxation by way of legislative encouragement or discouragement of the mining of various products.

Conduct of Mining Operations

19.8. A brief look at the climate in which a mining project is initiated and carried on is necessary for an appreciation of the form which over the years the legislation of Australia and other countries has taken. The search over wide areas for minerals under the ground by means of the techniques of topographical, geological and geophysical investigation is usually in itself an expensive and chancy enterprise meeting far more often with failure than success. Each passing year makes the chances of a lucky discovery of worthwhile significance at no great cost more and more remote. If the possibility of success is indicated, there must follow an intensive survey and testing of the site and assaying of test samples of the product obtained by drilling in order to gauge the volume and grade of the field. The likely profitability of the deposit, if it is to be opened up and worked, must be determined after examination of the suitability of extraction methods, transportation and infrastructure requirements, the availability of markets, and satisfactory financial accommodation. Contracts for the sale of the product must be obtained and, if the product is to be exported overseas, negotiations may have to be conducted in other countries. The costs of discovering and proving whether or not a prospective deposit will be a viable commercial mining proposition are frequently immense.

19.9. If the results appear to justify mining on a full scale and
negotiations and applications for mining tenures and royalty payments are consummated, further capital must be employed to engage the executive and technical staff and an adequate workforce, and to secure and install the necessary plant and machinery for the opening up of the mine. Where, as usually happens, the mine's site is at a great distance from populated centres, housing, medical care, educational facilities and other suitable amenities may need to be provided for the necessary personnel, their wives and children. Water, power and light may have to be provided. Roads, pipelines, railways, port facilities (including dredging of harbours and channel approaches) and heavy equipment are frequently essential for the transportation of both men and materials. These are some of the headings of expense incurred to initiate a major mining project. They require the availability of vast sums of money in an appropriate ratio of equity to borrowed capital.

19.10. Mining today on any effective scale requires the contribution of large amounts of funds in the shape of equity and loan capital and normally a lengthy period must elapse—on occasions up to ten years—before a cash-flow arises from the mining and sale of the product. Even if the stage of the discovery of what is considered to be a feasible project be reached, the risk factor does not disappear. Expectations based upon the volume and quality of the product to be won are not always fulfilled. In weighing up the prospects of a satisfactory profitability, continuous attention must be paid to the fluctuating demand for the product and the prices payable, the economic conditions governing the attitude of buyers, the possibility of competition from sellers mining in other locations in and beyond Australia, rises in production costs in excess of the original estimates and changing international monetary circumstances. All these factors are consequently reflected in the costs of borrowing money and the difficulties of raising capital when funds are required on a large scale. It is true that many of the factors in question apply to other industries, but the essential distinction lies in the extent to which they appear in the mining industry.

19.11. It would not be realistic to expect that the investment of large sums of money would be made in a business exhibiting these characteristics in the absence of the incentive of a rate of return upon the moneys invested commensurate with the size of the investment and the risks involved. When mining profits are remarked upon adversely, the critics are apt to ground their arguments on the results of a restricted number of established companies. It is not an uncommon error to judge the mining sector by its successful companies without reflecting upon its many failures. Because of the existence of the risk factor and the requirement of a vast contribution of capital, mining today is not an industry in which the
small company has much chance of successfully entering except in association with a large enterprise. Borrowed capital in the amounts required is usually well beyond its reach. Because of the time that must elapse before the capital invested can produce a return, a new company at the exploration or early development stage does not attract small investors who can only afford to look for a reasonably immediate return upon their investments.

19.12. The provisions of the Act that enable recoupment of capital employed in a mining venture are framed to some extent so as to give recognition to the fact that the expenditure has been incurred on a wasting asset, the value of which diminishes as mining operations continue. The extent of the recognition of this principle varies according to the nature of the capital expenditure that has to be recouped.

**Determination of Net Income from Mining**

19.13. A mining company's capital resources are expended in a number of different activities, commencing with exploration and leading up to the actual production of the mining product. Of necessity there is a very considerable time-lag between certain of these expenditures and the receipt of income from the sale of the mined product. It is therefore exceedingly difficult to match relevant costs with specific revenue or to charge them against a specific accounting period. Some costs may not produce any revenue at all and costs incurred in one period may be relevant to revenue derived over several future periods. As the production proceeds, the natural resource becomes progressively exhausted unless further exploration and development reveal the existence of additional quantities capable of being profitably mined in the same area. This is frequently a continuing process. If the total quantity of the natural resource capable of being mined in the area could be definitely ascertained during exploration or, perhaps, at the stage of initial development, and if the total costs of the mining company to be incurred in exploration, development, extraction and sale of the mining product were to remain constant throughout the whole of the company's operations, an exact rateable proportion of cost might be allocated to each quantity of the natural resource extracted and sold. Under those conditions the mining company could show what was a true net profit for taxation purposes at each annual balancing date. Even if it were possible to do so, the expense of determining conclusively at such an early stage the total quantity of the natural resource in any large-scale operation would be prohibitive. Hence further development must be undertaken simultaneously with the work of production then taking place in already
developed parts of the mine. Costs do not remain constant. In these circumstances it is a practical impossibility to identify with precision in the receipts obtained from time to time from the sale of the product a portion properly attributable to income and a portion required to recoup capital expended on assets used up in producing the receipts.

19.14. The imposition of taxation upon its sales revenues from mining operations without recognition of the fact that they constitute in part a recoupment of capital would throw a burden upon a mining company which could not be borne without considerable financial stress. There is a diversity of accounting write-off practices followed by the industry in relation to the recoupment of capital expenditure.

19.15. The methods adopted to arrive at a true net income for the purposes of mining income tax legislation must be arbitrary in varying degrees. The taxation systems of other countries also adopt different methods in order to arrive at a true net income; but each attempts to impose taxation in a way that achieves a fair result in an industry which, by its very nature, is compelled to operate in an exceptional way.

19.16. Industries other than mining are given individual fiscal treatment for their own particular problems. Provisions adapted to the special needs of the mining industry are not to be regarded as concessions merely because they are not available to other industries, unless it be demonstrated that they are unnecessary for the effective conduct of the mining industry on a basis which is not improperly favoured. Having regard to the circumstances in which a mining company must operate, such provisions ought to do no more than ensure in a practical way that the net income annually brought to charge is a fair and reasonable figure for the measurement of its income tax liabilities. The special provisions that apply to the taxation of the mining industry in Australia can now be very briefly referred to. A detailed analysis of these provisions is contained in Appendix A to this chapter, coupled with references to comparable legislation in the United Kingdom, Canada, the United States, South Africa and New Zealand.

Provisions of the Act

19.17. The Act gives recognition in certain respects to the different phases of a mining company's operations such as, broadly speaking, expenditures incurred in relation to exploratory and investigative activities, the acquisition of mining or prospecting information and of the right to mine or prospect (including leasing of land for mining or prospecting), preparation of the site for mining operations, operations to mine the
product, treatment and transport of the mined product, and the provision of residential accommodation for employees and health, educational, recreational and other similar facilities for employees at or adjacent to the mine site. These operations include the erection of buildings and the installation of plant, water, light and power essential for the efficient conduct of a mining business.

**Exploration and Prospecting Expenditure**

19.18. Included in the definition of ‘exploration or prospecting’ for general mining (see section 122J (6)) are geological mapping and geophysical surveys, as well as the systematic search by various specified means for areas containing minerals. The definition of ‘mining or prospecting information’ for general mining (see section 122 (1)) denotes geological, geophysical or technical information that relates to or is likely to be of assistance in determining the presence, absence or extent of minerals in an area, and has been obtained from exploration or prospecting or mining for minerals. The provisions of the Act themselves thus acknowledge the necessity for intensive study in arriving at a decision whether to mine or not. By virtue of the operation of section 122J, the expenditure incurred in respect of exploration and prospecting does not qualify for immediate deductibility unless the taxpayer (i) carried on a mining business in the year of income in which those expenditures were incurred, and (ii) derives assessable income from the mining business. It has been submitted to this Committee that these conditions result in Australian taxpayers being discouraged from exploring and prospecting for minerals in Australia. Only those taxpayers who are already carrying on a mining business and deriving an assessable income from it are given the benefit of an immediate deduction of these expenditures from that assessable income. Where such assessable income is insufficient to allow a deduction in full, the deduction will be available against similar income of subsequent years until fully absorbed. However, the deduction of the remaining amount is limited to those taxpayers who ultimately carry on ‘prescribed mining operations’.

19.19. It follows that the statute tends to confine new Australian mining ventures to those companies already engaged in mining. It appears to the Committee that the deductibility of such expenditures as these should not be limited to cases where a mining business is already being carried on or to cases where a mine is ultimately acquired and mining operations commence. Expenditure on exploration, which is a necessary and continuing part of a mining company's operations, should be treated
consistently, whether successful or not. The Committee favours the approach that would make all exploration and prospecting expenditure immediately deductible against assessable income derived from any source. The availability of a deduction upon the lines suggested would constitute an acknowledgement that exploration expenditure is a normal operating expense of a mining enterprise and should be treated as such. This recommendation also answers the submission made to the Committee by a number of mining companies to the effect that, under the present system, when funds awaiting expenditure on exploration are invested by the mining enterprise, any deduction entitlement in respect of exploration expenditure cannot be set off against the income from those invested funds.

19.20. If this recommendation is implemented, it has been suggested that the deduction facility may be open to abuse or that an opportunity will be provided for wasteful expenditure activated by the ready availability of the deductions rather than the real possibility of discovering minerals and initiating mining operations. This objection may be answered by that fact that, in order to become entitled to the deduction, the taxpayer must satisfy the Commissioner that he carries on a genuine business activity in mining exploration and that the expenditure claimed as a deduction is warranted in view of that activity. What might be regarded as a business activity in this connection is also referred to in paragraph 8.211.

Development of a Mine and Mining Infrastructure

19.21. Section 122A (1) of Division 10 provides as allowable capital expenditure the costs of preparing a site for prescribed mining operations, buildings and plant and the costs of other items that would fall under the heading of mining infrastructure (see also the definition of ‘housing and welfare’ in section 122 (1)). Allowable capital expenditure, including that in respect of ‘housing and welfare’ is deductible under section 122D over the life of the mine or over twenty-five years, whichever is the less, when computed as residual capital expenditure in accordance with section 122C. The election available to a taxpayer under section 122E to deduct certain allowable capital expenditure from assessable income in the year of income in which it was incurred is now of limited application. The ability to appropriate income for future allowable capital expenditure under section 122G is being phased out of the Act in a similar fashion. With regard to the period of twenty-five years in section 122D (2) (b), it has been submitted to the Committee that this figure is arbitrary in its application. There does not appear to be any reason for fixing upon that figure as being the appropriate limit for the deduction of allowable capital
expenditure. If the intention of the section be to appoint a maximum period of twenty-five years within which recoupment in full may be effected, the section is subject to the more basic criticism that, where that period must be availed of by a taxpayer (i.e. where the life of the mine exceeds twenty-five years), the amount of the deduction will equal 4 per cent annually on a reducing balance and thus the intention of the section is frustrated. The Committee considers that, where the estimated life of the mine is equal to or exceeds twenty-five years, the amount of the deduction should be computed as 4 per cent of the original amount of the total allowable capital expenditure without regard to any previous deductions made in respect of it.

19.22. Section 122A(2) specifically excludes from the category of allowable capital expenditure (i) ships, railway rolling-stock or road vehicles, or railway lines, roads, pipelines or other facilities, for use wholly or partly for the transport of minerals or products of minerals, other than transport wholly within the site of prescribed mining operations; (ii) works, buildings or other improvements or plant constructed or acquired for use in connection with the establishment, operation or use of a port or other facilities for ships; and (iii) an office building not situated at or adjacent to the mine site. Division 10AAA contains provisions dealing with certain items of capital expenditure excluded by virtue of section 122A(2). Subject to a transitional provision relating to expenditure incurred or contracted for prior to 17 September 1974, section 123B provides that one-twentieth of the expenditure incurred or contributed in respect of these items be deductible over twenty consecutive years, where those facilities are constructed or acquired for use for transport of minerals or processed materials from minerals obtained in prescribed mining operations. Railway rolling-stock, road vehicles and ships are still excluded as are port facilities or other facilities for ships. Division 10AAA has no application to capital expenditure to which the division would otherwise apply, where the expenditure has been or is liable to be recouped to the taxpayer and the amount of the recoupment is not to be included in the assessable income of the taxpayer in any year of income.

19.23. A number of submissions have been received in regard to the exclusion of port and other facilities for ships from the category of allowable capital expenditure. Where the mining operations cannot be serviced economically from an existing port, the development of port facilities for large-scale sea transport is a necessity for the viable operation of the mine. On occasions this requires the extensive dredging of the harbour and channel approaches, channel marking and the reclamation of land, and so on. The conditions of leases granted by some State
Governments to enable certain of these facilities to be constructed by and at the expense of the mining companies ensure that ownership of them passes to the State, without compensation, on the termination of the leases. Where ports are situated at remote parts of the coastline, a township and other facilities must also be provided to cope with the personnel engaged in the industrial operations carried out at the port. Submissions received have pointed out that sea transport is just as essential as rail transport in enabling the mining product to be disposed of for commercial purposes and the gaining of assessable income and that it is illogical that railroad expenditures are deductible but expenditures on ports and port facilities are not. It has also been contended that housing and welfare facilities at or adjacent to the mine site are classified as allowable capital expenditure, whereas similar facilities at a port which are equally necessary are not deductible.

19.24. The Committee understands that the anomaly with regard to port construction does not exist in all States. Whilst one State might insist that the mining company bear the costs of making a port viable for the entry and loading of large tonnage shipping, another State may itself bear those costs but seek reimbursement through higher freight rates, port charges and royalty payments. In the first case the mining company obtains no deduction for its expenditures, whereas in the second case the payments for the charges are fully deductible. The adoption of differing policies by State governments in this regard must lead to a form of discrimination between different mining companies depending upon the location of the mine and the port it uses. If the mining company can use an existing port operated by a State Government, it is not involved in any financial outlay for port development; but if the mining operation cannot be serviced economically by an existing port, the mining company's expenditure obligations to enable its product to be disposed of commercially depend upon the State in which its mine is situated.

19.25. The result is incongruous so far as mining enterprises are concerned and the treatment of railroad and transportation expenditures deductible under Division 10AAA would suggest that identical treatment should be extended to port facilities and ports constructed to service the requirements of a mine. The costs of transporting the mine product and erecting facilities to enable such transportation are, as stated earlier, necessary for the conduct of mining and the taxation system should recognise this fact. The twenty-year basis of deductibility under Division 10AAA was, it appears, the result of the fact that, since such facilities may service a number of mines, it is impossible to relate their effective lives to a single mine. Further, the period of deductibility may relate in many cases
to the term of a lease of land upon which the transport facility is erected. It is for these reasons that the Committee prefers that the deduction be available under and in accordance with the provisions of Division 10AAA.

19.26. The Committee acknowledges that the necessity for ports and port facilities may arise in other industries, particularly those concerned especially with an export market, and that those industries may incur expenditures of a similar nature. The granting of a deduction in respect of those expenditures must be considered by the appropriate authorities on their merits. No submissions have been received by the Committee in relation to this question. As regards housing and welfare facilities erected by a mining company at a port which is not at or adjacent to a mine site, similar expenditure is incurred in other industries. For this reason, the Committee considers that such expenditure does not warrant special treatment under the Act. However, it has recommended in Chapter 8 that a depreciation allowance be available with respect to buildings: if this recommendation is adopted, a deduction will be available in the mining industry for this type of expenditure.

Processing and Treatment of Minerals

19.27. Subject to any election that may be made under section 122H, section 122A (1) (b) provides that expenditure incurred on plant for use primarily and principally in the treatment of minerals obtained by prescribed mining operations is allowable capital expenditure. ‘Treatment’ is defined in section 122 (1) as consisting of a number of specified processes excluding sintering, calcining, and the production of or processes carried on in connection with the production of alumina or pellets or other agglomerated forms of iron. With this description of treatment, the definition of ‘processed materials’ in section 123 (1) of Division 10AAA may be compared. It has been submitted to the Committee that new methods of treatment or processing have been developed since the definition of ‘treatment’ was amended in 1968 and that both the Commissioner and taxpayers have experienced problems in determining whether these new methods constitute ‘treatment’ within the terms of its definition. The expenditure on treatment plant and on the buildings to house and service it in the vicinity of mines is often considerable and will not be recoverable on the exhaustion of the mine. Unless a number of minerals are afforded treatment at or close to the mine site, large sums are incurred for loading and freight charges in the carriage of materials over long distances from the mine to the point where treatment and processing must eventually be carried out. The Act should not discriminate between
methods of treatment, and the extension of the definition of ‘treatment’ to include processing at or adjacent to the mine might remove many of these costly inefficiencies.

19.28. The treatment and processing plant utilised by mining enterprises would normally be depreciable in accordance with sections 54 to 62. The utility of extending the definition of ‘treatment’ under section 122 must be viewed in the light of the fact that the accelerated depreciation provision of section 122E is now no longer available in respect of expenditure upon such plant. Hence the practical alternatives available to a mining enterprise, if the definition of ‘treatment’ were extended to cover all processing at or adjacent to the mine site, would be (i) amortisation of the expenditure over the life of the mine under section 122D, or (ii) depreciation of the plant under the depreciation provisions of sections 54 to 62. Since there would appear to be only marginal returns from extending the definition of ‘treatment’ under section 122 to cover all forms of processing at or adjacent to the mine site and since such an extension might precipitate demands by other industries for similar concessions, the Committee makes no recommendation on this question. Substantially all the allowances which would flow from the extension of the definition of ‘treatment’ will be available under depreciation provisions, if the Committee's recommendations in relation to building depreciation in Chapter 8 are adopted. Where buildings to house and service the plant are demolished or scrapped on the termination of mining operations a balancing allowance will be available to the taxpayer in respect of any unrecouped expenditure. The costs of preparing a site for the erection of treatment plant and associated infrastructures are not regarded by the Committee as unique to the mining industry and, accordingly, do not warrant any differential treatment under the Act.

Overseas Exploration and Prospecting

19.29. There is no provision in Division 10 for any deduction in respect of expenditures incurred in exploration or prospecting for minerals outside Australia, Papua New Guinea and the continental shelf delineated in section 6AA of the Act. Australian companies are consequently deterred from engaging in such an activity. It has been submitted to the Committee that ‘it is part of the Australian Government's enunciated foreign policy to foster and encourage closer economic and political ties with neighbouring island groups and the countries and territories of Asia’. The Committee's attention has been drawn to the fact that the United Kingdom, Canada and the United States each makes some provisions for tax concessions in
respect of overseas mineral exploration and it is argued that Australian companies should be placed on the same footing as their competitors from these countries who are able to offer overseas governments better terms in regard to royalties and to perform more exploration and prospecting for each dollar of net cost and still obtain a rate of return on productive operations equal to or greater than Australian companies. It is contended that it is in Australia's economic and political interests for Australians to do what reasonably can be done to expedite the growth and development of the economies of neighbouring countries. The Committee has noted these submissions with interest but is of the opinion that it is inherent in the very nature of the arguments supporting them that the decision to accede to or reject a submission of this nature lies outside the Committee's province: whether a deduction of this kind should be incorporated in the Australian taxation system depends not upon taxation policy but upon political policy. These submissions also raise the wider question of Australian taxation on foreign-source income. So long as the present exemption system applies in regard to such income of Australian residents taxed abroad, foreign exploration expenditure may be regarded as expenditure in deriving exempt income and thus, on general principles, not deductible. If exploration costs are properly to be regarded as revenue expenditure it would, as the Committee has recommended, on general principles be deductible if Australia moved to a system of taxing foreign-source income with credit for foreign tax payable thereon in accordance with the Committee's recommendations in Chapter 17. The restriction in Division 10 of deductibility would in this event be inappropriate. Accordingly, the Committee does no more than draw attention to the submissions themselves and to the fact that other countries have seen fit to make such taxation concessions available.

**Anti-pollution and Ecological Expenditure**

19.30. Anti-pollution and ecological expenditures fall into various classes: (a) pollution of the atmosphere; (b) pollution of the soil, streams and ocean; and (c) destruction of the environment by its physical alteration. The making of expenditures of this nature could be brought about by (i) legislative compulsion, or (ii) obligations attached to the right to mine (for example, covenants by the taxpayer as lessee under a mining lease), or (iii) the voluntary decision of the taxpayer. Those expenditures precipitated by (i) and (ii) may be seen as essentially different in character from those comprehended by (iii) since they constitute an unavoidable item of expenditure, necessarily incurred and part of the costs of mining in a
particular area. The costs incurred in complying with legal requirements as to pollution are not unique to the mining industry. The nature of the taxation treatment of anti-pollution and ecological expenditure should be no different in relation to mining from that accorded other industries. The general question is considered in paragraphs 8.207 and 8.208.

19.31. One item of expenditure which may be unique is that incurred on site restoration. This item of expenditure is incurred both during and at the termination of mining operations. Where there is some form of legal compulsion to undertake restoration, this may be viewed as a necessary outlay, anticipated by the mining company from the commencement of operations and recognised as part of the cost of mining. These features would dictate that such expenditure be viewed as a business expense and therefore subject to a deduction in the year in which it is incurred. This treatment is appropriate to such expenditure when incurred in the course of mining operations when the mine is generating income sufficient to absorb the deduction. However, there are difficulties involved in treating all such site restoration costs as operating expenses for taxation purposes, since a substantial portion of them may be incurred on or in the course of the termination of mining operations, when the activity is generating such a reduced income from the mine that it is unable to take full advantage of any deduction to which it would be entitled.

19.32. It may be argued that the timing of such expenditure is no different from the costs incurred by any other business when it has ceased to function profitably or a decision to terminate business operations is made. If this argument be supported, it leads to the conclusion that no differential treatment should be extended to the mining enterprise in this regard and that the loss arising from the deduction of such expenditure in the closing years of mining operations would be subject to the two-year loss carry-back recommended in Chapter 8 for all such losses. Thus, under this suggestion, site restoration expenditure would be recouped where the mining enterprise had generated assessable income within the preceding two years adequate to absorb the losses. However, to regard such expenditure as analogous to the costs of terminating any other business ignores two factors which may be viewed as unique to the extractive industries: (i) as a general rule, the income generated by a mine as it nears exhaustion is frequently minimal over a period, in many cases of more than two years; and (ii) the decision to terminate mining operations may in many cases be unrelated to profitability but impelled by exhaustion of the deposits. In this context, expenditure on site restoration is a necessary and anticipated incident of extractive industries.

19.33. Conventional accounting practice in this area would direct that site
restoration costs necessitated by the development and production phases of a mining operation should be dealt with by a provision for this anticipated expenditure that is charged against profits of the enterprise during the production phase. Such a practice ensures that this necessary outgoing is met from revenue generated by the mine over the period of its productive life. This approach commends itself to the Committee as meeting the unique problems of the industry, in addition to providing some consistency between the tax treatment of this deferred liability and that recommended in Chapter 8 in relation to other categories of deferred liability (for example long-service leave).

19.34. For this reason the Committee recommends that a provision for the estimated total costs of site restoration as development and production proceeds should be available as a deduction from assessable income of a mining operation in each year in which mining operations are conducted. The amount of the provision—and hence the deduction—would be reduced in each year by the amount of expenditure incurred on site restoration in that year. The amount of the provision would be re-estimated in each year and an appropriate deduction allowed. The amount of the provision should be subject to the Commissioner being satisfied that it is a reasonable sum to meet the obligations of the mining enterprise. Any amount of the provision unexpended in the year in which the liability to restore is finally discharged on termination of mining operations should be brought to account as assessable income in that year.

19.35. A strong argument may be made for the extension of this treatment to site restoration expenditures, when voluntarily incurred, on the basis that such expenditures may be viewed as necessary for the conduct of a mining venture whether they are incurred under legal compulsion or otherwise. The Committee has no information on the frequency or extent of such voluntary expenditures; but in some sense allowing a deduction for such expenditure may be regarded as an incentive, subject to the policy dictates of the Government of the day. For this reason, the Committee makes no specific recommendation on this question.

Depletion Allowance

19.36. The question arises as to whether some allowance should be made for the depletion of a mine not for the purpose of incentive but to establish a true net income by enabling the segregation of the capital element of a receipt from its income element.

19.37. Where depletion allowances are employed by a tax system for the purpose of attempting to present an accurate computation of the net income
of a mining venture, different considerations apply to the nature and extent of such allowances from those arising where the depletion allowance is used purely as an incentive measure. Where a depletion allowance, either cost or percentage, is framed in recognition for income tax purposes of the fact that a mine or well is exhaustible and that each year's production diminishes the value of the asset, the subject of depletion should be the cost to the taxpayer of the wasting asset. In this way depletion for tax purposes may bear some equivalence to normal depreciation of wasting assets, since the mine or well is only one component of the assets comprising a mining venture. Some acknowledgement of these considerations may be found in the United Kingdom provisions, which allow a deduction from assessable income of proportions of the ‘royalty value’ of the output of a mine that vary according to the time lapsing between acquisition of the mine and commencement of production (see United Kingdom Capital Allowances Act 1968, section 60).

19.38. The amount of the deduction available is delimited by the cost of acquisition. A fuller explanation of the working of these provisions may be found in Appendix A to this chapter. The depletion allowance is directed to preserving an equivalence between the mining enterprise which works the mineral area on a royalty basis, thereby obtaining a deduction for payments made, and the mining enterprise which purchases a mine or mineral area and itself works the mine. The United Kingdom Royal Commission on the Taxation of Profits and Income (1955) considered that, in enabling an allowance for depletion (equivalent to the amortisation of the costs of acquisition over the life of the mine), an ‘obvious element of cost’ would be recognised, thereby facilitating computation of the ‘true profit’ of a mining venture.

19.39. The Committee does not favour the percentage depletion allowances which Canada has (see Appendix A). Since percentage depletion is unrelated to expenditure incurred but is simply tied to income receipts, it does not provide a means of segregating the capital element of the receipts of a mining enterprise from the income element other than on a very arbitrary basis. Further, in computing the net income of a mining venture, capital expenditure incurred on a wasting asset should be the subject of allowance (whether by amortisation or otherwise), since it is that capital outgoing which is subjected to the process of depletion as the minerals are extracted. For these reasons, cost depletion is to be preferred as a method of arriving at a net income. Although cost depletion focuses upon the ratio of the annual output of the mine to its total estimated output as being the determinant of the extent of the deduction, this ratio is applied to the capital cost incurred by the mining enterprise in acquiring the mine,
since, as pointed out above, it is this cost which represents the asset that is being wasted.

19.40. Strictly speaking, the net effect of Division 10 is to provide a cost depletion allowance; but since most of the capital expenditures incurred in acquiring and developing the wasting asset are ultimately deductible over the life of the mine or earlier, this does not apply where the miner does not undertake exploration activities but acquires a mine from a prospector pursuant to section 122B. In this latter case, the capital expenditure incurred by the miner in acquiring the mine may be written off, but only to the limited extent of the residual capital expenditure at that time available to and transferred by the vendor.

19.41. In summary, depletion allowance of the cost type is essentially directed towards a proper allowance for all capital of a wasting nature in computing net income from mining; the amortisation and write-off provisions of Division 10 are similarly directed. Where those items of expenditure allowable as deductions within the amortisation provisions comprehensively reflect the assets of a ‘wasting nature’, the same overall result should be achieved. Thus, whichever approach be adopted—amortisation or cost depletion—the task is to ensure that all capital expenditure on assets of a wasting nature may be recouped as a prelude to computing the net income of a mining venture. The Committee considers that there is no need for a depletion allowance if Division 10 makes full allowance for the deduction of all expenditure upon assets of a wasting nature. There remains, however, the question of a full allowance for the cost of acquiring a mining or prospecting right or information.

**Purchase of Mining or Prospecting Right or Information.**

19.42. Section 122B relates to the situation in which a purchaser incurs expenditure in acquiring from a vendor for the purpose of carrying on prescribed mining operations, or prospecting for minerals obtained by prescribed mining operations, a mining or prospecting right or mining or prospecting information (see the definitions of these terms in section 122 (1)). Section 122B includes in the allowable capital expenditure of the purchaser his outlay in acquiring from the vendor mining or prospecting information or a mining or prospecting right, where both the vendor and purchaser join in giving a notice in writing to the Commissioner that they have agreed to the inclusion of an amount specified in the notice, which amount may be the whole or a part of that outlay. The notice must be lodged with the Commissioner not later than two months after the end of the year of income of the purchaser in which the information or right was
acquired or within such further time as the Commissioner allows. The intention of the section is to enable a transfer to the purchaser of the vendor's entitlement to deductions for certain allowable capital expenditure not exceeding in amount the expenditure of that kind previously outlaid by the vendor when he disposes of the information or right to the purchaser.

19.43. Provision is made in the section for the computation of the allowable capital expenditure which enures for the benefit of the purchaser and which in certain circumstances may be reduced to an amount less than that in the notice. The amount specified in the notice signed by both parties pursuant to section 122B, or the amount to which it is reduced under section 122B, is deductible by the purchaser over the life of the mine. It has been submitted to the Committee that in practice it is difficult to obtain the agreement of the vendor of a mining right to sign the notice required under section 122B, unless he has been trading unprofitably. If the vendor had been prospecting with a view to selling his right to mine upon discovery, then, unless he had been operating at a loss or was entitled to the benefit of the (now repealed) section 23 (p), he would be liable to be assessed to tax as income on the whole or a major part of the proceeds received by him on the sale of the right. In circumstances where the vendor has been trading unprofitably, and accordingly has been unable to take advantage of the mining deductions, the amount received on the disposal of the right may be set off against his accrued entitlement to deductions under section 122D and his agreement to specify the full amount in the notice is more readily obtainable.

19.44. While it may be strongly urged that the administrative convenience of section 122B would support its retention, the section does substitute the vendor's deduction entitlement as a predominant criterion upon which the sale price is set in lieu of normal market forces. It is also open to the criticism that, by allowing any previously undeducted exploration expenditure of the vendor to be transferred to a purchaser as a component of the vendor's ‘allowable capital expenditure’, it may in some instances encourage the fixing of an artificially high sale price, particularly where the vendor is withdrawing completely from the mining business so that he has no prospect of taking any further advantage of his accrued deduction entitlement. It has been pointed out to the Committee that in a number of countries the costs of the acquisition of the right to mine are allowed to be written off over the life of the mine or by some accelerated write-off method. The Committee favours the widening of the base of allowable capital expenditure under section 122A to include without limitation the cost of acquiring a mine; for this reason and for the reasons set forth in paragraphs 19.39–19.40, it is recommended that section 122B
be deleted so that the costs of acquiring a mine may be amortised over the life of the mine.

19.45. It may be argued that some distinction should be made in the treatment of the acquisition of mining or prospecting information, as distinct from that applying to the mining right, since the former does not constitute an asset subject to depletion. On this basis, it is contended that the cost of acquiring mining or prospecting information should be regarded as an exploration expense and hence subject to the immediate write-off recommended in paragraph 19.19. In all situations in which a mining right is disposed of, it is suggested that a component of the asset being sold may in some sense be regarded as ‘mining or prospecting information’. Such an approach would therefore differentiate between these two items in allotting different taxation treatment to each. The problems of apportionment might prove formidable. It is envisaged that the difficulties encountered in apportionment would move taxpayers purchasing mines to apportion a higher figure in respect of mining information vis-à-vis the mine in order to take advantage of any better basis of deductibility offered them. Further, in discussing the nature and extent of the appropriate base for amortisation, the Committee has taken the view that the total cost to the taxpayer of a mining venture provides a fair means of computing the net income of a mining enterprise where all costs associated with it may be recouped over the life of the mine. Where no mine is ultimately acquired or mining operations are not undertaken as a consequence of the purchase of such information, the expenditure may be characterised as abortive and subjected to the same treatment as that accorded similar expenditure under the present Act. In summary, it is suggested that the expenditure in purchasing mining rights and mining or prospecting information should remain linked together in the same category of ‘allowable capital expenditure’ for the purposes of taxation treatment under Division 10.

**Proceeds of Sale of Mining Right or Information.**

19.46. It will be recalled that the Committee has recommended that exploration and prospecting expenditure should be deductible in full in the year in which it is incurred as a business expense, subject to the conditions outlined in paragraph 19.20. The treatment of such expenditure necessitates a different approach from that presently adopted in relation to the sale of a mining right or information. The Committee regards such an asset as being the stock-in-trade of a person engaged in the business of mining and any other person who, by virtue of the criteria outlined in paragraph 19.20, is entitled to an immediate deduction in respect of his exploration or
prospecting expenditure. There would appear to be no difference between the ‘mining right’ and the ‘mining information’ for the purpose of applying this principle. Consequently, the Committee has formed the view that the proceeds of sale of a mining right or information should be brought to account in full in the year of sale. This approach would also provide a convenient brake on the consummation of a sale at an inflated value where the purchaser, by virtue of the recommendation contained in paragraph 19.44, is entitled to amortise the cost of such right or information by way of deduction from assessable income over the life of the mine. Difficulties may arise where the exploration expenditure deducted in previous years is unrelated to the mining right or information disposed of, but this difficulty could best be met by application of the approach directing that all sale proceeds be assessable on the basis that the mining right or information is part of the mine's stock-in-trade regardless of the manner of acquisition.

Section 23 (o)

19.47. Despite the recommendations of the Coombs Task Force, Parliament has not repealed section 23 (o). That section exempts from taxation income derived from the working of a mining property by the taxpayer during a relevant year of income principally for the purpose of obtaining gold, or gold and copper—in the latter case where the value of the gold obtained from the property in that period is not less than two-fifths of its output other than the value of pyrites. A taxation concession for gold has been in the legislation since 1924. The section of the Act in its amended form is the result of the amendment effected in 1952. There is no deduction under Division 10 for exploration and prospecting or for capital expenditure in relation to mining for gold, as these deductions are allowable only from assessable income and income derived from gold mining is exempt. Whether an incentive should be given in this or some other way for the mining of gold is not a decision for this Committee to make. If section 23 (o) is to remain in the Act, however, consideration should be given to its amendment to overcome the problems referred to in Appendix A and which, broadly speaking, arise by virtue of the restriction of the ambit of the section to ore taken from a mining lease held by the taxpayer, as distinct from that taken from another source in which the taxpayer has an interest. It should be noted that Parliament has considered that incentives should be provided for the production of gold in that, under certain conditions, a subsidy is payable to the producer of gold bullion under the Gold-Mining Industry Assistance Act 1954–1972.
II. Recent Amendments to the Act

19.48. In this section it is proposed to draw attention to some of the more important amendments made in 1973 and 1974 to those provisions of the Act relating to general mining and to offer some commentary upon them. Certain of the Committee's recommendations are also dealt with in this way.

19.49. In expressing its view upon any changes that have been made or that ought to be made in the Act affecting the taxation of mining, the Committee has not lost sight of the fact that political and economic considerations which are not for the Committee to decide must also be taken into account and that such factors have, over a long period of years, occasioned alterations in the legislation (see paragraph 19.53). In some cases the Committee has concluded that for obvious reasons it is not within its terms of reference to pass judgment upon some aspects of the submissions made to it. Finally, the Committee has borne in mind that an examination and report upon the mining industry has been referred to the Industries Assistance Commission.

19.50. Accordingly, the role of overseas finance in an industry involving the investment of immense sums of money, the benefits of attracting foreign technical expertise, the advisability of securing overseas markets through foreign participation in Australian equity capital, and the preservation in Australia of strategic minerals are not matters which govern the Committee's conclusions. The Committee has endeavoured to confine itself to the effects of the Act and the legislative alterations in relation to their impact upon taxation.


19.52. Section 23 (p), which was repealed in 1973, exempted income derived by a bona fide prospector from the disposition of his rights to mine in a particular area for gold and for any metal or minerals specified in Regulation 4AA of the Income Tax Regulations. The purpose of the section, which had a long history, was to encourage the finding of gold and the specified minerals and enable those prospectors who did not have the capital to develop a mine or to conduct mining operations on a profitable scale to be rewarded for their work and expenditures. A viable mining industry needs a continuity of prospecting, whether some minerals are presently in adequate supply or not. Prospecting today is not limited to companies. The question whether section 23 (p) should be restored to the Act in a revised form as an incentive to individual persons who have devoted their time to bona fide prospecting is a matter that might be
considered by the Industries Assistance Commission. The Committee in this connection simply draws attention to a proposal that to the extent to which a prospector has deducted his exploration or prospecting expenditures against his income (if any), the amount of the exemption under section 23 (p) should, on the sale of his right to mine, be reduced by the amount of that deduction, which should be brought to account as income in the year of income in which the disposal takes place.

19.53. Section 23A was repealed in 1974. That section exempted from tax 20 per cent of the net income derived from the mining of the metals and minerals specified in Regulation 4AA of the Income Tax Regulations. The predecessor of section 23A evolved out of the needs produced by World War II and applied to metals and minerals required for the prosecution of the war and was introduced into the Act in 1943.

It ceased to have any application in 1952. Section 23A was inserted in 1953 to encourage the production of the prescribed metals and minerals in Australia. It was timed to expire in 1960 but in that year the time-limit was removed. Submissions have been made to the Committee that section 23A has played a major role in the expansion of the mining industry over the last decade or so and it has been compared with the provisions operative in the United States which exempt a percentage of income from taxation without regard for the recoupment of particular expenditures in mining operations. Section 23A was brought into the Act as a short-term incentive measure and not for the purpose of providing a depletion allowance in respect of wasting assets. In the opinion of the Committee, the question whether section 23A should be reintroduced into the Act in respect of any category of metals or minerals as an incentive for their production in the Australian mining industry does not depend upon considerations of taxation but is a policy question outside the province of this Committee to determine.

19.54. For a number of years the Act has contained certain tax incentives for shareholders investing in exploration, prospecting and mining operations in Australia and Papua New Guinea for minerals obtainable by prescribed mining operations and for petroleum. These provisions were to be found in a number of sections of a complex nature which from time to time were made the subject of amendment. The concessions provided opportunities for abuse which were widely exploited. Section 77E (inserted in 1973) was enacted for the purpose of counteracting the misuse of the incentives available for bona fide investors. In the Committee's view, to restore the Act to its form prior to 1973 would only be to reopen the door to further abuse of the kind the amendment was aimed to prevent.

19.55. If a policy is to be followed for the encouragement of Australian
investment in the mining of Australia's natural resources, any form of taxation incentives for that investment is a matter for consideration by the Industries Assistance Commission.

Exploration Expenditure by General Mining Companies

19.56. Formerly, section 122J of the Act allowed an immediate deduction for ‘exploration or prospecting’ expenditure, subject to two main conditions. These were that the enterprise conducting the exploration should be carrying on a mining business and that the deduction for exploration expenditure incurred in a year of income should be allowed only against income derived from that business or associated activities in that year. The restriction of the amount of the deduction to the amount of net assessable income from mining derived in the year in which the expenditure was incurred has been retained in the 1974 amendment.

19.57. The significant change lies in the treatment of the amount by which the expenditure incurred exceeds the amount of net assessable income from mining. Under the former provision, any such excess qualified as ‘allowable capital expenditure’ of the taxpayer for amortisation over the life of the mine under section 122D. The 1974 amendment allows this excess to be deducted against net mining income in subsequent years in which prescribed mining operations are carried on, until the entire amount has been absorbed. Thus, provided that the mining enterprise generates income from its operations and acquires a mine, it may recoup all its exploration expenditure as a prelude to generating taxable income.

19.58. This treatment of exploration and prospecting expenditure does to some extent recognise the principle that such expenditure should be immediately written off against profits, since this expenditure does not of itself generate income, is a capital outgoing and is recognised by Division 10 as such. It may be argued that such costs should be amortised by way of deduction against future income of a mine; but this approach encounters a difficulty in that in many mining ventures at the exploratory stage it is impossible to predict with any certainty that the mine will generate income sufficient to recoup the exploration expenditure. It would appear that the 1974 amendment recognises this difficulty.

19.59. So far as abortive exploration expenditure is concerned, no such expenditure will be deductible unless a mine is ultimately acquired. It should be noted that such treatment is contrary to conventional accounting practice which dictates that such expenditure be immediately written off.

19.60. The amendment runs contrary to the recommendation of the
Committee in this area since, though permitting an immediate write-off to some extent, it allows recoupment only if the conditions mentioned above are met. As mentioned in Section I, the Committee regards such expenditure as a business expense of a mining enterprise, and, consistently with that view, it has recommended that an immediate write-off be allowed in full against income derived from any source. Consequently there is no difference in the treatment of such expenditure according to whether or not it is successful; nor is it necessary to endeavour to match the expenditure against any income later derived by the mine to which it may have related. The restriction of the deduction to mining income may be viewed as operating unfairly against the enterprise with no mining income which chooses to invest its capital in mining exploration and discriminating in favour of established mining companies.

19.61. In summary, if deduction in full is allowed in the year in which the expenditure is incurred, the mining taxpayer may recoup his costs from income or he may precipitate a loss under section 80, in which event he is subject to the same treatment accorded any other taxpayer. If exploration and prospecting expenditure may be fairly regarded as a business expense of a mining enterprise, then no restriction should be placed upon the class of income against which the deduction will lie.

Allowable Capital Expenditure: Costs of Company Formation and Capital-raising

19.62. Under the former section 122A (1) (e), costs of company formation and capital-raising incurred by a mining company which conducted ‘prescribed mining operations’ (as defined in section 122 (1) ) were classified as “allowable capital expenditure’ and were therefore immediately deductible under section 122E or on a life-of-mine basis under section 122D, subject to the conditions appearing in those sections. Section 122A (1) (e) had a relatively brief existence: it was specifically added as a category of allowable capital expenditure in 1969 but has now been deleted. There is provision for the retention of a transitional measure in relation to such expenditure between 17 September 1974 and 30 June 1976, provided it is incurred under a contract entered into on or prior to 17 September 1974. The Committee supports this amendment: this category of expenditure cannot be regarded as being peculiar to mining or justifying the taxation treatment formerly accorded it under Division 10.

Immediate Write-off Provisions

19.63. The operation of the immediate write-off provisions of section 122E or section 122G has been terminated in relation to eligible
expenditure incurred after 17 September 1974. Under section 122E the mining enterprise which has incurred capital expenditure within one of the categories of allowable capital expenditure under section 122A(1) (other than on acquiring a mining right or prospecting information or on ‘housing and welfare’) may elect to deduct the amount of such expenditure from income derived from any source during that year in lieu of a life-of-mine basis under section 122D. It will be recalled that most of the categories of allowable capital expenditure are deductible only where such expenditure is incurred in connection with the carrying on by the taxpayer of ‘prescribed mining operations’.

19.64. Section 122G allows a mining enterprise to appropriate income of any year to meet allowable capital expenditure to be incurred in the following year. If such an appropriation is made, the taxpayer may elect to claim a deduction in the year of appropriation for the amount so appropriated. As with section 122E, this does not apply to an appropriation for expenditure on ‘housing and welfare’ or on the acquisition of ‘mining information’ or a ‘mining or prospecting right’. The deduction allowable is equal to so much of the amount appropriated as the Commissioner is satisfied has been or will be expended as allowable capital expenditure in the succeeding year. Where a deduction has been allowed in an income year for an appropriation, an amount equal to that deduction is included in the assessable income of the next succeeding year. The amount so included in the assessable income is offset by the deduction allowable in that year for expenditure incurred out of the appropriated income. The facility afforded by these sections is usually employed in the ‘further development’ stage of an established mining operation when it is generating sufficient income to absorb available deductions.

19.65. Under the 1974 amendment, all items of allowable capital expenditure (section 122A(1)) will be deductible over the life of the mine in accordance with section 122D. As mentioned earlier, the assessable income against which such items can be deducted may be derived from any source. As an alternative, the mining enterprise may still elect to claim depreciation in respect of certain items of mining plant under the depreciation provisions of sections 54 to 62.

19.66. The major effect of the amendment will be to preclude a mining enterprise from availing itself of an accelerated amortisation allowance in respect of any class of allowable capital expenditure. Mining enterprises would thus obtain no differential treatment under the Act for such expenditure beyond the fact that certain items of capital expenditure may be written off over the life of the mine to which they relate, or twenty-five years, whichever is the less.
19.67. These amendments may be endorsed from a strict accounting point of view, since they give effect to the principle that the costs of developing a mine should be carried forward for amortisation during the production phase and matched with revenue earned. However, they ignore the practical problems that have been continually impressed upon the Committee in submissions as being the justification for the immediate write-off provisions. These concern the vastness of mining exploration and development expenditures compared with those incurred in other industries, the extreme difficulties involved in financing these operations and the fact that all such expenditures are of a wasting nature. The Committee has been informed that these sections of the Act have assisted the mining enterprise greatly in the past by alleviating its cash-flow problems during the development stage when substantial sums are being expended before peak profit levels have been attained. Perhaps the most important feature is that these sections also permitted a major portion of the total capital cost to be financed by short- and medium-term borrowings instead of by equity capital: limited funds are available in Australia for investment in high risk activities such as mining. It would not have been possible to service the repayment of these borrowings without provisions permitting immediate or accelerated write-off of the capital expenditure financed in this way.

19.68. Submissions have indicated that a substantial reduction in the return on investment in mining operations may be anticipated as a result of the 1974 amendments and that, as a consequence, some projects will require review where the major part of the capital expenditure in those projects would have qualified for deduction under sections 122E or 122G. One submission has presented calculations showing that the abolition of accelerated depreciation under section 122E has reduced the after-tax return on equity invested from 17.7 per cent to 10.2 per cent. These sections, it is said, reduced the dependence of mining enterprises on outside sources of finance, assisted in meeting interest commitments on loans raised in respect of a project, and accelerated development and expansion by providing a certain and, in some cases, substantial cash-flow in the early years of a mining project. The loss of the facility increases the requirement for funds in two ways. Firstly, additional equity capital is required in a project to fund the increased initial cash-flow requirements for which loan funds are rarely available. Secondly, lenders require the investing of additional equity capital to ensure that the project has an adequate margin for interest and loan repayments; they also have an additional risk factor in that the period of repayment is extended since earnings from the project are diminished. These submissions have also
argued that, in view of the additional uncertainty associated with mining projects, rates of return on investment should be commensurately higher than those for other industries. One submission has stated that it is unlikely that a project promising an after-tax return on equity of less than 15 per cent would be acceptable and that the minimum return employed as a guideline by an industry reflects the risk of investment in a project. It has also been noted that the gradual exhaustion of richer mineral deposits is accompanied by an increase in production costs for those remaining.

19.69. In summary, the accelerated depreciation allowances are said to match the unique requirements of the mining industry and that the loss to the Revenue of interest on tax deferred should be weighed against the prospect of a lesser amount of overall investment in mining projects by reason of the reduction in its attractiveness.

19.70. The Committee has taken the view that the deductibility of capital expenditure incurred in development of a mine should be by way of amortisation over the life of the mine and that this treatment is necessary to yield a true income profit. There are many features of the mining industry that may be said to require a unique approach under the income tax laws, not only for the purpose of revealing a true income profit but also in recognition of the structural peculiarities referred to earlier. The question of the nature and extent of any concessions, such as accelerated depreciation or investment allowances, is more appropriate for study by the Industries Assistance Commission. The Committee would point out, however, that sections 122E and 122G have appeared to serve a useful purpose in the past and that, assuming the taxation system to be an appropriate vehicle for granting these concessions, consideration might be given to the institution of some form of accelerated depreciation in recognition of the considerations outlined earlier. Housing and Welfare Expenditure.

19.71. ‘Housing and welfare’ is defined in section 122 (1) and encompasses all infrastructures erected to house and service the requirements of mine employees and all other essential personnel in the vicinity of the mine site. The 1974 amendments terminated the option of the taxpayer under section 122F to write off such expenditures over a period of five years.

19.72. The option of a five-year write-off facility was obviously provided as an incentive to the furnishing of suitable and adequate amenities in remote locations and by way of recognising the substantial costs involved in erecting them. For example, it has been estimated (in a submission to the Committee) that the cost of erecting a house in the Pilbara area is two-and-a-half times that incurred in erecting the same house in Perth. The
Committee has been given other examples of this type of discrepancy. The fact that expenditure on such infrastructures is deductible is attributable to its minimal or nil residual value when mining operations are terminated; and since the practical utility of these amenities is linked with the rate of exhaustion of the deposit, it is appropriate to write off such expenditures over the life of the mine. The five-year write-off facility may, like sections 122E and 122G discussed earlier, be viewed as an accelerated amortisation provision, the main effect and benefit of which is to provide a source of cash-flow in the early years of production which itself may be used to service loans raised to finance the erection of the infrastructures. It differs from the life-of-mine amortisation approach now remaining in that, while the latter enables computation of profit in an accounting sense, it does not provide any recognition of, nor alleviate, the practical burden confronting a mining enterprise in obtaining the capital, labour and amenity resources necessary to develop its mine. The Committee considers that, while the same comments may be made as those raised in relation to accelerated depreciation allowances in paragraphs 19.66–19.70, it is not appropriate for the Committee to make any recommendation as to the nature and extent of any concession to be granted in this area.

Transportation Expenditure: Division 10AAA

19.73. Prior to the 1974 amendments, expenditure on a large range of transport facilities was deductible over ten years; this expenditure did not have to be incurred by a mining enterprise as such and was deductible in equal annual instalments over a period of ten years commencing with the first income year in which the facility was used primarily and principally for the transport of minerals. It was not necessary for the person incurring the expenditure to own the facility: the deduction was available to a contributor. The range of facilities included in this special deduction included railways, roads and pipelines. The allowance under Division 10AAA was obviously framed as an incentive provision to enable accelerated amortisation of the substantial capital expenditure involved in servicing the mine in light of the fact that such facilities may have little value when mining operations are terminated.

19.74. With transitional provisions, the period of amortisation has been extended to twenty years and therefore halves the benefit formerly available. The amendment will also affect cash-flow and take away much of the incentive effect of Division 10AAA, bringing it more closely into line with Division 10 deductions on a life-of-mine basis. The Committee does not consider it appropriate to make any recommendation regarding
III. Petroleum Mining

19.75. The special provisions of the Act in relation to prospecting and mining for petroleum are contained in an entirely new Division 10AA of the Act which was substituted for the previous Division 10AA by the Income Tax Assessment Act (No. 2) 1974 enacted in December 1974. The new Division 10AA preserves to a taxpayer entitlements to capital expenditures incurred prior to 18 September 1974 or incurred on or after that date and before 1 July 1976 in pursuance of contracts made prior to 18 September 1974.

19.76. The provisions of Division 10AA apply to Australia, Papua New Guinea and the continental shelf as delineated in section 6AA of the Act, the word ‘minerals’ in section 6AA being defined in section 6 (1) as including petroleum.

Overseas Exploration and Prospecting

19.77. It has been submitted to the Committee that the availability of the deduction as allowable capital expenditure should be extended to expenditures made in exploration for petroleum overseas. Detailed arguments in support of this submission relate to Australia's future crude oil supply, the generation of overseas income with beneficial foreign exchange implications, the advantages of the export of Australian capital equipment and other products and support for Australian foreign-aid programmes. It is pointed out that the Governments of the United Kingdom, Canada, the United States, West Germany, France and Japan encourage the overseas activities of the private sectors of their economies by the provision of a range of financial incentives some of which are taxation concessions. Reference to the nature of these is made in the submission. It could not be denied that in these circumstances Australian companies engaged in overseas petroleum exploration would be placed at a considerable competitive disadvantage to the companies operating in this field from the major industrial companies but, as with the submission in relation to overseas mineral exploration (see paragraph 19.29), the Committee is of the opinion that the question whether a taxation concession of this kind should be granted upon these grounds does not depend upon matters within the purview of its terms of reference. Nevertheless, the Committee drews attention to the submission so that it may be considered in the appropriate quarters.
Exploration and Prospecting Expenditure

19.78. As with minerals in the earth's surface, deposits of petroleum in volume profitable to mine are difficult to find and the methods employed to discover these depend upon a variety of factors. A general survey of a wide area is first undertaken employing the techniques of photogeology, gravimetry and magnetometry. When sufficient and satisfactory general information has been obtained, the land search is pursued in the field by geological mapping and seismic work, and the offshore search is carried out by seismic work. The third stage is exploration by drilling, and offshore drilling is conducted by means of a floating rig. Only by means of drilling can the existence of a petroleum field be definitely established and the results obtained from this drilling be subjected to regular testing. If a field has been located by the exploration (or ‘wildcat’) well, it becomes necessary to mark out the field; for this purpose a number of other ‘step-out’ wells must be drilled. The field may be comprised by one large and profitable area or it may be distributed over a number of marginal or submarginal areas and questions will arise in relation to economic recoverability. Once it has been established that a viable field exists, a number of production wells are drilled to permit a flow of petroleum in profitable volume. A quantity of necessary equipment is then installed to separate the oil from the other constituents mixed with the mining product. When the production of petroleum is offshore, the installation of all this technical equipment must be effected upon a production platform. The petroleum must then be transported, whether from the land or offshore site, to a central storage facility. The expenses of the discovery of a profitable field and its subsequent development to the stage of commercial production need no emphasis.

19.79. Under section 124AH of the Act, expenditure incurred in ‘exploration or prospecting’ is an allowable deduction in the year in which it is incurred. The amount of the deduction is limited to the amount of net assessable income derived from petroleum operations in that year.

19.80. ‘Exploration or prospecting’ is defined in section 124AH (7) so as to include geological, geophysical and geochemical surveys, exploration drilling and appraisal drilling, but to exclude development drilling or operations in the course of working a petroleum field. The definition became necessary as a consequence of the distinction in treatment accorded exploration as distinct from development expenditure.

19.81. If the amount of exploration or prospecting expenditure exceeds the amount deductible in any year, the excess is carried forward for deduction against similar income of subsequent years until the entire
amount is absorbed. The provisions therefore enable swift recoupment of exploration and prospecting expenditure against petroleum income but do not permit of such recoupment where the taxpayer does not derive assessable income from petroleum. The taxpayer may recoup his capital expenditure at an early stage without the need to match his prospecting and exploration expenditure with revenue derived from exploitation of reserves in that area (for example, on a life-of-field basis). However, allowance is made for the deduction of abortive or non-productive expenditure only where petroleum income is subsequently derived.

19.82. No distinction is seen by the Committee in the features of petroleum exploration vis-a-vis general mining exploration so far as taxation treatment is concerned. Hence the Committee confirms the comments and recommendations made in paragraphs 19.19–19.20 in relation to general mining: that is, such expenditure should be immediately deductible in full in the year in which it is incurred from income derived from any source.

19.83. Certain items of capital expenditure incurred in carrying on ‘prescribed petroleum operations’ are deductible over the life of the petroleum field on the same basis as for general mining. Some of these items are set out in section 124AA and include those costs incurred in providing light, power or water to the site, the cost of providing residential accommodation and amenities for employees. Refinery plant, ships and transport facilities of the nature described in section 124AA (2) (f), (g) and (h) are specifically excluded.

19.84. As with general mining, accrued undeducted allowable capital expenditure is translated into ‘residual capital expenditure’ under section 124AC and the balance is divided by the number of years of the estimated life of the field, or twenty-five, whichever is the less. The amount of the deduction in any one year is limited to the amount of assessable income from petroleum that remains after allowing all other deductions except in respect of development or exploration expenditure. This position is in contrast to that obtaining with respect to general mining, where the deduction for accrued residual capital expenditure is available against income derived from any source. Any amount excluded from the deduction allowed in any year falls into residual capital expenditure to be deducted in future years. Where the estimated life of the field exceeds twenty-five years, the upper limit of the deduction allowed in any year is 4 per cent of the undeducted expenditure on a reducing-balance basis. The Committee confirms the comments made in paragraph 19.21 with regard to the reducing-balance basis.

19.85. The treatment of all petroleum exploration and development
expenditure prior to the 1974 amendments was characterised by immediate
deductibility of such expenditure from income when derived from
petroleum so that any such income when derived was exempt until all past
expenditure had been recouped. This approach did not require that only
expenditure incurred in the year of income should be deductible: it allowed
a deduction for all such accrued undeducted expenditure, regardless of
when it was incurred. These provisions constituted far more of an incentive
than the general mining provisions of Division 10, except that recoupment
was available only from profits generated by petroleum operations and
associated activities, whereas the deductions available under section 122D
or section 122E are available against income derived from any source.
Under section 124AG a taxpayer who incurs allowable capital expenditure
on plant may elect to have the normal depreciation provisions apply as an
alternative to a life-of-field basis of deductibility. The depreciation
deduction is, of course, available against income derived by a taxpayer
from any source.

Development Expenditure

19.86. A number of difficulties arise with the life-of-field basis of
deductibility in relation to petroleum development expenditure. The
Committee has been assured that it is almost impossible to estimate with
any accuracy the amount of recoverable reserves in, and hence the
estimated life of, a field. This will depend upon the data available as a
result of exploration and the adequacy of the production techniques
employed to tap the field. A change in economic conditions may also affect
the estimate, since an enterprise will undertake and continue extraction
only where and when profitable.

19.87. As stated in paragraph 19.84, the deductions available to a
petroleum mining enterprise in respect of its development expenditure are
different from those accorded its general mining counterpart in two
respects:

(a) the deduction for unrecouped capital expenditure is available only against
income derived from petroleum operations; and
(b) the petroleum enterprise cannot elect to claim its entitlement to the full
‘unrecouped capital expenditure’ deduction to precipitate a loss which would
provide access to the loss carry-forward provisions of section 80.

As to the latter, it has been suggested that this facility has been withheld
because the petroleum enterprise will not, as a general rule, be able to
recoup its losses within the period prescribed under section 80. This reason should not, however, stand in the way of granting the option. There does not appear to be any sound reason for according the differentiation in tax treatment in either of the two respects mentioned above.

19.88. The petroleum well or field, like the mine, is a wasting asset and the revenue it generates is partly income and partly capital in character. The process of exhaustion of the field necessitates an approach to taxation of the revenue which distinguishes and focuses upon the income element. Development costs are part of the asset subject to the process of waste and, for this reason, they should be recouped over the life of the field so that each barrel sold bears a proportionate share of the development cost. This treatment is framed towards the proper matching of expense with revenue derived from the field. The life-of-field method of amortisation embraces the time basis of amortisation so that development expenditure carried forward is allocated to each income tax year during the estimated life of the field. This method would be appropriate where time is the controlling factor in the consumption, or economic usefulness, of a reserve; but it may not be appropriate where rates of production or sale fluctuate according to changes in world market conditions or production techniques. This feature may be said to be more pronounced in petroleum mining than in general mining. Accordingly, the production basis of amortisation, whereby expenditure is amortised according to the ratio of production in a tax year to total estimated reserves, may be viewed as more appropriate. In addition, where the amortisation allowance is based upon actual production, it increases in periods of peak production and eases as mining operations near termination when income is correspondingly less. This achieves greater matching of costs and revenue. However, the time basis is more readily administrable and may be preferable from that point of view. The Committee makes no specific recommendation on this issue.

Depreciation Allowances

19.89. It remains to refer briefly to the question of accelerated depreciation allowances. The petroleum industry is faced with the same situation as was general mining in relation to section 122E, since the immediate write-off facility formerly enjoyed has now been extinguished. The practical difficulties attending this amendment are similar to those noted with regard to general mining in paragraphs 19.67–19.69. As with general mining, the Committee makes no recommendation regarding accelerated depreciation allowances. However, it reiterates the comment made with regard to general mining that consideration might be given to
some form of investment allowance or accelerated depreciation to alleviate the practical difficulties that arise as a result of the unique character of this industry.

**Acquisition of Prospecting Information or Mining Right**

19.90. The costs of acquiring petroleum prospecting information or a petroleum mining right are deductible over the life of the field under section 124AB along lines identical with those applying in relation to general mining under section 122B. The vendor of such information or right may transfer to a purchaser his deduction entitlement in respect of accrued undeducted allowable capital expenditure and the purchase price is deductible up to a limit constituted by that deduction entitlement. As with general mining, expenditure by the vendor on buildings and improvements in the area the subject of the right is not transferable unless the purchaser acquires rights in respect of them. The notice procedure contemplated by section 122B is echoed in section 124AB.

19.91. The Committee sees no distinction between general mining and petroleum so far as this category of expenditure is concerned and confirms the recommendations made, and the reasons given, in paragraphs 19.42–19.45. The Committee therefore recommends that the total cost of acquiring a petroleum prospecting or mining right or information be deductible over the life of the field. These amendments will, of course, necessitate bringing to account as assessable income the proceeds of sale of such information or rights in the hands of the vendor in the year of sale. This recommendation accords with that made in paragraph 19.46 in relation to general mining.

**IV. Quarrying**

19.92. The Committee has received submissions pointing to the wasting nature of quarrying assets as being similar to the wasting nature of general mining assets and requesting that deductions be allowable in respect of capital expenditure incurred in this branch of the extractive industry which is not permissible under the existing legislation.

**Nature of the Quarrying Industry**

19.93. Both ‘mining’ and ‘quarrying’ are extractive industries. The word ‘quarry’ primarily signifies surface operations, including the removal of overburden to enable the winning of the product to be quarried.

19.94. Despite the fact that its original meaning may have been restricted
to subterranean excavation, ‘mining’ has become an uncertain term and its meaning takes its colour from the context in which it is used. The same product can be won by both subterranean and open-cut methods, which is true of coal, gypsum and silver and other metals. Uranium and rutile can be won by open-cut operations. The products usually quarried in Australia are limestone, granite, blue-metal, sand, clay and gravel, and, to a more limited degree, marble. ‘Mining operations’ is a very wide term and whether it is limited to subterranean methods usually depends upon the wording of the statute in which it is found. For example, in the Gold-Mining Assistance Act 1954 ‘mining’ is defined as the production of minerals from a mine or from alluvial or surface deposits. In recent judicial construction, Courts have found that the legislative intention usually has been to employ the word ‘mining’ in the sense of underground workings in the absence of some extended definition.

19.95. The point at issue in submissions made to the Committee does not, however, rest on whether the product is extracted by subterranean or surface operations or whether the operations are commonly described as ‘quarrying’ or upon the character of the product extracted or the use to which it is put. The basis of the submissions is that quarrying is an extractive industry concerned with materials naturally occurring in the earth's surface, that its mode of operations, which differs according to the product to be extracted, is nevertheless similar to operations employed in various ‘mining’ operations, that its equipment is similar in size and identical to that used in certain ‘mining’ operations, that expenditure is incurred in locating and investigating quarrying sites, in acquiring rights to quarry, and in constructing certain infrastructures to enable the quarrying operations to be carried out. All quarries are under the control of the Mines Department in the State concerned: in New South Wales, for example, they are subject to inspection under the Mines Inspection Act 1901–1968. Above all, as in the mining industry, the deposit which is the subject of quarrying operations is a wasting asset.

**Expenditure Incurred in Quarrying**

19.96. Following the pattern of the mining industry, the quarrying industry incurs expenditures in the following categories:

(a) Location of deposits of extractive materials, geological and other surveys, drilling, analysing samples, etc., which expenditure, speaking generally, is similar to that incurred in gaining what is described in Division 10 of the Act as ‘mining or
prospecting information’.
(b) Securing rights to conduct the extractive operation, including obtaining the requisite permits under State legislation and in the acquisition of sites required for the extractive operations.
(c) The preparation of the site for the commencement of operations: removal of overburden, where the expenditure is of a capital nature; construction of access roads, buildings and other civil engineering works; and taking environmental protection measures.
(d) Closing down extractive operations, the removal of plant, demolition of structures, restoring the surface of the land and meeting other requirements of authorities responsible for supervision of the extractive industry and of landowners.

19.97. There is no provision in the Act for the deduction of expenditures of this nature. Yet some of them are classified as allowable capital expenditure in Division 10 of the Act (see section 122A) in relation to prescribed mining operations in the field of general mining. And at least those of them comprised in categories (a), (b) and (c) above are, in accordance with established accountancy principles, of a capital nature.

19.98. The submissions point out that in the United Kingdom capital allowances are granted to persons who incur capital expenditure in connection with the working of any source of mineral deposits of a wasting nature (see the Capital Allowances Act 1968, Chapter III). ‘Mineral deposits’ are defined in section 87 (1) of that Act as including ‘any natural deposits capable of being lifted or extracted from the earth’.

19.99 In the United States a percentage depletion allowance is afforded in respect of the extraction of clay, granite, limestone, gravel, dolomite and all other non-metallic minerals and other substances, the extraction of which is not accepted as mining under the Australian taxation legislation. The lowest of these rates is 5 per cent, which applies where these materials are sold as ballast, road materials, concrete aggregates, etc. For the operation of the percentage depletion allowance, reference should be made to Appendix A to this Chapter.

19.100. Submissions to the Committee have suggested that a new and separate Division be included in the Act for application to the quarrying industry. Broadly, the provisions of the suggested new Division should closely follow the lines of Division 10 of the Act in the form in which it stood prior to the 1974 amendments. The submissions have also proposed amendments to Division 10AAA to extend its provisions to cope with capital expenditure on facilities for the transport of products extracted by the quarrying industry.

Quarrying Plant Depreciation
19.101. Submissions would seem to indicate that for the most part difficulties do not arise with regard to plant used in the quarrying industry, as depreciation is allowed under sections 54 to 62 of the Act.

**Exploration Expenditure**

19.102. A quarry-master undertakes exploratory activity that includes geological investigation in order to find an appropriate place to commence operations: some drilling activity is necessary in order to ascertain the extent of a deposit, and it has been said that the investigation is, as a rule, more accurate than its equivalent in mineral mining. Further, most deposits are searched for and located near the markets the product will service as this is a strong factor in the viability of such an operation. Few quarries are located in remote areas away from townships and, where they are, they have been so located to fulfil a particular need of the market. The exploration expenditure incurred by a quarry-master is normally of a much smaller amount than that incurred by its general mining counterpart.

19.103. It is in this context that the taxation treatment of exploration expenditure must be viewed. In relation to general mining, it will be recalled that the Committee views such expenditure as being an integral part of the conduct of a mining business and hence appropriately treated as subject to an immediate deduction in the year in which it is incurred from income derived from any source. The rationale for regarding exploration expenditure in this way is the fact that, upon termination of mining operations on one mine, the miner must explore for and locate another mine to remain in the business. The same is equally true of the quarry-master, who must look for alternative sources of product. The exploration costs, though they may be abortive, must therefore be viewed as part of the costs of acquiring stock-in-trade. This would necessitate bringing to account as assessable income the proceeds of sale of any quarry acquired by a taxpayer who has received a deduction in the past in respect of exploration expenditure. As with general mining, the Committee sees no reason for restricting the class or source of income against which deduction may be made.

**Development Expenditure**

19.104. After the nature and extent of the deposit has been ascertained and the rights to quarry it secured, the next step in opening the quarry is the removal of overburden prior to exploitation of the deposit. This operation, together with the construction of access roads and associated facilities, constitute the preparation for production and is analogous to the
development phase in general mining. Some plant may be depreciable under the regular depreciation provisions; but certain items of expenditure, such as removal of overburden of a capital nature, attract no deduction at all.

19.105. The Committee has formed the view that the cost of removing the total overburden is an item of expenditure that should be accounted for in computing the net income of a quarrying venture: to the extent it is not allowed as a current operating cost, it should be recouped out of the profits generated by the quarry by amortisation over the life of that quarry.

19.106. Further, no deduction is at present allowed in respect of expenditure on buildings erected on the quarry site which may house plant, be employed for administrative purposes or provide staff amenities. Chapter 8 makes recommendations with regard to the depreciation of buildings and the Committee would apply these to the buildings here in question.

19.107. It has also been submitted that expenditure on plant employed in quarrying should be deductible as for general mining. Such plant is generally depreciable by the quarry miner under sections 54 to 62 but some of it may have little residual value on termination of quarrying operations. The problem of the discrepancy between the life of an article of plant employed in mining or quarrying and the period during which mining or quarrying operations will continue is a real one and dictates a distinctive approach, particularly where the plant has not been depreciated in full when quarrying operations cease and the plant is therefore, for practical purposes, useless. The problem could perhaps best be approached by following the alternatives available to general miners under Division 10. Expenditure on any plant employed in quarrying operations would be amortised, at the election of the taxpayer, by way of deduction from profits generated by the quarry over its life. Balancing charges would, of course, apply to plant sold or disposed of and, for this purpose, the Committee envisages a section along the lines of the present section 122K. As an alternative, the taxpayer may elect to claim depreciation in respect of the plant in accordance with Section 54. ‘Plant’ in this context should include any plant used in screening or crushing the quarry product: this is analogous to ‘treatment’ in the case of a general mining enterprise.

19.108. The cost of access roads should be deductible over the life of the quarry from income generated by the quarry, since they are a necessary item of expenditure undertaken by a quarrying enterprise and their value is intrinsically linked with the life of the quarry. In Division 10A (Timber Operations and Timber Mill Buildings), the cost of access roads is deductible by means of amortisation over the estimated period during
which the access road will be used for the purpose for which it was primarily and principally constructed, or twenty-five years, whichever is the less (section 124F). The cost of access roads is also deductible under Division 10AAA in relation to mining enterprises. This treatment has been provided in these areas where expenditure on a road forms part of the cost of recovering a wasting asset. The proposed treatment would embrace those roads (or railroads) providing access to the quarry and connecting it with a public road or railway.

19.109. It will be noted that, with regard to expenditure falling generally within the description of ‘development’, no recommendation has been made proposing the availability of accelerated depreciation allowances or write-offs. The quarrying enterprise does not face the problem of long delay between discovery and production, accompanied by the necessity for substantial expenditure, that characterises the general mining industry. As a consequence, the cash-flow difficulties of the quarry miners are not so substantial as to require differential taxation treatment. In view of this, the Committee's approach has been to recommend amortisation of certain classes of capital expenditure outlined above on a life-of-mine basis.

Anti-pollution and Ecological Expenditure

19.110. It has been submitted to the Committee that expenditure on ecological projects and site restoration is occupying an increasingly important place in the extractive industries. In most States authorities have been instituted to administer an increasing web of regulations governing these activities. With regard to anti-pollution and site restoration expenditure, the Committee favours the same approach as proposed for general mining.

Acquisition Costs and Proceeds of Sale of Quarry

19.111. In relation to general mining, the Committee has discussed the necessity of providing for amortisation of capital expenditure by way of deduction from assessable income over the life of the mine. The unique characteristic of the mining industry as involving the exploitation of a wasting asset necessitates applying such a provision in order to arrive at a true net income. The quarry is also a wasting asset and similar treatment is necessary. As quarrying operations continue, the capital represented by the quarry diminishes and any receipts or profits generated by the quarry are partly of a capital as well as an income nature. On the assumption that all costs incurred in establishing the quarry will be deductible over the life of the mine, the cost of acquiring the quarry itself should be the subject of
amortisation. At this stage, one should bear in mind that quarrying is essentially different from general mining in that the right to quarry is not generally separate from tenure of the land but is an integral part of it. In many cases the land is acquired for the purpose of exploiting deposits upon it; alternatively, a licence to quarry is acquired. Any lump sum paid for the acquisition of the land or the licence is not deductible and the Committee considers that some allowance should be given in respect of this expenditure, since it is this capital that ‘wastes’ in the course of depletion of the deposit. The allowance of a deduction in these circumstances, as with general mining, does not constitute an incentive but is necessary for the purpose of computing the true net income of a quarrying venture.

19.112. The Spooner Committee recommended, in 1950, that ‘the capital cost of freehold land acquired for the purpose of extracting clay, sand, gravel, etc., should be an allowable deduction to the purchaser, spread over the period of the estimated productive life of the deposit’. The recommendation was made in order to provide such treatment, since a similar deduction was available in respect of land acquired for the purpose of felling timber (now available under section 124J).

19.113. Where the land is sold upon termination of quarrying operations, the proceeds of sale should be brought to account as assessable income where they exceed the written-down value, but only to the extent of the deduction previously allowed in respect of its capital cost. In other words, the Committee favours a provision having similar effect to section 122K in relation to general mining.

19.114. It remains to consider the form of the deduction to be made available. The amortisation deduction has been mentioned above and would require an approach identical to that contained in sections 122A, 122C and 122D of Division 10 (with the maximum limit of twenty-five years). An alternative is the depletion allowance. This is computed by dividing the total capital cost of the quarry by the proven (undeveloped) reserves contained in the quarry, the quotient obtained constituting a depletion charge per ton. The depletion charge is then applied to the amount extracted during the tax year. For example, where there are 1,000,000 tonnes of proven reserves and the cost of acquiring the quarry is $500,000, the depletion charge will amount to 50 cents per tonne. If this is applied to, say, 50,000 tonnes produced in a year, the total depletion allowance will be $25,000. A variation of this is found in the application of developed reserves as the divisor. The advantage of these methods is that they are more akin to the accounting concept of depletion and facilitate matching of costs against revenue in any one period by linking the depletion allowance to the amount actually produced. However, this
allowance is usually applied to development costs incurred on a continuing basis, and the amortisation deduction would seem more appropriate where the capital cost of the quarry is certain and the estimated life of the quarry is capable of reasonably precise assessment. The allowance in any one year will not fluctuate according to the rate of exhaustion, though there may be some fluctuation where the estimated life of the quarry is re-estimated.

19.115. The Committee favours treating the cost of acquiring a quarry in identical fashion to general mining: there should be no distinction between classes of wasting asset where the object of the deduction is to enable computation of true income profit.

Chapter 19: Appendix A: Mining Taxation: A Comparative Survey

19.A1. The operation of mining may be divided into four separate phases: exploration for the mineral and selection of a mining site; development of the mine in the area selected; production or extraction of the mineral; and treatment of the mineral to bring it to the stage of readiness for sale or use in commercial quantities.

19.A2. Income tax legislation dealing with capital expenditure incurred in mining operations generally distinguishes two basic aspects of a mining enterprise: the phase of prospecting and exploration on the one hand, and the phases of development, production and treatment on the other. The former embraces those costs incurred in searching for minerals and, upon discovery, ascertaining the value and extent of a deposit. Development production and treatment costs are those incurred in opening up the mine, extracting and subsequent treatment of the mineral and all costs associated with producing the mineral as a raw product for sale in commercial quantities. It is proposed to preserve this distinction for the purposes of this survey.

I. Exploration Costs

Australia

General mining

19.A3. The Income Tax Assessment Act distinguishes petroleum exploration from general mining in its treatment of capital expenditure incurred in such operations. Section 122J allows a deduction for expenditure on exploration or prospecting on any mining tenements held in Australia or Papua New Guinea for minerals obtainable by prescribed
mining operations. This allowance is limited to those categories of operations within the purview of the definition of ‘exploration or prospecting’ in subsection (6) of section 122J.

‘Exploration or prospecting’ means any one or more of the following:

(a) geological mapping, geophysical surveys, systematic search for areas containing minerals, and search by drilling or other means for minerals within those areas; and
(b) search for ore within or in the vicinity of an ore-body by drives, shafts, cross-cuts, winzes, rises and drilling,

but does not include operations in the course of working a mining property.

19.A4. The expression ‘prescribed mining operations’ is defined in section 122 (1) to mean mining operations on a mining property in Australia for the extraction of minerals . . . from their natural site, being operations carried on for the purpose of gaining or producing assessable income. The definition excludes gold mining since income derived from gold mining is exempt under section 23 (o).

19.A5. The deduction is allowable only from income derived from the carrying on of a mining business or associated activities and the taxpayer must have been engaged in a mining business. Thus, where a taxpayer does not derive assessable income from a mining business, he will be obliged to defer deduction of any such exploration expenditure until such time as assessable income is so derived. The amount of the deduction is limited to the amount (if any) of ‘assessable income’ remaining after deducting all other allowable deductions that directly relate to such business. Where the exploration expenditure incurred in the year of income exceeds the amount allowable as a deduction in that year, it is, by virtue of sub-section (4) of section 122J, carried over to the next and successive years in which ‘prescribed mining operations’ are carried on until the entire amount has been absorbed by deduction against mining income.

19.A6. The deduction is not necessarily limited to capital expenditure so that, in some cases, a deduction may be available under section 51 in addition to section 122J. Where both are applicable, the section under which the deduction is allowable depends upon the Commissioner's discretionary decision under section 82 (1) as to which is the more appropriate. This finds significance in the fact that losses resulting from a section 51 deduction are subject to the time-limit on carry-forward, whereas a deduction under section 122J carries no such restriction. In addition, expenditure on ‘plant’ used in exploration activities is deductible
under section 122J unless the taxpayer makes an election under section 122H which invokes the general depreciation provisions of the Act (sections 54 to 62) in relation to such plant. Thus, where plant can be said to have been used for the purpose of producing assessable income, an alternative deduction will be available for depreciation.

19.A7. It appears that the section was inserted in the Act (in 1947) to allow a deduction for a class of expenditure that would not otherwise be deductible and to equate the position of such expenditure with petroleum exploration expenditure, which had been deductible since 1939.

**Petroleum**

19.A8. Expenditure incurred in exploration or prospecting for petroleum is treated on an identical basis to general mining. Under section 124AH of the Act, expenditure incurred in ‘exploration and prospecting’ is an allowable deduction in the year in which it is incurred. The taxpayer must derive assessable income from petroleum in that year and the amount of the deduction is limited to the amount of such income remaining after deducting all other allowable deductions.

19.A9. If the expenditure on exploration or prospecting exceeds the amount deductible in any year, the excess is carried forward for deduction against similar income of the next and subsequent years until the entire amount is absorbed.

19.A10. ‘Exploration or prospecting’ is defined in section 124AH (7) so as to include geological, geophysical and geochemical surveys, exploration drilling and appraisal drilling but excludes development drilling or operations in the course of working a petroleum field.

**Transfer to Purchaser of Benefit of Deduction**

19.A11. Where, by virtue of section 122J (4), there is an amount of exploration or prospecting expenditure which is not deductible in the year it was incurred, the taxpayer (vendor) may in effect transfer his entitlement to a deduction by a notice under section 122B (1). A similar provision enables a corresponding deduction to be transferred to the purchaser of a petroleum prospecting or mining right or information (see section 124AB). Transfer under section 122B (or section 124AB) is available where the taxpayer sells a mining or prospecting right or mining or prospecting information. The expenditure by the purchaser on acquiring the mining or prospecting right or prospecting information will become allowable capital expenditure of the purchaser to the extent of the amount nominated by the seller and the purchaser in a notice given to the Commissioner.
19.A12. It appears that entitlement to deductions for expenditure on exploration or prospecting may be passed on under section 122B, notwithstanding that the expenditure was not incurred in relation to the area to which the mining or prospecting right or mining or prospecting information the subject of the sale relates. The purchaser will be entitled to deductions under section 122D in respect of what is (after the sale) his residual capital expenditure, even though deductions by the seller would have been indefinitely deferred pending his entry on prescribed mining operations.

19.A13. Exploration expenditure which is not the subject of a notice under section 122B or section 124AB remains available for deduction by the taxpayer who incurred it, notwithstanding that he has disposed of the information gained by the exploration operation or has disposed of his right to explore or mine in the area to which it relates. Section 122B was added in 1968 to rectify the discrimination in this regard between general mining and petroleum mining, to which the former section 124DE had applied since 1963.

19.A14. Both provisions enable a vendor to capitalise outgoings incurred by him in exploration and to transfer any accrued income tax benefit to a purchaser and for the latter to claim the benefit of such a deduction although the cost was not originally incurred by him.

United Kingdom

19.A15. Under the United Kingdom Capital Allowances Act 1968, a ‘writing-down’ allowance is available in respect of expenditure on exploration. No distinction is made between the treatment of exploration and development expenditure for the purposes of this allowance, though certain other allowances made in respect of development expenditure (e.g. the initial allowance referred to later) are not made available in connection with exploration expenditure. The writing-down allowance closely resembles section 122D of the Australian Act in that exploration and development expenditure may be amortised over the life of the mine. Further, it is available to taxpayers carrying on a business which consists of or includes the working of a mine. It is computed by applying to the residue of qualifying expenditure the quotient obtained when the output of the mine in the tax period is divided by the total estimated output of the mine (or one-twentieth, whichever is the greater).

19.A16. This allowance extends to abortive exploration expenditure (which is immediately deductible as a business expense if taxpayer carries on a mining business) and expenditure on machinery or plant used for
exploration. Where the mine ceases to be worked, the person carrying on the trade may elect that the writing-down allowances, if any, for any assessable year which begins within six years before that event shall be revised. If he so elects, the writing-down allowance for that (or those) period(s) is revised, so that it is computed with the substitution of the actual output of the mine in lieu of the previous estimate.

19.A17. A depletion allowance is available with regard to the costs of acquiring a mine in lieu of a write-off. (The amount of the allowance varies from 50 per cent to 10 per cent of the royalty value of output according to the length of the period between acquisition and production.) However, the cost of acquiring a mine or mining rights outside the United Kingdom may be made the subject of a write-off allowance under the provisions outlined above.

Canada

‘Principal Business Corporations’

19.A18. The distinction between exploration and development expenditure is preserved under Canadian legislation. Section 66 (15) (h) of the Income Tax Act defines a ‘principal business corporation’ as a corporation whose principal business is (i) production, refining or marketing of petroleum, petroleum products or natural gas or exploring or drilling for petroleum or natural gas; (ii) mining or exploring for minerals; (iii) processing mineral ores to recover metals therefrom; (iv) a combination of (iii) and processing metals recovered therefrom; (v) fabricating metals; or (vi) operating a pipeline for the transmission of oil or natural gas. A ‘principal business corporation’ is allowed to deduct the aggregate of its past exploration and development expenditure incurred in Canada up to a limit represented by the amount of net income for the taxable year before deduction of depletion allowances or losses carried forward, but reduced by deductible dividends received. The provision resembles section 122J of the Australian Act and includes in the base of capital expenditure deductible under this heading the cost of any ‘Canadian resource property’, including amounts paid for the acquisition of mining rights (whether oil, gas or minerals). Any such costs not deducted in the year may be carried forward indefinitely against income from future years.

19.A19. The provision applies to:

(a) the cost of searching and drilling for petroleum and natural gas; and
(b) the cost of prospecting, exploration or development expenditure incurred by a
taxpayer in searching for minerals.

In Canada the Act accords different treatment to each of the above categories, since exploration and development expenditure incurred with regard to petroleum or natural gas is immediately deductible in the manner indicated above whereas in the case of general mining this provision relates only to exploration and other costs incurred up to the time of development of the mine for production. It appears that the oil and gas allowance is so framed because of the practical difficulty involved in distinguishing petroleum ‘exploration’ from ‘development’ expenditure.

**Taxpayers Other than ‘Principal Business Corporations’**

19.A20. The deduction for exploration and development expenditure is limited to the amount of income derived from the oil or gas well or mine or royalties therefrom, together with the amount by which a consideration received on sale of a mine exceeds the amount that would ordinarily be allowed as capital expenditure in respect thereof; alternatively, the limit is 20 per cent of the accrued undeducted exploration and development expenses if that amount exceeds the amount of income described above. (If the taxpayer's ‘income from Canadian resources’ is insufficient, he may deduct up to 20 per cent of the allowable expenditure from income derived from other sources.) A similar allowance is available for foreign exploration and development expenses.

19.A21. It will be observed that the provisions outlined above are directed towards enabling immediate write-off of exploration expenditure against income and this appears to have been prompted by the recognition that, in the words of the Carter Commission (1966): ‘The more uncertain the value of the asset created by a particular expenditure, the more rapidly the cost should be written off. Because the probability of success for a particular exploration venture is usually low, it is reasonable to deduct exploration costs immediately in determining income’.

**United States**

19.A22. An unlimited deduction against taxable income is available on an optional basis for exploration expenditure (except if incurred on oil and gas) provided that the amount deducted is brought to account as income (or ‘recaptured’) when the mine reaches production or is sold. This is accomplished by the taxpayer electing either to (i) include the previously deducted exploration expenditure chargeable to the mine as income for the year in which the mine reaches production or is sold, increase the ‘basis’ of
the property by the amount included as income, and subsequently recover
this amount through depletion, or (ii) forgo depletion from the property
until deductions forgone equal exploration expenditure previously
deducted. Expenses not recaptured by any of these methods are recaptured
on the sale or disposition of the mining property.

19.A23. Exploration-type expenditure which is incurred during the
development or producing stage of a mine is treated as development
expenditure deductible currently, rather than mining exploration
expenditure subject to recapture.

19.A24. With regard to oil and gas well drilling expenditure, a taxpayer
may elect to treat drilling expenditure as a current expense deductible in
the year in which it is incurred or, alternatively, as a charge to capital
which is recoverable through depletion or depreciation as ‘intangible
drilling and development costs’. If he elects for the latter alternative and
the well later proves to be non-productive, he may elect to deduct such
costs as an ordinary business loss. Thus, in oil and gas exploration, capital
investment is usually recovered in full.

South Africa

19.A25. Exploration or prospecting expenditure may, in certain cases, be
deducted in toto from mining income in the year in which it is incurred, or
over the life of the mine, according to the discretion of the taxing authority.
This twofold approach resembles section 122J of the Australian Act in that
an immediate write-off is generally allowed if the mine has reached the
production stage. Where a mine has not reached the production stage, no
portion of the capital expenditure can be deducted since such expenditure
may only be deducted from income derived from mining operations. In
such a case, the capital expenditure is accumulated and amortised over the
life of the mine.

19.A26. In relation to mines that commence production in any years of
assessment after 31 December 1973, capital expenditure (whether on
exploration or development) incurred after that date is fully deductible and
may, if it exceeds the assessable income of the enterprise, promote an
assessed loss. A balance of any assessed loss incurred in a previous year of
assessment may be carried forward to the succeeding year of assessment to
be set off against income derived from any other business in the Republic.
If in any year of assessment the taxpayer does not carry on any other
business, he is not permitted to carry forward to this year any balance of
assessed loss established in respect of the immediately preceding year of
assessment. In this way, the taxpayer forfeits his right to claim a deduction
for the accumulated loss.

New Zealand

19.A27. The outlay by a mining enterprise on both exploration and development is deductible in the year in which it is incurred. The capital expenditure provisions under relevant New Zealand legislation allow mining companies a deduction for exploration and development expenditure incurred and those companies are subject to income tax on mining income at only two-thirds of the rate applicable to other companies. This includes expenditure incurred as consideration paid or payable for the acquisition of an asset. This situation extends to certain specified minerals and petroleum. In relation to specified minerals, the concession applies to the accumulation, processing to the stage of concentration, and transport of the products to the stage where they are in saleable form and at a location suitable for acquisition by a purchaser or are ready to be processed beyond concentration, or used in a manufacturing operation.

19.A28. There is little restriction on the nature of capital expenditure by a mining company that qualifies for deduction: the entire outlay on exploration and development is deductible. Section 153F (12) requires the salvage value of any mining asset disposed of subsequently (or transferred to non-mining activities) to be returned as assessable mining income at that stage.

Mining Companies

19.A29. Section 153F provides the basis of assessment of mining companies and states that the assessable income is to be divided into mining and non-mining income. These special mining provisions apply only to New Zealand companies whose sole or principal source of income is mining in New Zealand for specified minerals and/or petroleum, or exploration and searching for minerals or petroleum for a reward related to and dependent on production or participation in profits from production of any specified mineral and/or petroleum.

19.A30. Mining expenditure is allowed first against assessable mining income of that same year, and two-thirds of any excess against other assessable income derived in that year. Any excess of non-mining expenditure over non-mining assessable income is allowed in full against mining income.

19.A31. Loss carry-forward. There is no time-limit on the availability of past losses for set-off against subsequent profits. Where mining expenditure is carried forward as a loss against income of a subsequent
year, or past non-mining losses are carried forward against mining income, that carried-forward loss takes into account the differential in tax rates between mining and non-mining income. Such losses are offset firstly against the same class of income in that subsequent year and any excess mining loss then allowed against non-mining income. In such an event the balance of any non-mining loss available for carry forward is reduced by 150 per cent of the mining loss deducted from non-mining income.

19.A32. Appropriations. Either a mining company or a non-resident mining operator may appropriate income for expenditure within two years on exploration and development and may elect to claim a deduction of that amount against the income of the year to which those appropriated profits relate. The amount so allowed as a deduction is treated as assessable income of the succeeding year. The relevant expenditure incurred may be claimed as a deduction in that succeeding year, subject to a further right to claim as a deduction in that year any unexpended portion of that initial appropriation and, subject to the same general terms, make any new appropriations in respect of the succeeding two-year period. This will not apply if the result would be to put the taxpayer into a loss situation for the year's result overall. The effect of this provision, it will be noted, resembles the former section 122G of the Australian Act, except that the latter applied essentially to development expenditure. Such an appropriation provision enables a company to preserve its liquidity during the exploration stage of a mining venture in anticipation of substantial capital outlay.

Mining Operators

19.A33. Section 153J covers the tax position of those New Zealand residents who do not come within the definition of a mining company but are engaged in or propose engaging in mining or associated operations as a business. Exploration and development expenditure is deductible as for mining companies but there is no deduction available for appropriations. The concessional tax rate does not apply to mining income. Mining losses are firstly to be offset against mining income of any year, with any excess available to be offset against other income. There is a restriction that a mining loss can be offset only as to 50 per cent against other income in any income year. Where a non-mining loss is offset against mining income, there is no such restriction.

Non-resident Mining Operators

19.A34. Section 153K covers all non-resident persons (individuals and companies) engaged in New Zealand in a business venture principally
involving mining operations. Exploration and development expenditure is deductible in similar fashion to resident mining companies, as also are amounts appropriated for such expenditure in the event that an election to that effect is made. The total income of non-resident operators relating to mining activities is taxable separately at the flat rate of 45 cents in the dollar.

19.A35. It will be observed that the New Zealand provisions do not discriminate between development and exploration costs, as immediate write-off is available in respect of each category. Further, the availability of a limited right of set-off of mining expenditure against non-mining income serves to ensure that mining exploration concessions may be available to, and utilised by, enterprises engaged in other businesses and infant mining enterprises for which the right of unlimited loss carry-forward preserves the value of accrued deductions for exploration expenditure.

II. Capital Expenditure on Plant and Development

Australia

General Mining

19.A36. Deduction for expenditure incurred in extraction, treatment and storage of minerals is provided for under Division 10 of the Act. In general, this Division allows a deduction for the cost of developmental works which would not qualify for any deduction under the normal depreciation provisions. The expenditure qualifying for deductions is provided for under the various categories of ‘allowable capital expenditure’ defined by section 122A. Some of these categories are:

(a) expenditure incurred in the preparation of a site, on buildings, and other improvements and plant necessary for carrying on the mining operations;
(b) expenditure on light, water and communications connected with the site and on ‘housing and welfare’ as defined in section 122 (1);
(c) treatment plant, storage facilities and buildings/plant connected therewith (‘treatment’ is restrictively defined in section 122(1)); and
(d) the costs of acquisition of a mining right or prospecting information.

The expenditure must in general be incurred by an enterprise that is in the course of conducting mining operations in Australia for the extraction of minerals, other than petroleum, from their natural site. These mining operations must be carried on for the purpose of producing assessable
income; but in contrast to the position with regard to exploration expenditure under section 122J, the deduction is allowed against income generated from activities other than mining. ‘Mining operations’ in general covers the extractive process up to the stage where the mineral is obtained in manageable lumps.

19.A37. The categories of expenditure outlined above may be claimed as a deduction by writing off that expenditure over the estimated life of the mine to which it relates or over a term of twenty-five years, whichever is the less (section 122D).

19.A38. Alternatively, a taxpayer may elect to have the normal depreciation provisions applied to expenditure on a ‘unit of plant’ instead of having that expenditure deducted in accordance with Division 10. The annual rate of depreciation of any unit of plant is determined by the Commissioner on the basis of the effective life of the unit. This rate is increased by 50 per cent if depreciation is claimed on the diminishing value method.

19.A39. Certain categories of expenditure are expressly excluded from the ambit of the provisions outlined above:

(a) ships, railway rolling stock or road vehicles, or railway lines, roads, pipelines or other facilities used for the transportation of minerals (other than wholly within the mine site);
(b) buildings or other improvements in port facilities and other facilities for ships and port employees; and
(c) office buildings not on or adjacent to the site of mining operations.

Some of these items are depreciable in accordance with the normal depreciation provisions but others, particularly those items of expenditure under categories (b) and (c), are not deductible at all.

19.A40. The amortisation deduction under section 122D is a manifestation of the recognition that the profits of a mining venture cannot be effectively gauged for accounting or tax purposes until provision has been made for the recoupment from profits of capital employed in the venture.

19.A41. Under section 122 (3), the taxpayer has a distinct ‘residual capital expenditure’ in respect of each mining property on which he carries on prescribed mining operations. The deduction allowed under section 122D may not exceed net assessable income unless the taxpayer so elects, thereby allowing himself access to the loss provisions under section 80.

19.A42. Railways, roads, pipelines. Division 10AAA provides for deductions to be allowed over a period of twenty years for capital
expenditure incurred on certain facilities used primarily and principally to transport minerals or products of minerals mined in Australia or Papua New Guinea for the purpose of producing assessable income. These facilities are defined in section 123 (2).

19.A43. The deduction is available in respect of the undeducted capital expenditure incurred after 17 September 1974 on the cost of an eligible railway, road, pipeline or other facility used for the transport of minerals. If such expenditure was incurred between 1 July 1961 and 17 September 1974, it is deductible over a ten-year period under section 123B (1). Expenditure on earthworks, bridges, tunnels and cuttings necessary for a railway, road, pipeline or other facilities is deductible as is that incurred in obtaining a right to install a railway, etc. on land owned by another. Compensation payments (for damage or loss due to construction of a railway, etc.) fall within the ambit of this Division and are deductible. Deductions are available for the transport facilities even though they are used to transport materials resulting from the treatment or further processing of certain minerals.

19.A44. The cost of transport facilities used wholly within the mine site which is deductible under Division 10 is not deductible under Division 10AAA; nor are petroleum transport facilities where the transport forms part of petroleum mining operations which are deductible under Division 10AA (see below).

19.A45. A taxpayer may claim a deduction under Division 10AAA even though not himself engaged in mining operations which produce the minerals being transported.

19.A46. Any expenditure eligible for deduction under this Division is deductible in equal instalments over twenty years, commencing with the first year in which the facility is used to transport minerals or their products for the purpose of gaining assessable income.

19.A47. Expenditure on railway rolling-stock, road vehicles and ships is specifically excluded from the application of the Division. If rolling-stock and vehicles are used for transport wholly within the mine site, a deduction may be available under Division 10; if not, they (in addition to ships) are depreciable under sections 54 to 62.

19.A48. No deductions are available with respect to expenditure on ports and port facilities.

Petroleum

19.A49. The provisions relating to expenditure incurred in prospecting and mining for petroleum are set out in Division 10AA. As with general
mining, this applies to operations conducted on the continental shelf, as the
definition of ‘Australia’ includes the Australian continental shelf, Papua
New Guinea and the continental shelf of that Territory.

19.A50. The scheme of the deductions for capital expenditure incurred in
development is the same as that applying under Division 10 in relation to
general mining. Certain items of capital expenditure incurred in carrying
on prescribed petroleum operations are deductible over the life of the
petroleum field, or twenty-five years, whichever is the less. These items
are set out in section 124AA and include:

(a) The cost of acquiring a ‘petroleum prospecting or mining right’ or ‘petroleum
prospecting or mining information’, where the parties to the sale have elected that
the deduction entitlement should be transferred from the vendor to the purchaser.
(b) Capital expenditure incurred at any time in prospecting or mining operations in
Australia for the purpose of obtaining petroleum or on plant necessary for carrying
out these operations. This embraces development expenditure incurred in drilling
and pumping.
(c) The cost of providing residential accommodation for employees when that
accommodation is situated on or adjacent to the site.
(d) The cost of providing health, educational, recreational or other similar facilities
or facilities for the supply of meals on or adjacent to the site (where provided
principally for employees and their dependants and not for the purpose of profit-
making).

19.A51. The categories of expenditure not allowed are set out in section
124AA and include:

(a) costs incurred on transport facilities which qualify for deduction under Division
10AAA (see above); and
(b) ships, railway rolling-stock and road vehicles used for the purpose of
transporting petroleum, and refinery plant. These items are subject to depreciation
under the normal provisions relating to depreciation.

19.A52. The deduction for accrued residual capital expenditure in any
year is limited to the amount of net assessable income from petroleum
derived in that year. Any excess is added to the residual capital expenditure
deductible in future years. As with general mining, a taxpayer may elect,
under section 124AG, that the normal depreciation provisions apply to
plant.

19.A53. Sale of prospecting or mining rights or information. As with the
general mining sections, provision is made whereby the parties to the
sale/acquisition of mining rights or information may elect to transfer from
the vendor to the purchaser an amount of undeducted allowable capital expenditure up to or equivalent to the consideration paid by the purchaser.

19.A54. Section 122B (general mining) and section 124AB (petroleum mining) were added to enable the purchaser of a mining right or information to obtain a deduction in respect of at least some part of the cost incurred by him. Under both sections, by giving notice to the Commissioner, certain allowable capital expenditure which would eventually have been deductible by the vendor will, to the extent of the amount nominated, but not exceeding the purchaser's expenditure in acquiring the mining rights, be deductible by the purchaser over the life of the mine or petroleum field, as the case may be. The vendor's allowable capital expenditure is correspondingly reduced.

19.A55. *Disposal of mining and petroleum mining assets.* Sections 122K and 124AM provide for balancing adjustments where assets in respect of which deductions have been granted on one of the special bases are sold, lost or destroyed.

**United Kingdom**

19.A56. The writing-down allowance mentioned in connection with exploration expenditure is also available for the amortisation of capital expenditure incurred in developing a mine and plant, machinery and works acquired or constructed for the purpose of mining, providing the latter are likely to be of little or no value when the mine is no longer worked. In addition, an initial allowance of 40 per cent of the expenditure incurred is given for expenditure on construction of works of a similar nature.

19.A57. Certain categories of expenditure are expressly excluded from the ambit of the provisions outlined above, namely:

(a) costs of acquiring a site or right to mine inside the United Kingdom;
(b) expenditure on works constructed wholly or mainly for processing raw product;
(c) office buildings; and
(d) facilities for occupation by or the welfare of, workers.

An industrial buildings allowance is granted in respect of buildings provided for occupation or use by mining workers.

19.A58. Where a taxpayer engaged in a mining business incurs capital expenditure on a mineral asset, and the acquisition of that asset entitles him to work a mine, oil well or other source of mineral deposits of a wasting nature, he is entitled to a depletion allowance in respect of the expenditure. The amount of depletion allowance is computed by reference to a variable
fraction of the royalty value of the output of the mine in a taxable year:

(a) where the first working of the mine after the expenditure was incurred (i.e. acquisition of the mine) is less than ten years before the end of the taxable year, one-half of the royalty value of the output;
(b) where that first working is less than twenty but not less than ten years before the end of the taxable year, one-quarter;
(c) in any other case, one-tenth.

19.A59. ‘Royalty value’ in relation to any output from a mine means the amount of royalties that would be payable on that output if the person working the mine were a lessee under a lease for a term expiring immediately after the output was produced, granted to him at the date when the expenditure was incurred (i.e. date of acquisition), and providing for the payment of such royalties on output from the source as might reasonably have been expected to be provided for by such a lease, but reduced by the amount of any royalties. The allowance is limited to the amount by which capital expenditure on acquisition exceeds aggregate depletion allowances for prior years. Balancing charges and allowances are provided where operations are terminated, calculated by appraising the market value of the land as notionally restored to its original condition.

19.A60. It appears that the depletion allowance was instituted in an attempt to equate the position of a taxpayer who acquired land for mining purposes with that of a taxpayer who works a mine on a royalty basis and thereby obtains a deduction from profits for royalties paid by him. Further, it was recognised that a proper ascertainment of mining profits must give some allowance or relief in respect of the wastage of capital expenditure on the purchase of the land.

19.A61. The equation of the treatment of mining leases or rights to ordinary leases for tax purposes was expressly repudiated by the Royal Commission on the Taxation of Profits and Income (1955):

‘The problem of allowance for mining depletion cannot be governed by the tax treatment of premiums paid for the acquisition of leases. The special treatment of such premiums is partly a product of the special conceptions of the tax on the annual value of land under Schedule A, under which the primary subject of taxation is the income that is inherent in the right of occupation of land. But a mining venture is taxed on the profits (if any) which arise from the venture itself, the mineral areas acquired being merely a part of the whole assets committed to the venture.’

Canada
Depletion Allowances

19.A62. A taxpayer operating certain classes of mine may deduct one-third of all his profits for the taxation year reasonably attributable to production from the mine. The classes of mine are:

(a) oil and gas wells;
(b) bituminous sand deposits;
(c) base and precious metal mines; and
(d) certain specified mineral deposits.

This excludes industrial minerals contained in bedded deposits (for example, sand and gravel pits, salt and stone quarries). ‘Operator’ includes a person who carries on extracting operations, persons who have an interest in the proceeds of production or a right to share in profits.

19.A63. A ‘non-operator’ who receives a rental or royalty or otherwise has an interest in production from a mine is entitled to a deduction equal to 25 per cent of the amount included in computing his income.

19.A64. Where the output of gold is 70 per cent or more of the aggregate output from all the mines operated by the taxpayer, the deduction allowed is the greater of (i) 40 per cent of the aggregate of the net profits reasonably attributable to all mines owned by him, or (ii) $4.00 per ounce of gold produced in the year.

19.A65. The computation of ‘production’ requires deduction from production profits of all production losses or outgoings, exploration and developmental expenses otherwise deductible, the capital cost allowance (referred to below), exempt income, and any interest paid on the purchase price of property used for exploration or production purposes. It would appear that this allowance tends to favour the profitable mining venture. A deduction equal to 10 cents per ton of coal mined is granted to a taxpayer who operates a coal mine.

19.A66. Until the end of 1973, a mine was granted a ‘tax holiday’ whereby its income was exempt for a three-year period commencing when the mine came into reasonable commercial production.

19.A67. After 31 December 1976 the depletion allowance (permitted under section 65(1) of the Act) will be computed on an ‘earned depletion’ basis under which, in general, taxpayers are entitled to deduct in computing income $1.00 for each $3.00 of specified eligible expenditures incurred by them after 7 November 1969. The automatic deduction allowed to operators and non-operators of (respectively) one-third and one-quarter of production profits will cease to apply. All taxpayers will be entitled to
deduct one-third of their ‘resource profits’ for the year to the extent of their earned depletion base at the end of the year. The term ‘resource profits’ will include profits from the kinds of activities which prior to 1977 would attract the depletion allowance. Only where the taxpayer has incurred qualifying expenditures after 7 November 1969 will he be entitled to a depletion allowance.

19.A68. Thus, any expenditure incurred in exploration for and development of minerals, oil and gas wells is a constituent of the earned depletion base which forms the ceiling limit of the depletion allowance.

19.A69. It appears that the purpose of the amendments was to promote a direct relationship between the extent of expenditure on exploration and development and the quantum of the incentive being offered: the previous system of depletion allowances under which deductions were related to profits or the volume of production was said to encourage exploration and development only indirectly. The deduction is designed to operate as a pure incentive and not merely to recognise expenses that ought to be taken into account in accurately measuring income.

19.A70. Certain categories of expenditure are not included in the ‘earned depletion base’. These are the cost of a Canadian resource property, interest on money borrowed for the purpose of exploration, prospecting or development and post-production exploration and development expenditure. The cost of ‘processing property’ is included in the earned depletion base: this encompasses all plant employed in processing mineral ores up to the prime metal stage or its equivalent. Additional Allowances,

19.A71. As seen earlier, a ‘principal business corporation’ may deduct the aggregate of its Canadian exploration and development expenses to the end of the taxable year to the extent that they have not been deducted previously.

19.A72. A taxpayer may deduct such expenses which have been incurred in connection with certain mines from the profits reasonably attributable to the operation in Canada of that mine. These include oil and gas wells and precious and base metal mines. The allowance in any year is limited to 25 per cent of the aggregate of all expenses reasonably attributable to the prospecting and exploration for and development of the mine prior to its coming into production in reasonable commercial quantities. This does not include:

(a) exploration and development expenses which may be claimed under other provisions;
(b) expenses deducted in computing the income of the taxpayer in the year they were incurred;
(c) the cost of properties in respect of which capital cost allowance may be claimed; and
(d) the cost of leasehold interests.

19.A73. After 1 January 1977 taxpayers deriving income from oil or gas mining operations may deduct all drilling and exploration expenses from current and earlier years to the extent not deducted previously.

Capital Cost Allowances

19.A74. Certain assets qualify for accelerated capital cost allowances. The assets must be acquired before a new mine produces in commercial quantities or the major expansion of an existing mine. This replaced a three-year exemption for the income of new mines. In general terms, assets qualifying for this allowance are ordinarily depreciable and comprise:

(a) a building (except an office building not situated on the mine property);
(b) mining machinery and equipment;
(c) electrical plant; and
(d) community and transportation facilities—for example, airport, dam, hall, hospital, house, power-line, recreational facilities—analogous to the ‘housing and welfare’ deductions under the Australian Act.

The rate of depreciation which may be claimed is 30 per cent of the undepreciated balance of each class of asset. Alternatively, taxpayers may claim a deduction for the full amount of the undepreciated capital cost up to the amount of income from the mine (before deducting depletion or any other allowance).

United States

Depletion Allowances

19.A75. A deduction for depletion of a natural resource (including mines and quarries) is allowed to the owner of such a resource and it is directed towards allowing recovery of the cost over the life of the resource.

19.A76. The basic method of computing depletion is known as cost depletion. Determination of cost depletion requires first an estimate of the number of units (tons, barrels) which make up the deposit. Then that part of the cost of the property which is attributable to the depleted reserves is divided by the number of units. The quotient is the cost depletion per unit.
This amount, multiplied by the number of units extracted and sold during the year, determines the cost depletion deductible for the year. Each year the ‘cost basis’ of the property is reduced, but not below zero, by the amount of depletion deducted for that year, whether cost or percentage depletion was used. The remaining basis is used in computing cost depletion for the next year.

Example

Taxpayer purchases a mine for $10,000 and estimates that there are 100,000 tons of ore to be extracted. During the first year he mines 7,500 tons and sells 7,000 tons. Depletion for the first year would be computed as follows:

Rate of depletion per ton = $10,000 ÷ 100,000 = 0.10 cent
Depletion for year (0.10 cent x 7,000) = $700

The next year taxpayer sells 6,000 tons. However, a revised estimate at the end of the year indicates that there are 180,000 tons unextracted. Depletion for the second year would be computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revised estimate of unextracted tonnage</td>
<td>180,000</td>
</tr>
<tr>
<td>Tons mined during the year</td>
<td>6,000</td>
</tr>
<tr>
<td>Total tonnage to be used on computing new rate</td>
<td>186,000</td>
</tr>
<tr>
<td>Original cost</td>
<td>$10,000</td>
</tr>
<tr>
<td>First year's depletion</td>
<td>$700</td>
</tr>
<tr>
<td>Remaining cost</td>
<td>$9,300</td>
</tr>
<tr>
<td>New rate of depletion per ton</td>
<td>$9,300 ÷ 186,000 = 0.5 cent</td>
</tr>
<tr>
<td>Depletion for year (0.5 cent x 6,000)</td>
<td>$300</td>
</tr>
</tbody>
</table>

Percentage Depletion

19.A77. An alternative method of computing a deduction is available for all depletable property except timber. Under this method a flat percentage of gross income from the property is taken as the depletion deduction. The percentage depletion may not exceed 50 per cent of the taxable income from the property, computed without regard to the depletion allowance. However, if cost depletion would result in a greater deduction, it must be used. Percentage depletion ordinarily permits recovery of much more than cost and is allowed at varying percentages of gross income from the property. For example, the depletion rate is 22 per cent in the case of uranium, oil, gas and sulphur, and 15 per cent in the case of gold, silver and iron.

Development Expenditures
Expenditure incurred for the development of a mine or other natural deposit after the existence of minerals has been disclosed is fully deductible in the year in which incurred. Alternatively, the taxpayer may elect to treat it as deferred expenditure to be deducted rateably as and when the mineral or ore is sold. The election to defer deductions may be made for each year while the mine or deposit is in the development stage, but must be for the total amount of net development expenditure made in that year with respect to the mine.

The normal depreciation provisions apply to improvements in the case of mines or oil and gas wells: the taxpayer may elect to employ the straight-line, fixed percentage or reducing-balance method of depreciation. In addition, the normal depreciation charges apply to all depreciable property used in drilling and development.

It will be noted that the taxpayer's deduction for wasted capital may exceed his actual unrecovered capital cost. This arises because a large part of the capital expenditure is permitted to be deducted as incurred, and then (percentage) depletion is allowed as a percentage of receipts without regard to the remaining unrecovered capital expenditure.

South Africa

Persons carrying on mining operations on a mine which commenced production after 1 January 1974 may deduct from income derived from mining in each year the whole of the capital expenditure incurred by them in the carrying on of such mining operations.

Capital expenditure, in order to qualify for the deduction, must fall within one of the following categories:

(a) Expenditure on shaft sinking and mine equipment—i.e. ‘all the apparatus (including buildings) necessary for carrying on mining’—and the cost of laying pipelines from the site to the marine terminal or refinery. Equipment under this category must exceed a certain cost (R40,000).
(b) Expenditure on development, general administration and management (including interest on loans utilised for mining purposes) prior to the commencement of production or during any period of non-production.
(c) In the case of deep-level gold mines, new gold mines, and natural oil mines, a special allowance of 5 per cent per annum of unredeemed expenditure incurred on a number of items: for example, expenditure incurred during any period of production on development of any reef on which, at the date of such development, stoping had not commenced. This deduction is available from the end of the month in which the expenditure is incurred up to the end of the year of assessment immediately preceding that in which the determination of the taxable income derived from the
working of the mine does not result in an assessed loss.

19.A83. Capital expenditure deductible is ‘net’: that is, where a capital asset falls within the description of an allowable category, any amount obtained as a result of its sale must be deducted in order to arrive at net expenditure. The cost of acquisition of a mining right does not form part of the capital expenditure ranking for redemption.

19.A84. *Computation of deduction.* Formerly, accumulated (net) capital expenditure together with 75 per cent of the capital expenditure incurred in the year of income were aggregated and the aggregate amount was divided by the estimated life of the mine (but not exceeding thirty years) and the resulting quotient was the redemption allowance for the year of assessment. Twenty-five per cent of the capital expenditure for the year was immediately deductible. After deducting the allowance from the aggregate amount, the portion remaining represented the unredeemed balance of capital expenditure and was carried forward to the next year of assessment to form the basis of a fresh calculation for that year.

19.A85. It will be observed that the provision resembled the Australian section 122D in relation to accumulated capital expenditure. Special provisions existed in relation to gold mines, diamond mines and natural oil mines.

19.A86. In relation to years of assessment after 31 December 1973, capital expenditure incurred after that date is fully deductible and may, if it exceeds the assessable income of the enterprise, promote an assessed loss. A balance of any assessed loss incurred in a previous year of assessment may be carried forward to the year of assessment to be set off against income derived from any other trade in the Republic. If in any year of assessment the taxpayer does not carry on a business, he is not permitted to carry forward to this year any balance of assessed loss established in respect of the immediately preceding year of assessment. In this way, the taxpayer forfeits his right to claim a deduction for the accumulated loss. (On 14 August 1974, the Minister of Finance announced proposals to allow taxpayers operating a mine to write off all balances of unredeemed capital expenditure over a period of five years expressly for the purpose of financing expansion.)

19.A87. *Closing down of mine.* As under the Australian provisions, where the mine is closed down, any balance of unredeemed capital expenditure remaining is lost unless the mine is ultimately reopened by the taxpayer. Further, similar to section 122K of the Australian Act, if, as a consequence of sale, recoupments of capital expenditure are in excess of unredeemed capital expenditure, such excess is brought to account as
income.

19.A88. Change of ownership. A purchaser may claim a deduction for capital expenditure computed as being the effective value to him at the time of purchase of the preliminary surveys, boreholes, shafts, development and equipment included in the assets purchased. Whatever amount is allowed to rank as capital expenditure for redemption by the new owner is deemed to be a recoupment from capital expenditure by the previous owner. ‘Effective value’ is determined by the Government Mining Engineer.

New Zealand

19.A89. As noted earlier, no distinction is made under New Zealand tax legislation between exploration and development expenditure: an immediate write-off is allowed in respect of both categories in the manner indicated.

19.A90. Where a landowner derives income by way of royalties from the sale of non-specified minerals extracted from his land or by way of mining, he is assessable on the profits. However, the New Zealand Act allows for the ‘commodity cost’ of the minerals realised to be deducted in ascertaining that income. This is in effect a depletion allowance of the cost type, as it allows miners to reckon their tax profits from the enterprise after deducting all working expenses and ‘an amount equal to the cost of’ those minerals. This involves matching the depletion allowance on the wasting mineral resource to the rate of production. The capital figure requiring amortisation is the cost of the resource plus developmental outlays.

III. Investment INCENTIVES

Australia

Deductibility of Capital Subscription

19.A91. The Income Tax Assessment Act formerly allowed the deduction from assessable income of the owner of shares (other than redeemable shares) in a company of certain moneys paid by him to the company in respect of such shares, and applied by the company towards the paid-up value of the shares, where the company was carrying on a business of mining or prospecting in Australia or Papua New Guinea for certain minerals (including petroleum) and it had made a declaration that it proposed to spend or had spent the moneys on mining or prospecting outgoings. The owner must have been a resident of Australia or Papua New
Guinea. To the extent that the deductions were available to shareholders, there were reductions of the deductions for capital expenditure available to the company under Division 10. (See section 77D). The section enabled in effect a transfer of the deduction for ‘allowable capital expenditure’ on mining (section 122A), on petroleum mining (section 124DD) and exploration expenditure (section 122J). It did not include expenditure on transport facilities deductible under Division 10AAA nor that incurred in acquiring a mining right or information. ‘Moneys paid on shares’ meant moneys paid by a company towards the paid-up value of the share, whether paid on application/allotment or to meet calls. See also section 122Q providing for the reduction of moneys otherwise deductible by the company.

19.A92. Further, section 77C of the Act allowed a deduction for moneys paid by shareholders as calls on shares in such companies. Such deductions, which were also available to a non-resident shareholder, did not involve any reduction of the deductions for capital expenditure allowable to the company under Division 10. The deduction was available when the company to which calls had been paid lodged a declaration stating that the money received would be spent on exploration or prospecting in Australia or Papua New Guinea for minerals (including petroleum). If these conditions were satisfied, one-third of so much of the calls as was included in the declaration lodged by the company was deductible from the assessable income derived by the person paying the calls. This did not include moneys paid on application or allotment.

19.A93. The differences between the section 77C deduction and the section 77D deduction were as follows:

(a) The declaration under section 77C must have related to exploration or prospecting expenditure. The declaration under section 77D could relate to such expenditure or other mining expenditure within Division 10, except expenditure in the acquisition of a mining or prospecting right or mining or prospecting information.

(b) The deduction to the shareholder under section 77C was one-third of calls, which excluded moneys paid on application or allotment which moneys were included under section 77D.

(c) As mentioned earlier, the deduction to the shareholder under section 77C did not involve any reduction in the deductions available to the company, as did the deduction under section 77D.

Exempt Income
19.A94. Section 23 (o) exempts income derived from the working of a mining property in Australia or Papua New Guinea where, throughout the working life of the mine, it has been mined principally to obtain gold or gold and copper and where, in the latter case, the value of the gold obtained from the property is not less than 40 per cent of total output.

19.A95. This exemption was expressly inserted as an incentive to gold mining. Until 1973 the exemption extended to such exempt income (less outgoings incurred in its production) distributed by way of dividend to the shareholders of a company. It should be noted that a deduction for exploration and prospecting expenditure under section 122J and for capital expenditure under section 122D is not available where the expenditure is incurred in prospecting or mining for gold, since these deductions related only to assessable income. Furthermore, where mining operations are carried on for the production of income exempt under section 23 (o) in addition to (other) assessable income, apportionment of expenditure is provided for under section 122P. This latter section excludes from the deductions allowable in relation to income from pyrites (which is assessable) expenses that would have been incurred even had the income from pyrites not been derived. The form of the section has led to some consequences which were not intended but which, in any event, appear to be anomalous. Income derived from the ‘working of a mining property’, where the output of gold is of the required percentage of the total value of the output of the mine and is extracted by a cyanide process from soil which has been raised from the beds of gold mines and from which the visible gold has been removed, has been held to be exempt. On the other hand, there is the case of the holder of a gold-mining lease who crushed ore from his own gold-mining lease, and also ore he had purchased from other such leases in which he held an interest, upon a surface machinery area lease also held by him. After extraction of the gold by crushing, the residues were run off in the form of slimes or tailings which the taxpayer collected in dumps and by means of a cyanide process extracted the residual gold from them. This process, in so far as it was applied to the ore obtained from the other leases, was held not to be the ‘working of a mining property’ and the income derived from it was held to be taxable. A distinction was drawn between the phrases ‘the working of a mining property’ and ‘mining operations’. In the case in question, Dixon, C. J. observed:

‘The various provisions of the Income Tax Assessment Act 1936–1943 relating to mining were introduced on different occasions and do not pursue a policy worked out with precision. They must be construed as they are expressed.’
Without casting any doubt upon the correctness of the two decisions, the criticism of the distinction between them implicit in the remarks of Dixon, C. J. illustrates the incongruity of the results produced by section 23 (o) in its present form. It is reasonable to suppose that the legislature, in enacting section 23 (o) was really aiming at encouraging the winning of gold in Australia. It was not concerned whether the gold was extracted by the taxpayer from ore taken from the soil of the mining lease held by him or was extracted by the taxpayer from ore taken from the soil of other mining leases.

Losses Incurred in Gaining Exempt Income

19.A96. Section 77 provides for the allowance from assessable income of a deduction for losses incurred in carrying on a business in Australia or Papua New Guinea, the proceeds of which are or would be exempt income. Where a deduction has been allowed for a loss and there are subsequent profits from the exempt business, those profits will be assessable to the extent of the deduction so allowed. Such profits are only assessable where the previous loss, for which a deduction had been allowed, was incurred within the three years of income immediately preceding the year of income in which the profit was derived.

19.A97. A deduction under section 77 is set off against other income in the following order:

(a) personal exertion income;
(b) income from property other than dividends;
(c) income from dividends.

United States

19.A98. As already indicated, a depletion allowance is available to taxpayers deriving income from an oil or gas well or mineral property: either the cost depletion or percentage depletion method may be employed. There appear to be no other distinctive incentives similar to those provided under Australian legislation.

Canada

19.A99. Under former legislation, the income of a mine was exempt for a period of three years from the time when the mine commenced reasonable commercial production. This has been replaced by the earned depletion
allowance. Similarly, prospectors and contributors were exempt from tax on sale of mining properties in certain circumstances. Under present legislation, they continue to receive special treatment, but it is by way of deferment of tax and capital gains treatment rather than exemption from tax. This special treatment is provided only if they receive shares in consideration of the transfer of their interest in the mining property.

19.A100. If cash or another asset is received, it may be treated as property income or capital according to general law principles.

19.A101. A prospector must be an individual while a contributor (or ‘grubstaker’) may be an individual or a corporation. Such persons, if they acquire an interest in a mining (not oil or gas) property through the prospecting or financing activity and dispose of that interest to a corporation for its shares, are not required to include in income any amount in respect of the shares received. However, the shares are deemed to have a zero cost to the recipient and the issue of shares is regarded as a zero cost to the acquiring corporation. Thus, subsequent sales (i) of the shares by the prospector or contributor, and (ii) of the mining interest by the corporation, are more heavily taxed than they otherwise would be. Further, the corporation is not entitled to any deduction in respect of its costs of acquiring the mining right.

New Zealand

19.A102. A concession exists similar to the former section 77C of the Australian legislation, in that sections 129BB and 129C of the Land and Income Tax Act 1954 allow a deduction of one-third of the amounts contributed by a shareholder to the paid-up value of shares held by him in a mining company. Any premiums paid on the issue of shares are not deductible under these provisions. If a mining company does not within a reasonable time use for mining purposes amounts it receives from its shareholders, the Commissioner may disallow the deduction for calls paid on shares to shareholders in the mining company or holding company as the case may be.

19.A103. Where under the general law profits on the sale of mining shares are assessable, then, in determining the amount of the profit, the cost price of the shares is to be reduced by any deduction allowed to the taxpayer in respect of calls on those shares. A similar situation applies when calculating losses.

19.A104. Where the assessable profit on sale of mining shares is made by a company, and that company ploughs the profit back into further investment in mining or exploring for petroleum or specified minerals, the
assessment of those profits (‘reinvestment profits’) is deferred. The company is allowed six years to reinvest the profits for mining purposes. The profits are in general assessed when the new mining investment is realised; but again there will be opportunity to reinvest in other mining activities, with a consequent further deferment of taxation of the profit so invested. The reinvestment profit can be invested by way of equity or loan capital; and if any portion of that amount is diverted for non-mining purposes within the six-year period, the relevant amount becomes assessable income of that year of diversion or expiry.

19.A105. Attention has already been drawn to the recent amendments to the income tax legislation conferring special tax treatment upon the income from mining derived by various classes of taxpayer: for example, mining companies pay tax on mining income at two-thirds of the normal company rate and non-resident mining operations are taxed at 45 per cent on their entire mining venture income.

South Africa

19.A106. There appear to be some exemptions available akin to those provided under the Australian Act. The profits of mining under a lease granted under section 46 of the Precious and Base Metals Act 1908 of the Transvaal are exempt from income tax.

19.A107. In general, exemptions are limited to operations deriving income from the production of particular minerals and afford little basis for comparison with the incentive provisions operating in the other countries mentioned above.


Chapter 20 Income Taxation in Relation to Particular Industries: General Insurance, Exempt Organisations and Mutual Associations

20.1. In Section I of this chapter aspects of the income taxation of general insurance companies are examined. In Section II the Committee considers exemptions granted to a number of organisations by section 23 of the Income Tax Assessment Act, and also the basis of assessment of co-operative companies and friendly society dispensaries. The exemption from income tax of charitable institutions is discussed in detail in Chapter 25, together with other taxation aspects relating to these institutions.

I. General Insurance

20.2. This first section deals with the operations of fire, general and marine insurance companies, which are concerned with the insurance of losses other than those covered by life insurance and those personal accident losses covered by insurance policies written by the life insurance offices. The basis of the insurance contract is that, in consideration of a payment or premium by the insured, the insurer will, on a certain event happening during a given time, pay to the insured, or some nominated person, either an agreed sum or the amount of the loss caused by the event. Fire, general and marine insurance companies insure various kinds of risks, such as loss at sea, loss by fire or accident, by burglary or breakage, by default of staff, and loss of profits consequent upon another loss.

20.3. Division 15 of the Act contains particular provisions covering insurance with non-residents. But apart from these provisions, the Act is silent on the treatment of the income of general insurance companies. Because of the nature of their business, however, the taxable income of such companies has in certain respects come to be calculated differently from the taxable income of other companies. Four special features of the industry are dealt with in turn: deferment of unearned premiums; claims incurred but not reported; catastrophe fund; and insurance with non-residents.

Determination of Earned Premiums

20.4. Throughout the tax year an insurance company receives premiums, a proportion of which will cover risks for a period after the end of that year. For this reason it has been the custom of the Commissioner to agree to the accounting practice of insurance companies to exclude from their
assessable income for a year an amount equal to a proportion of the
premium income for that year and to bring that amount to account in the
following year.

20.5. Until 1965, the proportion of premiums received in a year that
could be deferred to the next year was set at 40 per cent and
representations to the Commissioner that the percentage be increased met
with no success. The 40 per cent rule rests on the principle, dating back to
a Court decision in the United Kingdom as long ago as 1912, that 50 per
cent of premiums received as twelve-monthly business is unearned at the
end of the year; and as 20 per cent is customarily allowed for costs of
acquisition and documentation, the deferred amount should be 50 per cent
of 80 per cent, which is 40 per cent.

20.6. The 40 per cent rule has been criticised as it is unreal to assume that
premium income and risks are necessarily distributed evenly over the year.
For example, a substantial proportion of a company's contracts may be for
periods of more or less than one year; or the company may receive during
one year a substantial total of premiums on a new type of policy which it
first commenced to write midway through that year; or part of the
premiums received may refer to risks which did not commence during the
year of income; or a sizeable proportion of premiums may be received in
one calendar month.

20.7. The 1965 decision in the *Arthur Murray Case*\(^1\) lent support to the
Commissioner's practice of excluding unearned premiums from assessable
income and led the Commissioner to amend his view as to a reasonable
deferment of premiums in special circumstances. The Commissioner now
began allowing individual companies to defer amounts in excess of 40 per
cent of premiums received if, upon a careful examination of all the
circumstances, a larger percentage was thought to be justified. Since 1968,
the rules for deferment of premiums have been widened to allow for
calculations by the '24ths rule'. Behind the latter is the assumption that a
premium in connection with an annual risk is deemed to have been
received in the middle of the month, and that a risk attaching to a premium
received in the first month of the income year falls due as to 23/24ths in the
current year and as to 1/24th in the next year. The proportions for a
premium received in the second month are 21/24ths and 3/24ths
respectively; and so on. The calculation is based on net premiums (that is,
gross premiums less returned premiums, reinsurances, commissions and a
proportion of administration expenses).

20.8. The Committee is satisfied that submissions to it calling for
methods of assessing an allowance for the deferment of unearned
premiums more accurate than the 40 per cent rule are met to an extent by
the present acceptance of the 24ths rule. It therefore recommends that the 24ths rule be continued. However, this latter rule has its shortcomings: being based on the time at which premium is charged rather than the period of risk, it cannot be wholly accurate in all cases. Hence, as more exact methods of calculating the unearned premium are developed, they should be accepted by the Commissioner. In recommending continuance of the exclusion of unearned premiums from assessable income, the Committee is not seeking to treat the income of a general insurance company in a specially favourable way. It is concerned only with establishing a fair basis for calculating taxable income.

Claims Incurred but not Reported

20.9. Insurance companies are liable to meet claims arising from losses of the insured during the income year but not notified during that year. At the end of each year companies estimate claims which occurred during the year but likely to be made after the end of the year. Understandably, the delay in notifying claims varies according to the class of insurance business. With workers’ compensation and third-party insurance business, for instance, there may be a considerable time-lag between the occurrence of the injury, the manifestation of the symptom and of the extent of the injury suffered, and settlement of the claim. It is thus extremely difficult to calculate this provision accurately. The insurance industry as well as the Insurance Commissioner have been concerned with developing statistical techniques to enable the calculation of claims incurred but not reported to be made with greater precision.

20.10. Claims incurred but not reported have not until recently been submitted as deductions for income tax purposes. However, R.A.C.V. Insurance Pty. Ltd., in its return for the year ended 28 February 1971, sought a deduction in respect of claims reported after 1 March 1971 for accidents that had occurred during the financial year. In the assessment, the amount claimed was disallowed and the matter eventually became the subject of an appeal to the Supreme Court of Victoria. A decision in favour of the company was given by Menhennitt, J. in June 1974 and by consent an appeal by the Commissioner was dismissed. While by the facts of the case the decision is limited to motor-car insurance and third-party insurance, the Commissioner has accepted the decision as applying to all general insurance companies. The decision is not expected to give rise to practical difficulties for the Commissioner and will undoubtedly be welcomed by the insurance industry.

Catastrophe Fund
20.11 It has been put to the Committee in submissions that insurance companies should be allowed to deduct from taxable income additions to provisions built up to meet an exceptional aggregation of claims arising from a catastrophe. The maintenance of a high solvency margin, it is argued, would be facilitated by such deductions and the provisions would be available for emergency purposes, payments from the provisions not of course being allowable deductions.

20.12 While substantial provisions to meet unusual claims are desirable in any business, the Committee does not favour special treatment in this regard for insurance companies. The uncertainty of the basis of such provisions would cause serious administrative difficulties in deciding to what extent the amounts claimed should be allowed as deductions.

Reinsurance with Non-residents

20.13 It is not uncommon for resident insurance companies to reinsure certain risks with non-resident companies, and section 148 of the Act contains special provisions for taxing such non-residents. Amendments to the section have been sought in submissions to the Committee.

20.14 To bring the income of a non-resident reinsurer to tax in respect of premiums pertaining to insurance of property situated in Australia or of events that can happen only in Australia is an extremely complicated matter. Before 1938 the Australian insurer was assessable to tax as agent for each ex-Australian reinsurer on the profit derived by the reinsurer. The profit so derived was deemed to be 20 per cent of the premiums received by the reinsurer, unless the actual profit or loss made by the reinsurer could be established to the satisfaction of the Commissioner.

20.15 Under pressure from the insurance industry, this basis was abandoned in 1938. Thereafter, premiums paid to non-resident reinsurers and recoveries from the latter were excluded from the assessments of local insurers and the full profit or loss arising from the risk insured was included in the assessment of the local insurer.

20.16 It was found that in most cases the insurer was able to recoup from the non-resident reinsurer the tax attributable to the reinsurance in question; but some local companies were at a disadvantage when they could not make satisfactory arrangements to recoup.

20.17 To meet the disadvantages facing local companies, the Act was amended in 1947 to allow the Australian insurer either to bring to account in his own return the profit or loss derived by the reinsurer or else to return 10 per cent of the premium paid to the reinsurer as taxable income and pay tax on that amount as agent for the reinsurer.
20.18. Representations to have the figure of 10 per cent reduced have not been successful, the Commissioner being satisfied that, over a period, 10 per cent is not excessive. A submission to the Committee that overseas reinsurers be allowed to submit income tax returns for reinsurances ceded by Australian companies would lead to the unsatisfactory complications previously outlined, and to double taxation unless the Australian insurer elected not to bear the tax on the reinsurer's profits or losses.

20.19. Section 148 (3) of the Act refers to ‘ten per centum of the sum of the gross amounts of the premiums paid or credited by him . . . to non-residents’. The Committee understands that the Commissioner is interpreting this as not precluding the deduction from gross premiums of returned premiums and rebates for the purposes of calculating deemed profits on premiums. This interpretation will go some way to reduce deemed profit of local insurers on reinsurance business, and the Commissioner ought to notify the insurance industry of his current interpretation.

II. Exempt Organisations and Mutual Associations

Local Governing Bodies, Public Authorities and Institutions of a Charitable Kind

20.20. The incomes of local governing bodies, including those administering public utilities, have been exempt since the inception of Federal income tax, presumably because they are statutory bodies carrying out what are thought to be functions of government. On the other hand, the main commercial and trading undertakings coming within the control of the Australian Government are subject to income tax on the same basis as a public company. Thus, for instance, the Commonwealth Trading Bank and the Australian National Airlines Commission are taxed on this basis. The Committee sees no reason to vary the existing income tax position of these local governing bodies and Australian government undertakings.

20.21. In Chapter 25 the Committee has recommended that the present exemptions, under sections 23 (e) and 23 (j) (ii), of religious, scientific, charitable and public educational institutions and funds for charitable purposes be continued. There are some other institutions and funds exempted by the provisions of section 23 of the Act which might be thought to be of a similar nature. These are hospitals carried on by an association otherwise than for the profit of its members (section 23 (ea)), medical and hospital benefit funds registered under the National Health Act (section 23 (eb)), and funds established for the purpose of enabling scientific research to be conducted by or in conjunction with a public
university or public hospital (section 23 (j) (iii)). The Committee considers that these institutions and funds should continue to be exempt from income tax, though it acknowledges that the exemption may have to be qualified if business activities are carried on which compete with the activities of commercial organisations. This matter is considered in Chapter 25 in relation to charities.

**Non-Profit Associations and Societies Formed for Particular Purposes**

20.22. The income of trade unions, certain employer associations, friendly societies, cultural and sporting societies, and aviation, agricultural and manufacturing associations is exempt under section 23 (f) (g) and (h). Trade unions, whether registered or not, and associations of employers or employees registered under Federal or State laws relating to the settlement of industrial disputes are exempt from tax on income from all sources, including income from investments and from any business activities. If, however, an exempt trade union or association is a shareholder in a trading company—indeed the only shareholder—the income derived by the company is taxable in the same way as the business income of any other company carrying on the same kind of business.

20.23. The income of a non-profit friendly society is exempt except where it is the income of a dispensary run by the society. The liability to tax of the income of a friendly society dispensary is covered by Division 9A of Part III of the Act and is dealt with in paragraphs 20.38–20.45. The exemption of the income of a non-profit friendly society extends to income from other business activities and income from investments. ‘Non-profit’ is used here and elsewhere in this chapter to describe an activity not carried on for the purpose of profit or gain to individual members.

20.24. A non-profit society, association or club established for the encouragement of music, art, science or literature is exempt from tax on its income—both investment income and business income. The like income of a non-profit society, association or club established for promoting the development of aviation or of agricultural, pastoral, horticultural, manufacturing or industrial resources, or for the encouragement or promotion of an athletic game or athletic sport in which human beings are the sole participants, is exempt.

20.25. The mutuality principle would apply to prevent at least some of the receipts of a number of the organisations referred to in paragraphs 20.22–20.24 being taxed as income even if those receipts were not made exempt from tax by express provisions. The mutuality principle asserts that a person cannot derive income from dealings with himself. The principle
applies notwithstanding that the club or society in which persons are associated is incorporated. The principle may require that subscriptions received from members and some receipts for goods or services supplied to members should not be treated as income. It has been said that for the principle to apply in this way:

‘The cardinal requirement is that all the contributors to the common fund must be entitled to participate in the surplus and that all the participators in the surplus must be contributors to the common fund; in other words, there must be complete identity between the contributors and the participators. If this requirement is satisfied, the particular form which the association takes is immaterial.’¹

The Committee understands that it is the policy of the Commissioner to apply the mutuality principle in the assessment of non-profit clubs and societies whose receipts are not made exempt by express provisions. In the result, these societies and clubs are generally subject to tax only on their investment income and on income from trading with non-members. The law has not insisted on the degree of identity which the above quotation might suggest. In the case of a non-profit association there is sufficient identity in the fact that contributions by members which make up, for example, a cash surplus from bar trading will go to assist in financing the facilities and services available to members.

20.26. There should, in the Committee's view, be a limitation of the exemption of the income of the organisations referred to in paragraphs 20.22–20.24. There are undoubtedly cases, at the present time, where some of these organisations are carrying on business operations in competition with taxable persons and, through the exemption from tax, are enjoying an unfair trading advantage. Exemption should continue to be given to income arising from business activities directly related to the carrying out of the purpose for which the organisation was established and which gives it entitlement to exemption but not to other business income. Investment income should in general continue to be exempt, though it would be necessary to deny exemption to income such as interest or rents arising from an investment in a trading entity in which the organisation had an interest exceeding a specified percentage. There would otherwise be an avenue by which exemption might still be obtained in respect of trading income unrelated to the organisation's purpose: inflated interest and rent might be exempt to the organisation and deducted by the trading entity. Dividends might, however, remain exempt in all circumstances since the profits from which they have been paid will have borne tax. If the dividends were not exempt they would, in any event, give rise to an entitlement to rebate which would have the same effect as exemption from
tax. The notion of business should, for the purpose of all these proposals, include ownership of real property. In relation to the taxing of receipts from a non-exempt source, the mutuality principle explained earlier would apply where appropriate.

20.27. If the Committee's proposal were adopted, the exemption from tax would continue to be given, for example, to the proceeds of agricultural shows received by agricultural societies and to the proceeds of cricket matches received by cricket associations. The income from portfolio investments of trade unions would be exempt but not income from trading activities.

20.28. It has been submitted that the qualifications imposed by section 23 (g) for exemption of sporting clubs or associations are too restrictive. The exemption was introduced into the law in 1952 to give effect to a recommendation of the Spooner Committee and is similar in its terms to a previous concession in relation to entertainment tax for these organisations. The club or association must have been established for the encouragement or promotion of an athletic game or athletic sport in which human beings are the sole participants. Sports such as cricket, tennis and football are clearly included in the exemption; on the other hand, angling, horse racing, trotting and motor racing are clearly excluded. There are some sports which it might be difficult to categorise. In any case, all sports provide recreation to participants and spectators, and it has become difficult to draw any distinction, on the basis of the degree of commercial activity involved, between sports in which human beings are the sole participants and other sports. In New Zealand, exemption of a similar nature to that now given in Australia by section 23 (g) has been extended, from 31 December 1973, to horse racing, trotting and greyhound racing clubs. The Committee sees some force in the arguments which would support an extension of the exemption of sporting clubs and associations. But it would take the view that questions as to what societies and associations should be exempt are matters of government policy. There may be other organisations with equally strong claims for exemption.

Co-Operative Companies

20.29. Division 9 of Part III of the Act contains provisions setting out the basis of assessment of co-operative companies as defined in that Division. One effect of these provisions is to exclude the application of the mutuality principle in the taxing of such companies. Under the definition, if a company is to qualify as a co-operative company, there must be limits imposed by its rules on the number of shares which a member may hold,
quotation of the shares of the company on a stock exchange must be prohibited, the company must be established to carry on a business having as its primary purpose or purposes one or more of certain stated objects, and 90 per cent of business must be transacted with members. Most co-operatives have objects that relate to primary production activities.

20.30. A co-operative company is entitled to deduct amounts distributed to members by way of rebates or bonuses on business done with the company, and by way of interest or dividends on shares. A co-operative company having as its primary purpose one of the objects stated in the definition may deduct amounts repaid to the Australian or State Governments. Submissions to the Committee have maintained that the special basis of assessment of co-operative companies gives to these companies unfair trading advantages. Other submissions have sought the retention of the present position, and in some cases, complete exemption of co-operative companies.

20.31. It may be helpful in judging the present basis of assessment of co-operative companies to consider how they would be taxed if there were no special provisions. On one approach, a co-operative would be entitled to deductions of rebates and bonuses paid to members, based on business done by members with the co-operative, to the extent that the rebates and bonuses had the character of discounts allowed to members. The fact that the discounts on this basis were paid to customers who were also members would not, it is thought, prevent them being deductible. To the extent, however, that the rebates and bonuses had the character of distributions of profits, they would be treated as dividends paid by the co-operative and, like dividends paid as such, would not be deductible. Interest on borrowings by the company would be deductible.

20.32. On this approach, the taxation of a co-operative company would differ in three respects from taxation under the special provisions:

(a) Rebates and bonuses that are not covered by profits made from transactions with members and are therefore paid from investment income of the co-operative or from profits made from transactions with non-members would probably not be deductible.
(b) Rebates and bonuses that are not paid from the net gain made by the co-operative from transactions with the particular member to whom they are paid would probably not be deductible.
(c) Dividends paid by the co-operative to members would not be deductible.

The third difference may not be thought important, since dividends paid by co-operatives are not significant in amount. The first and second, however, indicate that under the special provisions a measure of
concession treatment is given to co-operatives.

20.33. In the absence of the special provisions it would be possible to approach the taxation of a co-operative in terms of the principle of mutuality. On this approach much the same consequences would follow as on the approach that would allow deductions of rebates and bonuses which have the character of discounts. Gains from transactions with members which the rules required should be returned to members as rebates and bonuses would not be treated as income of the co-operative. This would be so even though the gains are returned on a class basis, i.e. the rebate or bonus to a particular member is not necessarily proportional to the gain in fact made from transactions with him. To this extent the tax treatment would be more favourable than under the discount approach. Investment income and gains from transactions with non-members would be taxed without diminution by deduction of rebates and bonuses paid to members. Again it could be concluded that under the special provisions a measure of concession treatment is given to co-operatives.

20.34. The concession treatment is, in effect, given only to investment income and income from trading with non-members. The extent to which there may be income from non-members is limited by the provisions requiring that 90 per cent of a co-operative's business must be with its members if it is to qualify for the concession treatment.

20.35. If the law were to require that all of a co-operative's business activities must be with its members, or that the co-operative should be taxed on income from business with non-members, as is presently the case in Canada and New Zealand, it would, in effect, be taking away any concession treatment. The Committee appreciates the argument that the concession may give an unfair advantage to a co-operative in competition with other commercial organisations. However, whether any concession treatment now given should be limited—or, for that matter, extended—is a Government policy question. It is important, nonetheless, that the tax treatment of co-operatives be seen in correct perspective.

20.36. The Committee has received submissions requesting that the requirement for 90 per cent of a co-operative's business to be with members be relaxed. It was suggested that if a co-operative undertook secondary activities, possibly of a community nature, in which less than 90 per cent of the business was with the members it would lose the deductions for rebates and bonuses to members while its revenue would continue to be assessable income. The Committee does not feel that the present provisions should have this effect and suggests that it be made clear that any secondary activity would be treated as a separate business for tax purposes. The taxation of this separate business would not affect the concessional
treatment of the main activity.

20.37. Co-operative companies may deduct certain loan repayments to
governments. On general considerations of equity, the Committee
considers that the deduction for repayment of moneys to governments
should be withdrawn.

**Friendly Society Dispensaries**

20.38. Until 1947, the income of a friendly society dispensary was
exempt from income tax in the same manner as all other income of a
friendly society, as outlined in paragraphs 20.22–20.23. With the
introduction of Federal legislation to provide pharmaceutical benefits,
under which friendly society dispensaries were allowed to dispense
pharmaceutical products for the general public, the question of taxing the
income of friendly society dispensaries was considered. In 1952 the
Spooner Committee recommended that the taxable income of a friendly
society dispensary be deemed to be 10 per cent of:

(a) amounts received from the Australian Government under the Pharmaceutical
Benefits Act and special charges prescribed by that Act in respect of the supply of
pharmaceutical benefits;
(b) amounts received from the Australian Government under the National Health
Act in respect of the supply of medicines, etc. to pensioners; and
(c) proceeds of the sale or supply of medicines and other goods to persons who are
not members of a friendly society.

20.39. The recommendation of the Spooner Committee was not adopted.
In 1955, however, the present legislation was introduced. Under this a
friendly society dispensary is liable to income tax at the concessional rate
of 37½ per cent on taxable income exceeding $416, calculated as 10 per
cent of:

(a) amounts received by it from the Australian Government under the National
Health Act 1953 in respect of the supply of pharmaceutical benefits; and
(b) the gross proceeds received by it from the sale or supply of medicines and other
goods sold or supplied in the ordinary course of business, not including amounts
received from a friendly society for the supply of benefits to the members of that
friendly society.

This legislation differs from the recommendations of the Spooner
Committee in taxing all receipts from members. In 1961, the Ligertwood
Committee proposed a basis of assessment of friendly societies which broadly followed the recommendation of the Spooner Committee.

20.40. Submissions have been received from representatives of private pharmacists maintaining that unfair competitive advantages are enjoyed by friendly society dispensaries and that these should be removed. On the other hand, representatives of friendly society dispensaries have complained of being taxed on receipts from members. They also claim that the 10 per cent measure of profit in relation to other dispensary receipts should be reduced to take account of falling profit margins in the pharmaceutical trade since the legislation was enacted in 1955.

20.41. Earlier in this chapter the Committee has considered the basis of taxation of non-profit associations and societies formed for particular purposes. The general basis recommended is that those associations and societies now exempt should be exempt from tax only on business income arising from activities directly related to the carrying out of the purpose for which they were established and which is the justification for their exemption. Income from other business operations should be assessable subject to the application, where appropriate, of the mutuality principle.

20.42. It would follow from this basis of taxation that a friendly society should not enjoy a general exemption from tax on profits from the dispensing of medicines. Where medicines are supplied to members of the society, however, the mutuality principle should apply so as to preclude any profits arising being treated as income. To the extent that the law denies this application of the mutuality principle, a friendly society is denied the tax treatment enjoyed by other mutual associations. There appears to be no basis for distinguishing the supply of liquor by a club to its members from the supply of medicines by a friendly society to its members.

20.43. It follows, in the Committee's view, that the law should adopt the principles of assessment suggested by the Spooner Committee. Accordingly, the Committee recommends that friendly society dispensaries be assessed to tax on the net profit attributable to:

(a) amounts received from the Australian Government under the National Health Act for the supply of pharmaceutical benefits and any charges paid by members or by non-members for the supply of those benefits; and
(b) the proceeds of the sale or supply of pharmaceutical products, not coming under the pharmaceutical benefits scheme, and other goods to persons who are not members of the friendly society or societies conducting the pharmacy. These proposals would exclude from the taxable receipts of the friendly society dispensary,
receipts from members for the supply of medicines not subject to pharmaceutical benefits, receipts from members for other goods and receipts from a friendly society for the supply of benefits to the members of that friendly society. It is necessary to include in the receipts subject to tax any amount received from members for medicines supplied which are subject to pharmaceutical benefits, because of the difficulty of apportioning the profit from the supply between the payment received from the Australian Government and the payment received from the member. However, to include any other receipts from members would be a significant departure from the mutuality principle.

20.44. If it is considered that all friendly society dispensaries are in a position to supply figures of profit attributable to the taxable receipts outlined in the previous paragraph, such figures should be the basis of assessment. If this is not thought feasible, a percentage should be applied to those taxable receipts, the percentage being the approximate average net profit of private pharmacists conducting this type of business. If a percentage is to be applied, the present figure of 10 per cent should be reviewed to test whether it is appropriate at the present time.

20.45. On this recommended basis of assessment, friendly society dispensaries should be subject to tax at the normal rates for non-profit companies, that is at 42½ per cent on the first $10,000 of taxable income and at 45 per cent on the remainder. The Committee assumes that because of the narrowing of the base proposed, the increase in the rate of tax will not, generally, increase the amount of tax paid by individual friendly societies.


1. Municipal Mutual Insurance Ltd. v Hills (1932) 16 T.C. 430 at 448, per Lord Macmillan.
Chapter 21 Income Taxation in Relation to Superannuation and Life Insurance

21.1. Life insurance and superannuation, whilst they have many differences, also possess some important similarities. On one level they are, apart from the purchase of houses, the only common forms of contractual long-term savings in Australia and these savings provide a very significant pool of long-term investment capital. On another level, life insurance and superannuation give financial protection to the individual and those dependent upon him in the event of death or retirement. To this extent they provide benefits that society has come to regard as desirable.

21.2. For these reasons the Committee believes that, generally, life insurance and superannuation should not be dealt with in isolation from each other and that the tax treatment of one should be consistent with the tax treatment of the other. This is not to say, however, that the basis of taxing both should necessarily be identical, for important differences between the two must be recognised.

21.3. For convenience, this chapter is divided into three sections. The case for special treatment is briefly considered in Section I. This is followed, in Section II, by a close examination of superannuation and retiring allowances in terms both of the present legislation and possible lines of reform. Section III is addressed to life insurance.

I. The Case for Special Treatment

21.4. The Committee has, in Chapter 3, expressed the view that neutrality should be the general aim when economic efficiency is at issue and that, as far as possible, considerations of tax liability ought not to be allowed to influence the manner in which a person conducts his affairs. But in so far as certain inherent features of the tax system tend to make for non-neutrality in the overall operation of that system, some deliberately contrived offsetting correction may be warranted.

21.5. One such feature, of particular relevance in the context of the present chapter, concerns the taxing of income. As already pointed out in Chapter 3, a tax on income falls on the component saved as well as on the component immediately consumed; and when income is subsequently earned on the component saved, that too bears tax. In the result, the effective rate of return on saving is less than it otherwise would be and the balance of advantage between consuming income immediately and saving
it to consume later is shifted towards the former. Bias of this kind against saving is an inherent feature of income tax: it could be wholly eliminated only by abandoning income tax altogether and substituting an expenditure tax along the lines suggested by Lord Kaldor. The Committee is not prepared to go this far; though if greater reliance is placed on indirect taxes and less on income tax, which is the Committee's proposed long-run objective, the general bias against saving will in time diminish. In the meanwhile, however, special provisions in the income tax law must be relied upon to correct the bias.

21.6. Traditionally the law, in its special provisions, has gone beyond merely correcting the bias against saving. These provisions clearly reflect a policy of promoting long-term saving in the private sector. The policy reflects notions of thrift intended, among other things, to relieve the State of some of the heavy financial burden of providing for old age. It also reflects the need to foster a healthy capital market. The Committee does not see its role as enabling it to question the policy of promoting long-term saving, even were it minded to do so. It is concerned, nevertheless, to make an assessment of the existing law, or any alternative law, directed to promoting saving and to judge its effectiveness to this end as well as its fairness.

21.7. Clearly superannuation and life insurance are structured so that they can offer the assurance that saving undertaken through them is long term. In this respect they are the avenues of private saving most deserving of tax assistance.

21.8. While the Committee can thus see some justification for an approach that will result in the deferral of tax and some relief from tax on such long-term saving, it can find little justification in theory for a system that permits exemption from tax altogether. If contributions to superannuation funds are to be an allowable deduction at the time they are made, and the income of such funds is to be exempt from tax, then the virtual exemption from tax of the whole benefit payable at retirement is debatable. If some relief from tax is to be given in relation to life insurance premiums, and it is not practicable to tax the policy proceeds, the levying of some tax on the investment income earned by the premiums is seen to be appropriate.

21.9. Finally, and most importantly, it must be borne in mind that the matters with which the Committee is here dealing involve long-term commitments entered into by taxpayers on the basis of the existing taxation structure. It would be unfair to such persons if a significantly different taxation structure were to be introduced without adequate and reasonable transitional arrangements. Having regard to the importance of life
insurance and superannuation funds in the Australian capital markets, it
would be an unwise step to make recommendations likely to force such
institutions abruptly to slacken the pace of new investment or even to
liquidate a large portion of their existing holdings. The deleterious effect of
such action on the Australian economy would outweigh any gains in equity
in the treatment of taxpayers that recommendations of this kind might
bring.

II. Superannuation, Retiring Allowances and Related Matters

Background and Present Legislation

21.10. Figures released by the Australian Bureau of Statistics indicate
that, as at February 1974, of the civilian work force approximately 1.65
million, or 28.7 per cent, were covered by a superannuation or pension-
type scheme. The total number of such schemes in operation is not known
but is very large, as are the variety and scope of the benefits provided.

21.11. It is important to recognise that most schemes have been
established voluntarily by employers to provide for the needs of their
employees who retire or the needs of the dependants of those who die
while in employment. Any reform of the law directed to the curtailment of
abuses in this area should not be such as to discourage employers from
continuing to provide for these needs.

21.12. The Committee is also mindful of the effect of inflation on
superannuation schemes, particularly of the benefit promise type. If wages
and salaries continue to rise at current rates, considerable strain will be felt
by many funds in meeting objectives and that strain will be reflected in the
contributions required to be made by, or on behalf of, employees.

Taxation of Lump-sum Payments on Retirement

21.13. Section 26 (d) of the Income Tax Assessment Act includes in the
assessable income of a taxpayer:

‘(d) five per centum of the capital amount of any allowance, gratuity or
compensation where that amount is paid in a lump sum in consequence of
the retirement from, or the termination of, any office or employment, and
whether so paid voluntarily, by agreement or by compulsion of law . . . ’.

21.14. Section 26 (e) of the Act includes in the assessable income of a
taxpayer:

‘(e) the value to the taxpayer of all allowances, gratuities, compensations,
benefits, bonuses and premiums allowed, given or granted to him in respect
of, or for or in relation directly or indirectly to, any employment of or
services rendered by him, whether so allowed, given or granted in money, goods, land, meals, sustenance, the use of premises or quarters or otherwise:

Provided that this paragraph shall not apply to any allowance, gratuity or compensation which is included in the last preceding paragraph . . . ’.

21.15. The effect of section 26 (d), when taken in conjunction with the proviso to section 26 (e), is twofold. Firstly, it includes in assessable income 5 per cent of lump sums that would otherwise be regarded as wholly capital receipts. Examples of such receipts are payments from the trustees of a superannuation fund and compensation for loss of office. Secondly, it includes in assessable income only 5 per cent of lump sums that would otherwise be regarded as assessable in full under either general law principles or under the specific provisions of the first part of section 26 (e). Examples of this latter type of receipt are retiring allowances paid directly by an employer to a retiring employee (including such items as accrued long-service leave and holiday pay) and payments made under a service contract that provides for payment of a lump sum at the satisfactory conclusion of the contract.

21.16. The principle inherent in section 26 (d) of assessing only 5 per cent of a lump sum received on retirement has been followed ever since income tax was first levied by the Australian Government in 1915. The choice of the figure of 5 per cent was plainly arbitrary and reflected in part the inequity of taxing such a sum wholly in the year of receipt when it may have arisen from employment stretching over many years.

21.17. There are no limitations on the amount of any receipt to which section 26 (d) is applicable, nor is there any restriction on the number of occasions on which it may be applied. Thus it is open to a taxpayer who is employed by one of a number of related companies to resign and move to another company within the group and collect a substantial retiring allowance from the first employer which will be assessable only as to 5 per cent. Instances of this happening have been brought to the attention of the Committee where the amounts involved, and the consequent cost to the Revenue, have been extremely large.

21.18. Some control over the application of section 26 (d) in the case of a private company is provided by section 109 of the Act:

‘109. So much of a sum paid or credited by a private company to a person who is or has been a shareholder or director of the company or a relative of a shareholder or director, being, or purporting to be—

(a) . . .
(b) an allowance, gratuity or compensation in consequence of the retirement of that person from an office or employment held by him in that company, or upon the termination of any such office or employment,

as exceeds an amount which, in the opinion of the Commissioner, is reasonable, shall not be an allowable deduction and shall . . . be deemed to be a dividend paid by the company on the last day of the year of income of the company in which the sum is paid or credited.’

21.19. However, the Commissioner cannot make use of this section if the person receiving the retiring allowance is not within the class of persons prescribed in the section or if the company concerned is a public company.

21.20. Section 26 (d) was examined in the early 1950s by the Spooner Committee which recommended that the operation of the section be limited by restricting the concessional basis of taxation to so much of the retiring allowance as might be regarded as reasonable, having regard to remuneration and length of service. In effect the formula for assessment of retiring allowances and payments from superannuation funds proposed by that Committee was that the amount taxable on the concessional basis be limited to the equivalent of one year's salary for every eight years of service and should not, in any case, be allowed to exceed $30,000. The Spooner Committee further recommended that any payments received by an employee as consideration for entering into a restrictive covenant should be assessable in full, but, somewhat anomalously, recommended that any amounts received by an employee as compensation or damages for the termination of his employment should continue to be assessable only as to 5 per cent and without any limit on the amount received.

21.21. The Government decided to adopt the Spooner Committee's recommendations in principle and proceeded to implement a less generous version of the proposal. The Government's intention was that the amount subject to the 5 per cent basis of taxation be limited to one year's salary for every twenty years of service, with an upper limit of $20,000.

21.22. A Bill that would have given effect to this intention was introduced into the House of Representatives in 1952, but aroused much opposition. The principal ground of objection was that reputable private superannuation schemes had been operating for many years on the assumption that senior executives would be paid lump-sum amounts on retirement which would be substantially in excess of the amounts provided in the formula. If the excess were to be taxed in full, the application of the progressive graduated rate of tax to very large amounts received in a single year of income could result in most of the lump sum being lost in tax. It was contended that this would defeat the legitimate expectations of taxpayers who had been contributing to superannuation funds over a long
period on the assumption that they would receive a lump sum on retirement, 95 per cent of which would be tax free.

21.23. As a result of these objections, the clause relating to retirement allowances was deleted from the Bill.

21.24. The Ligertwood Committee, though aware of the previous Committee's recommendations on the matter, did not mention section 26 (d) in its 1961 report—probably because of what had transpired previously.

**Deductibility of Retiring Allowances Paid by Employers**

21.25. Amounts paid directly by an employer to a terminating employee, or to the dependants of a deceased employee, are at present an allowable deduction to the employer under either section 51 (1) of the Act, which provides that:

‘51 (1) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income’,

or under section 78 (1) (c), which provides that:

‘78 (1) The following shall . . . be allowable deductions:

(a) . . .
(b) . . .
(c) Sums which are not otherwise allowable deductions and are paid by the taxpayer during the year of income as pensions, gratuities or retiring allowances to persons who are or have been employees or dependants of employees, to the extent to which, in the opinion of the Commissioner, those sums are paid in good faith in consideration of the past services of the employees in any business operations which were carried on by the taxpayer for the purpose of gaining or producing assessable income.’

21.26. Certain lump sums paid to terminating employees have always been considered to be allowable deductions under section 51 (1). These include accrued holiday and long-service leave pay and certain payments made under service contracts. To the extent that other payments were regarded as being deductible it had been the practice of the Commissioner—in line with what was thought to be the intention of the legislature evinced from the words in section 78 (1) (c)—to apply similar standards of reasonableness in determining the amount of the deduction as
those now applied in determining the maximum benefit that may be provided by a tax-exempt superannuation fund under section 23F (2) (h) of the Act.

21.27. However, it has lately become clear that the Commissioner is unable to resist claims that section 51 (1) authorises the full deduction of retiring allowances paid by public companies where it can be established that the payments are made for one or more of the following reasons:

(a) as a matter of commercial expediency in order to establish harmonious relationships between the management and staff;
(b) as a means of ensuring greater efficiency; or
(c) as a means of inducing executives to press themselves to the limit by giving them the prospect of being treated generously on their retirement.

Once the company has established that the payment was made for one or more of these reasons—and in practice it is not difficult to establish this—then the quantum of the lump-sum payment is for the company itself to determine and it must be allowed a deduction for the full amount. Instances of amounts of up to $250,000 being paid by public companies to retiring executives and deducted under section 51 (1) have been brought to the notice of the Committee. In some of these cases the executives have also received very large amounts from the companies’ superannuation funds and also under service contracts. The amounts received by the executives are reported to have been assessable only as to 5 per cent in their hands.

21.28. It is to be noted that the foregoing applies not only to employees of public companies, but also to arm's length employees of private companies. However, section 109 of the Act imposes an effective limit on the deduction that can be claimed for a retiring allowance paid to a person who is or has been a shareholder or director of a private company or a relative of a shareholder or director. In addition, section 65 gives the Commissioner power to disallow a deduction for a retiring allowance paid by a non-corporate employer to a relative to the extent that the retiring allowance is excessive.

21.29. Even if the deduction is claimed under section 78 (1) (c), the Commissioner may be unable to challenge the amount of the payment. If the payment is made by a public company and approval for the payment has been granted by the shareholders in general meeting, then the Commissioner would be hard-pressed to superimpose his opinion as to the reason for, or the amount of, the payment.

Deductibility of Contributions to Superannuation Funds
21.30. Contributions by an individual to a superannuation fund for the benefit of himself or his spouse or child are a concessional deduction under section 82H of the Act. Such contributions when aggregated with life insurance premiums and payments to friendly societies are subject to a maximum deduction of $1,200.

21.31. Concessional treatment of personal contributions to superannuation funds can be traced back to the first time income tax was levied by the Australian Government in 1915. From that year until 1935 superannuation contributions were a concessional deduction subject initially to a maximum of $100, but from 1922 a maximum of $200 applied. From 1936 to 1941 superannuation contributions and life insurance premiums were amalgamated with an overall maximum deduction of $200. From 1942 to 1951 concessional rebates of tax were substituted for concessional deductions against income and the maximum amount on which a rebate was allowed remained at $200, raised in 1950 to $300. Concessional deductions were reintroduced in 1951 and the maximum deduction increased to $400. This maximum was increased to $600 in 1957, $800 in 1960 and to the present level of $1,200 in 1968.

21.32. In 1973 section 82H was amended to restrict the availability of the deduction for personal superannuation contributions to cases where the contribution was made to a fund that had been approved by the Commissioner for the purpose of total or partial exemption from tax of the income of the fund. This was done in order to prevent abuses of section 82H whereby funds that were superannuation funds in name only were being set up by individual taxpayers who would make contributions to the fund, claim a deduction and then terminate the fund and withdraw their contributions.

21.33. Deductibility of contributions by employers to superannuation funds for the benefit of their employees is governed by the provisions of sections 82AAA-82AAR of the Act. These sections, some of which are exceedingly complex, were inserted in 1964 and 1965 largely as a result of the Report of the Ligertwood Committee. That Committee detailed abuses which had developed as a result of the then section 66 (governing deductibility of contributions by employers) and section 79 (governing deductibility of contributions by persons other than employers).

21.34. In summary, the provisions of sections 82AAA-82AAR provide for the deductibility of amounts set aside or paid as or to a fund by an employer for the purpose of making provision for superannuation benefits for an eligible employee or his dependants (section 82AAC). It is to be noted that the deduction is available regardless of whether or not the fund concerned is one that complies with the requirements necessary for partial
or total exemption from tax of the fund's income.

21.35. By section 82AAE the amount of the deduction available in
respect of each employee is limited in any year to the greater of $400 or 5
per cent of the employee's remuneration in that year. However, this
limitation is of little practical significance since the Commissioner is given
power to allow the deduction of a greater amount if he considers that there
are special circumstances justifying such greater deduction. The
Commissioner exercises this power in such a way that, since 1970, the
amount which will be allowed as a deduction is the amount (or rate of
contribution) which, when aggregated with the contributions, if any, being
made by the employee, will produce an end-benefit that is ‘reasonable’ for
the purposes of section 23F (2) (h) (see later). These amounts will often be
extremely large, particularly where the maximum permissible benefit is
being funded over a relatively short period for an executive close to
retirement. Deductions in excess of the employee's annual salary are not
unusual in these circumstances.

21.36. Self-employed persons are disadvantaged by comparison with
employees since they are restricted to claiming a deduction for personal
superannuation contributions under section 82H which imposes a limit of
$1,200 on deductions for superannuation contributions and life insurance
premiums. Employees may receive the benefit both of the section 82H
deduction and of contributions made on their behalf to a superannuation
fund by their employer. The Ligertwood Committee recommended that
self-employed persons be allowed an additional deduction, over and above
the section 82H deduction, of $400 per annum for contributions to
superannuation funds set up to cater specifically for the self-employed.
However, this recommendation has never been implemented.

**Taxation of Income of Superannuation Funds**

21.37. There are a number of provisions in the Act governing the total or
partial exemption from tax of the income of superannuation funds.

21.38. Section 23 (jaa) exempts from tax the income of a superannuation
fund established by:

‘(i) an Act, a State Act or an Ordinance of a Territory of the
Commonwealth; or

(ii) a municipal corporation, other local governing body or public
authority constituted by or under an Act, a State Act, or an Ordinance of a
Territory of the Commonwealth’.

No conditions are prescribed for the exemption of the income of such a
fund.
21.39. Section 23 (ja), which was inserted in the Act in 1952, exempts from tax the income of a superannuation fund established for the benefit of self-employed persons where:

(a) the number of members of the fund is not less than twenty; and
(b) ‘the terms and conditions applicable to the fund . . . have been approved by the Commissioner, having regard to the classes of persons who are eligible for membership, the reasonableness of the benefits provided for, the amount of the fund in relation to those benefits and such other matters as the Commissioner thinks fit’.

The Commissioner has set out guidelines for the approval of funds under section 23 (ja) and these include a restriction on the maximum permissible benefit to $100,000 and a limitation on the maximum contribution which a member may make in any one year, ranging from $1,200 where the member is under forty years of age up to $2,800 where the member is over fifty-five. In addition, such a fund must comply with the provisions of section 121C in regard to the maintenance of a minimum proportion of its assets in public sector securities in order to qualify for exemption. At least 30 per cent of the increase in the assets of the fund since 1 March 1961 (at cost price) must be invested in public sector securities, with at least 20 per cent being invested in Australian Government securities—the so-called ‘30/20 ratio’.

21.40. Section 23 (jb) exempts the interest and dividend income derived in Australia by a foreign superannuation fund. No conditions are prescribed for this exemption.

21.41. Section 23F governs the exemption of the income of ‘conventional’ private sector superannuation funds set up by employers for the benefit of their employees. This section was inserted in the Act in 1964 and amended in 1965 and was largely the result of recommendations contained in the Report of the Ligertwood Committee. That Committee had found that the earlier provision—section 23 (j) (the predecessor of which dates back to 1915)—which simply exempted the income of such funds, was being seriously abused. In particular such funds were being used as recipients for private company dividends that would otherwise have borne tax in the hands of shareholders (who were of course members of the superannuation fund as well). The present section 23F closely parallels sections 82AAA-82AAR in many respects, including the complexity of its provisions.

21.42. The main requirements for approval of a superannuation fund under section 23F and the exemption from tax of its income under section 121C are:
(a) The fund must be established and maintained solely for the provision of superannuation benefits for employees in the event of their retirement or in other circumstances of a kind approved by the Commissioner, or the provision of benefits for the dependants of employees in the event of death.
(b) The employer(s) must contribute to the fund and, broadly speaking, only employees and employers may contribute.
(c) Benefits forgone by an employee who leaves the service of the employer before retirement must be either applied towards providing benefits for the members (or their dependants) or dealt with in some other manner approved by the Commissioner.
(d) The benefits to be provided by the fund for an employee or his dependants must not be excessive having regard to his remuneration and length of service, to benefits which he or his dependants have received or may receive from another fund to which section 23F applies, and to such other matters as the Commissioner considers relevant. This is commonly referred to as the ‘reasonable benefits’ test. The criteria that have been adopted for determining reasonable benefits are discussed below.
(e) The amount of the fund must not be substantially in excess of the amount required to provide the benefits, having regard to the future contributions that will be made to the fund and its earning rate.
(f) Rights of members to benefits must be fully secured and members must be notified of the existence of a right to receive benefits.
(g) That part of the income of the fund comprising private company dividends will not be exempt, and will be currently liable to tax at a rate of 50 per cent, unless the Commissioner is satisfied that it would be reasonable to exempt such dividend. Broadly speaking, the dividend must have the character of an arm's length transaction to qualify for exemption.
(h) The fund must also satisfy the 30/20 ratio, outlined in paragraph 21.39, in relation to its investments.

21.43. The concept of ‘reasonable benefits’ is quite central to the operation of section 23F and, as pointed out in paragraph 21.35, the Commissioner now, as a matter of practice, applies the standards of reasonableness determined for the purposes of section 23F in stipulating the maximum deduction allowed for contributions to a fund by an employer under section 82AAE, and also, where this is possible, to retiring allowances paid by an employer and claimed as a deduction under section 78 (1) (c). The standards of reasonableness have been increased at various times since they were first introduced in 1965 and the present position, in very general terms, is that a benefit will be considered ‘reasonable’ in the following circumstances:
(a) In the case of a lump sum, if it does not exceed the lesser of $100,000 or seven times the average annual remuneration of the employee in the three years preceding retirement. In cases where seven times the average annual remuneration at retirement exceeds $100,000, the Commissioner is normally prepared to approve a higher figure—up to approximately $300,000 in the case of very highly-paid executives—but the multiple of average annual remuneration that will be approved will decline progressively from seven as the amount increases. Thus a benefit of $250,000 may be approved in a particular case but this may represent only three or four times the average annual remuneration of the executive over the three years preceding his retirement.

(b) In the case of a fund providing pension benefits on retirement, the pension must not exceed 70 per cent of the employee's average remuneration over the three years preceding his retirement. No dollar limit is set on the pension, providing the same method of calculating pension entitlement is applicable to substantially all the members of the fund.

(c) In the case of a fund providing benefits in part pension, part lump-sum form, a combination of methods (a) and (b) is used.

The above criteria apply, without any further limitations, to employees of private companies. In the case of non-arm's length employees of private companies (directors, shareholders and their relatives), the same tests apply with the two following exceptions:

(a) Where section 109 of the Act has been applied to reduce the amount of the employee's remuneration which may be claimed as a deduction, the remuneration so reduced will be used as the basis for calculating the maximum benefit permitted.

(b) Where the employee concerned will have had less than twenty years’ service with the company at retirement, the maximum benefit permitted will be the benefit calculated as above but reduced by the ratio that the service which will be completed at retirement bears to twenty years.

21.44. If a superannuation fund fails to qualify for exemption from tax under any of the foregoing provisions, it may nonetheless qualify for approval under section 79 which was inserted in the Act in 1965. Funds to which section 79 applies do not receive exemption from tax but instead are granted a deduction from assessable income of an amount equal to 5 per cent of the cost price of the assets of the fund. The balance of the income of the fund is liable to tax at a rate currently fixed at 50 per cent. However, by investing in assets such as shares that have a dividend yield of 5 per cent or less but high capital growth prospects, it is possible to avoid tax altogether and indeed this is the policy followed by most funds approved under this section. The main tests a fund must satisfy for approval under section 79 are:
(a) its membership must be restricted to persons following a gainful occupation either as employees or self-employed persons;
(b) it must impose restrictions on benefits and contributions which are broadly similar to those applicable to a fund approved under section 23 (ja); and
(c) no benefits may be paid out of the fund prior to a member's sixtieth birthday or his prior death or disablement.

It is to be noted that funds of this type do not have to comply with the 30/20 ratio nor must they have a minimum number of members, as is the case with a fund approved under section 23 (ja). Several large funds approved under section 79 have been set up by banks and similar institutions to cater for self-employed people or employees whose employers may not have a staff superannuation fund of their own.

21.45. A superannuation fund that fails to qualify for concessional treatment under any of the foregoing provisions will be taxed on its income under section 121DA. The rate of tax currently applicable in such cases is a flat 50 per cent.

21.46. Many superannuation funds are managed by life insurance companies and the assets of the funds comprise life policies of one type or another. Changes to the Act made in 1961 have the effect of exempting life insurance companies from tax on that part of their investment income attributable to policies issued for the purposes of tax-exempt superannuation funds. This exemption is subject to certain conditions, including compliance by the life insurance company with the 30/20 ratio in respect of all its assets. The exemption from tax on superannuation policies results in the life insurance company being able to issue these policies on more favourable terms than non-superannuation policies. One minor anomaly of these provisions is that where a policy is issued in respect of a fund approved under section 79 of the Act, the whole of the investment income attributable to that policy is exempt rather than simply the first 5 per cent of the cost price of the assets concerned. On the other hand, as the life insurance company has to comply with the 30/20 ratio in respect of such a policy, the two aspects probably balance out fairly evenly.

Taxation of Benefits Received from Superannuation Funds

21.47. A benefit received from a superannuation fund in a lump sum on the occasion of the taxpayer's termination of office or employment is assessable as to 5 per cent under section 26 (d). In the absence of this provision such a receipt would be regarded as a capital amount and would not be subject to tax at all. Benefits paid from a fund upon the death of a member do not come within the scope of section 26 (d) and are regarded as
receipts of capital. The question of whether or not the fund is an approved one for the purpose of total or partial exemption from tax of the fund's income is not relevant in determining whether or not section 26 (d) applies to the benefit received by the member.

21.48. Pension benefits received from a superannuation fund are wholly assessable in the hands of the recipient, either on general law principles or under the specific provisions of section 26AA. This latter section includes in assessable income of a taxpayer:

‘the amount of any annuity, excluding, in the case of an annuity which has been purchased, that part of the amount of the annuity which represents the undeducted purchase price.’

The exclusion does not operate in the case of a pension or annuity provided by a superannuation fund, since either the annuity is not a purchased annuity or, if it is, there is no ‘undeducted purchase price’, unless, and to the extent that, the member had made personal contributions to the fund in excess of the limits allowed as a deduction under section 82H.

21.49. Use can however be made of section 26AA to give a substantial relief from tax on a superannuation pension. If the retiring employee receives a lump-sum benefit and then elects to use this lump sum (after meeting his tax liability on 5 per cent of the amount under section 26 (d)) to purchase an annuity from a life insurance company, section 26AA will operate to exempt from tax that part of the annuity payments representing the undeducted purchase price of the annuity. The amount to be exempted in each year is found by dividing the purchase price of the annuity by the life expectancy of the employee at the time of purchase according to the prescribed tables of expectation of life. In spite of the theoretical tax-saving advantages of such a transaction, it is seldom encountered in practice.

21.50. Where a retiring employee wishes to receive a lump-sum superannuation benefit it is possible, subject to the rules of the fund concerned, for him to avoid even the minor imposition of tax on 5 per cent of the benefit. If he elects to receive a pension and then, after one or two pension payments have been made, exercises a right to exchange the pension for a lump sum, the latter amount is not received ‘in consequence of retirement’ but in consequence of giving up a right to future income and, according to long-standing legal authorities, is a receipt of capital. This technique is now not uncommon, retiring employees from some funds that pay pensions being advised to make use of it.

21.51. Where a lump-sum benefit is received from a superannuation fund other than in consequence of termination of an office or employment, it
will normally be a capital receipt and, being outside the scope of section 26 (d), will escape tax altogether. This will usually be the case with benefits received from funds approved under section 23 (ja) or section 79, since the time of receipt of the benefit will be different to the time at which the office or employment terminated and since many members of such funds are self-employed people to whom section 26 (d) will not be applicable. However, it has been held that this exemption from tax will extend to cases where lump-sum benefits are paid to persons whose employment has not been terminated. It has come to the Committee's attention that this position is being increasingly abused by people who set up funds that comply with section 23F and then amend the deed governing the fund to permit benefits to be paid out of the fund while members of the fund are still employed. The benefits so received are exempt from tax; and while the fund can be taxed at the rate of 50 per cent on income derived in that year, the amount involved is usually quite small and there is no power to reopen the assessments of previous years.

International Comparisons: A Brief Summary

21.52. All industrialised countries with which Australia can be compared have special tax regimes governing provision for retirement. In general and subject to a multitude of conditions, contributions to superannuation funds by employers, self-employed persons, and, in most countries, employees are allowed as a deduction in computing assessable income. The income of superannuation funds is, again subject to a variety of conditions, exempt from tax. Thus far the present Australian position is comparable with that obtaining in other countries. However, in the treatment of benefits other than in the form of pensions flowing from superannuation funds or paid directly by an employer on retirement, the Australian tax treatment is markedly more favourable. Australia virtually stands alone in the generosity of its treatment of lump-sum retiring allowances paid to employees.

21.53. Information currently available to the Committee shows that legislation and practice in New Zealand, Canada, the United Kingdom and the United States are as follows.

21.54. The New Zealand Government, though still regarding lump-sum benefits received from superannuation funds as wholly exempt, has been forced to legislate to limit the excessive lump-sum retiring allowances paid directly to employees by their employers. Broadly speaking, the effect of section 88B of the New Zealand Land and Income Tax Act is that an employee with ten years or more service is taxable on a lump sum received
in consequence of retirement as to 5 per cent to the extent it does not exceed one-third of his total remuneration for the last three years of service and in full to the extent it exceeds that amount.

21.55. In Canada there is no escape from tax on retiring allowance or superannuation benefit paid in a lump sum. However, the effect of the tax is alleviated by general income-averaging provisions and further relief can be obtained by the taxpayer, if he so desires, purchasing an income-averaging annuity contract.

21.56. In the United Kingdom, as in New Zealand, the Government was forced to act to tax large amounts paid on retirement or removal from office, especially on the occasion of take-over bids. Very broadly the provisions of the United Kingdom legislation tax the excess of the retiring allowance over £5,000 and relief is allowed for the long-service or superannuation component included in the payment. In respect of any amount chargeable to tax, relief is allowed by way of a reduction of tax which is based on the additional tax payable being spread over a period of six years. Further constraints are imposed in the United Kingdom by virtue of provisions governing the contributions to and income of superannuation funds which require that benefits must be paid predominantly in pension form if concessional treatment is to be obtained.

21.57. In the United States lump-sum payments from exempt superannuation funds are taxed as income but subject to generous forward-spreading provisions. These provisions have been significantly changed by the Pension Reform Act 1974 and form the basis for the proposals contained in paragraph 21.77 below. Other amounts received on retirement are taxable in full, subject however to the application of the general income-averaging provisions which are briefly described in Chapter 14 (paragraph 14.74).

Proposals

21.58. The number and variety of superannuation schemes in existence make it difficult to effect any fundamental change in the tax treatment of superannuation funds, particularly if such change is directed to a restructuring of the benefits provided by the schemes and the contributions that may be made to them. The long-term nature of these funds and the expectations arising from membership of them have been referred to at the beginning of the chapter. Proper transitional arrangements are necessary to reduce the aspect of retrospectivity to which amendments to the law may give rise.

21.59. The findings of the Committee are set out in the form of two
views. The first view proceeds on the basis that, while the obvious anomalies and shortcomings of the existing tax regime ought to be corrected, the basic structure of superannuation and other retirement provisions should be left untouched. The second view recommends some fundamental changes which for their implementation would have to be confined to new schemes following amendment to the law. The proposals in the second view take full account of the proposals in the first view and are expressed partly as differences from the latter.

21.60. After the paragraphs setting out the second view some observations on the advantages and disadvantages of the two views are made. It should not be thought that the use of the terms ‘the first view’ and ‘the second view’ indicates a preference: the approach in the form of two views has been adopted for ease of exposition.

The First View

21.61. This view proceeds to comment on section 26 (d), referring to the ultimate position and the transitional arrangements by which it is reached. The discussion then moves to the income of approved superannuation funds and the conditions to be observed if the income is not to be subject to tax. Contributions to such funds, provisions for self-employed persons and the ‘30/20 requirements’ are referred to before the proposals in the second view are set out.

21.62. Section 26 (d) is a section of the Act by which practically every taxpayer who has been or is in employment is likely to benefit at least once in the course of his working life. In many cases, both the benefit and the corresponding loss in potential revenue are substantial. The weaknesses of the section, the inequities which flow from it and some of the methods adopted to abuse its provisions have already been outlined.

21.63. The problems inherent in making any change in this area are not to be underestimated. The present tax treatment of lump-sum retiring allowances has been with us since 1915, making it one of the oldest, best-known and most entrenched aspects of our income tax structure. Many people, particularly those nearing retirement, have made their plans for the future on the assumption that the amounts they receive on retirement would continue to be taxed on the present basis. The legitimate expectations of such people deserve the utmost consideration. To change suddenly to a harsher basis of taxing such receipts would generate justifiable complaints that the legislation was retrospective in nature, since the amounts concerned would normally have accrued over a considerable period—possibly over the entire working life of the person concerned.
21.64. There is nonetheless a limit to the extent to which concern over such retrospectivity can be allowed to influence recommendations for a fundamental change in the tax structure. Pushed to its extreme such an argument leads to a legislative straitjacket where it is impossible to make changes to any revenue law for fear of disadvantaging those who have made their plans on the basis of the existing legislation. It would, for instance, prevent any change to estate duty legislation, since the change might conceivably disadvantage the estate of somebody who had accumulated his wealth and done his estate planning on the basis of the present legislation.

21.65. The Committee is acutely aware of the difficulties in reconciling the considerations advanced in the above two paragraphs but believes that some attempt must be made to do so. The inequities inherent in section 26 (d) are likely to become greater rather than less in the future and, if the problems involved in making a change now are formidable, they are unlikely to diminish as the years go by.

21.66. There is a very strong tradition in Australia of lump-sum rather than pension benefits upon retirement. The reasons for this, and in particular the relevance of the existing tax structure, can be debated endlessly and the Committee sees no merit in expressing an opinion on this point. It recognises that there are valid reasons for many people wishing to receive a lump sum at retirement; and indeed some payments received on termination of employment, such as accrued holiday and long-service leave pay, can in practice only be received in lump-sum form. The Committee does not think that the tax system should be used to discourage people from choosing a lump sum rather than a pension at retirement. If a person is entitled to a lump sum he should be quite free to receive it, but he should not gain an unwarranted tax advantage by so doing. The Committee notes the view of the National Superannuation Committee of Inquiry, in its Interim Report (1974), that steps be taken to achieve parity of treatment for benefits received as pensions and those received as lump sums.

21.67. What follows in relation to section 26 (d) is in two parts. The first deals with the ultimate situation to which the tax system should move in lieu of the present section 26 (d), and the second deals with the type of transitional arrangements that might be appropriate in order to avoid too sudden a change for those nearing retirement.

21.68. The ultimate position. It is proposed that section 26 (d) be repealed and replaced by provisions to the following effect.

21.69. With the exception of payments that can validly be regarded as received upon age retirement or earlier retirement because of ill health, all amounts received by a taxpayer upon or in consequence of the termination
of an office or employment should be included in full in taxable income and taxed in the ordinary way. This inclusion should extend to amounts received from a superannuation fund prior to the termination of employment. However, where a taxpayer receives a lump-sum retiring allowance or lump-sum benefit from a superannuation scheme, he should be exempted from tax if, within three months of the receipt of the amount, he applies it as a contribution to another approved superannuation fund.

21.70. Where retirement occurs on account of age or ill health the taxing of the lump-sum retirement benefit is also proposed. However, the additional tax that would be incurred under the progressive personal income tax scale were the total amount received to be included in taxable income in the year of receipt could be onerous. Accordingly, it is proposed that the spreading provisions outlined later in paragraph 21.77 should be available in respect of lump-sum retiring allowances, superannuation benefits, payments under service contracts and accrued long-service leave payments received upon the retirement of a taxpayer at the age of fifty-five or over, or upon his earlier cessation of work through ill health. To cater for certain employees such as members of the armed forces who retire before fifty-five, this concessional treatment could be extended down to the age of forty-five if the Commissioner is satisfied that it is reasonable for a taxpayer in that employment to retire before fifty-five. There seems to be no reason, however, for extending any concessional treatment to lump-sum receipts representing accrued holiday pay.

21.71. Lump-sum amounts received by self-employed persons after the age of fifty-five (or upon earlier cessation of work through ill health) should be accorded similar treatment to amounts received by employees. These amounts would include lump sums received for loss of office, amounts received from a superannuation fund and amounts received upon the termination of employment of a person who is both an employee and a self-employed person.

21.72. Any part of a lump-sum superannuation benefit received by an employee or self-employed person representing contributions made by that person which have not been an allowable deduction under section 82H should be exempt from tax.

21.73. It is to be noted that the ‘bunching’ effect of a large taxable lump sum can be mitigated by the taxpayer, if he so desires, making use of the income equalisation scheme recommended by the Committee in Chapter 14. It would however be necessary to restrict the availability of the income equalisation scheme for these amounts to circumstances where ‘forward spreading’ of the amount has not been availed of.

21.74. Payments received as consideration for entering into a restrictive
covenant (such as a covenant not to join a competitor of the employer) present considerable difficulties. On the one hand, where the transaction is at arm's length and bona fide it could be argued that it is an affair of capital, with the employee agreeing in return for a lump-sum payment to give up a substantial future area of activity. On the other hand, there is the possibility of such restrictive covenants being used merely to cloak what is in substance a retiring allowance. On the whole it is thought best simply to give the Commissioner power to examine payments made under such agreements and include them in assessable income if he is not satisfied that the amount received by the employee corresponds to the area of future activity forgone.

21.75. The acceptance of the views above would mean that all lump-sum retiring allowances would be taxable in full, subject to whatever ‘spreading’ arrangements are thought appropriate. If the person receiving the amount wishes to use it to provide a pension for himself at retirement, then as long as the pension is going to be assessable there should be no liability for tax on the lump sum. Where a person receives such a sum, he should be permitted to exclude it from his assessable income provided that he applies it immediately to the purchase of an annuity to commence not earlier than his sixtieth birthday (or earlier cessation of work owing to ill health). The subsequent commutation to a lump sum of any such annuity would be taxed as if it were the receipt of a lump-sum retiring allowance.

21.76. In paragraph 21.70 it was emphasised that it would be inequitable to tax as income in the year of receipt the whole of any lump-sum retirement benefit. Various methods are available to ‘spread’ the amount received over a number of years. Two methods in particular are worth close attention:

(a) The amount received is divided by 10 and the result added to the taxable income of the taxpayer in each of the ten succeeding years. This is an attempt to approximate the tax treatment of a pension, the ten-year period being close to the average life expectancy of a person at retirement. Since it is undesirable to defer the tax until up to ten years after the amount has been received, it would be necessary to levy provisional tax at the time of receipt and then give progressive credits for this provisional tax against the tax liability of the taxpayer over the next ten years. Because the final tax liability attributable to the lump sum is not known until more than ten years after its receipt, difficulties will arise in the event of the death or emigration of the taxpayer before the expiration of that period.

(b) Alternatively, there is the method now adopted in the United States under the Pension Reform Act 1974. This involves looking only at the lump-sum receipt and ignoring all other income of the taxpayer. After an initial exemption of $US10,000,
the lump sum is divided by 10 and the tax on an income of this amount is calculated and the result is multiplied by 10 to give the total tax payable. Since the calculation pays no regard to the other income of the taxpayer, it is necessary to have provisions for aggregating lump sums received from different sources and at different times. Under the United States legislation there is a six-year ‘look-back’ period whereby the tax on a lump sum is calculated having regard to all such lump sums received in the preceding six years. This method has the considerable merit of simplicity in that the tax liability attributable to the lump sum is determined once and for all at the time of its receipt. However, since it ignores the other income of the taxpayer it might be thought to offend notions of equity and progressivity in the income tax system.

21.77. On balance the Committee favours the new United States treatment and proposes that it be adopted with certain modifications. There would seem to be no justification for any initial exemption and the look-back period should be extended to ten years. In view of the differences between personal income tax scales in the United States and Australia (see Table 14.A in Chapter 14), the forward-spreading period should be fifteen rather than ten years. However, the Committee has proposed changes in the rate scale, and if these are adopted the forward-spreading period will need to be reconsidered.

21.78. Reference has already been made to the need to enable a person who receives a lump-sum retiring allowance to defer the tax on the amount received by purchasing a deferred or immediate annuity. It is also anticipated that the proposals made earlier in paragraphs 21.68–21.77 will lead to a reduction in the present bias in favour of lump-sum superannuation benefits. Many superannuation funds however are geared only to providing lump-sum benefits, and in particular those that operate on the money accumulation principle would find it almost impossible to underwrite pensions themselves. Thus many employees who might prefer to receive a pension could be forced into accepting a lump sum on which they would be taxed. This problem could largely be solved by permitting life insurance companies to sell annuities to the trustees of approved superannuation funds at the time of the employee’s retirement, the investment supporting the annuity to be subject to the same tax treatment as the investment supporting a pension paid directly from the fund itself. At the moment, apart from the inbuilt bias towards lump sums, there are two factors militating against a life insurance company offering annuities on realistic terms under these circumstances.

(a) There is considerable uncertainty as to whether such contracts are ‘superannuation policies’ for the purpose of the exemption from tax of that part of
the life insurance company's investment income derived from assets held in respect of those contracts. This uncertainty should be removed by making it quite clear that annuity contracts of this type are 'superannuation policies' for the purposes of the Act.

(b) More importantly, the Life Insurance Act 1945–1973 specifies that the reserves held by a company in respect of annuity business must be calculated on a certain minimum basis. Under present conditions, this basis is unnecessarily conservative. This leaves a life insurance company with two choices as far as the underwriting of annuity business is concerned. It can write the business on a realistic basis, in which event the rest of the policy-owners have to provide a large initial subsidy to the business, thus putting a brake on the volume of annuity business the company can undertake without severely disadvantaging the other policy-owners; or it can write the business on the basis used in the Life Insurance Act for calculating the reserves, thus disadvantaging the annuitant. It is essential that the relevant provisions in the Life Insurance Act be amended to enable annuity business to be freely undertaken on a realistic basis. The National Superannuation Committee of Inquiry has made a similar recommendation.

Consistent with the tax treatment of lump-sum benefits, it appears advisable to provide that if an annuity acquired by the trustees of a superannuation fund, or an ordinary superannuation pension, is commuted into a capital sum, that capital sum will be taxed as if it were the receipt of a lump-sum benefit from a superannuation fund.

21.79. If the foregoing proposals for replacing section 26 (d) are adopted, most of the avenues for avoidance and inherent weaknesses of the present tax system in the area of superannuation and retiring allowances will be removed. Nonetheless, in order to ensure parity of treatment between unfunded retiring allowances and benefits paid from superannuation funds, it is proposed that section 78 (1) (c) be amended and strengthened to make it clear that retiring allowances paid by an employer are deductible only under this section and only up to the amount that would be allowed as a reasonable benefit from an approved superannuation fund. For this purpose, amounts receivable in consequence of retirement or cessation of employment from a superannuation fund should be taken into account in determining whether the amount paid was in fact reasonable.

21.80. Transitional provisions: lump-sum retirement benefits. The opinion has been expressed that the main difficulty in making changes to the present basis of taxing lump-sum retirement benefits derives from the fact that the taxpayers have built up expectations and often made plans on the basis of the existing provision. The problem of dealing with such legitimate expectations was the reason why the recommendations of the Spooner Committee on this matter in 1951 were ultimately not followed. This difficulty, while not to be underrated, is nonetheless not insuperable
and to this end transitional provisions should be adopted which ease, as far as possible, the change from the old basis of taxation to the one recommended above. These transitional provisions should be such as to err, if at all, on the side of generosity and ease of understanding. The Committee has given a great deal of attention to the practical effects of the various possible types of transitional provisions.

21.81. Nonetheless it is necessary to distinguish legitimate expectations from mere hopes. A person who is one day from retirement obviously has a legitimate expectation that his retiring allowance or superannuation benefit which may have accrued over forty years or more will be accorded the present treatment. On the other hand, it is unrealistic and unnecessary to give much weight to the expectations of the twenty-year-old as to the tax treatment of his ultimate retirement benefits.

21.82. In theory the approach might be that only amounts which can be regarded as accruing after the date of the legislation should be subject to the new treatment. This would prevent radically different treatment of the man who retires one day after that date and the man who retires one day before. It would also largely remove any complaints about retroactivity in the new legislation. There are certain types of payment, however, which are currently subject to tax only as to 5 per cent under section 26 (d) for which transitional provisions of this type are either undesirable or unworkable. Accrued holiday pay, for instance, would present administrative difficulties on apportionment and in any case should not be regarded as a retiring allowance.

21.83. The method by which such payments should be apportioned into pre and post legislation amounts is open to some debate. With superannuation entitlements, for instance, it might be argued that the amounts accrued in respect of each member of a superannuation fund at the crucial date should be calculated at that date and those amounts should be the amounts subject to exemption. Similarly with longservice leave entitlements, the entitlement of each person could be calculated at that date having regard to his current salary and the amounts so calculated would eventually be exempt. On balance this approach is not favoured, largely because of the administrative complexity involved and the extremely high compliance costs for employers, employees and superannuation funds.

21.84. If an apportionment method is to be used, then the benefit should be regarded as accruing uniformly over the period of employment (or self-employment in the case of a self-employed person) and should be apportioned accordingly into the amount accrued before the commencement of the legislation and the amount accrued after such date. It is to be noted that this assumption of uniform accrual will usually be
generous to the taxpayer, since in practice most such amounts accrue at an increasing rate. The apportionment should only apply to amounts attributable to the employment (or self-employment) of the taxpayer current at the date of the legislation and, for administrative reasons, it may be necessary to regard the employment (or self-employment) as having commenced no earlier than the age of twenty.

21.85. The apportionment method of the latter type would be difficult to administer and give rise to disputes. The greatest difficulties would be in the need to establish the date of commencement of employment (or self-employment), particularly where there has been a break in employment.

21.86. If the apportionment method is adopted so as to tax only a portion of a lump-sum receipt, there is no reason for retaining the present inclusion in taxable income of 5 per cent of the balance. The 5 per cent is a derisory figure and serves only to confuse and complicate the picture. Accordingly, it is proposed that any amount to be given concessional treatment under these provisions should be totally exempt.

21.87. An alternative approach, and one that is considerably simpler than the apportionment method, would be to phase out section 26 (d) by providing that the figure of 5 per cent be progressively increased to 100 per cent over a lengthy period. This method has the advantage of certainty in that the percentage inclusion at any time would be the same for all taxpayers and would apply regardless of whether the payment involved arose from an employment (or self-employment) entered into before or after the date of the legislation. It would, of course, be necessary to provide that certain superannuation payments received by self-employed persons (and some employees) which are currently wholly exempt should be brought within the escalating inclusion provisions.

21.88. The choice of the period over which section 26 (d) should be phased out involves conflicting considerations. On the one hand, if the period is too short then those employees who are now middle-aged would have just cause for complaint; moreover, there may be a tendency for employees to change jobs immediately so as to receive an almost totally exempt lump sum instead of waiting until the normal retiring age and receiving an admittedly larger benefit which will be subject to a higher rate of tax. On the other hand, it is undesirable that the transitional period should be excessively lengthy. A long transition with its slowly escalating rate of inclusion is very generous to those persons, often relatively young, who change jobs and receive superannuation benefits and lump sums in lieu of accrued long-service leave.

21.89. On balance the second approach is favoured largely because of its certainty and simplicity. The period during which section 26 (d) is phased
out should not be less than twenty-five years or more than forty. Furthermore, to avoid sudden jumps in the rate of inclusion, the adjustments should be made at quarterly rather than annual intervals.

21.90. The transitional provisions (of whatever type) should be available in respect of lump-sum retiring allowances, benefits from superannuation funds, amounts paid under service contracts or accrued long-service leave payments. They should not however be available in respect of amounts representing accrued holiday pay. These latter amounts should be regarded as income and taxed accordingly.

21.91. The amount that is not exempted under the transitional provisions would be eligible for forward spreading as outlined in paragraph 21.77 if received after the age of fifty-five or upon earlier retirement because of ill health.

21.92. There is some difficulty in devising an equitable method of taxing benefits paid upon the death of an employee, and amounts received from a superannuation fund upon the death of a self-employed member of that fund. At present such amounts, if paid as a lump sum, are totally exempt from tax. Strict logic would seem to suggest that if such lump sums received during life are to be taxable they should also be taxable if received at death. To exempt them at death is to give markedly different treatment to the man who dies one day after receiving his retirement benefit (and paying tax thereon) as compared to the man who dies one day before retirement and whose retirement benefit is thus received, tax-free, by his widow or estate.

21.93. The Committee will be recommending in Chapter 24 that such amounts be included in the deceased person's dutiable estate, though it would not be possible to include in the dutiable estates pure ex gratia payments made by the employer to the widow or dependants of a deceased employee. The Committee believes that to subject such benefits to income tax as well as to estate duty would be undesirable and unwarranted. Accordingly, no change in the present system is recommended.

21.94. The income of superannuation funds. As stated in Section I of this chapter, the Committee believes that the present exemption from tax enjoyed by most superannuation funds can be justified. It encourages the provision of the future needs of employees both by themselves and by employers recognising a moral obligation. It also serves to correct the bias against saving inherent in a system of tax on income and helps promote capital formation.

21.95. Furthermore, if the benefits that eventually emerge from a superannuation fund are to be taxed, the contributions to the fund, whether made by employer, employee or self-employed person, should be an
allowable deduction at the time they are made.

21.96. The general propositions advanced in the two preceding paragraphs must, however, be qualified in the following manner:

(a) The amount of fund income exempt from tax must be subject to some limitation, preferably by the imposition of limits on the benefits that can be provided by such funds and thus, indirectly, on the assets and income of the funds.

(b) Exemption of the income of, or deductibility of the contributions to, such funds is not justified unless there is some assurance that the funds will only provide benefits in the event of age retirement or earlier death or ill health. In other words, there must be some assurance that the savings undertaken through such media are indeed long-term savings.

21.97. Ignoring foreign superannuation funds, there are at present four different provisions of the Act under which a superannuation fund may gain total or partial exemption from tax on its income. These four different types of fund should be replaced by an omnibus category of ‘approved superannuation fund’. The fact that government superannuation funds are subject to no controls and do not have to satisfy the same criteria for exemption as do private sector funds is open to question. Similarly, if some funds have to comply with the 30/20 requirements there seems no good reason why others should not be under a similar obligation.

21.98. To gain approval, such a fund should satisfy the criteria set out in the following paragraphs, in addition to those outlined earlier in paragraphs 21.37–21.42.

21.99. The benefits to be provided by the fund must not be excessive and the amount of the fund should not be excessive having regard to the benefits to be provided. The existing ‘reasonable benefits’ limits have been outlined at paragraph 21.43 and these are regarded as satisfactory in principle since they take into account the earnings of the person concerned (except in the case of funds for self-employed persons) and impose overall limitations on the dollar amount of the benefits. However, a stricter approach should be taken to the period of service necessary to qualify for maximum benefits: in this respect it is noteworthy that the new superannuation scheme for Australian Government employees proceeds on the basis of a thirty-year period. It is proposed that the scale of reasonable benefits which may be provided by an approved fund should only apply in the case of an employee with at least thirty years service at retirement and should be reduced for those with lesser service. Furthermore, greater attention should be paid to the current value of assets of superannuation funds, since the benefits actually paid will in many cases be based on
current values at that time.

21.100. There should be power to reopen past assessments of a fund if, at any time, its rules are changed to permit the payment of benefits before the death or retirement of its members.

21.101. The fund should be debarred from investing (except to a minor extent) in shares of or loans to an employer of the members of the fund. Such ‘investment’ is undesirable from the standpoint of the security of the members’ benefits, since if the employer's business fails they lose not only their jobs but also such part of their superannuation entitlement as is represented by the investment. If this proposal were to be adopted, a transitional period would clearly be necessary.

21.102. Contributions to approved superannuation funds. The present tax treatment of contributions to superannuation funds is illogical and defective. Personal contributions are aggregated with life insurance premiums and are subject to a maximum deduction of $1,200 under section 82H, whereas contributions by an employer are, broadly speaking, deductible up to whatever amount will, when aggregated with the employee's contributions, produce a ‘reasonable’ benefit. This often results in different tax treatment of members of contributory superannuation funds vis-a-vis members of non-contributory funds. For instance, if the maximum overall contribution in respect of a certain employee that will not produce an excessive benefit is $3,000 per annum, then the tax consequences will be different if the contribution is divided equally between employer and employee than if the contributions are paid wholly by the employer. The differences will be accentuated where the employee is already using part of his $1,200 deduction under section 82H to pay life insurance premiums. It is hard to see the justification for this.

21.103. Subject to the conditions set out in the next paragraph, contributions to an approved superannuation fund should be an allowable deduction for both the member of the fund and his employer without any specific limit. There will of course be an indirect limit imposed by virtue of the fact that approved superannuation funds will be restricted to providing ‘reasonable’ benefits and, if contributions were to be made that would lead to benefits becoming excessive, they would have the effect of terminating the status of the fund and hence of the deductibility of such contributions. In particular, personal contributions by the member of the fund should be taken outside the ambit of section 82H, thus divorcing them from life insurance premiums.

21.104. Such contributions, to qualify for a deduction, must have some element of regularity about them, for otherwise employers and employees may tend to make large irregular contributions. This would be alien to the
concept of long-term contractual saving which is one of the justifications for giving special treatment to superannuation, and would also lead to superannuation contributions being used as an income-averaging device. This assurance of regularity is best achieved by giving the Commissioner a discretionary power to disallow a deduction for large irregular contributions.

21.105. *Provision for self-employed persons.* The Committee has considered many submissions relating to the tax treatment of superannuation provisions for the self-employed. In the Committee's view it is necessary to take some steps in order to achieve a greater parity of treatment between employees and self-employed in this area. The proposals made above in regard to the taxation of benefits will apply equally to both categories of taxpayer. However, it is in the area of deductibility of contributions and maximum benefits that some change from the present system is needed. Owing to the fluctuations in the earnings patterns of self-employed persons, it is difficult to lay down the same standards of reasonableness for benefits as would be applicable to employees. Accordingly, it is proposed that the benefits to be provided from a superannuation fund for self-employed persons should, as now, be subject to overall dollar limitation. It is suggested that this amount be in the vicinity of $200,000. Moreover, contributions made by a self-employed person should be an allowable deduction up to a limit of 15 per cent of the taxpayer's personal exertion income from self-employment, averaged over the three years preceding the year in which the contribution is made. Provision should also be made for limited carry-forward of unused contributions. The figure of 15 per cent is chosen as representing the total of employer and employee contributions that could be expected in a reasonably generous superannuation fund.

21.106. *Transitional provisions for superannuation funds.* The proposals made above in relation to superannuation funds represent a significant departure from the present position and, as such, would give rise to a considerable amount of work for both the revenue authorities and the fund administrators before they could be fully implemented. The problems encountered after the 1964 and 1965 legislation indicate the need for a prolonged phasing-in period and for continuous consultation between fund administrators and the revenue authorities before the details of the legislation are settled and before the guidelines for the exercise of the Commissioner's discretion in various areas are determined.

21.107. *The 30/20 requirements.* The virtual compulsion on superannuation funds (and life insurance companies) to invest 30 per cent of their assets in public sector securities should be reconsidered.
Compliance with the 30/20 rule need not be regarded as some sort of *quid pro quo* for the exemption from tax of the income of a superannuation fund: as already indicated, this exemption can be justified on other grounds. If the 30/20 requirements are to be retained, the Government should give consideration to the issue of special index-linked bonds, bearing a relatively low interest rate, which would provide that both principal and interest would escalate in step with the consumer price index or some other suitable measure of inflation. Furthermore, the Government should ensure that there is a market at all times for any security that a superannuation fund is required to hold.

**The Second View**

21.108. The second view adopts the proposals advanced in the first view, subject to five main differences. The first difference requires that a reasonable benefit from an approved superannuation fund, as described in the following paragraphs, should be a standard amount for which any employee or self-employed person may qualify. The amount of saving made by a person or in respect of him to be tax-assisted, up to a common stated maximum, will depend on capacity to save.

21.109. The second of the five differences is connected with the first and requires that the maximum amounts of contributions to an approved fund to be allowed as tax deductions should be limited only by a requirement that the standard amount of total benefit should be gradually built up.

21.110. The third difference requires that only benefits flowing from an approved superannuation fund should receive the forward-spreading treatment described in paragraph 21.77. This treatment involves a concession which should apply only to receipts that may fairly be said to be the return to the taxpayer of income invested by him or in respect of him by his employer in long-term saving the consumption of which has thus been deferred. Other receipts should be subject to anti-bunching provisions of the type proposed in Chapter 23 (paragraphs 23.34–23.37) for capital gains, unless applied in the purchase of an annuity in accordance with paragraph 21.73. Alternatively, the taxpayer would be able to make use of the income-equalisation scheme proposed by the Committee in Chapter 14.

21.111. The fourth difference requires that an employee's interest in contributions made in respect of him by his employer, after a qualifying period, should be vested, in the sense that on retirement these contributions and accumulations of income will be available to him, or on ceasing to be a member of the fund other than by retirement they will be retained for him in the fund until he reaches retiring age, or they will be transferred to his
account with another approved fund, or they will be paid to him and attract income tax. If the tax law gives its assistance to savings that are subject to forfeiture on the employee leaving his employment, it is assisting the restriction on mobility of labour that the prospect of forfeiture involves.

21.112. The fifth difference requires that there should be a complete assimilation of the tax treatment of a lump sum paid on retirement and a pension paid on retirement from an approved superannuation fund.

21.113. The first, second, fourth and fifth differences, more especially the fourth, would cause difficulties for many existing superannuation schemes and it would be necessary to give effect to them by new law which would apply to a person who is not a member of an existing scheme or who withdraws from an existing scheme.

21.114. This new law would seek to give effect to the following principles:

(a) The maximum amount of long-term saving for which any tax assistance can be expected should be the same for everyone.

(b) The maximum amount of the deduction against earned income available to a person for contributions to an approved superannuation fund should be the same for everyone.

(c) Contributions made by an employer in respect of his employee to an approved fund should be treated as income of the employee, but the total of those contributions and the employee's own contributions would be allowable deductions by the employee within the amount referred to in (b). Equality of treatment of the employed person and the self-employed person would in this way be assured.

(d) The fund to which contributions would be made must be an ‘approved’ fund—i.e. approved by the Commissioner or some other government authority which may take over his function. A cardinal condition of approval should be that an employee's interest in contributions made in respect of him by his employer is vested, in the sense explained in paragraph 21.111.

(e) To be approved a fund should give to the taxpayer a right to receive all contributions and accumulations in the form of a lump sum on his retirement. He may elect to take a pension, in which event he will be taxed on a notional receipt of the lump sum and will be taxed on pension receipts as if he had received the lump sum and then applied it in payment for the pension. In the result, the amount of each pension receipt that is a return of the payment for the pension will be free of tax. Equality of treatment of a lump-sum receipt and a pension would in this way be assured.

(f) A lump-sum receipt from an approved superannuation scheme should receive special income tax treatment, a portion up to a stated amount being exempt from tax and a further portion, where applicable, being subject to forward spreading. In today's circumstances, up to the first $50,000, say, should be exempt from tax and up to a further $100,000 subjected to forward spreading over ten years by the
method shown in paragraph 21.76(b).

(g) When the new law comes into operation, only schemes complying with it should be allowed to admit new members; and a person by or in respect of whom contributions continue to be made to a fund approved under the old law should not be entitled to join a fund complying with the new law.

21.115. The way in which some of these principles would be expressed in the details of the proposed law requires some elaboration.

21.116. The amount of tax-assisted saving. At present prices tax-assisted saving might be set at $150,000. The authority supervising approval of funds would need to be satisfied by the trustees of a fund that any member's estimated entitlement will not exceed the maximum on his retirement. For this purpose the authority need only be concerned with the amounts already standing to the credit of the employee or self-employed person and the estimated earning rate of the fund. If it appears that the maximum will be exceeded, the fund would not be allowed to accept contributions by, or in respect of, the taxpayer.

21.117. Contributions to the fund. The amount of contributions that may be made to a fund and that will be deductible against earned income should be set at a figure which, if made over a period of the full working life, will produce with accumulations an amount not exceeding $150,000, with provision for benefit on early retirement due to ill health and for dependants on the taxpayer's death. There should, however, be some increase in the amount of deductible contributions with the age of the taxpayer to allow for later entry into a scheme and to take account of inflation. The amount of contributions deductible should be reviewed annually. The employer's contributions to an approved fund are treated as employee contributions. The deductibility by the employer of his contributions will follow general principles in regard to the deduction by an employer of salary paid to his employee.

21.118. It is not contemplated that the increase in allowable deductions by reference to the age of the taxpayer should be such as to make any substantial allowance for late entry. Tax assistance should be given only to long-term saving.

21.119. Approved funds. The tests of approval should be applied to all schemes in respect of which tax assistance is claimed. Thus a fund that does not give an employee a vested interest in the employer's contributions would not be approved under the new law. Only an amount received on retirement standing to the credit of the employee's account in an approved fund would receive the treatment proposed in paragraph 21.114 (f). Exemption from tax on its income would be available only to an approved fund. Contributions would be deductible only if made to such a fund.
21.120. *The taxing of receipts from an approved fund.* Provided the amount received does not exceed the ceiling of $150,000, it will be taxed as proposed in paragraph 21.114 (f) if the taxpayer is over fifty-five or it is paid as a result of the death of the contributor or his early retirement due to ill health. The supervision of approved funds will not always ensure that the taxpayer's entitlement does not exceed this figure. To the extent that it does, the receipt by the taxpayer should be subject to tax in the same fashion as an unfunded retiring allowance.

21.121. If the taxpayer is not yet fifty-five at the time of the receipt and he has not retired due to ill health, the receipt should be treated as an unfunded retiring allowance and taxed as proposed in paragraph 21.110. However, the taxpayer should be allowed a deduction of a contribution he makes to another fund subject to the new law, and the fund should be allowed to accept his contribution, provided the contribution will not involve the consequence that the taxpayer's entitlement on retirement will exceed the maximum of $150,000. He will thus ‘roll-over’ his entitlement from one new fund into another.

21.122. A taxpayer who, in similar circumstances, receives an amount from a fund approved under the old law should also be allowed a deduction of any part of it contributed to a fund approved under the new law, subject to the same qualification. He will thus ‘roll-over’ his entitlement from an old fund into a new fund.

21.123. *The phasing out of funds approved under the old law.* The fact that only funds approved under the new law would be allowed to take in new members and the restrictions that would preclude a continuing member of a fund approved under the old law from joining a new fund, must in time ensure that old funds disappear. It might however be anticipated that old funds will tend to be converted to new funds.

21.124. Some employer-employee funds would continue, but the financial advantages of new funds for employees, other than those on high incomes, would generate a significant pressure for conversion. In addition, pressure for conversion would arise from the vesting of an employee's interest under the new law, which may not be available under the old law.

**Comparison of the Two Views.**

21.125. The two views put forward are alternatives but it is of course possible to construct other alternatives combining aspects of each. The Committee does not express a preference for one view over the other, and some members of the Committee would not wish to commit themselves to certain aspects of each view.
21.126. A comparison of the major aspects of the two views is briefly summarised in the following paragraphs.

21.127. The first view, in its application to employee superannuation, follows closely the present law in giving tax concessions to provisions for retirement benefits, which may not always involve long-term saving, if they are considered reasonable having regard to earnings from employment. The second view believes that tax concessions should be given only to long-term saving and that there should be a maximum standard tax-assisted benefit available to all persons in employment but not directly related to their employment earnings.

21.128. The first view also follows the present law in giving concessional tax treatment to a lump-sum payment on retirement whether or not any provision has been built up to meet the payment. Under the second view a lump-sum benefit paid on retirement other than from funds that have been built up from long-term saving would not receive any tax concession. Thus a non-funded benefit received from a scheme of the type now generally used in the public sector would not qualify for any concessional treatment in the hands of the recipient.

21.129. The basic approaches of the two views to achieve parity in taxing a pension benefit and a lump-sum benefit also differ. Under the first view pensions would continue to be fully taxable as at present and lump-sum benefits would fall to be taxed on the assumption that the total amount was to be paid by equal annual instalments over the fifteen years subsequent to retirement and that this instalment would be the sole annual income of the recipient in that period. Admittedly, true parity would not be achieved in this way in many instances. Under the second view parity would be sought by requiring that on his retirement an employee should always be entitled to take a lump-sum benefit. The first $50,000 of this lump sum would be exempt from tax and the balance of up to $100,000 would be subject to forward spreading on the basis applying under the first view but over a ten-year period. If the retired person elected to take a pension, he would be taxed at the time of election as if he had received a lump sum, and he would be exempt from tax on so much of the pension receipts as represented the sum he had applied in purchasing the pension. Parity in taxing a lump sum and a pension flowing from an approved fund would thus be substantially achieved.

21.130. Under the first view an employer would be able, subject to the Commissioner's discretion to disallow irregular contributions, to make tax deductible contributions for the later years of an employee's service in an effort to ensure that his total retirement benefit was reasonable in relation to his remuneration close to retirement and these contributions would not
be income of the employee. Under the second view, where the approach is that only long-term saving should qualify for tax assistance, the consequence might be different. Although the employer would obtain a deduction for an additional contribution to meet this eventuality, the employee might be taxed on the additional contribution: he could fail to obtain a deduction for the contribution, which would have been treated as his income, because it exceeded the set maximum annual contribution for a person in his circumstances.

21.131. Under the first view it is not proposed that there should be a requirement that the employer's contribution for an employee's benefit be vested. Under the second view it is a basic principle that a contribution by an employer to an approved fund is to be allocated as being for the benefit of identified employees. The approach of the second view will therefore impose vesting on benefits flowing from contributions by both the employer and the employee to an approved fund.

21.132. Expenses in varying trust deeds to fit in with the first view should be minor and thereafter there ought to be no continuing added costs. Under the second view, which requires more substantial changes to the rules of existing funds, and in some cases the institution of new funds and the running down of old ones, the initial administrative costs could tend to be heavy. It also seems that there will be heavier continuing administrative costs under the second view due to the requirement to keep separate accounts for the contributions and share of earnings of all members of the fund, including some members who have left the employer's service but have not yet reached retiring age. In addition each employee would need to be advised annually of the employer's contribution to the approved fund for his benefit.

21.133. In the first view the present flexibility in the adoption of a type of fund—for example, an accumulating fund or an actuarial-type deferred benefit fund—would continue. Under the second view an accumulation-type fund only would in practice be permitted. An actuarial-type fund, which is now used by many business organisations, would be incompatible with the requirements of the second view: these funds by their very nature do not identify a specific contribution for each member or the annual division of the total fund in proportion to the actuarial liability of the benefit planned for each member on retirement.

III. Life Insurance

Background and Present Legislation
Deductibility of Premiums

21.134. The granting of some form of tax concession in respect of premiums paid on life insurance policies is of long standing, both in Australia and overseas, going back in the case of the United Kingdom to 1799.

21.135. In Australia the position is now governed by section 82H of the Act the predecessors of which date back to the first levying of income tax by the Australian Government in 1915. The concession granted in respect of life insurance premiums has at various times taken the form of a deduction from income or a rebate of tax and, since 1936, amounts paid as premiums have been aggregated with superannuation contributions for the purpose of determining the maximum amount in respect of which the concession is granted. Since 1951 the concession has been by way of a deduction the maximum amount of which has, since 1968, been $1,200 per annum.

21.136. Section 82H as it now stands provides in subsection (1) (a) that:

‘(1) Amounts paid by the taxpayer in the year of income . . . as—

(a) premiums or sums—

(i) for insurance on the life of, or against sickness of, or against personal injury or accident to, the taxpayer or his spouse or child; or

(ii) for a deferred annuity or other like provision for his spouse or child . . .

shall be allowable deductions.’

Subsection (1) (b) allows as a deduction payments to superannuation funds and friendly societies, while subsection (2) provides that the total deduction allowable under this section is not to exceed $1,200.

21.137. Section 82H was amended in 1973 by the insertion of new subsections (1A)-(1H). These were directed to curtailing abuses that had developed in relation to policies of a very short term or policies surrendered shortly after being effected. The amendments result in the deduction of premium payments being disallowed if the policy is for a term of less than ten years and in the retrospective disallowance (by the reopening of past assessments) of all or a part of the deduction of premiums paid on a policy taken out for a term greater than ten years if discontinued within ten years of its commencement for any reason other than serious financial difficulty. These provisions apply only to policies the first premium on which was paid on or after 1 January 1973.

21.138. Deductions for premium payments may also be available under section 51 (1) in certain circumstances where an employer effects a policy on the life of an employee. Such cases are relatively few in number and
will not be further considered.

21.139. The total amount of deductions claimed under section 82H for life insurance premiums is extremely large, as is the number of taxpayers claiming a deduction. Statistics published by the Life Insurance Commissioner indicate that as at 31 December 1973 approximately $696 million per annum was being paid in premiums on life insurance policies (excluding superannuation policies) and most of this amount would have qualified for deduction under section 82H. No estimate is available of the precise number of taxpayers claiming a deduction for life insurance premiums, but at 31 December 1973 there were nearly 8 million individual life insurance policies in force in Australia.

**Taxation of Life Insurance Companies**

21.140. Life insurance companies are the subject of a special tax regime under Division 8 of Part III of the Act. The underlying approach is that the company is taxed on its investment income; but the fact that this is not the only possible approach to taxing life insurance companies is illustrated by the diversity of practice in other countries and, indeed, the diversity that existed in Australia before the introduction of the principle of uniform taxation legislation in 1936.

21.141. Prior to 1936 life insurance companies were taxed on the basis of their investment income under Commonwealth, New South Wales and Western Australian legislation. In Victoria, Queensland and Tasmania they were taxed on a percentage of premium income, while in South Australia the taxable income was based on the amount of the company's actuarial surplus. All these methods, and others, are in use overseas and a brief summary of some of them is contained in paragraphs 21.150–21.157 below.

21.142. Since 1936 all life insurance companies have been taxed on a basis that owes its origin to the pre-1936 Commonwealth legislation. This followed the recommendation of the Ferguson Commission (1932–34).

21.143. The assessable income of a life insurance company, in respect of its life insurance business, comprises its investment income. Dividends are included in assessable income, though resident life insurance companies are entitled to the rebate of tax thereon provided by section 46. Premiums received in respect of policies and considerations received in respect of annuities are excluded from assessable income under section 111 but form part of the total income of the company for the purpose of determining certain deductions. Furthermore, subject to compliance with the 30/20 requirements, that portion of investment income referrable to
superannuation policies is exempted by virtue of section 112A.

21.144. The main deductions allowed in computing the taxable income of a life insurance company are as follows:

(a) A deduction under section 51 (1) for expenses directly incurred in earning the assessable (investment) income. These are usually a small part of the total expenses of a life insurance company.

(b) A proportion of the ‘expenses of general management’ of the company. The practical effect of section 113 is to allow a deduction of the proportion of those expenses which is equal to the proportion that the assessable income of the company bears to the total income of the company. Expenses incurred wholly in gaining or producing non-assessable income (primarily salary and commission to salesmen) are specifically excluded from the definition of ‘expenses of general management’, as are expenditure of a capital nature and expenditure incurred in producing assessable income.

(c) A deduction is allowed in full under section 82AAC of contributions to superannuation and pension funds.

(d) A deduction is allowed under section 115 of a percentage of the ‘calculated liabilities’ of the company. This is a controversial deduction and is further considered in the next paragraph.

(e) Rebates of tax are granted to resident life insurance companies on dividends (under section 46) and a rebate of 10 per cent is granted under section 160AB on interest received on certain Australian and State Government securities issued before 1 November 1968.

21.145. The Ferguson Commission stated in paragraph 858 of its Report:
‘In our opinion a life assurance company should be taxed on the basis of its investment income, which cannot be correctly determined without providing for the interest assumed to be earned on the investments set aside to provide for the payment of the liabilities of the company to its policy holders.’

The Report noted that this principle had already been conceded under Commonwealth legislation, by an amendment made in 1933. The recommendations of the Ferguson Commission were subsequently adopted and a deduction of 4 per cent of the calculated liabilities of a life insurance company was allowed. This figure was reduced to 3 per cent in 1942 when the income tax field was taken over wholly by the Commonwealth. The figure remained at 3 per cent until the 1973–74 Budget which reduced it to 2 per cent and made certain other changes that had the effect of greatly increasing the amount of tax paid by life insurance companies. The figure was further reduced to 1 per cent in the 1974–75 Budget, with the inference that the deduction would be removed completely in the near future.
21.146. Finally, section 116 of the Act provides that a life insurance company shall not be liable to pay income tax in respect of the income derived by it from business of life insurance if its calculated liabilities exceed the value of all its assets.

**The 30/20 Requirements**

21.147. Under provisions introduced in 1961 a life insurance company is virtually obliged to maintain 30 per cent of its assets in public sector securities, and at least 20 per cent of its assets in Australian Government securities. Failure so to do results in:

(a) the loss of exemption on the income derived from assets referable to superannuation business; and  
(b) a reduction in the section 46 dividend rebate available.

Over-compliance with the 30/20 requirements generates ‘bonus points’ for a life insurance company in that the section 115 deduction is slightly increased. This has had the effect of making investment in public sector securities relatively more attractive, other things being equal, than investment in the private sector and has led to a greater margin between public and private sector interest rates than would be accounted for by market factors alone. However, the reduction in the section 115 deduction has led to a lessening of the value of such bonus points and the abolition of the deduction would mean that no tax advantage could be gained by exceeding the minimum requirements.

**Taxation of Policy Proceeds**

21.148. Policy proceeds are in general regarded as a non-income receipt and are accordingly exempt from tax. Exceptions to this arise in the case of certain policies effected by employers on the lives of employees but these are relatively few in number and do not have a significant impact on the overall picture.

21.149. The actuarial surplus of Australian life insurance companies is distributed in the form of reversionary bonuses—i.e. additions to the sum insured. By virtue of section 26 (i) such reversionary bonuses are exempt from tax in the hands of the policy-owner.

**International Comparisons: A Brief Summary**

21.150. The manner of taxing life insurance in countries with which
Australia is broadly comparable presents a pattern of considerable diversity, perhaps indicative of the fact that the taxation of life insurance does not fit easily into any of the accepted categories of taxing income moving through intermediaries.

21.151. The United States and Canada give no tax concessions for premium payments as section 82H does in Australia. New Zealand broadly follows the Australian pattern of giving a concessional deduction (called there a ‘special exemption’) with an overall dollar limitation which applies to the aggregate of life insurance premiums and superannuation contributions. In the United Kingdom relief is allowed in the form of a rebate calculated at the basic rate of tax (currently 33 per cent), subject to a restriction on the amount of premiums qualifying for relief to one-sixth of the taxpayer’s total income. Both New Zealand and the United Kingdom have found it necessary to legislate to restrict the availability of the concessions to long-term policies, as was done in Australia in 1973.

21.152. It is in the area of the definition of the taxable income of a life insurance company that the greatest differences emerge.

21.153. The basis used in the United Kingdom is the closest to that employed in Australia. The company is in practice taxed on its investment income but is allowed a deduction for all expenses, including those incurred solely in gaining non-taxable income, such as expenses of selling new policies. Furthermore, the rate of tax is limited to 371/2 per cent.

21.154. In New Zealand a life insurance company is taxed on its annual actuarial surplus calculated on a specified basis. The rate of tax is limited to 40 per cent of the general rate of company tax.

21.155. Life insurance companies in the United States are taxed in a complex series of operations which, in substance, include in the tax base both investment income and underwriting profit or loss.

21.156. A life insurance company in Canada is taxed in a manner analogous to the taxation of a general insurance company in Australia. All receipts, whether by way of premiums or investment income, are included in its assessable income; a deduction is allowed of all expenses, claims and increases in policy reserves. In addition, a separate tax is levied on investment income subject to certain deductions.

21.157. The proceeds of life insurance policies are wholly exempt from tax in normal circumstances in New Zealand and the United Kingdom. In Canada policy proceeds received otherwise than on death or permanent disability are taxable to the extent that the amount received exceeds the adjusted cost base of the policy, which is the premiums paid less any dividends paid during the currency of the policy. The United States treatment is similar to the Canadian. Unlike life insurance companies in
Australia, New Zealand and United Kingdom, which distribute their surplus in the form of reversionary bonuses, United States and Canadian companies traditionally distribute their surplus in the form of cash dividends.

Conclusion

21.158. Having regard to the fact that two of its members are directors of Australian life insurance companies, the Committee feels that it is unable to make detailed recommendations on tax changes in this area. In addition, the subject is one of considerable complexity, particularly when it comes to determining the correct basis of taxing life insurance companies themselves. Life insurance is distinctive in combining elements of investment, protection and mutuality. The very diversity of overseas practice is an indication that no single method of taxing a life insurance company is accepted as correct. It often tends to be arbitrary.

21.159. Accordingly the Committee, while acknowledging assistance received from several submissions, recommends that a review of the taxation aspects of life insurance be undertaken by a separately constituted committee which can consider the particular problems in this area in greater depth than the present Committee has been able to do. Though minor anomalies such as the denial of the section 46 dividend rebate to non-resident life insurance companies and the treatment of foreign-source income may be noted, the Committee wishes to confine itself to some observations of a general nature.

21.160. Firstly, as with superannuation, the taxation of life insurance must be considered as a whole. There must be harmony between the treatment of premium payments, the income of the life insurance fund and payments of policy proceeds. No one element can be looked at in isolation from the other two.

21.161. Secondly, unlike the situation with superannuation benefits, it is neither feasible nor desirable to tax the proceeds of a life insurance policy; nor is it possible to impute to a policy-owner for tax purposes his share of the company's income during the term of the policy. Because of the insurance, as distinct from investment, aspects of life insurance, there is no reasonable way of taxing the excess of the policy proceeds over the amount of premiums paid. This being so it is necessary to exact some tax from the company itself, particularly since there is no way of imposing a limit on the extent to which high-income taxpayers may use life insurance as a saving and investment medium. Maximum benefit limitations can be imposed on tax-exempt superannuation funds to prevent the tax-free
accumulation of excessive amounts, but this approach cannot be adopted with life insurance.

21.162. Thirdly, if it is desired that life insurance be encouraged there is justification for giving some form of concession related to the payment of premiums. The Committee has already recommended in paragraph 21.103 that superannuation contributions be taken outside the ambit of the present section 82H and divorced from the treatment of life insurance premiums. While a deduction system should be retained for superannuation contributions, largely because the benefit will emerge in taxable form, it is felt that a rebate, which is an equal per-dollar subsidy, is more appropriate in the case of premiums for life insurance the benefits from which are non-taxable.

21.163. Fourthly, and most significantly, the Committee wishes to stress that the tax treatment of life insurance should not be subject to abrupt changes. Life insurance is a long-term undertaking for both the policy-owner and the company. The long-term financial plans of individuals should not be lightly interfered with and it should be borne in mind that a life insurance company must be able to build up assets to meet liabilities due many years in the future. Because of the long-term nature of the contract entered into between the policy-owner and the company, it is necessary that there be some stability of the tax structure within which this contract will function.

21.164. Finally, regard must be paid to the eroding effect of inflation on the protection and savings provided under life insurance policies. No less than in the case of business and professional income, the tax system should have regard to the impact of inflation on the income of life insurance funds, which are particularly vulnerable because of their required holdings of fixed-interest securities.

1 Attention is drawn to the fact that two members of the Committee serve on the boards of directors of Australian life insurance companies. Whenever discussions on subjects in this chapter have taken place, they have declared their position and particular interest.
Chapter 22 Income Tax Administration

22.1. This chapter deals with a variety of matters which relate to the administration of the Income Tax Assessment Act and which have been made the subject of a number of submissions to the Committee. Section I deals with legislative, appeals and prosecutions aspects, Section II with procedures and taxpayer compliance, and Section III with payment of tax.

I. Legislative, Appeals and Prosecutions Aspects

The Commissioner's Discretion

22.2. A number of submissions have been received by the Committee which relate to certain powers which the Act vests in the Commissioner by some such language as enables him to make an assessment where he is ‘of the opinion’ or ‘is satisfied’ that a certain state of affairs exists. These may be conveniently referred to as the Commissioner's ‘discretionary powers’.

22.3. The tenor of these submissions is that, whenever possible, the use of a discretion in the Commissioner should be removed and liability to tax should be determined upon clearly defined criteria; that a Court should be able, in the same way as a Board of Review, to review the exercise by the Commissioner of a discretionary power, and that, where the Commissioner exercises his discretion, at the request of the taxpayer he should within some stipulated time furnish a statement containing his reasons for the exercise of the discretion.

22.4. Submissions have also been received to the effect that a system of advance bulletins should be set up indicating the matters which the Commissioner would take into account in the exercise of his discretion. These and a number of related matters are discussed below and certain recommendations made.

22.5. It must be at once conceded that the ideal for all fiscal laws should be certainty so that the taxpayer can discern from them the precise limits of his liability. An examination of the legislation of many countries—Australia is by no means unique in this regard—reveals that in many respects this goal has not been achieved. The failure to achieve simplicity and precision in every aspect of a taxation statute is readily understandable. Tax is levied over the whole community and upon all manner of persons and bodies. The fundamental basis of its imposition is the ability of each to pay, a difficult objective to achieve in view of the infinite variety of circumstances which attends even those with comparable grades of
income. When the sources of income which range so widely have to be taken into account, the problems confronting attempts to achieve certainty in a law, which must at one and the same time have a general application and also as far as possible aim at equality of burden for each taxpayer according to his particular situation, are compounded. This will be recognised by anyone who attempts to reduce a taxation concept into statutory terms.

22.6. As all would readily agree, individual legislative treatment is an impossibility. The only practical means, on the one hand, of coping with the cases of hardship and of providing an equitable result for the inevitable departure from the norm so that the Revenue should not obtain more than in all fairness it is entitled to and, on the other, of ensuring that at the same time the taxpayer should not, at the expense of his fellow taxpayers, escape payment of his just liabilities, in many instances is by the exercise of a discretionary judgment to reach the solution called for by the particular circumstances of the case. The possession of a discretion by the Commissioner does not mean that he is completely at large in its exercise. It is not his private opinion that he is to express. He must act according to law and reason and to the justice of the case and not arbitrarily or capriciously or upon inadmissible or irrelevant grounds.

22.7. Another obstacle to simplicity and certainty in taxation legislation is the ingenuity and complexity of schemes which are evolved for the purpose of tax avoidance. By the use of documents and the adoption of procedures to which the Courts are impelled to give an operation according to their legal effect, it has become a not too difficult matter for some who have access to highly skilled advice to avoid a situation which the statute intended should be either taxable or taxable upon a higher scale. Some reference to this has been made in Chapter 11 (paragraphs 11.5–11.6) in dealing with the subject of income-splitting. The vesting in the Commissioner of powers of discretion, opinion, satisfaction and determination in this field is regarded by the Committee as a more satisfactory alternative to both the Revenue and the taxpayer than lengthy and complex provisions which can themselves be infected with the vice of uncertainty. It should not be overlooked that a power of this kind enables the Commissioner to give just recognition to transactions which bear the stamp of a genuine ordering of affairs and to separate them from those of an artificial nature designed to shelter their real purpose of tax avoidance. As both types of transaction frequently follow so closely the same path, the task of framing a definition which will include one without excluding the other usually presents insuperable obstacles for the draftsman.

22.8. It is admitted that in view of the number of cases arising the
Commissioner's discretions must be exercised on his behalf by his officers who have delegated powers. But the Committee is informed that there are procedures established within the Department to ensure that, so far as possible, like treatment in the exercise of discretions is given to all taxpayers.

22.9. Whenever the law gives a discretion to the Commissioner, it should at the same time indicate the principle to which the Commissioner is to give effect in the exercise of the discretion: if the principle is not otherwise evident, it should be possible to infer it from any guidelines included in the section giving the discretion.

22.10. Accordingly, whilst the Committee has a definite preference for certainty in a fiscal statute it is not a sound practical measure to remove from the Commissioner's jurisdiction all the discretionary powers which he possesses under the Act. Where it is appropriate so to do, it would be an advantage for guidelines to be inserted in the Act to indicate the matters to which regard should be paid in the exercise of a discretion. But, as it is not possible to formulate guidelines to cover all the possible circumstances of every case, in the interests of the taxpayer as well as the Revenue, they should not be framed in the Act as the only relevant matters which the Commissioner should reasonably be entitled to take into account in the just exercise of the particular discretion vested in him. The proper exercise of a discretion necessarily involves a latitude of choice according to the particular circumstances of each individual case.

22.11. It has been submitted that whenever the Commissioner forms an opinion, makes a determination or exercises any like power, he should supply the taxpayer with the reasons or grounds upon which he has based it. As desirable as this might appear in theory, it would throw an enormous burden on to the administration and cause delay in the issue of assessments. Comparatively few of the Commissioner's actions of this nature are made the subject of challenge and, when an objection is made to an assessment, the Commissioner's reasons are placed before a Board of Review (see later) which in turn makes its own determination in reviewing the reasons of the Commissioner in light of the facts and the arguments of the taxpayer.

22.12. The Committee recommends that greater use be made of the procedure of the issue by the Commissioner of Public Information Bulletins setting forth the general guidelines which the Taxation Office usually takes into account in the exercise of powers of this nature in their different settings in the Act; but it should be made clear that such Bulletins are published for general information only. Because there will always be the exceptional case and because the facts of one case will rarely be on all
fours with another, Public Information Bulletins should not be treated as evidentiary material before a Court or Board of Review.

22.13. The protection which the taxpayer has against any error made by the Commissioner in the exercise of these discretionary powers is the review and appellate provisions in the Act. Where the taxpayer is dissatisfied with a decision of the Commissioner disallowing, either in whole or in part, his objection to an assessment he may, within sixty days after service of the Commissioner's decision upon him, request the Commissioner to refer the decision to a Board of Review for review. If the request is accompanied by a fee of two dollars, the Commissioner is obliged, subject to his right to obtain further information from the taxpayer, to act in accordance with the request.

**Amendment of an Assessment**

22.14. Section 170 of the Act contains a general power for the amendment of assessments by the Commissioner. The limits imposed by the section have no application where the Act makes provision for the amendment of assessments in specific cases (see section 170A). Aside from the cases of fraud or evasion, or where there has not been a full and true disclosure of all the material facts necessary for the assessment, no amendment may be made either to increase or reduce the liability of the taxpayer except to correct an error in calculation or a mistake of fact. No such amendment may be made after the expiration of three years from the date when the tax became due and payable under the assessment, except where the taxpayer has applied for the amendment of his assessment within that period and has supplied to the Commissioner within that period all the information needed by the Commissioner for the purpose of deciding the application. Subsection (9) of section 170 provides that, where an assessment includes an estimated amount of income from an operation or series of operations extending over more than one or parts of more than one year and where owing to that fact the profit or loss was not ascertainable at the end of the relevant year of income, at any time within three years after ascertaining the total profit or loss actually derived the Commissioner may amend the assessment to ensure its completeness and accuracy.

22.15. It has been submitted that a taxpayer who makes application for amendment of his assessment in these cases should have the right to lodge an objection if the Commissioner fails to accede to his application. The Committee is of the opinion that, where the taxpayer requests amendment of an assessment under section 170 (9) and supplies all the information
necessary for amendment within some specified time, he should have the same rights of objection and appeal as are available in respect of an assessment. The right of objection should be allowed against a refusal by the Commissioner to amend, which should be notified, or against the amendment so made, even if it reduces the tax payable. The Committee does not recommend that this right of objection and appeal should be extended to amendments of assessment under other sub-clauses of section 170. To do so would seriously impair administration of the Act and virtually give unlimited opportunity to dispute an assessment any time in the period of three years after its due date for payment.

**Objections to an Assessment**

22.16. The Committee has received a number of submissions bearing upon the question of objections to an assessment and the nature of these will be apparent from the discussion which follows and in which it may be useful to bear in mind the following statistics which give the number of objections lodged with the Commissioner in recent years:

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<tr>
<td>Number</td>
<td>37,169</td>
<td>36,623</td>
<td>48,381</td>
<td>58,793</td>
<td>54,401</td>
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22.17. The time-limit for a taxpayer to lodge an objection to any income tax assessment with which he is dissatisfied—within sixty days after service of the notice of assessment—would seem to be reasonable in practically all cases. The Committee recommends that this time-limit should apply in relation to assessments issued under all taxation statutes. Submissions to the Committee, however, have raised the question that there should be some means by which further time may be granted for lodgement of an objection where unusual circumstances arise. It is of interest to note that in the income tax legislation of the United Kingdom, Canada and New Zealand there are provisions enabling the granting of a further period for lodgement of an objection beyond the initial statutory period.

22.18. Provision should be made in the Australian taxation statutes enabling the Commissioner to grant further time if he is satisfied that there was a reasonable excuse for not lodging the objection in time. Where the Commissioner is not prepared to grant a request for further time, the request should be referred to a Board of Review for decision. There should be similar powers to grant extended time in relation to the lodgment of requests for reference to a Board of Review and appeals to a Court, but in these latter cases the power to extend should be vested in the Board or the
Court as the case may be.

22.19. Whilst the Commissioner is bound to serve the taxpayer with written notice of his decision upon the objection, no time-limit is imposed within which he must do so. There are practical difficulties in setting a time-limit upon the Commissioner's decision. It is by no means unusual for the grounds of the objection to make it necessary for him to call for further information from the taxpayer. Moreover, grounds of objection are frequently lengthy and complex and raise important questions of law. Next should be borne in mind the large volume of individual objections to be dealt with, and lastly it should be recalled that in the exercise of his office the Commissioner stands between the requirements of the Revenue and just treatment for the taxpayer and this position imposes upon him a double duty of care. In light of these considerations the Committee believes that it is better not to impose a time-limit upon the Commissioner. It is not to be supposed that, where real hardship can be shown by the taxpayer, his representations for a speedy decision upon his objection would not be heeded. In the last resort it seems that under section 75 (v) of the Constitution the taxpayer could obtain from the High Court an order to compel the Commissioner to give his decision upon an objection.

22.20. The Act provides that upon a reference to a Board of Review or an appeal to the Court a taxpayer is limited to the grounds stated in his objection. It is not within the jurisdiction of a Board or Court to permit the taxpayer to add any new ground of objection even though the Commissioner may be willing to consent to that being done. There is no corresponding restriction placed upon the Commissioner as to the grounds upon which he can support an assessment except that where there are two sections of the Act, each giving power to make an assessment, an assessment made under one of those sections cannot be made effective under the other. The contents of an assessment with which the dissatisfied taxpayer is bound to object ‘fully and in detail’ may make it difficult for the taxpayer to understand the basis of his purported liability to tax and the Commissioner is not bound to supply him with an adjustment sheet. It is pointed out later that a taxpayer may not be able to gather from the document supplied to him under Regulation 35 (2) the basis of assessment or the reasons for the Commissioner’s decision but, even if at that stage he could do so, it would then be too late to amend his grounds of objection.

22.21. This state of affairs is highly unsatisfactory and unfair to the taxpayer. Conceded that there should not be any unlimited right of amendment, it is eminently reasonable that a taxpayer should be able to contest his case upon any ground open to him when he is placed in a position for the first time to understand the contentions which he has to
meet. The Committee refers to its later recommendation in paragraph 22.25 to the effect that the Board, in the exercise of its discretion, should have power to require the Commissioner to supply the taxpayer with further particulars of the computation of the assessment and of the reasons for the decision disallowing the objection and is of the opinion that the Board should in such a case fix reasonable time after the supply of those particulars for the taxpayer to amend his grounds of objection where the particulars revealed that the original grounds were not sufficiently widely expressed. The same situation should apply where in the first instance the taxpayer appealed to a Supreme Court against the Commissioner's decision upon his objection. The Commissioner should have a corresponding right to give his decision upon the amended grounds. It could be safely left to the discretion of the Board of Review or the Court to determine the procedure which in the particular circumstances would be just to both parties.

Powers and Procedures of a Board of Review

22.22. The powers of a Board of Review are not judicial and its functions are to review all decisions of the Commissioner as are referred to it. For this purpose the Board is in the same position as the Commissioner and, in making its own decision, can substitute its own opinion or determination for that of the Commissioner. A Board of Review is an administrative body and is not bound, as is a Court, by the rules of evidence and it has no power to award costs against an unsuccessful party. It is bound to give its decision in writing either confirming, reducing, increasing or varying the assessment and, at the request of either the Commissioner or the taxpayer, must state its findings of fact and the legal reasons for its decision.

22.23. Regulation 35 of the Income Tax Regulations requires the Commissioner when referring a decision to the Board of Review, to furnish both the Board and the taxpayer with, amongst other material, the Commissioner's reasons for disallowing the taxpayer's claim. It has been held that this regulation does not empower the Board to order the Commissioner to supply the taxpayer with particulars as to how the assessment is made up or the steps in the reasoning by which the ultimate conclusion of the Commissioner was reached.

22.24. Nevertheless, whilst not a Court, a Board of Review is a quasi-judicial body and natural justice requires, especially as the taxpayer bears the onus of displacing the decision of the Commissioner, that the taxpayer should have a sufficient knowledge of the basis of that decision to enable him to go about his task with factual material and legal argument relevant
to the question which the Board is called upon to decide. The taxpayer is bound to state ‘fully and in detail the grounds on which he relies’ in his objection and the Committee sees no good reason why he should not be fairly apprised of the basis of the assessment to which he has objected and the reasons for the disallowance of his objection. While normally this information is readily available from the Commissioner, if the position is reached where a taxpayer is challenging the decision of the Commissioner before a Board of Review and considers he has not received an adequate explanation, there should be some remedy for him.

22.25. If the taxpayer was genuinely unable to gather from the document supplied by the Commissioner pursuant to Regulation 35 (1) (c) and (2) sufficient information for that purpose, he would come before the Board under a considerable handicap in the presentation of his case and the hearing would be either unduly prolonged or adjourned and further expense would in consequence be incurred. Clarification of these matters in the course of the hearing before the Board would in many instances be unsatisfactory and not a viable substitute for an adjournment. The Act should be amended to give the Board power exercisable at its discretion to require the Commissioner to supply the appropriate particulars to the Board and the taxpayer in cases where it was of the opinion that it was reasonable for the taxpayer to be provided with further particulars of the computation of the assessment and of the reasoning by which the Commissioner's decision was reached. Any application by the taxpayer for the exercise of the Board's powers on his behalf should be made within a specified reasonable time after the receipt by the taxpayer of the documents referred to in Regulation 35 (2), and the Commissioner should be notified of the application and have the right to be represented thereat. The Board's power in this connection could be exercised by any one member. The availability of a procedure of this kind would increase public confidence in the review and avoid the possibility of lengthy delays and adjournments.

22.26. An identical procedure should be followed where the taxpayer appealed directly to a Supreme Court from the Commissioner's decision upon his objection.

22.27. Any procedure which speeds litigation and reduces costs is highly desirable. Although not bound by the strict rules of evidence, the Board of Review quite properly follows those rules where the importance of the proof of certain facts is apparent. But, whilst the purpose of a reference to a Board of Review has been described in the High Court as providing ‘a less formal method of investigating facts at a hearing, and opportunity of exercising discretion and the like by a more detached administrative process’, parties before the Board tend at times to regard a hearing before
the Board as one in which the whole of the evidence to be adduced must be presented and proved as if in a formal trial. The result often is that a great deal of time is taken up with the proof of facts which are or ought to be common ground between the Commissioner and taxpayer and which could readily have been admitted in advance of the hearing, thus saving time and expense in the calling of witnesses and production of documents. If, after the receipt by the taxpayer of the document referred to in Regulation 35 (2) and its possible further particularisation (referred to above), the parties were to come together before a single member of the Board in a short, preliminary hearing akin to what is known as ‘pre-trial’ procedure, all or many of the facts could be admitted and reduced to writing and such facts as remained in dispute could be brought within such a small compass that much of the fact-finding work of the Board would be eliminated. A further consequence would in all probability be that the questions of law would be narrowed. The saving of time, work and expense would result in the rate of progression of the cases before Boards of Review being accelerated. In the Committee's view the Board should be invested with a power to invoke a procedure of this nature to be exercised at its discretion.

22.28. Section 181 of the Act provides in effect that a person who is or has been a member of a Board of Review shall not be under any liability for any non-feasance or misfeasance in connection with his duties. The words ‘non-feasance’ and ‘misfeasance’ have technical legal meanings. It has been stated on high authority that ‘there is no such distinct wrongful act known to the law as misfeasance’; and what constitutes a misfeasance or non-feasance is a matter of not infrequent disputation.¹ The Committee is of the opinion that the immunity to be afforded to members of the Board of Review in connection with their duties should be the same as that afforded by section 72 of the Insurance Act 1973 to members of the Insurance Tribunal, namely, the immunity of a Justice of the High Court. The Committee also considers that a barrister, solicitor or other person appearing before a Board of Review should have the same protection and immunity as a barrister in proceedings in the High Court (cf. section 85 (2) of the Insurance Act 1973).

22.29. Section 194 of the Act provides that two members of a Board of Review shall form a quorum, the decision of the majority shall prevail, but that the Chairman shall have a deliberative but not a casting vote. Provision is made in section 180 for the appointment by the Governor-General of a member as Chairman in cases where the Chairman cannot be present. The Committee recommends that where two members form a quorum in the absence of the Chairman, the member appointed as Chairman should have a casting as well as a deliberative vote in order to prevent the possibility of
a deadlock.

22.30. Section 196 (2) of the Act empowers the Board of Review to refer a question of law arising before the Board to a Court. But this power may be exercised by the Board only at the request of the Commissioner or the taxpayer. Bearing in mind the experience of the Board, the Committee believes that the power to refer a question of law to a Court should be exercisable by the Board at its discretion. There will be cases in which the state of the law in relation to a question arising before the Board is, in the opinion of the Board, in such doubt that both time and expense will be saved by a judicial decision before embarking upon a lengthy hearing of factual and legal argument before the Board itself. In a case where the Board does so refer a question of law to a Court, the Commissioner should bear the costs on the same basis as is outlined later in paragraph 22.42.

22.31. Some of the powers of a Board of Review are contained in the Act but others appear in the Income Tax Regulations. It would be more convenient and satisfactory in all respects for taxpayers and their advisers if all such powers were collected together in one place, the Act being the appropriate place for them. It is intended to propose certain amendments to the regulations in question, but the Committee must be understood as recommending that the amended regulations, if adopted, should be incorporated in the Act.

22.32. Regulation 39 (2) in effect enables a Board of Review to require persons to furnish information to the Board, to attend and give evidence before the Board and to produce to the Board books, documents and papers in his custody in relation to cases where the Board is of the opinion that the exercise of these requirements is necessary for the determination of matters arising before the Board. Regulation 39 (2A) provides that a person shall not without just cause or excuse fail to comply with any such requirement. Regulation 39 (3) enables the reimbursement of such a person's expenses to be made in certain circumstances. The weakness of these powers appears to be that there is no sanction provided to ensure compliance with them, and it has been ascertained that in some instances the Board's requirement is ignored with impunity. Powers such as these are essential for a proper determination of matters referred to the Board in the interests of both the Commissioner and the taxpayer. A failure on the part of a person to comply with any such requirement of the Board without just cause or excuse should be an offence against the Act and punishable by a fine of such an amount as to act as a satisfactory deterrent against non-compliance.

22.33. Whilst a Board of Review, being an administrative tribunal, is not bound by the rules of evidence, Regulation 39 provides that it shall ‘take
evidence’ and may require a person to attend and ‘give evidence’. However, there is no provision as to the mode by which such oral evidence is taken or given other than the requirement of an oath or affirmation and the general statement in Regulation 38 (1) that reviews by a Board shall be conducted as the Chairman from time to time directs. It should be enacted that a witness giving oral evidence before the Board may, subject to the Chairman's directions, be examined, cross-examined and re-examined in accordance with the established procedure in the Courts. It should be expressly provided that a Board of Review should not be bound by the formal rules of evidence. A witness appearing before a Board of Review should have the same protection and be subject to the same liabilities in any civil or criminal proceedings in the High Court (cf. section 84 (3) of the Insurance Act 1973).

22.34. With these recommendations in relation to Boards of Review, the Committee also recommends that the provisions of Division 1 of Part V—Constitution of Boards of Review—in the Income Tax Assessment Act and such other provisions of Part V as relate to the practice and procedure of the Boards be transferred to the Taxation Administration Act. At the present time the Boards deal with matters arising in relation to taxes other than income tax, including estate duty and sales tax, and it is more appropriate that the constitution of the Boards and their practice and procedure be provided for in the Taxation Administration Act. This latter Act, of course, covers among other things the appointment and tenure of the Commissioner of Taxation and Second Commissioners of Taxation and provides for the constitution and procedures of Valuation Boards.

Appellate Powers and Procedures

22.35. Either the Commissioner or the taxpayer may appeal to the Supreme Court of a State from any decision of a Board of Review which involves a question of law and the Board shall, at the request of the Commissioner or the taxpayer, refer a question of law arising before a Board to a Supreme Court. The appeal or reference shall be heard by a single Judge of that Court and from his decision either party may appeal to the High Court. A question of law may arise on the facts as found by the Board of Review which facts are not themselves challenged by the appellant or may arise in the finding of the facts themselves where, on the evidentiary material before the Board, that finding could not be properly made or where the Board has committed some other error of law in arriving at that finding. The jurisdiction of the Court to entertain an appeal does not depend upon the Court's view that the Board has made an error of
law which has affected its decision. Once it appears that some question of law has been involved, the whole decision of the Board and not merely the question of law is open for review on the appeal. The Court will give due weight to the Board's finding of fact, but is not bound by them and will arrive at its own conclusions on the questions of fact which have to be decided. If necessary the Court will hear evidence additional to that which was given before the Board. The essential question for the Court is whether the decision of the Board was correct. If the taxpayer who was dissatisfied with the Commissioner's decision was to by-pass the Board of Review and have his objection treated as an appeal to a Supreme Court, that Court would have the duty both of finding the relevant facts and also of ruling as a matter of law on the questions to which those facts gave rise. Where the Board, in exercising the same functions as the Commissioner, has exercised a discretion, the Court will not invalidate what the Board has done in this connection unless some error of law can be seen to have affected its determination.

22.36. If a taxpayer exercises his option to ensure that his case goes in the first instance to a Board of Review, it is reasonable that he should be bound by a finding of fact by the Board which is arrived at without breach of legal principles. If, on appeal to a Court by the taxpayer, the question of fact was enabled to be re-opened at the request of the taxpayer, there would be no good reason to deny the same right to the Commissioner. If the taxpayer wishes to have the Court determine the facts, he has the right to choose that tribunal to try his case in the first instance. To have two determinations of the same factual issues where no error of law can be discerned in the first instance is only a multiplication of time and expense.

22.37. The Committee would not propose that a Court should have the same general power to exercise discretions as is given to Boards of Review. But there is one situation where it considers that a Court should have power.

22.38. At the present time a Court can examine the validity of the exercise of the Commissioner's discretion to see whether it has been infected by legal error as, for instance, whether it has been exercised on irrelevant or inadmissible grounds and, if so, the Court can set it aside. But under the existing legislation, if the discretion has been validly exercised in point of law, the correctness of its exercise is unexaminable. It cannot substitute its opinion in this regard for that of the Commissioner or that of a Board of Review, although the Court may have before it the identical relevant material as the Commissioner or the Board of Review and be in some cases in the same position to exercise the power. Courts are constantly called upon to exercise discretions of widely differing kinds
under both statutory powers and inherent powers. At present, if the case in which the Court finds legal error in the exercise of the discretion is an appeal direct to the Court from the Commissioner, the case is remitted to the Commissioner for further consideration; if it is an appeal from a Board of Review, it is remitted to the Board for the same purpose. Here lie the seeds of further litigation which in some instances will lead to unnecessary expense. The Committee sees no reason why a Court, in a case where it finds legal error in the exercise of a discretion by the Commissioner or by a Board of Review, should not be in the same position as the Commissioner and a Board of Review in regard to the exercise of a discretionary power where it is satisfied that it has the whole of the facts and other relevant considerations before it. In such a case, where the discretion to be exercised is one capable of determination by an objective test or standard, the Court should be entitled to exercise the discretion if it sees fit to do so where the Commissioner and the taxpayer, or their representatives, consent.

22.39. What is said in the preceding paragraph covers a main area of present difference in jurisdiction between a Board of Review and a Court which a taxpayer would take into account in deciding whether to take his case to a Board or to a Court. However, the Committee has noted that, once a taxpayer has applied to the Commissioner for a reference to a Board or for an appeal to a Court, his choice of tribunal is unalterable. This position could be made more flexible without disadvantage to the Commissioner and with advantage to a taxpayer in some cases. Accordingly, the Committee recommends that provision be made to enable a taxpayer to change the tribunal which he has chosen at the time he lodges an application for review or appeal. Any such request for a change of tribunal would need to be lodged before the Commissioner has referred the case to a Board or forwarded the objection to a Court.

Costs of Objections, Reviews and Appeals

22.40. Submissions have been received by the Committee in relation to the recovery of the costs incurred by taxpayers in formulating their objections to assessments and in appealing against the Commissioner's decisions which disallow the objections. Annually a great many objections to assessments are lodged with the Commissioner (see paragraph 22.16 above). Many of these are without substance and are withdrawn by the objecting taxpayer, some after reference to a Board of Review; some are wholly and some partly disallowed by the Board, and some are wholly allowed by the Board. In some cases either the taxpayer or the
Commissioner appeals to a Court in respect of a Board's decision. Frequently, even in those cases in which the taxpayer is successful, the form of the objection goes far beyond the requirements of challenging the particular decision to which objection is taken. In many cases the objection takes what is a standard or substantially standard form. In short, to arrive at some reasonable basis for the taxpayer's costs in formulating his objection presents formidable difficulties and in practice the expense of doing so would more often than not exceed what would be a reasonable sum for the objection itself. The Committee does not recommend that the costs of an objection, even if successful, should be met by the Commissioner.

22.41. Bound up with the question of the costs of the objection is the other question whether the taxpayer who is successful before a Board of Review should be reimbursed for his costs and expenses of the hearing before the Board. In considering the answer to that question, these matters should be kept in mind. Firstly, the reference to the Board is one made at the taxpayer's option. Secondly, the reference to the Board puts him at no risk of costs being awarded against him if he is unsuccessful. Thirdly, the taxpayer, confident of success, can always take his case directly to a Court where the winning of his case will result in his costs being paid. The Board of Review is an administrative body and, having regard to the matters referred to, the Committee does not think that costs should be awarded either against the Commissioner or against the taxpayer in respect of its proceedings. The fees and travelling expenses of persons who are required to attend and give evidence pursuant to Regulation 39 (2) of the Income Tax Regulations are entitled to be reimbursed on a scale fixed by regulations—where requested to attend at the behest of the taxpayer, by the taxpayer, and in any other case by the Commonwealth.

22.42. It has been suggested that the Commissioner should abide by the decision of the Board of Review or that, if he wishes to appeal, he should pay the costs of the taxpayer whatever the result of the appeal in the Courts. This raises a somewhat different problem. The Commissioner may decide to appeal because he considers that a point of law of general importance is involved or that there is a substantial amount of tax at stake. Appeals to a Court—and the case may go further on appeal from the Supreme Court to the High Court—are usually expensive. In 1967 the Commonwealth Treasurer issued a statement in the following terms:

‘Although it will still be necessary to consider each case on its merits, it has been decided that, when the Commissioner appeals against a decision of the Board of Review, the Commonwealth will, as a general rule, be prepared to bear its own costs and the reasonable costs of the taxpayer in connection with the appeal, irrespective of the outcome. The Treasurer said
he would not be prepared to enter into any arrangement regarding costs in cases where the taxpayer was seeking some benefit which the legislature clearly had not intended to grant. Apart from these exceptional cases, however, taxpayers who seek rulings from a Board of Review will have a reasonable assurance that they will not thereby become exposed, against their will, to the cost of litigation in the courts.’

In the Committee's view the Courts should have a wide discretion with regard to the costs on appeals to them from a Board of Review by the Commissioner; but, unless there is some feature of the case which in the opinion of the Court warrants a different order, the costs of such an appeal from a Board of Review should be borne by the Commissioner in any event.

**Interest upon Pre-paid Tax Liabilities**

22.43. A number of submissions have been made to the Committee to the effect that in certain circumstances payments made on account of taxation liabilities should bear a rate of interest for the benefit of the taxpayer. Some of these relate to a payment of tax in accordance with a notice of assessment notwithstanding that the assessment is objected to, or notwithstanding that, where the objection has been disallowed by the Commissioner, his decision has been referred to a Board of Review or is the subject of an appeal to the Court. By virtue of section 201, the fact that the assessment is objected to and that the Commissioner's decision disallowing the objection has been referred to a Board of Review or is the subject of an appeal to the Court does not relieve the taxpayer from his liability to pay the tax, which may be recovered from him by Court process unless the Court in which such action is taken grants a stay of proceedings, a course which would rarely be taken by the Court. It is not unusual in practice for the Commissioner not to take any recovery action in these circumstances where the taxpayer pays to the Commissioner a proportion of the tax levied, usually 50 per cent. If the taxpayer is ultimately successful in having the assessment set aside in whole or in part, it is this sum, or so much thereof as is refundable to the taxpayer, that is claimed should be repaid with interest.

22.44. Where a taxpayer has paid to the Revenue an amount in full or partial discharge of his purported taxation liability and his objection is upheld by the Commissioner, a Board of Review or a Court, there is justice in the claim that interest should be paid on the amount refundable to the taxpayer. In this case the Crown has enforced from him payment of a sum which has been shown to be taken from him without any justification under
the Act which was relied upon for the exaction. Where the Crown rightly resumes property and delays payments therefor, interest is generally payable upon the debt and, where property is taken from the citizen without sanction, the case for the payment of interest appears to the Committee to be unanswerable. The rate of interest should be specified as a realistic one in keeping with current economic conditions.

**Taxation Prosecution Procedures and Penalties**

22.45. The Committee has received submissions relating to penalties and prosecutions dealt with in Part VII of the Act. Section 243 provides (*inter alia*) in effect that any allegation of fact (averments) contained in the process initiating a taxation prosecution shall be prima facie evidence of the matter averred. The purpose of the section is to enable the prosecution to sheet home its case without calling evidence to prove the facts necessary to sustain the charge made against the defendant. The section has no application where the intent of a defendant has to be proved or where the proceedings are for an indictable offence or an offence directly punishable by imprisonment. Section 221G is, for example, one of a number of sections in Division 2 of Part VI of the Act relating to collection of income tax by instalments and requires an employer, other than a group employer, to keep a tax deduction sheet and imposes a series of obligations in regard thereto. The penalty for failure to comply with certain of these obligations is fine or imprisonment. In many instances defendants charged with breaches of section 221G and other sections in Division 2 do not appear to answer the charge but, as the prosecution cannot rely upon the averments, the time of the Court is taken up in proving all the ingredients to sustain the charge.

22.46. It has been put to the Committee that the penalty of imprisonment should be deleted from these sections to permit charges under these sections to be proved by means of the averments. In these cases the penalty of imprisonment is rarely imposed and the Committee would favour its deletion.

22.47. It has also been submitted that section 243 should be altogether repealed and that the onus of proof in prosecutions under the Act should follow the general law. The type of provision found in section 243 is by no means unique and can be found in other fiscal and criminal legislation. It does not alter the fact that the prosecutor is left with the onus, both initial and final, of establishing the ingredients of the offence beyond reasonable doubt. Where the criminal intent of a defendant is an ingredient of the offence charged, this must be proved in the ordinary way. The Committee
sees no good reason why section 243 should be repealed. It also sees no
good reason why service of summonses for offences against the Act should
not be effected by registered post.

22.48. The Court should be empowered in its discretion to extend the
time for payment of pecuniary penalties which have been imposed. By
virtue of section 247 (2) the Court, when an offender is convicted and
ordered to pay a penalty, may order that the offender be given a specified
time for its payment or allow it to be paid by specified instalments. Failure
to pay the penalty or an instalment within the time specified will result in
the imprisonment of the offender and, in all probability, any chance of
recovering the penalty or the balance of it unpaid will be lost. No account
is taken of some unexpected difficulty or hardship occurring to an offender
who may be prepared to meet his liability rather than suffer imprisonment.
Power in the Court to grant an extension of time would be in the interests
of the Revenue as well as the taxpayer.

22.49. A submission received with reference to section 226 raises the
question of penalty in a different fashion. For the failure to furnish, where
required by statute or by the Commissioner, a return or any relevant
information or for the omission from a return of any assessable income or
for the inclusion therein of an excessive deduction for expenditure, the
taxpayer becomes liable to pay an amount of additional tax calculated as
prescribed by the section. The Commissioner is empowered for reasons
which he thinks sufficient to remit the additional tax or any part thereof. It
has been urged upon the Committee that section 226, which admittedly
imposes heavy penalties in the shape of additional tax for breaches of its
provisions, should be amended to distinguish between an accidental and
deliberate breach of the section and the penalty for its infringement should
only be determined by a magistrate. Section 226 is fundamental to the basis
of the collection of income tax and it is essential that there should be a
powerful deterrent standing in the way of non-compliance with the
provisions of the Act and that the Revenue should be protected against
procrastination and carelessness.

22.50. That is not to say, however, that every breach of the section
should be visited with the totality of the penalty which the section
prescribes. Returns are not always easy to compile and mistakes may occur
even when care has been used to avoid them. It is not to be supposed that
the Commissioner would not give full recognition to the likelihood of
excusable, accidental error and by his power of remission he is enabled to
make due allowance for it. If the taxpayer, however, is dissatisfied with the
decision of the Commissioner relating to the remission of additional tax
imposed by section 226, he is entitled to take the matter before the Board
of Review which, by virtue of section 193 (2), has a limited power of reviewing that decision. In the Committee's view, no amendment of sections 226 or 193 (2) is called for along the lines suggested.

22.51. Representations have also been received by the Committee in relation to section 226 (4) which precludes the imposition of additional tax under the section where a prosecution is instituted in respect of the same subject-matter. Where a prosecution for failure to furnish a return is instituted under section 223, the penalty is not less than four dollars or more than $200; and it has been put to the Committee that many persons who have failed to lodge a return for a substantial income deliberately court prosecution knowing that the maximum fine of $200 under section 223 will be less than the additional tax which would be imposed by the Commissioner for late lodgment of the return without prosecution action being instituted. It is understood that additional tax imposed by the Commissioner for late lodgment of a return is normally based on what is in effect an interest charge of 10 per cent per annum of the tax payable for the period the return is late. It has been submitted to the Committee that it is anomalous that a taxpayer by courting prosecution can limit the penalty to $200 in these types of cases.

22.52. While the Committee elsewhere in this Report recommends revision of all of the penalties specified in the Act, this is not necessarily the complete answer to the submissions. Several proposals might be considered. One would be to repeal subsection (4) of section 226 and thus enable both the additional tax and the Court-imposed penalty to be exacted in appropriate cases. Subsection (3) of section 226 dealing with the Commissioner's power to remit additional tax could be expanded to include a direction that, in considering remission, the Commissioner is to take into account any penalty imposed by a Court. Another proposal would be to provide in section 223, which deals with prosecutions for failure to furnish returns or information, for a penalty of stipulated minimum and maximum amounts and, in addition, to give the Court power to order the person to pay to the Commissioner a sum not exceeding the maximum additional tax which could be imposed by the Commissioner under section 226 (1) of the Act. This latter is the pattern of the present legislation in relation to prosecutions and additional tax in cases of false returns, wilfully understating income and fraudulent avoidance of tax in sections 227, 230 and 231 respectively. The additional tax for failure to furnish a return is at present the greater of two dollars and an amount equal to the tax assessable on the return. To overcome cases where a return has not been furnished at the date of a Court hearing, a Court could order the taxpayer to pay to the Commissioner a specified proportion of the tax eventually found to be
22.53. The Committee recommends the second of the two proposals outlined in the preceding paragraph: that the penalty specified in section 223 for failure to furnish a return or information be of the same nature as the penalty in the sections dealing with prosecutions for false returns and understating income.

22.54. Section 246 provides that no minimum penalty imposed by the Act should be liable to any reduction under any power of mitigation which otherwise is possessed by the Court. It has been submitted that the Court should have such a power. The Committee is not of that opinion. The real question would be whether the minimum penalty set by the Act for some particular offence is too harsh and that is another matter altogether. The Committee thinks that there ought to be a general review of the penalties which the Act imposes.

**Hardship Relief**

22.55. It has been proposed to the Committee that a tribunal should be established to consider cases of hardship under the Act. By virtue of section 265 such a tribunal already exists in the form of a Board consisting of the Commissioner, the Secretary to the Treasury and the Comptroller-General of Customs or such substitutes as the Minister may appoint for any of them. The practice is that substitutes are appointed to constitute the Board of Relief. Where the amount of the liability does not exceed $200, the powers of the Board of Relief may be exercised by the Commissioner; where the relief claimed is less than $2,000 in an amount of tax, the Board of Relief may refer the application to a member of a Board of Review; and where the relief claimed is not less than $2,000 in an amount of tax, the Board of Relief is bound to refer the application to a member of a Board of Review. In lieu of referring the application to a member of a Board of Review, the Board of Relief may refer the application to the Chairman of a Valuation Board constituted under the Taxation Administration Act 1953 before whom the same procedure for examining the application for relief is to be followed. It will be convenient in what follows below to discuss the matter in terms of a reference to a member of a Board of Review. Provision is made in the section for the attendance of the applicant or his representative before the member of the Board of Review who may permit the applicant to be assisted by other persons. The section contemplates that a careful and recorded examination, upon oath if necessary, shall take place before the member of the Board of Review, who must submit a report to the Board of Relief, together with the record of the examination, drawing
attention to any facts which have a particular bearing on the application for relief.

22.56. The section does not, however, provide, at any rate in terms, that the member of the Board of Review shall make any recommendation as to the form or amount of relief which in his opinion ought to be granted; nor does it ensure that the Board of Relief must act upon the report of the member of the Board of Review. It is clear from the construction which Courts have placed on sections similarly worded to section 265 that, although it is shown to the satisfaction of the Board of Relief from the report and the examination of the applicant before a member of a Board of Review that the hardship of the applicant which the section contemplates does in fact exist, the Board of Relief is not bound to grant any relief to the applicant, as its power to grant or to decline to grant relief is purely discretionary. The Board of Relief is not obliged to state its reasons, so that it would be virtually impossible for an unsuccessful applicant to discover the basis of the refusal of his application. Accordingly, it would not be possible for him even to ascertain whether the discretion for which no limits are imposed in the statute was nevertheless exercised on grounds which were irrelevant to the purposes for which it was granted. From the decision of the Board of Relief there is no appeal.

22.57. The number of cases of hardship annually dealt with and the total amount of relief granted fluctuate. In the five tax years from 1969–70 to 1973–74 the average annual number of income tax cases dealt with was 427 and the average annual total amount of relief granted was $423,263.

22.58. In the Committee's opinion the procedure for dealing with cases of hardship in section 265 should be altered. Where the amount of the liability in question does not exceed $500, the powers of the Board of Relief should be exercised by the Commissioner. Where the amount in question does not exceed $2,000, the Board of Relief should in its discretion refer the application to a single member of a Board of Review. Where the amount in question exceeds $2,000, the Board of Relief should on its discretion refer the application to a Board of Review and ought to be bound to do so if so requested by the applicant. The Board of Review is entrusted under the review provisions of the Act (see Division 2 of Part V) with functions of great importance and deals with questions involving tax liabilities which can be very considerable in amount. Judging alone by the number of cases referred to them, it is apparent that the Board of Review has the confidence of the majority of taxpayers in the disputes between themselves and the Revenue. It is obvious that Parliament reposes the same confidence in the work performed by it. The system of review as conducted by a Board of Review in a difficult field works very well. Where an application is
referred by the Board of Relief either to a member of the Board of Review or to the Board of Review itself, section 265 should provide that the single member or the Board of Review, as the case may be, be required to make a recommendation which should be implemented by the Commissioner. The Committee wishes to make it abundantly clear that there is not the slightest suggestion that applications for relief have not been dealt with fairly and upon their merits by the Board of Relief under its present constitution; but it believes that the treatment of hardship applications in this way would remove from the minds of taxpayers any feelings of bias which otherwise might be present when, as is the present position, a release of a tax liability rests solely with the representatives of government departments.

22.59. The scope of the hardship covered by section 265 is that

‘(a) a taxpayer has suffered such a loss or is in such circumstances; or
(b) owing to the death of a person, who, if he had lived, would have been liable to pay tax, the dependants of that person are in such circumstances,

that the exaction of the full amount of the tax will entail serious hardship.’

In the exercise of the discretion the whole or part of the tax liability may be released. The coverage of the hardship to be taken into consideration is very wide. The Committee does not favour the suggestion that guidelines be incorporated in the section for the exercise of the discretion: the circumstances in which hardship may be met with could vary in so many different ways that it would be a practical impossibility to enumerate them and a partial listing would only tend to place a restrictive construction on a discretion which ought to be capable of dealing with any genuine situation that may arise. But power should also be given to extend the time for payment for such of the tax as may not be released.

22.60. A particular aspect of hardship relief raised in submissions to the Committee deals with Australian tax on income from overseas where remittance of that income cannot be obtained because of exchange control operating in the country of origin of the income. Some cases of dividends are particularly in point.

22.61. In some instances the provisions relating to relief from hardship are appropriate, but the vast majority of these cases can be satisfactorily dealt with by the Commissioner under his powers to grant extensions of time for payment and to waive completely, or collect additional tax for late payment, as is appropriate to the circumstances of each case.
22.62. It has also been submitted to the Committee that foreshadowed amendments to the Act and regulations should be given public circulation so that they may be discussed by members of the interested professions, commercial organisations, trade unions and other persons. This could be done in the form of the publication of a draft Bill or a Green Paper, as is the common and successful practice in the United Kingdom. Where the proposed introduction of a new tax is decided upon by the Government, protection against advantage being taken of the intended enactment is achieved by making a public announcement, simultaneously with the publication of the draft Bill or Green Paper, that the tax, when the appropriate legislation is passed by Parliament, will take effect from a specified day. In that way the stigma of retrospectivity of taxation would be avoided. The Committee is of the opinion that these procedures should be followed and that informed discussion of any new fiscal laws will be of considerable assistance in the framing of the legislation. The experience of this Committee suggests that publicity of the kind referred to will not lead to only a mindless opposition to taxation proposals.

**Independent Standing Committee**

22.63. It has been submitted to the Committee that an independent standing committee should be constituted whose duties, in liaison with the Treasury and the Taxation Office, would be to keep under constant review the working of the Act, to examine and report upon any amendments to the Act either suggested by members of the public or conceived by one or other of the government departments or made advisable by reason of decisions given by the Courts. The standing committee would be in a position to give assistance in the preparation of draft Bills or Green Papers and to examine any proposals forthcoming as the result of the publicity given thereto. The Committee believes that the opening up of changes in taxation legislation to general public discussion will not only prove of great benefit in framing the statutes which impose the taxes but also educate all categories of the public in the reasons for their introduction. By means of education and open debate, upon their enactment the laws will meet with a more ready and general acceptance and understanding on the part of all those called upon to comply with them, in place of the hostility which is often displayed on those occasions. Abundant proof of this is recently to be seen in the United Kingdom. The knowledge of the existence of an independent standing committee, which would always be in a position to receive the views of persons and bodies outside the area of government and to discuss them with their authors, would tend strongly to instil confidence
in the public and allay the criticism that those who pay the taxes are never heard.

II. Procedures and Compliance

22.64. Submissions have been received dealing with the relationship between the Taxation Office and taxpayers and their advisers. The matters raised include the manner in which taxpayers are informed of adjustments made in assessing returns lodged, information disseminated by the Taxation Office for the benefit of taxpayers and their advisers, and the question of whether a formal assessment should be issued in respect of non-taxable returns specifying the amount of a loss available for recoupment in other income years.

Adjustment Sheets

22.65. Where the taxable income shown by an assessment varies from that shown by the taxpayer in his return, or there is some other matter affecting the assessment that needs to be explained to the taxpayer, the Taxation Office issues an explanatory advice known as an ‘adjustment sheet’. Some submissions have criticised these sheets on the grounds of insufficient detail and inadequate disclosure of reasons.

22.66. It is always open to taxpayers and their representatives to seek further clarification by correspondence or by personal attendance at the Taxation Office or at a regional office. Earlier in this chapter the Committee has suggested a procedure that would enable taxpayers, in cases under appeal, to obtain from the Commissioner further details of an assessment.

22.67. The Committee acknowledges that some of the criticism of the details shown on adjustment sheets may be justified. However, improvement cannot be achieved by a change in the law; it appears to be largely a matter of administration. The Committee recommends that the Commissioner and his officers arrange for a review of the present practices to provide greater detail of adjustments made in those cases where a spelling out of reasons is needed to explain the variation made.

Supply of Information

22.68. *Return forms*. With return forms the Taxation Office supplies instruction sheets and other information designed to assist taxpayers in completing their returns. This material has been expanded in recent years: in relation to a salary or wage return (Form S), the 1974 Guide to Form S
and the pamphlet explaining age concessions are proving particularly helpful.

22.69. There is a continuing need to expand and improve material available to taxpayers and their advisers in relation to the preparation of returns, and to this end many of the practices adopted in the United States and Canada might usefully be followed. In particular, the Committee recommends extending the provision by the Taxation Office of standard forms for attachment to the return where appropriate. Standard forms could be made available giving details of disposals of property, net rental income, motor-car expenses, and travelling and entertainment expenses—this list is clearly not exhaustive.

22.70. *Information bulletins.* From time to time the Commissioner has issued pamphlets, bulletins and the like setting out guidelines on the interpretation of the taxation laws and practices being adopted. The series of Income Tax Orders issued in the comparatively early years of Federal income tax and the Public Information Bulletins published after the 1964 amending income tax legislation are cases in point.

22.71. The publication by the Commissioner of rulings, guidelines and information on these lines is desirable and creates a better understanding of taxation laws and practices. Further, the dissemination of this information leads to fuller co-operation by taxpayers and their advisers in complying with the provisions of the law. Published information of this nature also helps to dispel the frequently-voiced criticism, when the operation of the taxation laws has an effect believed to be disadvantageous to the taxpayer, that the Taxation Office is endeavouring to assume the role of ‘rule-maker’.

22.72. The Committee is aware of the activities of overseas taxation administrations in issuing general rulings and information and is particularly impressed by what is being done in the United States and Canada. In issuing rulings and guidelines, the Taxation Office needs to make it clear that the published information is not binding upon the Commissioner in any proceedings before a Court or other tribunal.

22.73. *Advance rulings.* When requested by a taxpayer, the Taxation Office now gives advance rulings on the application of specific provisions of the law to a proposed transaction where full details of the contemplated transaction are supplied. The ruling is normally given on the understanding that it is not legally binding on the Commissioner. There is considerable merit in placing advance rulings by the Commissioner on a formalised basis binding him to the decision given. Rulings of this nature would clearly be of benefit to the taxpayer concerned and it is therefore reasonable that the cost of providing the service should be met by him
rather than by the general body of taxpayers. In Canada an advance rulings service has been inaugurated for which there is a charge of $Can20 per hour, with a minimum of $Can 150 for any one ruling. The Committee recommends that a charge be made for giving advance rulings, based on the cost incurred by the Commissioner, subject to a minimum charge of, say, $200.

**Non-taxable ‘Assessments’**

22.74. Each year the Taxation Office receives returns of income upon which no income tax is payable. In relation to these returns the legislation does not require the Commissioner to issue any binding notification of his computation of the taxable income or loss, as it does in respect of returns upon which tax is payable. It has been put to the Committee that any adjustment sheet or other advice issued by the Commissioner should in effect be treated as an ‘assessment’ under the legislation, particularly where losses available for carry-forward are involved. This would mean, among other things, that the provisions of the law relating to the amendment of assessments and to objections and appeals against assessments would apply in relation to non-taxable ‘assessments’.

22.75. The argument for treating advices of losses as assessments is mainly that it would enable the taxpayer promptly to challenge, by the procedure for objection and appeal under the law, any adjustment made by the Commissioner with which the taxpayer did not agree. The present position, of course, is that the taxpayer is in no way deprived of the right of objection and appeal against adjustments in determining losses that become effective as a deduction from subsequent income. In the year of effective set-off, the taxpayer can object and appeal against the quantum of loss so brought forward and thus challenge any adjustment by the Commissioner.

22.76. If advices of losses were to be regarded as assessments, consequences other than rights of objection and appeal would follow. The provisions of the law relating to amendment of assessments would apply so that taxpayers would be subject to the time restrictions on adjustments that now apply to taxable assessments. If a taxpayer did not object within sixty days of service of a notice, he could find that a required adjustment to a loss involving a question of interpretation of a law was not possible under the legislation or that the time to correct an error in calculation or mistake of fact had run out. Further, a taxpayer in reaching a decision whether to challenge, by objection and appeal, an adjustment in a non-taxable assessment would need to weigh up the time and cost involved against the possible tax effect in the future.
22.77. It would be difficult to confine any provisions granting assessment status only to cases involving losses. Instances where adjustments to claimed losses create a taxable income but no tax liability would have to be included; also those cases involving a taxable income but no tax payable, where the year concerned could be taken into account in determining an average income, would have claim to similar treatment. In the result, the Taxation Office might be faced with the task of issuing a great number of non-taxable assessments to taxpayers who did not require the information.

22.78. The Committee does not favour provisions requiring the Commissioner to issue a non-taxable assessment in every non-taxable case or provisions treating all advices issued by the Commissioner in relation to non-taxable returns as assessments. It recommends that a taxpayer be entitled to request the Commissioner to issue a formal non-taxable assessment which, on issue, would for all purposes be regarded as an assessment. At the same time opportunity might be taken to clarify the intended purpose of section 171 of the Act, which deals with the position where no notice of assessment has been served within the period of twelve months after lodgment of a return.

Taxpayer Compliance

22.79. Any system of direct taxation relies heavily on the general acceptance of the system by those required to pay the levy and on the rendering of true returns. Legislation imposing taxes normally provides for additional imposts for incorrect and untrue returns or statements and failure to supply returns or information on time; and there are Court processes for prosecution in these instances. Like the taxation authorities of many other countries, the Taxation Office maintains on its staff officers whose task is to audit and examine the returns of taxpayers to detect inaccuracies or deception. In the opinion of the Committee this audit activity is essential. There is merit in extending it to the greatest possible number of taxpayers and giving it maximum publicity.

22.80. Elsewhere in this Report the Committee has proposed the introduction of a capital gains tax, measures for dealing with income splitting and ways of tightening up on the taxation of gifts of property. These recommendations relate mainly to capital transactions which will require the disclosure to the Commissioner of relevant information. In order that the Commissioner can properly administer provisions to this effect and also to assist in the general administration of income tax, estate duty and gift duty laws, the present requirements to supply balance sheets or statements of assets and liabilities with income tax returns should be
22.81. At the present time balance sheets or statements of assets and liabilities must be furnished with each income tax return of a company, a superannuation fund, a partnership in business and certain trust estates. The Committee recommends that these requirements be extended so that a balance sheet or statement of business assets and liabilities is also supplied with each income tax return of a taxpayer carrying on a business or profession; all trust estates and partnerships should be included too.

22.82. A standard form of balance sheet or statement of assets and liabilities should be issued by the Commissioner for completion and forwarding with returns other than company returns. The form should also provide for the supply of associated information required by the Commissioner, such as movements in capital accounts of taxpayers in business.

Registered Tax Agents

22.83. The income tax law provides for the registration as tax agents of all persons who charge fees for the preparation of income tax returns or for transacting income tax business on behalf of taxpayers. At 31 March 1974, there were 19,432 individuals, partnerships and companies registered as tax agents.

22.84. The Act and Regulations provide for a Tax Agents’ Board in each State and for the constitution and conduct of these Boards, the registration and cancellation of registration of tax agents, and the imposing of penalties for offences against the provisions. Apart from the cancellation of a tax agent's license where, for example, he does not wish to continue as an agent or where a partnership or company is dissolved or liquidated, there are provisions for cancellation where the Board is satisfied that an agent has prepared a false return, neglected the business of a principal, been guilty of misconduct as an agent or is not a fit and proper person to remain registered. There is a right of appeal to a Court against the decision of the Board.

22.85. Where the Board finds a tax agent guilty of misrepresentation, neglect, incapacity or unfitness, the only disciplinary action it may impose, apart from reprimand, is to cancel his registration—a somewhat drastic step. There are obviously cases where cancellation is too severe a penalty but something stronger than a reprimand is called for. Accordingly, the Committee recommends that provision be made for other disciplinary action such as the imposition of a fine and suspension of registration for a period.
22.86. In view of the growth in the number of registered tax agents, with consequential increase in the number of disciplinary cases coming before Tax Agents’ Boards, and the additional disciplinary measures recommended in the previous paragraph, it is necessary that the present constitution of the Boards be reconsidered. The Boards at present comprise a Chairman, who is the officer in charge of the Commonwealth Sub-Treasury in the State, the Commonwealth Chief Auditor for the State and a person appointed by the Governor-General—normally a senior practising accountant. When the constitution of the Boards is being reviewed, consideration should be given to attaching greater weight to their disciplinary functions and less weight to their registration procedures. Moreover, one member, preferably the Chairman, should be an experienced legal practitioner.

22.87. The certificate relating to sources of information that a tax agent is required to complete on each return he prepares for a client includes the following, as set out in the Regulation:

‘(b) Have you satisfied yourself, and, if so, how, that the books of account, or other sources of information upon which the return is based, are correct and disclose the whole of the taxpayer's income from all sources?’

This question is frequently answered by a statement by the tax agent that he has not satisfied himself as to the accuracy of the return.

22.88. This question should be reviewed by the Commissioner in consultation with members of the accountancy profession and organisations representing tax agents. The purpose of the review should be to develop a question or series of questions that would go further towards securing a statement from the tax agent recording the steps he has taken to ensure the accuracy of the return covered by his certificate.

III. Payment of Tax

22.89. At the present time the liability for payment of tax is discharged by means of three main systems: firstly, the tax instalment deduction system (pay-as-you-earn), which requires tax to be deducted by the employer from salary and wages; secondly, the system of provisional tax payments by individuals in respect of income that is not salary or wages, applying principally to business income and income from investments and property; and thirdly, the system of payment of tax by companies. The system applying to companies is in course of change from one basically of payment in a single lump sum in the financial year following the year of income to one of payment by four instalments spread over the later year.
22.90. There is also the system of withholding tax on interest and dividends flowing from Australia to non-residents.

**Tax Instalment Deduction System**

**Excess Instalment Deductions**

22.91. The present system of tax instalment deductions from salary or wages is well established. Deductions from salary or wages comprise over half the total collections of income tax. The system is accepted by both employees and employers and generally works satisfactorily. But there are several aspects of the system requiring examination.

22.92. The instalment deductions from salary or wages are based upon schedules in the Regulations to the Act. The main schedule provides for instalment deductions in relation to concessional allowances for dependants and for home loan interest to which a taxpayer may be entitled. An employee may formally notify his employer of any of these concessional allowances and the employer is then required to take account of this information in making instalment deductions. The main scale of instalment deductions has built into it some recognition of average concessional allowances for items other than dependants, such as superannuation contributions and medical expenses; but generally the aim is to ensure that total instalment deductions exceed the amount of final tax payable, so that for a very high percentage of salary or wage earnings without other income there are end-of-year refunds. In some cases taxpayers deliberately refrain from informing their employers of entitlements to dependant allowances and in this way voluntarily increase the amount of their refunds. Moreover, in recent years there have been indications that the application of the main schedule of instalment deductions is resulting in greater numbers of salary and wage earners with further tax payable at the end of the year: the taxpayers chiefly involved are those without dependants and with few other concessional allowances. In September 1972 an optional schedule was issued with the object of reducing the number of cases where a further tax payment has to be made after the end of the year.

22.93. It is apparent from submissions that some taxpayers favour instalment deductions being aligned more closely with their final tax liability. It has also been put to the Committee that the rapid growth of end-of-year refunds, mainly in the months of July, August and September, is leading to more pronounced seasonal movements in the economy's liquidity—movements involving costs for the whole community. The end-of-year refunds have grown from $507 million in 1970-71 to $772 million
in 1973-74 and an estimated $930 million in 1974-75.

22.94. Under the present legislation an employee can reduce his tax instalment deductions to a figure closer to his final liability by special application to the Commissioner for a variation of the instalment deductions. In the Committee's view this procedure should be more readily available to employees and more widely applied. The present system of declaration forms supplied by employees to employers should be extended to include a number of concessional allowances in addition to those for dependants and for mortgage interest. Within the limits of a maximum yearly allowance, the extension ought at least to encompass employee superannuation and medical and hospital benefit fund contributions collected through employers, and deductible life insurance premiums where supported on the declaration form by details of policy number, name of payee, etc. as now required on return forms.

22.95. The reduction of tax instalment deductions in this fashion should be entirely optional in the manner of the present reduction for dependants: it would be solely up to the employee whether he wishes to take advantage of it. Where an employee claims reduction of instalment deductions other than for dependants, the employer would be obliged to apply an instalment scale that takes no account of concessional allowances. The implementation of a scheme of this kind will inevitably involve the Taxation Office in an expanded role in advising upon and policing the pay-as-you-earn system. But the work load on employers would not be significantly increased; and as is the case at present, employers would not be required to accept responsibility for the accuracy of the items claimed by employees.

**Limited Effectiveness**

22.96. The key to the effectiveness of the tax instalment deduction system is the definition of ‘salary or wages’ in the legislation. While the definition is drafted to include payments made ‘under a contract which is wholly or substantially for the labour of the person to whom the payments are made’, its interpretation has severely limited the application of tax instalment deductions. Generally the system cannot apply unless payments are made in circumstances where a relationship of employer and employee clearly exists, and difficulties arise where payments based on work performed are made to one of a group of workers operating in a loose partnership arrangement: payments of the latter type cannot be said to be substantially for the labour of the one person to whom the payment is made.
22.97. Where the relationship of employee and employer is absent, the Committee recommends that payments substantially for the labour of one person or a small group of persons be included in the system of tax deductions at source. Like salary and wages, the income would be brought to account as income in a return after the end of the income year and, on assessment, credit would be given for the tax deductions. In similar fashion the system of tax deductions at source could be extended to certain payments for goods where the payment is substantially for the labour of the seller: for example, payments to individuals for supplying animal skins or opals. The systems of tax instalment deductions employed in the United Kingdom and New Zealand contain provisions similar to what is being proposed here.

22.98. The tax deductions would have to be made at a flat rate. However, a taxpayer would need to be given an opportunity of applying to the Taxation Office for a reduced flat rate where the nature of his operations and expected net income warranted a lower rate. Similarly, where the extent and nature of a taxpayer's operations, the maintenance of adequate records and the lodgment of past returns give grounds for reasonable expectation of the lodgment of complete and accurate returns and the payment of tax, exemption from flat-rate deductions at source might be sought from the Commissioner.

22.99. The areas of activity to be covered by extended tax deductions at source might include the building and construction industry; primary production, including forest operations and fishing; the entertainment industry, including professional sport; and free-lance writing. The experience of the Taxation Office in these and other fields of activity where difficulties have been experienced in collecting tax should be drawn upon in delineating the areas to be covered.

22.100. Secondary or casual employment is another area in which the system of tax instalment deductions fails to operate effectively. At present secondary or casual employment yielding $20 or less per week is not subject to instalment deductions; and a casual employee who lodges with his employer a declaration claiming reductions for dependants is freed from instalments in respect of considerably higher casual earnings. While, to an extent, earnings not subject to tax instalment deductions must be shown in Statements of Earnings supplied to employees, with a copy to the Taxation Office, the coverage is far from complete. There is thus substantial scope for tax avoidance in the case of earnings from secondary or casual employment, and the opportunity of using false names increases the scope yet further.

22.101. Where a relationship of employer and employee arises, the
Committee recommends that, for tax instalment deduction purposes, a distinction be drawn between main regular employment on the one hand and all other employment—secondary or casual—on the other. The former should be subject to tax instalment deductions on the present basis, main regular employment being interpreted as employment expected to continue for more than one week and to involve working on at least four days for a minimum of 30 to 35 hours a week. Other employment ought to be subject to tax instalment deductions at a flat rate high enough to discourage working under a false name and giving strong encouragement to include the income, and the credit for tax instalment deductions, on a return of income. It would be necessary to determine an amount per week, less than the present $20, below which no tax deductions would have to be made. There would also need to be provision for an alternative to the basic flat-rate deductions: employee taxpayers taking secondary or casual employment should be able to apply to the Taxation Office for a certificate authorising, in relation to a particular employment, flat-rate instalment deductions at a lower rate or in some cases no deductions. The employee would have the option of accepting the basic flat-rate deduction with the prospect of a refund on assessment of his return of income after the end of the year or of applying to the Taxation Office for a reduced flat-rate deduction: in both instances the income and credit for instalment deductions would still have to be included in the return of income.

22.102. A third area in which the tax instalment deduction system lacks effectiveness is in relation to benefits in kind—‘fringe benefits’—given by an employer to an employee. In Chapter 9 the Committee has made recommendations on the tax treatment of non-cash benefits from employment. Briefly, the Committee recommends that the tax instalment deduction system be extended, where possible, to ensure adequate instalment deductions in respect of the assessable value of employment benefits that are to be brought to account as assessable income. The present legislation on tax instalment deductions covers meals, sustenance or the use of premises or quarters, in addition to salary or wages, but the statutory figures of value obviously need to be lifted.

22.103. The Committee recognises that these recommendations will, to some extent, involve employers and certain other users of labour in additional work. But if, as a result, the effectiveness of the tax system is increased, the price is worth paying.

Other Aspects

22.104. On several other aspects of the system of tax instalment
deductions the Committee does not propose to make firm recommendations. One of these concerns the difficulties in establishing the true identity of employee taxpayers at the employment point. An employee, with or without the connivance of his employer, may work under a false name. The recommended system of flat-rate tax instalment deductions for secondary or casual employment is likely to reduce tax evasion in this area. But if each adult person were to be given an identifying number to be used in all employment documents and in tax instalment deduction documents and tax returns, scope for tax evasion would virtually disappear. The Committee is aware of objections to any general system of allotting numbers to members of the population for purposes of identification, though it should be pointed out that such a system is in operation in the United States.

22.105. In the Committee's view the advantages of a system of identity numbers far outweigh the disadvantages, a matter mentioned earlier in paragraph 13.14. The obvious advantage in reducing tax evasion, and thereby conveying benefits by way of potentially lower imposts upon honest taxpayers, is in itself a major factor in favour of such a system. At 30 June 1974 the total amount of unapplied credit on Group Certificates was some millions of dollars. This figure represents tax instalment deductions made by group employers and included on Group Certificates issued to employees which the Taxation Office has not been able to match with returns lodged. Clearly this figure must include a substantial sum in respect of employees working under false names where there is not a corresponding return lodged: the tax correctly payable would generally exceed the amount deducted at source.

22.106. The Committee is also aware of the likelihood, under the present system, of false claims for dependent children in dependant declaration forms furnished by employees to employers, whether the employee is working under his true name or not. By this means an employee can substantially reduce tax instalment deductions or eliminate them completely. The proposal of the Committee in Chapter 12 that concessional tax allowances for children be replaced by benefits given solely through the child endowment system will eliminate claims for children in dependant declaration forms. This is a further point in favour of handling child maintenance benefits through the expenditure side of the Budget.

22.107. Finally, the question has been raised in submissions of the Australian Government paying interest on end-of-year excess tax instalment deductions due for refund. The Taxation Office endeavours to issue these refunds to a maximum number of taxpayers as soon after the end of the income year as possible, and by the end of October well over 80
per cent of refunds of excess tax instalment deductions have normally been posted to taxpayers.

22.108. The Committee has made recommendations that would enable any taxpayer concerned at the size of his expected refund to have the amount reduced. To calculate interest entitlements in relation to end-of-year excess tax instalments would be extremely expensive and might result in delays in making refunds to employee taxpayers. The Committee therefore does not favour the payment of interest.

Provisional Tax System

22.109. It is by means of the provisional tax system that individual taxpayers with income from sources other than salary or wages have since 1944 been called upon to pay tax on a basis broadly similar to the pay-as-you-earn basis applicable to salary or wage earners. In a year of income in which income other than salary or wages is derived, a taxpayer pays, not earlier than 31 March in that year, an amount of provisional tax normally based on the taxable income from this source in the preceding year of income. The amount and due date for payment of provisional tax are notified with the assessment for the preceding year of income. Where prior to this due date for payment of the provisional tax, or an extended due date, a taxpayer confidently anticipates that his taxable income in the current year will be less than in the preceding year, he may by a process of self-assessment have the amount of provisional tax reduced. Penalties by way of additional tax are provided for undue underestimation of income. A taxpayer may also have the amount of provisional tax increased above the notified figure by the same self-assessment process.

22.110. Submissions to the Committee on this subject can be conveniently divided into two categories, the first advocating that the provisional tax system be abolished and the second claiming that provisional tax should be paid by instalment. At the basis of the latter claim is the view that payment by instalment is a more convenient means of satisfying a substantial liability and that payment of all provisional tax in the last quarter of the year is a major contributing factor to the pronounced seasonal movements in the liquidity of the whole economy.

22.111. In the Committee's opinion, the pay-as-you-earn character of provisional tax should not be abolished. Receipt by the Government of substantial amounts of revenue from this source in the year of derivation of the taxed income is well established and abandonment of pay-as-you-earn would severely affect revenue in the year of change. So long as pay-as-you-earn applies to salary and wage earners by instalment deduction as
income is received, there seems little justification for other individual taxpayers paying tax on any substantially more advantageous basis.

22.112. In considering the payment of provisional tax by instalment, the Committee has had in mind two other relevant matters upon which submissions have been received. These are criticisms of the present requirements that apply to taxpayers carrying on business activity who find it more convenient and desirable, for a variety of reasons, to prepare accounts on a year ending on a date other than 30 June; and representations on the problems facing tax agents in meeting the program set by the Commissioner for lodgment of clients’ returns. On both these matters companies as well as provisional taxpayers are involved: the company aspects will be taken up later when the system of paying company tax is considered.

22.113. The two matters mentioned in the preceding paragraph need spelling out. Under section 18 of the Act, a person desiring to lodge returns on an accounting period ending other than on 30 June requires the approval of the Commissioner. The Commissioner takes the view that where such approval is granted the person should not receive a tax advantage, such as a deferment or delay in payment of tax, compared with a taxpayer lodging on the basis of 30 June. Special conditions are not normally attached to approval to lodge returns on an accounting period ending on say 30 September, being after 30 June, except that there must be no period of income not covered by returns. In such a case the person involved accepts some tax disadvantage compared with a 30 June basis because he pays tax on income derived in the last three months—July, August and September—at an earlier date.

22.114. On the other hand, where a taxpayer seeks leave to lodge returns on an accounting period ending on, say, 31 March, being before 30 June, the granting of leave without a conditional adjustment would result in the taxpayer gaining an advantage from the deferment or delayed payment of tax on income derived in the three months of April, May and June following the balance date of 31 March. The usual condition attached to the approval is agreement to pay, in conjunction with the tax due on the first period ending 31 March, a further amount equal to tax attributable to taxable income derived or estimated to be derived in the following three months of April, May and June. Subsequent returns cover a twelve-month period ending 31 March and the further amount is held by the Revenue until the person ceases to be a taxpayer or changes the balance date, when an appropriate tax adjustment is made. Few individuals, partnerships and trust estates lodge returns on an accounting period ending other than on 30 June, though quite a number of companies do. The requirement to pay the
further amount has been the main subject of complaint by companies in submissions to the Committee, and the matter is taken up later. Not all companies and individuals now lodging returns on an accounting period ending before 30 June have actually paid the further amount referred to, or an amount that is realistic in the light of their current income. There are a variety of reasons for this: for example, the present accounting period may have been adopted many years ago when annual income was considerably lower than it now is.

22.115. The second matter relates to the lodgment of clients’ returns by tax agents after the general due date of 31 August in conformity with a pattern set by the Commissioner. Briefly, the pattern requires that each tax agent lodge a certain percentage of returns, differentiated by category, by various dates between 31 August and 31 March. For many years now this has been a source of contention between tax agents and the Commissioner, the contending issues being the continually growing work load falling on tax agents and the need of the Commissioner to have returns lodged in sufficient time for assessment and collection of tax within the financial year. Some relaxation in the lodgment program has been advocated in submissions.

22.116. For taxpayers deriving income other than salary or wages—provisional taxpayers is a convenient term for them—the Committee recommends that tax payments be made by instalments on a pay-as-you-earn basis involving an adaptation of the present provisional tax system. The adapted system would not apply to income other than salary or wages below a set figure where both salary or wages and other income are received by a taxpayer.

22.117. Several other countries have adopted a system of pay-as-you-earn taxation for provisional taxpayers involving payment by instalments. In the United States and Canada, provisional taxpayers pay self-calculated tax on estimated income in the year of derivation by quarterly instalments; in New Zealand and South Africa payment is by two instalments. It is usual for arrangements to differ somewhat in the case of farmers and certain other taxpayers. In some instances heavy reliance is placed on estimates of income and self-assessment of tax by the taxpayer progressively throughout the year, with penalties by way of ‘interest charges’ for undue underestimation of income or underpayment of instalments.

22.118. Australia’s present provisional tax system has a number of unsatisfactory features. For one thing, it involves a degree of unfairness vis-à-vis the system of tax instalment deductions applying to non-provisional taxpayers. Under the instalment deduction system a salary or
wage earner is forced to meet his tax liability progressively as he receives his remuneration over the year of income, whether it be paid weekly, fortnightly or monthly. In fact, under the present system a very high percentage of salary and wage earners without other income are required to pay more tax than they strictly should during the year of income and to wait for an end-of-year refund of the excess: the Committee has earlier made recommendations that will mitigate the extent of the excess payment.

22.119. On the other hand, in the income year in which he derives his income a provisional taxpayer pays an estimated amount of tax applicable to that income; but in no case is he called upon to make payment until at least nine months of that year have passed and, in the majority of cases, until nine months’ income has been derived. Published figures reveal that more than half the 1.4 million assessments issued to provisional taxpayers in 1973-74, based on 1972-73 income, were due for payment after the end of the first week in April 1974 and more than a third were due for payment in May-June 1974 and later. Thus for a substantial proportion of provisional taxpayers provisional tax relating to income derived in 1973-74 did not become payable until the second quarter of 1974. The time of issue and due date of provisional tax assessments are of course largely dictated by the date of lodgment of returns by taxpayers and by tax agents on behalf of clients in line with the program referred to in paragraph 22.115.

22.120. A further area in which a provisional taxpayer gains an advantage in tax payment over a salary or wage earner is in relation to the excess of actual assessed tax for a year of income over provisional tax. The pattern of payments in figures published by the Commissioner indicates that provisional taxpayers who in 1972-73 year paid provisional tax that fell short of the amount subsequently assessed on their returns for that year would have made up the short-fall in the second quarter of 1974 or later. The short-fall would have been paid nine to twelve months after the close of the income year to which it related and, where substantial amounts were involved, a significant breakdown in the pay-as-you-earn principle would have resulted.

22.121. The setting of a due date for payment of any short-fall and for payment of the next round of provisional tax will depend on when the taxpayer's return is lodged. Ideally, all returns of provisional taxpayers should be lodged in sufficient time to enable the issue of assessments with due dates for payment on 31 March. This is not feasible and some taxpayers obviously delay lodgment of returns in an endeavour to postpone payment day. In the 1973-74 year the Commissioner issued almost 308,000 final notices calling for returns and information and instituted legal proceedings in some 54,000 cases.
22.122. Other features of the provisional tax system are the almost complete dead-letter character of provisions requiring taxpayers who begin to derive income subject to provisional tax to take steps to pay in the first year, and the minimal use of the self-assessment procedures to increase provisional tax payments to realistic levels, particularly where major increases in income can reasonably have been anticipated. These two aspects have led to unwarranted criticism of the provisional tax system, including claims that the system calls, in some cases, for tax payments absorbing virtually all the taxable income of the year in which the assessment is received or all the taxable income of the previous year shown in the assessment. Not infrequently, of course, the tax payable is in reality the tax attributable to the income of two years.

22.123. For a number of reasons, therefore, the Committee has come to the conclusion that a system of pay-as-you-earn should be applied to provisional taxpayers, involving tax instalments of, say, one-third on 30 November and two-thirds on 31 May in the year of derivation of income. Where the actual tax payable falls short of the provisional payments, the taxpayer would be required to make up the short-fall by 30 September following the end of the year of income. The base for the instalments would, in the first place, be the final estimated income for the immediately preceding year of income; and the Taxation Office would issue before 31 October of the financial year in which the instalments are payable a notice showing estimated income, the total estimated tax, the amounts of each instalment and the date on which it is due for payment. With each instalment payment the taxpayer would be required to adopt the base and estimated tax in the Commissioner's notice, or provide a fresh estimate of the income of the current year and adjust his payment as necessary. Lodgment of a return for the preceding year and receipt of an assessment on that return would require the taxpayer to review, and vary if necessary, his base income and instalment with his next payment. The one-third instalment on 30 November would be payable after the equivalent proportion of the income of the year had, in most instances, already been derived, and the 31 May instalment would be payable towards the end of the full year. The final opportunity for estimation, and any necessary further payment, three months after the close of the year, would permit actual income figures or a more accurate estimate of the likely outcome to be used in calculating any short-fall of tax due for payment on 30 September. An ‘interest charge’ at a commercial rate on underpayments as a result of underestimates of income of more than 20 per cent on 30 September would be necessary to encourage taxpayers to comply, including taxpayers commencing to be taxed under the provisions for
whom special provisions will be necessary.

22.124. Special rules will also be necessary for taxpayers, mainly certain primary producers, who receive the bulk of their income in the second half of an income year. For such persons instalments of, say, one-third on 15 February and two-thirds on 31 May might be appropriate, with the same opportunity as other taxpayers for a final estimate and further payment after the end of the year. Taxpayers lodging on accounting periods other than 30 June would have instalment payment dates set at the same intervals following the first day of their accounting period as taxpayers lodging on the basis of 30 June are allowed from 1 July.

22.125. The Committee believes that many taxpayers will find the move to paying provisional tax by instalment convenient. At present provisional taxpayers are often called upon to pay very large amounts in one lump sum in April, May or June, though the majority of these adequately plan for the meeting of such payments. There are some, however, who fail to plan their financial affairs efficiently and consequently experience difficulties in meeting the once-a-year tax bill: for them the instalment payment plan will be of considerable assistance.

22.126. The recommended system of instalment payments by provisional taxpayers will have the effect of aligning the tax payments of these persons, numbering about a million, more closely with the tax payments of approximately 4.7 million nonprovisional taxpayers. It will reduce the undue delays that now occur in meeting payment of substantial short-falls of provisional tax. The spacing of provisional tax payments over the year will also reduce the present seasonal drain on the liquidity of the economy stemming from the concentration of payments in the last three months of a financial year. However, the system would need to be phased in over several years.

22.127. The taxpayers affected—mainly business people and investors—should have little difficulty adapting to the recommended system, especially as the majority of them already employ tax agents. By divorcing the amount and date of payment of provisional tax from the lodgment and assessment of the return of the preceding year, the way will be paved for the Commissioner and tax agents to settle a program of return lodgments which will answer much of the present criticism in this area.

22.128. Further, the setting of patterns of payment of the instalments at a single set of intervals from the commencement of the current income year, whether the income year be July-June or some other, will facilitate leave being granted to lodge returns on an accounting period other than one ending on 30 June: there will not be the same need as now for the Commissioner to insist on the special payment to overcome any delay or
deferment in payment of tax. However, it will be necessary to have provisions to overcome any advantage or disadvantage brought about by the application of progressive tax rates to the assessment of a return for less than one or more than a full year on the occasion of the change-over from a July-June income year. Where a change in the rate of tax occurs between one income year and the next, the Commissioner at present does not attempt to split the income of an accounting period ending other than on 30 June into income subject to the previous rate and income subject to the new rate. This practice should continue.

Company Tax System

22.129. Under the system of collecting company tax by quarterly payments now being phased in, most companies will in a current year pay tax assessed on the income of the preceding year by instalments on 15 August, 15 November and 15 February, with the balance to be made up on the due date shown in a notice of assessment of the income of the preceding year. Where instalments are paid, the due date for payment will not be before 30 April.

22.130. This system is expected to result in a substantial reduction in the seasonality of company tax payments and will bring company tax somewhat closer to the pay-as-you-earn basis already applying to non-provisional taxpayers and recommended for provisional taxpayers. Although this company system is not on a pay-as-you-earn basis, it has most of the advantages of the system being proposed for provisional taxpayers. However, in the case of a company with an approved tax year ending other than on 30 June, the Committee recommends that the due date for payment of the three instalments of the company tax be set in relation to the tax year and not to 30 June, though it recognises that this change will need to be phased in.

22.131. The considerations behind this recommendation are twofold. Firstly, the Committee believes that on grounds of equity companies should pay tax as nearly as possible at the same time as one another in relation to the period in which the income is derived. Secondly, the adoption of this recommendation would meet much of the present criticism of the conditions set by the Commissioner before he allows a company to adopt an accounting period, particularly one ending before 30 June. This criticism has been referred to in paragraph 22.114.

22.132. There is, in the Committee's view, no valid reason why a company with an approved accounting period ending on, say, 31 March should not be required to lodge a return and pay tax at the same time
intervals in relation to 31 March as a company balancing on 30 June is required to do in relation to 30 June. If this were done, greater tax neutrality would be achieved: no special adjusting tax payments, as a condition of leave to lodge returns on an accounting period, would be necessary and no tax constraint would therefore apply where a company desires for sound commercial reasons to balance at a date other than 30 June. In paragraph 22.128 the view was expressed, in the context of provisional taxpayers, that there should be no change from the Commissioner's present practice where an alteration occurs in the rate of tax from one income year to the next. That view has equal application here.

22.133. Under the system of quarterly payments now being phased in, some quarterly instalments as proposed by the Committee would be payable in a different financial year from at present. For instance, a company balancing on 31 March will, under the quarterly instalment system, make a first quarterly payment on the following 15 August, whereas under the Committee's proposal the first quarterly payment would be due on 15 May. The implications for Revenue of changes in timing involving different financial years are unlikely to be particularly significant. Moreover, the greater flexibility in the availability of balance dates other than 30 June for companies would also result in a better spread of the work involved by tax agents in preparing and lodging these returns and by the Commissioner's staff in checking and assessing. Over a year it would lessen the peak work loads and be more efficient generally.

22.134. With the changes proposed for payment of provisional tax by individuals and the recently enacted measures calling for the payment of company income tax by instalments, the date of payment of tax on profits flowing through the intermediary of companies has been brought forward. However, there will continue to be a major difference in the time of payment of tax on profits earned through a company and profits earned by an individual or partnership. Profits flowing through a company will not bear tax until the year following the year of income: on the other hand, profits derived by an individual or by him through a partnership fall to be taxed, by the operation of the provisional tax procedures, mainly in the year in which they are earned.

22.135. A provisional taxpayer with 1973–74 taxable income from a business would, under the provisional tax system proposed by the Committee, have substantially paid his tax liability by instalments on 30 November 1973 and 31 May 1974 with a final payment on 30 September 1974. The September payment would have been sufficient to bring the total payments to within 80 per cent of final liability or be subject to an interest charge. If that business had been conducted as a private company in that
year it may be said that the tax on the ‘owners’ salary would be paid in the 1973–74 year on a true pay-as-you-earn basis but the tax on the balance of income taxed to the company would be paid by quarterly payments commencing 15 August 1974 with the final payment after 30 April 1975. Tax on dividends paid out of the 1973–74 profits would, under the provisional tax system, be substantially paid in the 1974–75 year. The financial advantage to a person operating through a company being able to hold and use funds which will ultimately go in payment of tax, is evident.

22.136. However, the difference in timing of payment of tax by companies should not be considered in isolation: there is the closely related fact that company profits are currently being taxed in the hands of the company and, to the extent they are subsequently distributed, also in the hands of the shareholders as explained in Chapter 16. This has the effect, for taxpayers who are on marginal rates somewhat less than the maximum, that more tax is eventually paid than would be paid if the profits had been derived as a sole trader or in partnership. The recommendation of the Committee in Chapter 16 for an imputation system will mitigate this greater liability depending on the extent of imputation given.

22.137. In theory, a trading profit earned through a company should fall to be taxed no later than a similar profit derived from trading by a sole trader. While the Committee favours a pay-as-you-earn system of tax payments by companies, the Committee also appreciates the difficulties of changing from the present system to a complete pay-as-you-earn basis.

22.138. Companies are at present still involved in the phasing in of the earlier payment of tax which arises from the system of payment by instalments. Proposals relating to the date of payment of tax by companies which have adopted a substituted accounting period, made in paragraph 22.130, will, if adopted, result in bringing forward the date on which tax is paid for some of them. Moreover, as yet, no imputation credit is available to shareholders. The Committee does not propose the introduction at the present time of a system to bring companies on to a basis more uniform with that recommended earlier in this chapter for provisional taxpayers. It may, however, become appropriate at a later date to give consideration to such a proposal. The method of introduction should, in any event, involve phasing in over a period of, say, ten years. This was the method of introduction of a system of pay-as-you-earn payment of tax by companies recommended by the Spooner Committee in 1951.

**Withholding Tax**

22.139. In Chapter 17 the Committee has considered the taxing of
income flowing overseas, including interest and dividends subject to withholding tax. Here, brief consideration is given to the question of paying withholding tax on small amounts of interest and dividends. It has been put to the Committee that the costs of collecting withholding tax on trifling amounts of interest are out of all proportion to the tax collected. A survey carried out by the member banks of the Australian Bankers’ Association in 1971 showed that withholding tax of one dollar or less on bank interest accounted for 2.6 per cent of total collections of interest withholding tax by the banks and 0.1 per cent of total Commonwealth receipts from interest withholding tax. Some countries require withholding tax to be deducted only when the annual interest exceeds $10.

22.140. Freeing of small amounts from withholding tax raises the possibility of tax avoidance by the splitting of investments and by the splitting of payment of dividends and interest. The advantage to be gained from splitting of investments—several investments in distinct companies or borrowers—may not be significant. But splitting of payment—several payments of dividends or interest in the course of a year by the same company or borrower—could involve significant tax advantage, unless it was provided that payments would be free of tax only when they did not exceed in aggregate an annual total amount. This total amount, in the Committee's view, would need to be set at a modest figure, say no more than $20.

22.141. The Committee sees no objection to freeing small amounts from withholding tax if a limit of this kind on total annual payments is imposed.

1. Re B. Johnson & Co. (Builders) Ltd. (1955) 2 All E.R. 775 at pp. 781-3; Gorringe v. The Transport Commission (Tas.) 80 C.L.R. 357.
Chapter 23 Capital Gains Tax

23.1. In this chapter the Committee turns to the difficult and controversial topic of the taxation of capital gains, one on which it has received a great many submissions. Its discussion is in six sections. The first three examine the case for the general taxation of such gains by special provisions to that end. In section IV proposals are made for the amendment of certain provisions of the Income Tax Assessment Act relating to capital and income. Section V notes the possibility of special treatment of certain types of gain from the sale of land. The conclusions are summarised in Section VI. Certain reservations to the conclusions reached are appended.

23.2. Since the preparation of the Committee's preliminary report, which drew attention to the complexities of this type of tax and the need to prepare and circulate explanatory material, the Government has announced proposals for a capital gains tax which will operate in respect of assets disposed of after 17 September 1974. To date these proposals are available in outline form only, and the legislation to give effect to them has yet to be introduced into Parliament. As a consequence, the full details of the new tax are not available and many taxpayers are in a state of uncertainty as to the tax implications of transactions entered into after 17 September 1974. This is particularly so in the case of deceased estates, the administration of which in many cases cannot proceed until liability for capital gains tax can be ascertained.

23.3. The Committee believes that such a new and complex tax should not be introduced in this fashion. In view of the uncertainties created by the Budget announcement and the fact that the tax will represent a new dimension in the Australian tax structure, the form and details of the tax should be exposed to critical public discussion and comment before the enactment of legislation and certainly before the tax takes effect.

23.4. The other significant development in this area since the preparation of the preliminary report has been the almost unprecedented and rapid acceleration in the rate of inflation being experienced in Australia.

23.5. Accordingly, the Committee recommends that the plans for introduction of the tax with effect from 17 September 1974 be abandoned. Instead, a Green Paper setting out the details of the proposed tax should be published as is now the practice with new taxes introduced in the United Kingdom. This will provide the means for public discussion and enable potential problem areas to be examined before rather than after the
enactment of legislation. Only after allowing considerable time for such critical examination of the proposed tax should legislation be introduced. In particular, the Green Paper envisaged should examine the difficulties caused by inflation in the context of a capital gains tax and should traverse all possible approaches to dealing with the problem.

23.6. It appears from the details so far available of the 1974–75 Budget proposals for capital gains tax that the broad outline of the proposed tax is similar to the Committee's recommendations in its preliminary report; but there are a number of significant areas of divergence. Attention will be drawn throughout this chapter to areas where the Committee's recommendations differ from the Government's proposals in the outline of the tax so far announced.

I. The General Issue

23.7. A capital gains tax is essentially a tax upon gains from the realisation of property where the realisation is not an aspect of the carrying on of a business or the carrying out of a business deal. At present, subject to the Budget proposals, such gains are not taxed in Australia unless they come within sections 26 (a) or 26AAA of the Act (see paragraphs 23.73–23.74). Where such a gain is taxed it is taxed as ordinary income of the taxpayer. A capital gains tax seeks to tax gains that at present escape levy.

23.8. A tax on capital gains is levied today by a number of countries including Canada, France, West Germany, Japan, the Netherlands, the United Kingdom and the United States. In addition Ireland has recently announced its intention of introducing such a tax. Thus most countries comparable with Australia in terms of social background and economic development have the tax and, while this in itself is not a justification for its introduction in Australia, it is an indication that Australia is somewhat out of the mainstream of current thought and practice on this matter.

23.9. The general arguments for and against a capital gains tax can be set out succinctly by testing the tax by the three main criteria of equity, simplicity and efficiency employed in earlier chapters.

23.10. It is a tax which, in any administrable form, must be complex and difficult, and produce some anomalies and inequities of its own. There is no doubt whatever that any revenue it raises could be more cheaply and easily raised in other ways. By the criterion of simplicity it fails.

23.11. The arguments over its consequences for the efficient use of resources are somewhat less easy to assess. In a number of submissions received by the Committee its deleterious effect upon the investment of risk-capital is referred to. But the deterrent effect of a tax on realised gains
would be matched by the encouraging effect of an allowance of losses in capital gains assessments, and the Committee doubts whether there is much substance in this argument. The converse argument has also been put that in the absence of a capital gains tax there will be excessive investment in assets which, though they yield relatively little taxable income, are especially likely to appreciate in capital value. There may be truth in this proposition. If so, it is possible that a capital gains tax might deflect investible funds from this area into areas where more risk has to be accepted. On balance, while recognising that a capital gains tax, by the complexity of the calculations it inevitably involves, must be troublesome to investors, the Committee believes that there is a case for it on efficiency grounds.

23.12. It is on grounds of equity that, in the Committee's view, the arguments for a capital gains tax may reasonably be held to be so strong as to overwhelm the admittedly strong case against it on grounds of simplicity.

23.13. The fundamental argument here is that in a taxation system in which ability to pay is a primary test of liability, capital gains, whether accrued or realised, constitute an increase in ability to pay in so much the same way as receipts of wages, salaries, interest, dividends and rents as to make it inequitable for them not to be brought to tax. Failure to tax them gives rise to inequity of both the kinds earlier distinguished:

(a) Horizontal inequity occurs because individuals in similar economic circumstances are treated unequally in that those who derive their accretions to market power in the form of non-taxable capital gains pay less tax than those deriving more conventional income.
(b) Vertical inequity occurs between individuals in dissimilar economic circumstances in that the failure to tax capital gains will usually favour those who are more well-to-do rather than those who are less, since the former own more capital per head than the latter and are more likely to make investments that realise capital gains.

23.14. Before the validity of this central proposition is examined, two points need to be made:

(a) The impracticability of taxing capital gains as they accrue is universally recognised: the tax can only attempt to deal with realised gains. Where these gains are in effect the receipts at one moment of several years of accrued gains, to tax them, under a progressive tax system, as if they were one year's income would be inequitable. This is the phenomenon of ‘bunching’ and its treatment requires special
(b) In inflationary conditions a part, and possibly a large part, of capital gains will be 'purely monetary' rather than 'real'. Though this is a complication that to some extent also affects other categories of income, it is essential to make allowances for it in the taxation of capital gains.

23.15. While these points are, in the Committee's view, sufficient to make it wrong wholly to equate all realised gains with ordinary income, they are peripheral to the question of whether they should be regarded as income at all.

23.16. It is sometimes argued that their present non-taxation is anomalous primarily because many of them are virtually certain, as for example in the case of urban land and works of art. This, pushed to extremes, would not make a very satisfactory case. For if both buyers and sellers were equally well informed, the non-taxation of appreciation would already have been reflected in the relative current prices of the assets so that over time their future returns net of tax to their holders would be the same. Hence the introduction of a capital gains tax would principally create a crop of capital losses among holders of such assets as land, and a parallel crop of capital gains among owners of assets the main yield of which was in taxable income form. The substantive situation here is, however, that no market is ever ideally well informed and that, in relation to such assets as land and works of art, capital gains are mainly achieved by those buyers who have a better knowledge than sellers of market trends. Thus their gains are rightly judged akin to income because most are the fruit of skill and effort.

23.17. The corresponding case against taxing capital gains is sometimes made by suggesting that they are too uncertain, too irregular to be treated as income and should for that reason be left with the non-taxable status now accorded to 'windfalls'. The temporal irregularity of some realised capital gains has already been conceded as a valid argument for special treatment in a progressive taxation system. But in the Committee's view the other considerations are not persuasive. Uncertainty attaches in greater or less degree to all income, and intermittent earnings are properly brought to tax at present. However, pure windfall gains and payment of compensation for physical injuries and injury to reputation should be exempt from taxation. This favourable treatment is in the former case due partly to public tolerance towards good luck but in the latter to the administrative difficulties in bringing the income element in such receipts within the income base.

23.18. The Committee does not believe that the purposes of a capital gains tax can be adequately served by any other taxes. The land taxes
currently levied by all State governments do not seem to be adaptable: they only tax one of many vehicles for these gains and they tax the whole value of land and not changes in it. Estate duties impose a tax at only rare intervals and do not impinge on capital gains devoted to consumption during lifetime. A wealth tax would tax them but only incidentally; however, for reasons explained in Chapter 26, this tax is not recommended.

23.19. Hence the Committee concludes that the taxation of capital gains should be introduced in Australia at an appropriate time, and in the next section examines the main provisions new legislation should contain. It is not feasible to do more than set out a broad outline of the coverage and mode of a tax on capital gains that appears suitable for Australian conditions. In particular, certain matters such as the jurisdictional base of the tax and the treatment of lease transactions and part-disposals of assets are not considered here. The Committee has, in general, not attempted to deal with aspects of the tax beyond those covered in the preliminary report and the proposals announced by the Government.

23.20. Complex legislation would be required and much explanatory material would need to be prepared and circulated. The pamphlet giving general information about capital gains tax, issued in the United Kingdom by the Board of Inland Revenue, runs to 112 pages. In preparing the summary suggestions that follow, the Committee has studied with considerable interest the provisions relating to the similar tax introduced in the United Kingdom in 1965 and Canada in 1971.

II. The Method of Taxing

23.21. As already noted, despite the theoretical merit in taxing capital gains as they accrue, the tax can only feasibly be levied upon realisation. To tax gains on an accruals basis would lead to unacceptable problems in the periodical valuation of assets and would generate severe liquidity difficulties for taxpayers. Furthermore, assets fluctuate in value and an asset that eventually gives rise to no gain may nonetheless have given rise to payments and refunds of tax during the period of ownership. Deferring the tax until realisation does, however, have a number of undesirable consequences. It can cause what is known as ‘lock-in’ whereby the taxpayer, unwilling to pay any tax before he has to, defers realising an asset for as long as possible. Moreover, the asset-holder may, by judiciously arranging to realise his gains and losses in the years in which they will secure him maximum tax advantage, be placed in a more favourable position than other taxpayers who are not able to adjust their income between years. Nonetheless the Committee recommends that the
tax be levied only upon the occasion of the realisation of the asset, or upon
certain occasions (discussed below) on which there is a notional or, as it is
usually termed, deemed realisation.

23.22. The role of inflation in generating illusory capital gains cannot be
ignored. Inflation is the factor which leads to the greatest difficulty in
devising an equitable and workable capital gains tax. It was suggested in
several of the submissions to the Committee that the problems associated
with levying capital gains tax in inflationary conditions can be obviated by
applying a suitable index to the cost price of an asset to allow for inflation
over the period between purchase and sale, thus separating out the purely
inflationary element of the gain. The idea is attractive, but there are two
important objections:

(a) Indexation of assets will distort the measurement of gains and losses unless
indexation is also applied to reduce the real value of monetary liabilities. Indeed, in
the extreme example of a person who purchases an asset entirely with borrowed
funds and the asset increases in value at a rate less than the rate of inflation, the
application of an index will produce a capital loss whereas in reality there has been a
considerable gain because the debt has declined in real terms. The application of an
index to all liabilities as well as to all assets was considered by the Committee but
rejected as impracticable.
(b) The choice of an appropriate index presents great problems and its application
would involve much administrative labour.

After considering at length various forms of indexation, the Committee
has come to the conclusion that such a device cannot be recommended as a
general solution to the problem posed by inflation. The merits and defects
of indexation should however be accorded further study, particularly in the
light of the level of inflation currently being experienced in Australia.

23.23. An alternative method of allowing for inflation in the inclusion of
a variable proportion of the gain in assessable income, the proportion to be
included declining the longer the asset has been held. This will, in general,
not make the desired correction for inflation and will usually give the
opposite result to that sought. Consider, for instance, an asset purchased for
$1,000 which increases in money value at a constant annual rate of 10 per
cent during a period when inflation is running at 5 per cent a year. As
Table 23.A shows, the net gain (after the cost price has been adjusted for
inflation) becomes an increasing proportion of the nominal gain as the
period of holding increases. Where an asset has increased in value at
exactly the same rate as the rate of inflation, thus giving rise to a gain in
money terms but no gain in real terms, the effect of the declining-
proportion method would be to impose a capital levy by taxing a gain that has not in reality occurred. The rate of capital levy would not necessarily decrease as the proportion of the nominal gain that was taxed decreased but it might rise before eventually declining to zero. Where an asset has increased in value at a rate less than that of inflation, giving rise to a gain in money terms but a loss in real terms, the declining-proportion method would again impose a capital levy in addition to the capital loss sustained through inflation. As in the preceding case the rate of capital levy would eventually decline to zero, though it might rise for a time before it starts to fall.

23.24. A point in favour of the declining-proportion method of taxing capital gains is that it is less harsh than some other methods in the case of assets which have generated either real losses or no real gains, but as a general method of allowing for inflation it has no merit. In addition there would be unacceptable difficulties in devising an equitable and workable method of dealing with capital losses.

23.25. Broadly, there are two main systems in use in those countries that levy capital gains tax: the flat-rate method, which imposes a fixed rate of tax on the gain, and the proportional-inclusion method, which includes a proportion of the gain in the taxpayer's income. The former is employed in the United Kingdom while Canada has adopted the latter.

23.26. A flat-rate capital gains tax has many attractions. It is simple, certain and easily understood. Because it is divorced from the income tax

### TABLE 23.A: INFLATION AND CAPITAL GAINS: PERIOD OF HOLDING

<table>
<thead>
<tr>
<th>Period of holding Years</th>
<th>Sale price</th>
<th>Nominal gain</th>
<th>Net gain</th>
<th>Net gain as percentage of nominal gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,100</td>
<td>$100</td>
<td>$50</td>
<td>50.0</td>
</tr>
<tr>
<td>5</td>
<td>$1,611</td>
<td>$611</td>
<td>$335</td>
<td>54.8</td>
</tr>
<tr>
<td>10</td>
<td>$2,594</td>
<td>$1,594</td>
<td>$965</td>
<td>60.5</td>
</tr>
<tr>
<td>20</td>
<td>$6,727</td>
<td>$5,727</td>
<td>$4,074</td>
<td>71.1</td>
</tr>
<tr>
<td>50</td>
<td>$117,391</td>
<td>$116,391</td>
<td>$105,924</td>
<td>91.0</td>
</tr>
</tbody>
</table>

(a) ‘Net gain’ is computed as the gain expressed in dollars at the time of sale after adjusting the original cost of the asset ($1,000) for inflation at the rate of 5 per cent a year.
system there is no incentive for the taxpayer to realise capital gains in years when his other income is low, whereas this incentive does exist with the proportional-inclusion method. For the same reason there is no way in which the tax can be minimised by diverting capital gains to other members of the taxpayer's family. It avoids the problem of bunching of gains in one income year, particularly bunching arising from a provision for deemed realisation at death, and the necessity for provisions to mitigate this. It is a simple and effective method of taxing capital gains made by non-residents; and it can be argued that it is a more neutral method of taxing gains made by companies and certain types of trusts as against gains made by individual taxpayers. In addition, since the assessment of the tax would be separate from the assessment of income tax it would be easier to calculate its revenue yield and the issue of an assessment for capital gains tax would not be delayed pending the issue of the normal tax assessment.

23.27. On the other hand, it has the drawback of lack of progressivity. If the rate of tax were set at, say, 30 per cent, then a low-income taxpayer who makes a small capital gain would pay more tax than if the gain had simply been added to his other income and taxed accordingly, while the high-income taxpayer would pay less. This inequity is recognised to some extent in the United Kingdom legislation which gives the taxpayer the option, subject to certain limitations, of including half the gain in his income. With such an option, however, much of the simplicity of this method is lost. More importantly, the tax will normally be progressive over a narrower income range than in the case of personal income tax.

23.28. After considering the alternatives, the Committee has come to the conclusion that the less unsatisfactory method is the second of those mentioned: to tax a fixed proportion of the gain by including it in income, subject to the arrangements described in paragraph 23.35–23.37 for spreading the taxable gain over a period of years. It is recognised that the use of a fixed proportion for determining the taxable elements of all capital gains is open to a number of objections. In particular it will be overly harsh in those cases where gains are largely or entirely due to inflation; and it will be excessively lenient in those cases where very large gains have been made in relation to the amount of inflation that has taken place during the period of ownership of the asset, more especially when the ownership was financed from borrowed funds. Nonetheless the Committee believes it to be an approach that should prove satisfactory in the majority of cases, and it has the advantage of ease of understanding and administration.

23.29. The choice of the proportion of the gain to be included in taxable income is not one that can be made without reference to the actual level of inflation being experienced. It should not be regarded as fixed and
immutable and should be varied if there is a significant increase or decrease in rates of inflation. For illustrative purposes only, this chapter assumes the inclusion of one-half of a capital gain in income and with capital losses being dealt with in accordance with the recommendations in paragraph 23.71. It is recognised that adjustment to the proportion to be included is a very blunt instrument for dealing with variations in the rate of inflation, but it will at least operate in the right direction. It is to be noted in this respect that the Government's proposals for the introduction of a capital gains tax involve the inclusion of half the gain in income; but the rationale for this has not been made public and in particular there has been no statement as to whether or not this half-inclusion is designed as an implicit allowance for inflation. The Committee believes that half-inclusion in circumstances where inflation is at an annual rate approaching 20 per cent is altogether too harsh. If capital gains tax is to be introduced in such circumstances, the amount of the gain to be included in income should be considerably less than half—possibly even less than a quarter.

23.30. The Committee is conscious of the fact that proposing an allowance for inflation in regard to capital gains raises questions as to similar allowances in regard to income gains, particularly when trading stock and fixed assets subject to depreciation are involved. There is also a question of the fairness of treating the whole of any interest on fixed-money return investments as income. These questions are considered in Chapters 8 and 9.

III. Specific Issues

Transitional Provisions

23.31. Only capital gains arising after the introduction of the tax should be liable to tax. The Committee however rejects the view that only gains on assets acquired after the introduction of the tax should be liable. Such an approach would be inequitable and would have a very powerful lock-in effect for existing owners of appreciating assets.

23.32. To ensure that only capital gains arising after the date selected for commencement of the tax are subject to levy, and also that a deduction is given for losses incurred after that date, it is necessary to lay down a procedure for valuing all assets (other than those exempted from the tax) at the commencement date, usually referred to as ‘valuation day’. Furthermore, to reduce the scope for investors to rearrange their affairs so as to benefit from advance notice of the date from which the tax will commence, it is proposed that the valuation day be selected and announced
after the decision to introduce the tax has been publicised and after the date selected as valuation day has passed. This should be the case even if the recommendation as to the deferment of introduction of the tax and publication of the Green Paper is adopted. This procedure was followed in Canada, apparently with success.

23.33. The major transitional problem is fixing the value of all assets (other than assets the gains from which are exempt from tax) at the valuation date. In the United Kingdom and Canada specific provisions were introduced to reduce to a minimum the occasions when special valuations by independent or government valuers would be required. The transitional provisions in the 1974–75 Budget proposals have drawn on the United Kingdom and Canadian experience. While there are numerous aspects of the transitional provisions not yet announced, the Committee is in general agreement with the principles which it appears are to apply, with the one exception referred to in the next paragraph.

23.34. One method of determining a gain or loss, called the ‘valuation method’, involves comparing the proceeds from the disposal of an asset with the value on a particular day—17 September 1974 in the Budget proposals. The method, as proposed, will apply subject to an over-riding rule that no taxable gain or allowable loss may exceed the difference between the proceeds of the disposal of the asset and its cost. This rule is fair if, for example, the taxpayer can establish that an asset sold in 1975 for $21,000 was purchased early in 1974 for $20,000 although its value on 17 September 1974 was $18,000. The rule limits the gain to $1,000. The rule is unfair where an asset is sold in 1975 for $21,000 and its value on 17 September 1974 was $25,000, as the Commissioner will be obliged to deny the loss to the taxpayer until the taxpayer can establish that the cost of the asset was in excess of $21,000. The ‘cost’ may include some expenditure incurred by the taxpayer and of which he now has no record. The Committee considers that the rule should be limited to gains and not be extended to losses.

**Bunching and Spreading**

23.35. Since capital gains will usually have accrued over a period of years, it is considered excessively harsh to tax the gain as if it were ordinary income by simply adding half the gain to the other income of the taxpayer in the year of receipt of the gain. With a progressive tax structure this would often mean that the taxpayer would move into a higher tax bracket and the gain be taxed at a higher rate than if it had been subject to tax as it accrued. There are several ways of mitigating such bunching.
These include averaging the gain and reopening past assessments, spreading the gain over the period of ownership, and spreading all gains over a fixed period. The Committee recommends that the third method be used and that all gains be spread over a fixed term of years, say five. It is recognised that the choice of an arbitrary period will be generous in the case of assets held for shorter periods and harsh in the case of assets held for longer periods. Nonetheless these inequities are outweighed by the advantages of a fixed period as far as ease of understanding and administration are concerned.

23.36. As an example of how spreading over a five-year period will work, consider three taxpayers A, B and C who earn taxable income (other than capital gains) of $25,000, $15,000 and $5,000 respectively. Assume that in the income year in question each taxpayer sells an asset at an actual gain of $40,000, thus producing a taxable gain of $20,000 (i.e. half the actual gain). Instead of simply adding this $20,000 to the taxpayer's other taxable income, it is divided by five and $4,000 is added to give taxable incomes of $29,000, $19,000 and $9,000 respectively. The additional tax attributable in each case to the addition of the $4,000 is then calculated and multiplied by five to give the total additional tax payable in respect of the capital gain. The results are summarised in Table 23.B on the basis of 1974–75 tax rates.

### TABLE 23.B: SPREADING OF CAPITAL GAINS

<table>
<thead>
<tr>
<th></th>
<th>Taxpayer A</th>
<th>Taxpayer B</th>
<th>Taxpayer C</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Taxable income (before capital gain)</td>
<td>$25,000</td>
<td>$15,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>(2) Tax payable on (1)</td>
<td>$11,620</td>
<td>$5,470</td>
<td>$680</td>
</tr>
<tr>
<td>(3) Taxable income plus one-fifth of taxable gain</td>
<td>$29,000</td>
<td>$19,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>(4) Tax payable on (3)</td>
<td>$14,180</td>
<td>$7,820</td>
<td>$2,300</td>
</tr>
<tr>
<td>(5) Difference between (4) and (2)</td>
<td>$2,560</td>
<td>$2,350</td>
<td>$1,670</td>
</tr>
<tr>
<td>(6) Tax payable on taxable gain: 5 x (5)</td>
<td>$12,800</td>
<td>$11,750</td>
<td>$8,100</td>
</tr>
<tr>
<td>(7) Total tax payable: (2) + (6)</td>
<td>$24,420</td>
<td>$17,220</td>
<td>$8,780</td>
</tr>
<tr>
<td>(8) Rate of tax on gain: (6) as percentage of $40,000</td>
<td>32%</td>
<td>29.4%</td>
<td>20.3%</td>
</tr>
<tr>
<td>(9) Marginal tax rate on top bracket of income including taxable gain (per 64 cent)</td>
<td>64%</td>
<td>60%</td>
<td>48%</td>
</tr>
</tbody>
</table>

23.37. By way of comparison, the tax payable by the three taxpayers if the whole $20,000 of taxable gain were treated as ordinary income is shown in Table 23.C. It can be seen, by comparing line 8 of Table 23.B with line 4 of Table 23.C, that spreading makes little difference to the tax liability of someone who already has a high taxable income; however, the difference is quite marked for anybody on a lower taxable income.

### TABLE 23.C: NON-SPREADING OF CAPITAL
23.38. The Committee notes that the Budget proposals for a capital gains tax contain no reference to any form of spreading provisions. While such provisions involve a degree of administrative complexity, they are well justified. The differential effect of spreading provisions on high- and low-income earners in particular is to be noted: the absence of such provisions operates harshly in the case of low-income taxpayers who may realise one or perhaps two large capital gains during their lifetimes. Many taxpayers, especially those of fairly modest means, may not realise any capital gains during life but may have substantial accrued gains at death which will be brought to tax as notionally realised. The absence of spreading provisions is particularly harsh in these circumstances.

**Determination of Amount of Gain**

23.39. It is recommended that to determine the amount of the gain there should be deducted from the proceeds of sale of the asset:

(a) The cost of the asset, including all costs directly incurred in the purchase such as stamp duty, legal costs and agent's commission. This will apply in the case of assets purchased after the date of introduction of the tax, while to those already owned by the taxpayer at that date the provisions outlined in paragraphs 23.31–23.34 will apply.

(b) Expenditure incurred in enhancing the value of the asset or preserving the taxpayer's title to it. This would usually include the cost of improvements and additions but not expenditure that has been previously allowed as a deduction for income tax purposes. In particular, expenditure related to the use or enjoyment of the asset would not form part of the cost base nor would outgoings such as repairs or interest which have been allowed as a deduction for income tax purposes.

(c) Costs directly incurred in the sale of the asset, such as stamp duty, legal costs and agent's commission.

The actual capital gain thus determined then will be halved to give the taxable gain.

**Treatment of Companies**

<table>
<thead>
<tr>
<th>Taxpayer A</th>
<th>Taxpayer B</th>
<th>Taxpayer C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$25,000</td>
<td>$15,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>$45,000</td>
<td>$35,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>$24,570</td>
<td>$18,020</td>
<td>$11,620</td>
</tr>
<tr>
<td>32.4%</td>
<td>31.6%</td>
<td>27.4%</td>
</tr>
</tbody>
</table>
23.40. The Committee recommends that in general the treatment of capital gains realised by companies should be the same as for individual taxpayers: a proportion of the gain should be included in income. The Committee notes that the Budget proposals envisage the taxation of capital gains made by companies at a flat rate of 33 1/2 per cent. The effect is the same as the inclusion in income of, approximately, three-quarters of the gain. The logic of this approach is difficult to discern and the reasons for treating companies in a significantly different fashion to individual taxpayers is not clear. If a proportion of a capital gain is to be regarded as income there is no reason why, in effect, different proportions should be deemed to be income depending upon whether the recipient of the gain is an individual or a corporate entity. The Committee thus disagrees with the Budget proposal. Further problems do, however, arise in considering the appropriate tax treatment of capital gains made by companies. These gains will ultimately be distributed to shareholders and the liability of the shareholders to tax on such distributions must be considered.

23.41. Several different approaches are possible, but the Committee favours, at least at the outset, the simple one of regarding half the gain as income of the company and the other half as a non-income receipt. The half regarded as income will be treated as such for all purposes, and thus it will enter the calculation of a sufficient distribution for purposes of undistributed profits tax when the company is a private one. If the amount treated as a non-income receipt in the hands of the company is the subject of a dividend it will, to this extent, be included in the income of the shareholder. There will, in the result, be some failure to carry through to the shareholder the quality of capital gain which the gain had in the hands of the company. However, if the system of imputation credit on the Canadian model as proposed by the Committee in Chapter 16 is adopted, the shareholder will be entitled to credit in respect of the whole of the dividend, both that part of it representing the amount of the gain taxed to the company and that part representing the amount not taxed. There will, in the result, be some correction of the over-taxation of the gain. If, however, Australia comes to adopt the method of advance corporation tax used in the United Kingdom, which restricts the imputation credit by reference to the amount of tax paid by the company, special provisions will be necessary to give some recognition to the quality of capital gain in the receipt by the shareholder. Thus, one-half of a capital gain derived by the company and treated as not being income might be held in a separate account, and a distribution from that account given favourable treatment in the hands of the shareholder. Canada, in relation to such distributions by private companies, gives an exemption from tax.
23.42. The introduction of a capital gains tax will require a reconsideration of section 47 of the Act. That section deems distributions on the liquidation of a company to be dividends to the extent that they represent income derived by the company. While the section remains, there will be two elements that have to be distinguished in distributions on liquidation. To the extent that they represent income derived by the company, they will be dividends taxable as such to the shareholders with whatever imputation credit is allowed. For the rest, they will be proceeds of realisation of shares.

23.43. In the United States and the United Kingdom receipts by a shareholder in the liquidation of a company are in general treated as the proceeds of realisation of his shares, which may give rise to a capital gain or a capital loss depending on whether the proceeds exceed or are less than the cost to the shareholder of his shares. This approach has the advantage on the score of simplicity. Section 47 gives rise to some perplexing problems of interpretation and application. If a significant amount of imputation credit comes to be given, the section might be repealed. The present advantage of section 47 to the Revenue in terms of the amount of tax collected would be diminished by the availability of an imputation credit. If a substantial imputation credit is given, and section 47 remains, the advantage to the Revenue will disappear.

23.44. Income may be derived by a company in the course of liquidation, for example from the disposal of trading stock. If section 47 is repealed, there should be provision whereby the liquidator may pay a dividend out of such income or out of income accumulated in periods prior to liquidation which will qualify for imputation credit. In a parallel fashion it could be provided that capital profits generated in the course of a liquidation by the disposal of fixed assets might also be the subject of a dividend. However, if such disposal is simply not recognised for capital gains tax purposes it will be possible to avoid two impositions of tax: there will be no tax to the liquidator. The United States law does not recognise the realisation of a capital asset in liquidation for purposes of taxing company capital gains, though assets distributed in specie are deemed to have been received by shareholders at their market values for purposes of determining the capital gains tax liabilities of shareholders on the deemed realisations of their shares. However, the United States law has not been proof against tax avoidance: if that example is followed, protective provisions will be necessary.

Treatment of Trusts
23.45. As in the case of capital gains derived by companies, the Committee sees no reason for treating capital gains derived by a trust estate in a markedly different manner from the treatment of capital gains derived by an individual. The same proportion of the gains should be included in the income of the trust estate as would be the case with a capital gain realised by an individual taxpayer. However, particular problems arise in apportioning the liability of the tax on a capital gain between the beneficiaries entitled to the income from the trust estate and those who will ultimately be entitled to the capital of the estate. Capital gains will not generally be income according to trust law principles and, unless the terms of the instrument creating the trust estate direct otherwise, will not be available to those beneficiaries entitled to income: they will become accretions of the capital of the trust estate and will enure ultimately to those beneficiaries who take the capital. This being so, it would be unfair as a general rule to impose a tax liability on the income beneficiaries. On the other hand, the identity of the capital beneficiaries is often unknown at the time the capital gain is realised and it is thus impossible to levy the tax directly on them. Accordingly, the Committee recommends that as a general principle the tax be levied on the trustee. It will then be for the trustee to apportion the liability between income and capital beneficiaries in accordance with general principles of trust law and with the terms of the instrument creating the trust.

23.46. The determination of an appropriate rate of tax will pose difficulties. In Chapter 15 (paragraph 15.34) a special rate of tax of less than 50 per cent is recommended to apply where income is taxed to the trustee because income for tax purposes exceeds income calculated in accordance with trust law. In the Committee's view, it is appropriate to apply this special rate to the half of capital gains taxed to the trustee, except where a lower rate is determined in accordance with paragraph 23.47 or a lower rate is applicable to income taxed to the trustee in accordance with paragraphs 15.33–15.35 (which refer to estates in the course of administration or certain trusts whose income is being accumulated for minor children).

23.47. Where a beneficiary is absolutely entitled to both income and corpus, or the present entitlement of an income beneficiary includes the capital gain, and the beneficiary so elects, the rate of tax should be determined on the basis that half the gain has been added to and is subject to tax as the top slice of the income of the beneficiary. This exception will cover the case where the beneficiary is an infant who is entitled to both income and corpus and the case of a bare trust. It will apply where the trust instrument defines trust income in a way that will include capital gains.
23.48. The transfer of an asset by the trustee to a beneficiary should be treated as a deemed realisation of the asset for purposes of capital gains tax. There should also be a deemed realisation on any occasion when a fraction of the trust assets falls to be included in the estate of a deceased person or is deemed to be disposed of for gift duty purposes. And there should be a deemed realisation on the expiration of each period of twenty-five years referred to in paragraph 24.A42.

23.49. Because of the complexities involved, the Committee does not propose that there should be carry-back of capital losses suffered by a trust. Nor should there be any application of capital losses against income of a trust. Generally, unrecouped capital losses will cease to be available on the termination of a trust. To this there should be one exception. Where a beneficiary who, at the time of the loss, was absolutely entitled to income and corpus receives the corpus of the trust, any unabsorbed capital losses of the trust should be transferred to him.

23.50. Except in one situation, income losses should not be applied against capital gains. The exception proposed is where there are income losses unabsorbed at the termination of a trust. These losses should be applicable against capital gains that arise in the winding up of the trust and the transfer of assets to beneficiaries.

Treatment of Gifts

23.51. Where the taxpayer disposes of an asset by way of a gift or sale at less than market value, he should be deemed to have disposed of the asset at market value and should be liable to taxation on the notional capital gain arising from a deemed disposal at that value. Not to so treat gifts and sales at an undervalue would be to provide a means of avoiding capital gains tax or indefinitely deferring it. There may of course be liquidity difficulties for a taxpayer in meeting the tax arising from the gift of an asset where the notional capital gain is large. However, this would be a factor to be taken into account by the taxpayer in deciding whether or not to make a gift and is in any case essentially no different to the position with regard to a liability for gift duty. Though the primary liability of the tax would be upon the donor, it may be necessary to impose a secondary liability upon the donee. It is noted that the Budget proposals envisage that gift or sale at an undervalue will be treated for capital gains tax purposes as a disposition at full market value. The liability of the donor for capital gains tax should be deducted from the value of the gift in computing his liability for gift duty; the effect would be to give a lifetime gift treatment comparable with that of a bequest.
Treatment of Unrealised Gains at Death

23.52. As a general principle the Committee recommends that a taxpayer should be deemed to have realised his assets at death for the purpose of determining capital gains or losses and the taxable portion of any gain treated as if it were income of the taxpayer in the year of death. Not to do so would be to create severe inequities between the individual who dies shortly after realising his gains and the individual who dies before realising them. It would also create a severe lock-in effect for the elderly investor who would be reluctant to sell assets and incur a tax that he would not incur were he to hold the assets until death. It has been suggested that an alternative to a deemed realisation on death is to have a carry-over of the deceased's cost-basis to the beneficiary for the purpose of determining the latter's capital gains tax liability on ultimate disposal, but this might result in an indefinite deferment of tax. The deceased should be deemed to have disposed of his assets, and the beneficiaries be deemed to have acquired them, at their fair market value as determined for estate duty purposes.

23.53. While the Committee recommends that there should be a deemed realisation on death, it recognises that this may give rise to practical difficulties in the case of an estate consisting largely of non-liquid assets such as rural property or shares in a private company. In many other instances, too, when associated with the need to find moneys to pay estate duty (which would be reduced by virtue of the fact that the liability for capital gains tax diminishes the net value of the estate), the imposition of capital gains tax on the deemed realisation may impose a liquidity strain on an estate. Some provisions are necessary to mitigate this hardship and the capital gains exemption recommended in paragraph 23.55 is one such step. As a further measure it is recommended that, in the case of an estate holding a high proportion of its assets in non-liquid items, the capital gains tax liability arising at death should be assessed in the normal way but the payment should be deferred for a specified period or until the realisation of the items, subject to interest at a reasonable rate. As an alternative, provision could be made for payment of the capital gains tax over an extended period, again with interest: a maximum of seven years might be fair.

23.54. The Budget proposals make no reference to any concessional treatment of capital gains deemed to be realised at death. In the Committee's view the liquidity strain that would be imposed on many estates by the combined effect of capital gains tax and estate duty would be so significant as to require relief. This will particularly be so in the case of those estates consisting largely of small businesses or rural property.
Exemption on Retirement, Death or Disablement

23.55. It is important that there be a concession, available on the death of the taxpayer, to give some relief to the estate from what might be a heavy liability to capital gains tax arising from the deemed realisation at death. It is also reasonable that there be some relief to the taxpayer who, as a result of retirement or permanent incapacity, will be realising capital gains after he ceases to be employed or retires from his business or profession. Accordingly, it is proposed that there should be an exemption from capital gains tax of a specified amount of gains realised after attaining the age of 65 or upon permanent incapacity or deemed to be realised at death. The amount should be revised at regular intervals in the light of the rate of inflation: a figure of not less than $40,000 might be appropriate under present circumstances. In the case of gains deemed to be realised at death, the exemption will apply no matter what relationship the beneficiaries bear to the deceased, but in the majority of cases it could be anticipated that the exemption will ensure to the benefit of the deceased's spouse and children. The total amount of exemption will be limited and, to the extent that it has been used during the deceased's life, it will not be available on death.

23.56. The Budget proposals do not envisage any exemption from capital gains tax in respect of gains realised after retirement or deemed to be realised at death. This is unduly harsh, particularly in view of the fact that many taxpayers, especially those in the lower income brackets, may not realise any gains during their lifetime but may have accrued gains at death. The liability for capital gains tax on the whole of such accrued gains is likely to impose liquidity strains on the estate, with concomitant hardship for dependants.

Treatment of Taxpayer's Principal Residence

23.57. The taxpayer's principal residence should be considered in a different light to his other assets, particularly in a society such as ours where home ownership is so highly valued and encouraged. A home is regarded as more than simply an investment and it must be remembered that any capital gain on a home will usually be in a sense illusory since the taxpayer will normally have to use all the proceeds of sale to purchase another house of comparable size, comfort and location. To tax the gain would have serious effects on the mobility of the work force. A person might be unwilling to accept a job in another city if the gain on the sale of his house is to be taxed, thus reducing the amount available for purchase of a new house and forcing him to accept a house of a lower standard than the one he has left. In addition, the administrative problems of levying tax
upon the gains on the taxpayer's principal residence would be unacceptable. Apart from the task of valuing all houses on the date of commencement of the tax, there would be a continuing problem of determining the costbase of the house. All expenditures on repairs, alterations and extensions would need to be accounted for and dissected into those that enhanced the value of the property (and would thus be taken into account in determining the cost-base and hence the gain) and those that were related only to the use or enjoyment of the property. In addition, homes are commonly owned for very long periods, and records of expenditure on the taxpayer's home are likely to be scanty or non-existent.

23.58. The Committee accepts that it would be possible to adopt provisions giving a ‘roll-over’ (explained in paragraph 23.69) instead of an exemption or confining the proposed exemption to houses below a certain value. If either alternative were adopted, the tendency for resources to be diverted into overlarge houses would be corrected. The former alternative would, if anything, increase the administrative problems. Under the second alternative the administrative problems would be less: only a small number of houses need be outside the exemption. The administrative difficulties would nonetheless still be considerable.

23.59. Accordingly, the Committee recommends that capital gains on the taxpayer's principal residence should in general be exempt from tax. But there is a need to ensure that this exemption is not abused and the Committee favours limiting the exemption to the house together with a reasonable amount of the land on which it is situated. It is recommended that the amount of land qualifying for exemption should be such amount as is reasonably necessary for the enjoyment of the house having regard to its location. The appropriate limits might be:

(a) in the case of land zoned residential, industrial or commercial: two-tenths of a hectare (approximately half an acre) or such greater area not exceeding four-tenths of a hectare (approximately one acre) as may be reasonably necessary for the enjoyment of the house;

(b) in the case of rural land: one hectare (approximately two-and-a-half acres).

The Committee recognises that any arbitrary limits such as these will produce inequities and anomalies. Four-tenths of a hectare of land in a densely populated inner city suburb may be an excessive amount of land to exempt, whereas a similar amount on the outskirts of a country town may be unreasonably small. Nonetheless the advantages of certainty in this matter outweigh the possible inequities. Where the amount of land on which the principal residence is situated exceeds the exempt amount, the
gain would have to be apportioned between the house and exempt amount on the one hand, and the remainder of the land on the other and the latter will be subject to tax. This would give rise to some administrative difficulties and disputes but these should not be numerous having regard to the fact that the vast majority of homes are situated on areas of land below the suggested exemption level.

23.60. The Budget proposals envisage an exemption of the taxpayer's principal residence together with such area of surrounding land (not exceeding four-tenths of a hectare) as may be reasonably necessary for enjoyment of the house.

Exemption of Small Gains

23.61. For ease of administration it is necessary to have some provisions for exempting small gains from tax. While it would be desirable to express this in the form of an exemption for gains not exceeding a certain amount in any one year, overseas experience indicates that such an approach is not satisfactory since it necessitates the computation of the actual gain in order to determine whether or not the exemption applies. For this reason the Committee recommends that an alternative method be adopted and that the exemption apply to the gains arising from the sale in any one year of assets where the total proceeds of sale do not exceed a certain figure, say $1,000. Although this may involve some inequity in that the exempted gain could be $1 or $999, it is felt that in practice the inequities will be slight and will be greatly outweighed by the administrative simplicity of the recommendation.

23.62. The Budget proposals contained no general provisions exempting small gains from capital gains tax. Having regard to the administrative difficulty for both taxpayer and revenue authorities involved in assessing tax on small capital gains, the wisdom of this is questionable. The Committee has been particularly impressed by evidence from the United Kingdom on the difficulties involved in assessing small capital gains and believes that the loss of equity involved in the provisions suggested in the previous paragraph is small compared with the gains in simplicity and ease of administration.

Exemption of Certain Assets

23.63. Gains and losses on certain items of personal use such as motor vehicles and household furniture should be disregarded for capital gains tax purposes. Such items will in general depreciate rather than appreciate over time and if brought within the net of capital gains tax would for that
reason lead to capital losses. For those few items such as antique furniture and jewellery that may appreciate, the problems in determining the cost of assets which may have been purchased many years before ultimate disposition would often be extremely difficult.

23.64. The Budget proposals envisage that items of personal-use property originally costing less than $500 will be deemed to have cost $500 for the purpose of assessing any gain on disposition; and where the proceeds of disposition are less than $500 they will be taken to $500, thus limiting the taxable loss to the excess of cost over $500. In addition, under the Budget proposals certain specified personal-use items such as jewellery, coins and works of art will be treated in the same manner as non-personal-use property to the extent that all gains will be subject to capital gains tax but losses will be available to be offset against gains on similar property. The Committee is in general agreement with the philosophy underlying the Budget proposals: personal-use property which normally deteriorates through use should be disregarded for capital gains tax purposes, but property which is as much for investment as for personal use and which may thus appreciate in value over time should not be exempted. Nonetheless there are considerable difficulties in drawing a clear dividing line between the two types of personal-use property. The Committee therefore recommends that while such property as jewellery should be subject to the tax, furniture, even though it may be antique furniture, should be altogether exempt. Furthermore, attention is drawn to the fact that the application of the $500 rule referred to above is likely to give rise to considerable dispute and administrative difficulties in the case of items such as stamps and coins which may be disposed of in sets.

Life Assurance Policies

23.65. The general tax treatment of life assurance is considered in Chapter 21. The Budget proposals envisage the exemption from capital gains tax of the amount payable under a life assurance policy or any part of such amount, which is in line with the Committee's own thinking.

Superannuation Rights

23.66. The tax treatment of superannuation is also considered in detail in Chapter 21. The Committee is in agreement with the Budget proposals that superannuation receipts should not come within the ambit of capital gains tax.

Depreciable Assets
23.67. Where assets on which depreciation has been allowed for income tax purposes are sold at a price greater than the original cost of such assets, the excess should be regarded as a capital gain. It is to be noted, however, that the practical application of capital gains tax in the area of depreciable property on which a surplus arises on sale will usually be mitigated by the roll-over provisions referred to in paragraph 23.69. Where the asset is sold for less than the written-down value, the deficit will, as now, be treated as an income loss.

Intangible Assets

23.68. The Committee can see no good reason why, in general, the disposal of intangible assets such as goodwill, patents and trade-marks should be treated any differently, for purposes of capital gains tax, than tangible property.

Roll-over for Certain Assets

23.69. In certain circumstances where an asset is disposed of and the proceeds are invested in a similar asset, or where the disposal of one asset and acquisition of another involves merely a change in legal form but not a material change in the substance of what is owned, the new asset should be regarded as a continuation of the old with the cost-basis of the latter being carried over. This is known as a ‘roll-over’, and provisions of this nature are commonly found in capital gains tax legislation as a means of reducing the undesirable aspect of lock-in. The Committee recommends that roll-over provisions should apply in the following cases:

(a) The disposal and replacement of certain business assets (such as plant, machinery and buildings) within specified periods and the expropriation, loss or destruction of such assets followed by a replacement with assets of a similar nature. A suggested period in which the replacement must take place is one year for plant and two years for buildings.
(b) The transfer of assets to a company in which the equity shares are wholly owned by a taxpayer. A proportionate roll-over should be allowed where the taxpayer takes up more than a nominal proportion of the equity shares.
(c) The transfer of assets to a partnership in which the vendor is a partner, to the extent that the vendor acquires an interest in the capital of the partnership.
(d) The distribution of assets upon the dissolution of a partnership.
(e) Certain types of company mergers and reconstructions.
(f) The liquidation by a company of a wholly-owned subsidiary.

23.70. The Budget proposals envisage the availability of roll-over
provisions in circumstances yet to be precisely defined but which accord in broad outline with the recommendations of the Committee.

**Treatment of Losses**

23.71. One of the distinguishing features of capital gains in comparison with other income is that the taxpayer will usually be able to choose the time at which he realises his gains and losses. If half the gains were included as income and half the losses allowed as a deduction from income, there would be a considerable incentive for taxpayers to realise their unprofitable investments, thus obtaining a deduction, and retain their profitable ones, thus deferring the tax on their gains: in short, a taxpayer would realise his losses and ‘hoard’ his gains. Such an approach cannot be countenanced and the Committee recommends that in general capital losses should be taken into account only as an offset to capital gains. However, special provisions should be made for capital losses unrecovered at death, for small capital losses (on administrative grounds) and for the carrying back of capital losses by re-opening past assessments of capital gains, the allowable capital loss being assumed, in line with the treatment of a capital gain, to be half the actual loss. Accordingly, it is recommended that:

(a) There should be a limited carry-back of allowable capital losses, the extent of the carry-back to be the same as that recommended by the Committee for income losses.

(b) Allowable capital losses should be permitted to be carried forward indefinitely as an offset to future taxable capital gains.

(c) A limited allowance of, say, $1,000 of allowable capital loss (i.e. up to $2,000 of actual capital loss) should be permitted to be offset against other income.

(d) Special provisions will be needed to counter artificial losses and sale-and-buy-back transactions.

The order of application of allowable capital losses should be:

- firstly against taxable capital gains of the same income year; secondly against taxable capital gains made during the period allowed for carry-back;
- thirdly as to (say) $1,000 of allowable capital loss (i.e. $2,000 actual capital loss) against other income;
- any excess to be carried forward with the first (say) $1,000 of the excess allowable capital loss available as an offset to other income in the next year.

Where a taxpayer dies with unrecovered or unrealised capital losses, the allowable capital loss should be applied:
firstly against taxable capital gains made in the income year of death and gains deemed to be realised at death;
secondly against taxable capital gains made during the period allowed for carry-back;
thirdly against any other income (without limit) of the income year of death or the preceding income year.

23.72. The treatment of capital losses proposed in the Budget diverges quite considerably from the recommendations of the Committee. In general the Budget proposals appear to be harsher than the Committee's recommendations in that they allow no general carry-back of capital losses (other than a three year carry-back at death) and there is no provision for offset of any part of a capital loss against other income.

IV. The Distinction Between Capital and Income

23.73. If the Committee's recommendations with regard to the introduction of a capital gains tax were to be adopted, the recurrent disputes between the Revenue and the taxpayer attendant upon the realisation of various forms of property would be diminished in number. The present conflict in the rival contentions, on the one hand, that the profit is a taxable income-profit and, on the other, that the profit is a nontaxable capital profit, should be reduced for the reason that the difference in the amount of tax exigible in any transaction will be considerably less than under the ‘all-or-nothing’ approach which must result under the legislation in its present form. The problem of distinguishing between capital and income will continue to exist since, with the presence in the system of a capital gains tax, a capital-profit and an income-profit will be brought to tax in ways producing different monetary consequences. That problem is one which has always defied easy solution because the criteria for distinguishing between the two types of profit can, according to circumstances, encompass such a wide variety of matters which may be relevant to its determination that no universally infallible touchstone is possible. Hence, the fact that the Act does not contain any comprehensive definitions of capital, income, gross income or assessable income should occasion no surprise.

Section 26(a)

23.74. An attempt was made in 1930 to achieve a greater degree of certainty in this area by the enactment of provisions now represented by section 26 (a) which includes as assessable income of the taxpayer:
‘(a) profit arising from the sale by the taxpayer of any property acquired by him for the purpose of profit making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme.’

This enactment has proved to be unpredictable in its application and a most potent source of disagreement and litigation between taxpayers and the Commissioner. Until recently its first limb had been thought to involve a subjective test: what was the taxpayer's dominant purpose at the moment of acquiring the asset? The second limb, however, had been thought to involve an objective test as to whether or not the taxpayer was ‘carrying on or carrying out a profit-making undertaking or scheme.’ The second limb thus involved an examination of whether or not the undertaking or scheme was essentially of a business nature, whereas the first limb simply involved an inquiry as to the purpose of the taxpayer at the time of acquisition of the asset. These long-held interpretations of the somewhat differing requirements of the two limbs of the section have now been shown to be incorrect by a recent decision of the High Court. It appears that the first limb as well as the second limb requires that some ‘business purpose’ be shown before the section will have any application. The section is thus considerably narrower in scope than had been thought, and in the Committee's view this narrowing of the section means that it now adds nothing to the determination of income for the purposes of the Act. In other words its operation is merely declaratory, adding no more to the section than section 25 has already provided. Furthermore, the High Court's decision has placed further constraints on the operation of section 26 (a) by requiring that there be a complete identity between the property acquired and the property disposed of. This means that the section may have no operation in cases such as the exercise of an option and subsequent profitable resale. The Committee can see no good reason for retaining the section and recommends that to avoid any further uncertainty it be repealed.

Section 26AAA

23.75. Section 26AAA was inserted into the Act in 1973 and by the introduction of a time-limit seeks to remove some of the difficulties inherent in section 26 (a) by including in the assessable income of the taxpayer any profit arising from the sale of property (other than the taxpayer's home realised as a result of a change in his place of employment or business) within twelve months of its purchase. In the absence of a capital gains tax of the type referred to above, it achieves a measure of certainty in that, in effect, it is a short-term capital gains tax. However,
where property is held for more than twelve months after its acquisition, the taxpayer and the Commissioner are then faced with the problems which section 26 (a) creates. In practice a great many land transactions, and probably a number of other property sales, will fall outside the ambit of the section. The section also does not take into account any deductions for losses incurred when property is sold within twelve months; nor does it make any provision for the cases where through some unexpected hardship the taxpayer is forced to realise his property, especially his residence, within the time-limit. The Committee does not favour a short-term capital gains tax by reason of the complexities such a method of taxation involves, in particular in conjunction with the general capital gains tax the Committee has proposed. Having regard to the wider application of the capital gains tax recommended above, the Committee also recommends the repeal of section 26AAA.

Replacement of Sections 26 (a) and 26AAA upon their Repeal

23.76. Firstly, it will be convenient to point out that the Committee's recommended capital gains tax will cover the ground presently marked out by section 26AAA. Secondly, with regard to section 26 (a), it is apparent that no definitions or principles can be framed to provide either a universal or, short of that, a satisfactory solution for the problem of distinguishing between capital and income and between business income and non-business receipts. The distinctions between these concepts will of necessity remain areas of difficulty. The Committee is, however, of the opinion that consideration should be given to strengthening the broad sweep of section 25 without in any way detracting from its generality as a substantive enactment. This objective could be attained by giving to the decision-making tribunals directory emphasis of the fact that a business transaction can just as easily be constituted by a single act or operation or by one performed apart from the taxpayer's usual occupation, as a series of repetitive acts. This proposal, expressed as being without restriction of the generality of section 25, would neither add to nor detract from its actual scope and operation and would have an application equally to transactions resulting in a profit as to those in which a loss occurred. The well-known 'badges of trade' would still be the major considerations to which recourse would usually be had. However, the effect of the proposal would be that a declaratory warning would be contained in the section that the absence of one of those 'badges', which is so often relied upon to deny the business element in an isolated transaction, i.e. the frequency of similar transactions, cannot always be successfully relied upon. The repeal of section 26 (a)
would necessitate the repeal of the similar verbiage in the definition of ‘income from personal exertion’ in section 6 (1) and also the repeal of section 52.

23.77. The Budget proposals specifically state that capital gains tax will not apply to transactions caught for income tax under section 25 or under sections 26 (a) or 26AAA upon the assumption that these two latter sections are to be retained against the Committee's recommendation.

V. Development Gains Tax

23.78. Certain types of gains on land have characteristics distinguishing them from gains on other assets. Three main varieties of gain can occur with land:

(a) Gains from carrying on a business in land dealing or development. These are essentially the same as any other business activity, with the land forming the trading stock of the enterprise and the gains, as now, normally being taxed as income. (It should be noted that the Committee's recommendations in paragraph 23.76 will ensure that such profits are taxed as income even if the transaction is an isolated one.)

(b) Gains arising from the realisation of the land by its owner where there has been no change of permitted use. These gains would emanate from inflation or from the normal operation of rising market demand when a commodity is in fixed supply. Such gains would normally be taxed as capital gains.

(c) Gains arising from the actions of public authorities in permitting change of use of the land together with any gains arising from associated or consequential development carried out upon that land. These mainly take the form of gains upon the re-zoning of land or the granting of development approval for a large project and gains resulting from subsequent sub-divisional or other development operations.

23.79. The third category of gains has one main characteristic distinguishing it from other capital gains. The change-of-use gains are made possible, not by the efforts of the individual, but by the planning decisions of public authorities. As such, they should enure more to the benefit of the whole community than they do now or would do under a capital gains tax of the kind proposed. Where the actions of the community give rise to a sudden increase in land values, as in the case of population growth leading to the re-zoning as residential of outer suburban or rural land, the community has a right to a greater share in such increases. The taxation system should if possible be brought to bear on such gains by taxing them more severely than if they were ordinary capital gains.

23.80. A tax on the gains arising from the disposal or deemed disposal of
land with development potential was foreshadowed by the Conservative Government in the United Kingdom in late 1973 and a Bill to give effect to this was then introduced by the present United Kingdom Labour Government in the early part of 1974 and enacted as a part of the Finance Act 1974. This Act was extremely complicated in its provisions and application and was subject to considerable debate and criticism. The Australian Government's Budget proposals for taxing land gains of this type appear to be a somewhat simplified version of the United Kingdom provisions. However, it is understood that the United Kingdom Government will now not be giving effect to the recent legislation but intends instead to introduce a special development land tax. Details of this latest proposal are not yet available.

23.81. The Committee has been unable to undertake a full study of the ramifications and difficulties of the various systems for taxing the increment in land value attributable to changes in the permitted use of land. While the equity arguments for a tax of some sort on these gains in addition to a capital gains tax are impressive, any such tax must undoubtedly be extremely complex, difficult to administer and productive of some inequities and anomalies. Accordingly, the Committee makes no recommendations in this area but suggests that any proposals for such a tax should be subject to the widest possible public debate before their introduction.

VI. Conclusion

23.82. In conclusion it may be helpful to give a broad summary of the analysis of this chapter:

(a) On grounds of equity there is a very strong case for taxing capital gains, and there is a case too on economic efficiency grounds. A tax on capital gains should therefore form a part of the Australian tax structure. However, the introduction of such a new and complex tax is a matter requiring careful thought and considerable public discussion. Furthermore, the introduction of such a tax at a time when inflation is running at an annual rate approaching 20 per cent must result in the taxation of ‘paper’ gains in many cases.

(b) Accordingly the 1974–75 Budget proposals to introduce a capital gains tax with effect from 17 September 1974 should be withdrawn. A Green Paper on the United Kingdom model should be published to provide adequate opportunity for critical analysis and debate before any legislation is introduced and before the tax goes into operation.

(c) Further study needs to be given to the most appropriate way of allowing for the impact of inflation in the context of a capital gains tax. Whilst the Committee rejects
the indexation of gains as impracticable under normal conditions, it recognises that this device has some merit in conditions of very high inflation and is worthy of further examination. If a capital gains tax is to be introduced which adopts the proportional inclusion method recommended by the Committee, then the proportion of the gain to be included in income should be considerably less than half during periods of high inflation.

(d) The tax should apply only to gains accruing and realised after the introduction of the tax and the family home should be exempt.

(e) Continued efforts are needed to achieve a workable system of distinguishing between income gains and capital gains.

(f) The possibility of treating development gains more severely than other capital gains requires close consideration, but the attendant complexity of any such separate tax on development gains must be borne in mind.

**Reservation to Chapter 23: Capital Gains Tax**

**R. W. Parsons**

My first reservation relates to one of the Committee's reasons—the prevailing high rate of inflation—for recommending that the introduction of a capital gains tax should be deferred. I have a second reservation about the steps proposed by the Committee to clarify the distinction between an income gain and a capital gain.

In paragraphs 23.4 and 23.5, and in 23.84 the Committee recommends that the introduction of a capital gains tax should be deferred. One reason given is that the public have not been sufficiently informed of the details of the tax which has been announced. With this reason I agree. Another reason given is the prevailing high rate of inflation. With this I disagree.

It is true that inflation distorts the operation of a capital gains tax but it distorts the operation of other taxes as well, more especially income tax in relation to business income and interest income. Any thoroughgoing adjustment of the tax system to take account of inflation involves radical changes first in business and investment practices, and then in the tax law, so as to apply indexation in the calculation of gains and losses from transactions. Meanwhile it is only possible to provide mitigations which offer rough and ready relief in an inevitably discriminatory fashion. The Committee has proposed such relief in the form of the inclusion of only a fraction of capital gains in income. It has also proposed that there be some relief from the taxation of interest income, though relief which is much less significant than that contemplated in respect of capital gains.

The difficulties associated with adjusting gains and losses to take account of inflation may point to the conclusion that a capital gains tax should not be introduced at all and that one should move away from income tax to
other taxes such as value-added tax, gift and estate duty and, perhaps, a
wealth tax, where the difficulties associated with adjustments for inflation
can be handled more easily. There is much to be said for such a view. But
temporising about the introduction of a capital gains tax is a different
matter.

The suggestion is made in paragraph 23.28 of the report that altering the
fraction of capital gains to be included in income is a means of adjusting
tax on capital gains to the prevailing level of inflation. It is said that it
might be appropriate to introduce a capital gains tax now if only a small
fraction of gains were to be included in income. The suggestion, in my
view, has no merit. It is enough to draw attention to the implication that the
fraction will be increased when the present period of high inflation has
passed, and to the consequence that a taxpayer who held an asset during
the period of high inflation, but realised the asset after it had passed, will
be denied the special relief. If special relief to deal with a period of high
inflation is contemplated, it could be provided by a limited indexation of
costs of property held during the period. The special relief would of course
be rough and ready—it should not be applied so as to give rise to a loss—
and it would be subject to the criticism that it would give an advantage to a
taxpayer who had acquired his asset with borrowed funds. But it will, at
least, be directed to giving relief to those whose gains are illusory because
of the inflation which prevailed while they held the assets.

The Committee has recommended in paragraphs 23.75–23.79 that the
specific provisions of the Act, sections 26 (a) and 26AAA, which are
concerned with the distinction between an income gain and a capital gain,
should be repealed. As I understand the recommendation, it is proposed
that it should be left to the Courts to define the boundary line, subject only
to an additional provision giving directory emphasis to the fact that a single
act or operation or one performed apart from the taxpayer's usual
occupation may give rise to an income gain. I would prefer a reform which
would seek to strengthen the specific provisions. In my view the boundary
line is more likely to be clarified by legislative prescription than by judicial
precedent.

Section 26 (a) is admittedly unsatisfactory as at present drafted. Amendment
to the first limb is called for to remove the emphasis on the
subtleties of dominant motivation. The operation of the amended provision
should be made to depend on the drawing of an objective inference from
the actions of the taxpayer and other circumstances, that at the time of his
acquisition of the property he had a purpose to profit by the realisation of
the property. The inference will in most instances be drawn from the very
limited current return in income or enjoyment from the property during the
period it was held by the taxpayer, or from the short period it was held by him. Purposive acquisition will not be a condition of the application of the section. It will be applicable to a receipt under a gift inter vivos or by will. Those questions which presently arise when the taxpayer's purpose of profit-making at the time of acquisition cannot be identified with the part of the property he realised, can be avoided by the way the new provision is drafted. And the drafting should seek to overcome the tendency to bring refinements of property law to bear in determining whether the property realised was the property acquired and in the interpretation of the words acquisition and realisation.

Consideration might be given to extending the scope of the new provision so that it will be applicable when the inference is that for some period prior to disposal of the property that taxpayer had a purpose to realise it at a profit. He may have ceased current income-producing operations on the property some time prior to its sale. It would of course be necessary, in determining the amount of the profit, to value the property at the time when, according to the inference, the purpose arose.

I suggest that the second limb of section 26 (a) should be replaced by a new section which would include as income the profit derived from a business undertaking. Both this new section, and the section which will be constituted by the amended first limb, should be limited in their application so that they will not cover profits of transactions which are aspects of a continuing business. Such profits may be left to be dealt with by other provisions of the Act. The new section would provide that, in addition to any other circumstances which may indicate a business undertaking, regard should be had to the presence of a number of specified circumstances, any one of which may be held to be a sufficient indication. The circumstances so specified would be such as would be thought to justify treating a resulting profit as income. The list of indications might, for example, include the following:

(a) That the taxpayer made physical changes to property as a preliminary to its realisation.  
(b) That property held by the taxpayer in one parcel was divided as a preliminary to, or in the course of, its realisation in several parcels.  
(c) That the taxpayer secured an enlargement of his interest in property as a preliminary to the realisation of his interest.  

It is true that the phrase ‘business undertaking’ must qualify the force of any indication. But the indications must in turn affect the meaning of the phrase: the words must be read in their context. Hopefully, the new section
would bring a greater measure of certainly to an area of tax law which has been characterised by divergences of judicial opinion.

In my opinion section 26AAA should be retained. The section makes a short period of holding—twelve months—conclusive that any profit is income. The sections replacing section 26 (a) will have limited application to share transactions. Section 26AAA provides, I believe, an acceptable way of drawing the distinction between income gains and capital gains arising from share transactions, when the taxpayer is not engaged in a continuing business involving such transactions. Within the limits of its operation it achieves certainty. The section may seem unfair where the taxpayer has been forced to realise property within the period: an exception, added to the one relating to the taxpayer's residence, would however cure this. The section has been criticised on the ground that it deters non-residents from entering into transactions on Australian stock exchanges: an exemption, if thought appropriate, would answer this criticism. The failure of the section to provide that a short period of holding is sufficient to give the right to a deduction of a loss is an element which, if it be unfair, cannot easily be cured. To allow such a deduction would convert the section into a short-term gains tax, since the application of the loss would have to be restricted. It may not, however, be unfair that a taxpayer who can choose to realise property outside the twelve months period, and thus prevent an income gain arising, should be denied a loss available against income gains when he chooses to realise within the period. A loss within the period will be deductible as a capital loss under the Committee's proposals.

Three collateral matters in relation to the sections to replace section 26 (a) merit some attention. Recent authority has made evident the need for a provision which will bring in as income a deemed profit when a transaction or undertaking otherwise within one of the sections has been commenced but has been terminated by a disposal of property otherwise than in carrying out the transaction or undertaking. The common illustration of such a termination is a gift of the property to a spouse or other associated person. An existing provision (section 36) of the Act will bring in a deemed profit when the property is stock in trade of a continuing business carried on by the taxpayer. But this is presumably inappropriate when the transaction or undertaking is not an aspect of a continuing business. There is a subsection (subsection (4) ) in section 26AAA which might be the model for the proposed provision. Consideration might be given to extending the operation of the proposed provision so that it will bring in a deemed profit on the death of the taxpayer.

A number of authorities, some of long standing, indicate the need for a
provision by which shareholders and their closely-controlled company are to be treated as one: a realisation of shares may then be treated as a realisation by the shareholder of property of the company.

It is not by any means clear that a loss arising from an isolated transaction or undertaking will be deductible in the absence of an express provision. The meaning to be given to the word ‘loss’ in the general deduction section (section 51) is left obscure by judicial pronouncements. In my view section 52, which presently allows a deduction of a loss arising from a transaction within section 26 (a), should not be repealed. It should, however, be adapted so that it applies to a transaction or undertaking within the sections replacing section 26 (a).

R. W. Parsons

Reservation to Chapter 23: Capital Gains Tax

K. Wood

My reservation to this chapter relates to the Committee's proposal in paragraph 23.58 that a tax on capital gains, when imposed, should be levied by a proportional inclusion method.

This proposal will add unnecessarily to the unavoidable complexities of a tax of this type and in my opinion the flat rate method to which reference is made in paragraphs 23.25, 23.26 and 23.27 is preferable. It would be altogether more simple, even with any modification incorporated to reduce the impact of tax on lower income taxpayers.

K. Wood

1 The Committee had concluded its deliberations upon this chapter of the Report and had arrived at its decision to recommend deferral of this tax prior to the announcement made on 29 January 1975 that the Government's plans for the introduction of a capital gains tax had been postponed. No attempt has been made in the discussions and recommendations of this chapter to take account of this change in the Government's policy.

Reservations to conclusions reached in this chapter are appended.
Chapter 24 Estate and Gift Duty

24.1. Taxes on capital on the occasion of death are imposed by the Commonwealth and all States of Australia. Taxes on gifts are also imposed by the Commonwealth and all States. The main function of the latter is to support the death taxes: gifts during life put capital out of reach of taxes on capital passing at death. As Table 24.A indicates, revenue from these taxes, while not great, is by no means insignificant especially at the State level. Table 24.B shows the breakdown, for the most recent year for which published figures are available, of Commonwealth estate duty by size of estate.

### Table 24.A: Death and Gift Duties: Revenue Statistics

<table>
<thead>
<tr>
<th>Year</th>
<th>Commonwealth Estate duty (a)</th>
<th>Commonwealth Gift duty and gift duties</th>
<th>States: Estate, gift, probate and succession duties (a)</th>
<th>Commonwealth States: Death and gift duties (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
<td>per cent (b)</td>
<td>$m</td>
</tr>
<tr>
<td>1955–56</td>
<td>19.2</td>
<td>3.3</td>
<td>22.5</td>
<td>1.2</td>
</tr>
<tr>
<td>1960–61</td>
<td>29.6</td>
<td>5.6</td>
<td>35.2</td>
<td>1.2</td>
</tr>
<tr>
<td>1966–67</td>
<td>41.5</td>
<td>7.7</td>
<td>49.2</td>
<td>1.1</td>
</tr>
<tr>
<td>1972–73</td>
<td>66.4</td>
<td>6.9</td>
<td>73.3</td>
<td>0.9</td>
</tr>
<tr>
<td>1973–74</td>
<td>66.0</td>
<td>9.7</td>
<td>75.7</td>
<td>0.7</td>
</tr>
</tbody>
</table>

(a) Includes gift duty only where distinguishable from broader category of stamp duties. (b) Percentage of Commonwealth taxation. (c) Percentage of

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(1) Includes gift duty only where distinguishable from broader category of stamp duties. (b) Percentage of Commonwealth taxation. (c) Percentage of
State taxation.
(d) Percentage of Commonwealth and State Taxation. (e) Affected by the handing over of payroll tax to the States in 1971.


**TABLE 24.B: COMMONWEALTH ESTATE DUTY: ASSESSMENTS ISSUED, BY SIZE OF ESTATE, 1972–73**

<table>
<thead>
<tr>
<th>Grade of net value of estate</th>
<th>Estates value</th>
<th>Number of total</th>
<th>Per cent</th>
<th>Amount</th>
<th>Per cent of total</th>
<th>Amount</th>
<th>Per cent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$ million</td>
<td>$ million</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0–19,999</td>
<td>2,265</td>
<td>13.5</td>
<td>8.3</td>
<td>1.4</td>
<td>0.3</td>
<td>0.4</td>
<td></td>
</tr>
<tr>
<td>20,000–39,999</td>
<td>7,063</td>
<td>42.2</td>
<td>73.5</td>
<td>12.4</td>
<td>2.2</td>
<td>3.5</td>
<td></td>
</tr>
<tr>
<td>40,000–79,999</td>
<td>4,552</td>
<td>27.2</td>
<td>169.6</td>
<td>28.7</td>
<td>9.5</td>
<td>14.8</td>
<td></td>
</tr>
<tr>
<td>80,000–119,999</td>
<td>1,489</td>
<td>8.9</td>
<td>113.3</td>
<td>19.2</td>
<td>10.5</td>
<td>16.3</td>
<td></td>
</tr>
<tr>
<td>120,000–199,999</td>
<td>876</td>
<td>5.2</td>
<td>104.4</td>
<td>17.7</td>
<td>14.0</td>
<td>21.8</td>
<td></td>
</tr>
<tr>
<td>200,000–349,999</td>
<td>358</td>
<td>2.1</td>
<td>65.7</td>
<td>11.1</td>
<td>13.5</td>
<td>21.0</td>
<td></td>
</tr>
<tr>
<td>350,000–499,999</td>
<td>72</td>
<td>0.4</td>
<td>22.0</td>
<td>3.7</td>
<td>5.6</td>
<td>8.7</td>
<td></td>
</tr>
<tr>
<td>500,000–999,999</td>
<td>49</td>
<td>0.3</td>
<td>23.3</td>
<td>3.9</td>
<td>6.0</td>
<td>9.3</td>
<td></td>
</tr>
<tr>
<td>1,000,000 +</td>
<td>10</td>
<td>0.1</td>
<td>10.6</td>
<td>1.8</td>
<td>2.8</td>
<td>4.3</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>16,734</td>
<td>100.0</td>
<td>590.7</td>
<td>100.0</td>
<td>(a)64.4</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

(a) The discrepancy between this figure and the total of $66.4 million in
Table 24.A is explained by the fact that Table 24.B relates to assessments issued during the year, whereas Table 24.A records net duty actually collected. It is also worth noting that $18.7 million (29.1 per cent) of the $64.4 million net duty assessed in 1972–73 involved primary producer estates.


24.2. Death taxes in Australia have been the subject of inquiry by the Senate Standing Committee on Finance and Government Operations which reported in December 1973. The taxes have been subject to strong criticism in submissions made to the Committee and in comment by members of Parliament, the Press and members of the public. Some of the criticisms concentrate upon the ineffectiveness that afflicts these taxes in their present form because of the narrowness of the base and the possibilities of avoidance by tax-planning techniques. These complaints are perhaps more applicable to the Commonwealth taxes than to some of the State taxes. Other critics urge that hardship is caused, especially to widows and dependent children, by rate structures which have not been adequately adjusted for inflation. A third criticism points to the complexity of a system of separate Commonwealth and State taxes and the considerable costs of administration and compliance that result. It is pointed out too that the revenue yield to the Commonwealth is only a relatively small fraction of its total revenue. Many then draw the simple conclusion that the Commonwealth taxes, if not also the State taxes, should be abolished.

24.3. The Committee acknowledges the force of these criticisms, but disagrees with the conclusion. It believes that the avoidance and hardship difficulties can largely be overcome, and that, in concert with the States, a system of Australian death taxes can be devised which would minimise costs of administration and compliance. Above all it believes that, though death taxes can never be simple taxes and though revenue from them will never be great compared with that from some other taxes, they have an
essential role to play in the tax structure considered as a whole.

24.4. A death tax serves two main purposes. It serves to support the progressivity of the tax structure by the indirect means of a progressive levy on wealth once a generation. It also directly limits the growth of large inherited fortunes, a trend that most people would agree to have undesirable social consequences.

24.5. It is helpful, and essential, to the purpose of the income tax largely because much that is income on any wide definition cannot effectively be measured as such—for example, the enjoyment of works of art—though its capitalised value is accessible at death. Furthermore, it would be quite impracticable to distinguish in the income tax between income from savings and income from inherited fortunes. Finally, although the empirical and theoretical evidence if far from conclusive, the consensus is that death taxes are not as detrimental to saving, risk-taking and work effort as are higher marginal rates of income tax.

24.6. An annual wealth tax could in theory do what death taxes do, and the case for such a tax is examined in Chapter 26. The Committee believes a death tax is to be preferred. It is probably more acceptable to a person who has wealth than is a wealth tax: a death tax enables a person to enjoy for his lifetime the benefits of any saving he undertakes. Its disincentive effects are likely to be less than those of a wealth tax. And it has a number of administrative advantages. It is imposed at a time when, for the purpose of administering the estate of a deceased taxpayer, a complete inventory of his assets must be prepared. Valuations are required only once and not on a regular basis, thus ensuring that costs of collecting the tax are kept to a minimum. Also, it is imposed at a time when a significant proportion of assets would in any event be realised in the course of administering the estate. Even in the case of an illiquid asset such as a house, a business or a farm, it can be argued that death is an occasion when beneficiaries ought to take stock to determine whether they can or should hold the assets bequeathed to them.

1. The Form of a Death Tax

24.7. The rather unpleasant term death tax has been used as a general expression for a wide class of possible taxes imposed at the time of death, some of which have long histories and some of which have been recently proposed:

(a) The present Commonwealth tax and that of most of the States is an estate duty,
the distinguishing feature of which is that the tax is levied on the value of the estate as a whole.

(b) *Inheritance taxes* are those death taxes in which the tax is progressively related to the size not of the estate but of the individual bequests.

(c) *Accessions taxes* have been proposed in which the tax is related not just to the size of the bequest but to the total of the sums the beneficiary has received over some period of years (or his whole life) from either that testator or all testators and donors.

(d) A still nameless variant—that bequests and gifts be taxed as income in the hands of the recipients—was advocated by the Carter Commission (1966) which adopted the theory of the ‘comprehensive income base’.

24.8. Each of these has advantages and disadvantages by various tests. The schemes under (c) and (d) have prime concern for the situation of the beneficiary, if that be thought right. But each is somewhat arbitrary in the feature of his affairs that is held relevant to the rate of tax levied on his receipt: in one it depends upon his wealth and not at all upon his income and, in the other, it depends upon his income in the year of receipt. The Committee, however, believes that the wishes of the testator should predominate over the circumstances of the beneficiary: he (or she) after all saved the wealth in the estate or at least refrained from dissipating it, and subject to his obligations to his family it is rightly his privilege to dispose of it to whom he wishes with such regard as he wishes to their particular circumstances. Hence in the Committee's view the choice in equity between the four lies between an estate duty and an inheritance tax. They are also administratively the simplest.

24.9. While there is some merit, when taxing the assets of a deceased person, in having regard to the number of his heirs, the Committee prefers an estate duty partly because it is familiar and would be complicated to change but for other reasons as well. The Committee is unconvinced that, under the inheritance tax, the burden ‘falls on the beneficiary’ or that there is need in Australia to encourage wider dispersion of legacies. As regards the first argument, a testator can vary the incidence of the tax by the manner in which he makes his will. A person who wishes to leave a sum of money to a beneficiary can provide in his will that inheritance tax shall be charged not against that sum but against the balance of his estate. Even if express legislation forbids this, it will continue to be open to the testator to make a larger bequest to the beneficiary to compensate for the tax the beneficiary will have to pay. The other argument may have force where lingering traditions of primogeniture lead testators to concentrate their legacies on single heirs, but this is not the tradition in Australia. Furthermore, avoidance is probably more easily controlled under an estate duty, particularly where the law permits the creation of discretionary trusts
and other equitable interests.

II. Proposed Reforms

24.10. After recommending the preservation of a death tax, in the particular form of an estate duty, it is incumbent upon the Committee to demonstrate that it can be rendered a more effective levy than it is at present. It is certainly at present a tax which can be avoided by well-advised persons with ease, and which might almost be said to be paid principally from the estates of those who died unexpectedly or who had failed to attend to their affairs with proper skill. The Committee believes that far-reaching reforms are required, but it also believes that they are possible and that this tax, though inevitably a complex one, can be allotted and perform a significant role in any long-term reforms.

The Tax Base

24.11. The base of an estate duty must at least include that property owned by the deceased at the time of his death which in fact becomes part of his estate administered by his personal representative. However, the objective of taxing all wealth once a generation will require that the base be wider than this actual estate. In some circumstances property should be included in respect of which the deceased had only some of the incidents of ownership and which does not in fact pass to his personal representative. And valuable rights should be included which the deceased had at the time of his death but which ceased on his death or suffered a change on death that diminished their value. The tax base for the present Commonwealth estate duty and, though to a lesser extent, for the death taxes of the States, is too narrow and should be widened.

24.12. The Committee proposes that the base of estate duty should include property the deceased had power to acquire at the time of his death. Thus it would include property the subject of a power of appointment which the deceased had at the time of his death and could have exercised in his own favour. It should also include property in which a deceased person had an interest for life. If it is not included, property in which a life interest is given, for example in favour of a son, may escape tax for a generation: it would not be subject to tax until the death of the son's children who are given the property subject to their father's life interest. It is also proposed that there should be provisions whereby property subject to discretionary trusts will be brought to tax on the death of a beneficiary.

24.13. The base should include valuable rights in the form of an option to
acquire property or a right to repayment of a loan or rights attendant on shares which the deceased had at the time of his death even though those rights are, by their terms, extinguished by his death. The option may be so expressed that it lapses on death; the right to recover the loan may be conditional on a personal notice being given which cannot be given after death; the articles of association of the company may provide that the shares will cease to carry certain rights on the death of the shareholder.

24.14. In addition to extensions to the tax base, it will be necessary to ensure that property included in the base is taxed at its true value. The law will need to take account of the various techniques used in ‘estate planning’ to bring about a change in the value of an asset on death so that the value for computing tax liability is far less than its value to the deceased during his life. Associated with this loss of value is an increase in the value of assets already owned by the deceased's heirs. One of the techniques involves a valuable parcel of shares which, by virtue of a provision in the articles of association of the company in which the shares are held, suffers a considerable decrease in value on the death of the shareholder.

24.15. No extension of the tax base can ensure that all wealth is taxed at least once a generation. The law cannot forbid a grandfather leaving his property to his grandchildren when their parents are still living. Generation-skipping of this kind could be dealt with indirectly by provisions that would make tax on the grandfather's estate depend on the difference in age between himself and his grandchildren, but such provisions would be complicated and could produce some unexpected and probably unwelcome consequences.

24.16. The Committee's detailed proposals for the base of the reformed estate duty are set out in Appendix A to this chapter. The appendix also includes the Committee's proposals in regard to the base of a reformed gift duty which, as indicated in the next paragraph, should be integrated with the estate duty.

Integration of Gift Duty with Estate Duty

24.17. An estate duty must fall short of its objectives unless the tax base is extended to include gifts made by a deceased person during his lifetime. The present Commonwealth estate duty aggregates with the estate gifts made within three years of death. Any gift duty incurred on such gifts is credited against estate duty and will have diminished the estate for estate duty purposes. Gifts made outside the three-year period are in general subject only to gift duty. No tax is payable if a donor makes a gift and the
value of the gift (when aggregated with the value of all other gifts he has made in the preceding 18 months and will make in the following 18 months) does not exceed $10,000. Thus, if a donor makes one gift of $10,000 after the end of each successive period of 18 months and no other gifts in between, he can dispose of assets to the value of $120,000 in a period of little more than 18 years, without incurring any liability for gift duty. Even if the gifts are larger and duty is payable, the amount of duty is modest compared with the saving in estate duty that usually results when a deceased survives a gift by three years.

24.18. A further shortcoming of the present Commonwealth gift duty is that many transfers that are, in substance, gifts but are cast in a form falling outside the ambit of the existing tax base manage to escape duty. A simple example is the interest-free loan, repayable at call, made by a husband to a member of his family. In substance, there is a gift of the income forgone by the lender; yet no gift tax is attracted. Partnerships, companies and trusts are commonly used by taxpayers to divert income from themselves to wives and children in circumstances that do not attract duty, even though a gift of the relevant income is in effect being made. Transactions involving companies are used to diminish the property of a donor and increase the property of a donee, again in circumstances attracting no gift duty. Allowing another to use property without any payment for its use does not attract gift duty. Valuable rights such as an option may be allowed to lapse without attracting gift duty.

24.19. In paragraph 24.12 it was stated that the objective of ensuring that wealth is taxed once a generation requires that property subject to a life estate or a discretionary trust should be taxed on the death of the life tenant or of a beneficiary under a discretionary trust. If provisions including such property in the estate duty base are not to be defeated by the assignment or surrender of the life estate or interest during the lifetime of the life tenant or beneficiary, the assignment or surrender must be made to generate a liability to gift duty.

24.20. The Committee proposes a full integration of estate duty and gift duty which will have the effect of treating gifts virtually in all respects in the same way as bequests. There will be only one rate structure. Gifts over life will attract increasing rates of duty set by the rate structure, the rate of tax on any gift being determined by the amount of the gift and the value of gifts already made. The rate of tax on bequests will be determined by the amount of bequests and the value of all gifts made during life. Thus an estate will attract the same tax whether it is given away wholly during life, partly during life and partly on death, or wholly on death.

24.21. An effect of the proposed integration will be to take away the
incentive offered by the present law to make gifts during life. There seems no compelling reason why gifts during life should be treated more generously than bequests. In other words, gift duty should fully support the estate duty. The testator ought not to be encouraged by tax considerations, or be persuaded by his heirs with tax considerations in mind, to give up the security of wealth during his lifetime.

**Deductions in Determining the Estate Duty Base**

24.22. The base of the estate duty should be the value of assets included in the base less the amount of all liabilities of the deceased. In the case of contingent liabilities, an estimate should be made and allowed. The Committee considers that, in addition, certain other deductions should be allowed, including funeral expenses incurred in relation to the deceased (subject to a ceiling), and the cost of valuations required in connection with the assessment of duty.

**Rate Structure**

24.23. The present rate structure of the Commonwealth estate duty uses a ‘slab’ system, that is to say, rates are laid down for different sizes of estates, the appropriate rate being applied to the whole of the estate. An alternative is the ‘slice’ system. Under this system, each successive slice of an estate bears a different and higher rate. Each system involves a progressive rate structure. Only the ‘slice’ system, however, is appropriate to an integrated duty. A ‘slab’ system does not enable the final determination of the amount of tax on a gift.

24.24. Later in this chapter the Committee explains its view that a national system of estate and gift duty should replace the existing sets of Commonwealth and State provisions. And it is in terms of this national system that the rate structure is considered. The Committee does not wish to recommend a particular structure in quantitative terms, but three general comments may be made:

(a) To minimise administration and compliance costs, and relieve some of the very real hardships of the existing provisions, it is essential that there be a substantial minimum exemption limit, in the form of a zero-rated slice. At present prices a zero-rate slice of, say, $60,000 might be suggested.

(b) How high the rate should go on the top slices of large estates depends upon the desired rate of progressivity in the tax system as a whole which, as already suggested in Chapter 4, is very much a matter of prevailing political and social judgments. There is also here an interrelationship with the top marginal rate of
income tax. A heavier tax on capital at death could be used to offset a lower tax on income during life, and produce the same overall progressivity. In terms of incentives such a combination might be superior to high lifetime rates and low death rates, since a man might save more to enjoy more possessions in his lifetime.

(c) In setting the rate, regard should be paid to the effect that integration of death and gift duties will have on smaller estates. For example, a rate equal to the combined New South Wales death and Commonwealth estate duty rates could well result in more tax being imposed on smaller estates than at present, due to the widened base. Regard should also be paid to the fact that the reforms to the tax base recommended in Appendix A will result in property being brought to tax more frequently than at present. And it must be borne in mind that the occasion of a gift or death will be a deemed disposal for capital gains tax purposes. The total tax liability on death may thus be considerable if the integrated tax is set at a high rate.

24.25. The Committee does not believe that the rate system should favour lifetime giving against bequeathing property on death. Some of the advantages of lifetime giving under the present system were explained in paragraph 24.17. Except for the effect of the annual exemption of a fairly modest amount recommended by the Committee, these advantages will no longer obtain under the proposed rate structure, provided that gifts are grossed up when duty is to be paid by the donor. The term ‘grossing up’ in this context means that duty is payable on an amount which includes the duty itself. Suppose, for example, that a person makes a gift of $1,400 and the rate of duty is 30 per cent. Under grossing up, duty (of $600) is payable on $2,000—the amount required to produce a net-of-tax figure of $1,400.

24.26. An estate duty is levied on the whole of the estate and then paid out of the estate, leaving a balance which passes to the beneficiaries. There is a want of equivalence between such a levy and a levy of gift duty which involves the application of the appropriate rate to the amount of the gift and the payment of the duty out of the other assets of the donor. To ensure an equivalence, the Committee proposes that where the gift duty is to be paid by the donor, the levy of gift duty should involve the application of the appropriate rate to the amount of the gift grossed up by the amount of the duty. For the purpose of determining tax on subsequent gifts, the gift must be treated as a gift of the grossed up amount—in the illustration given in the previous paragraph an amount of $2,000.

24.27. Even when, under the present law, there is some integration of estate and gift duties through a gift made shortly before death being brought back into the estate for the purpose of estate duty, there is still an advantage in lifetime giving, for the gift brought back is not grossed up by the amount of gift duty paid. This is illustrated in Appendix B to this chapter.

24.28. Where payment of duty is sought from the donee, equivalence
with estate duty requires that gift duty, at the donor's rate, be levied on the amount of the gift. For the purpose of determining the tax on subsequent gifts by the donor, the amount of the gift should be the actual gift.

Concessions for Dependents

24.29. Two arguments suggest a case for special treatment of the surviving spouse's share of an estate. First, a husband has a moral and legal obligation to provide for his widow. Indeed, it might be said, in justice, that the support she has given him during his life has had its share in the creation of the property left to her by her husband. Secondly, if the purpose of an estate duty be to tax wealth once a generation, it is logical that property passing on death between spouses should be exempt.

24.30. The Committee agrees that there should be special treatment but would not recommend complete exemption. Complete exemption would be exceedingly generous in the case of large estates passing to a surviving spouse. In addition, it would open up avenues for abuses which would give rise to inequity. For example, a testator might leave half his property to his wife and half to his children. The half left to his wife would be taxed only on her death; but the result would be tax on two estates, each half the original estate, and under a progressive rate structure there could be substantial tax saving. Some planning of this kind will be available even under a partial exemption. The tax planning involved would be defeated in a degree if, notwithstanding the partial exemption, property passing to a spouse were taken into account in determining the rates of tax on property that is not exempt. This, however, could not be done under an integrated system of the kind proposed if the exemption available to a spouse is to be available in relation both to gifts and to bequests. This may be an argument for confining the exemption in favour of spouses to property passing by bequest, a matter discussed below.

24.31. The manner of any relief under an estate duty for a surviving spouse may take the form of an exemption of the bequest received by the spouse or a tax on part only of the bequest received. The initial question is whether the relief for a surviving spouse under the integrated system should be available for both gifts and bequests. If it is available for both, it follows that the exemption should be of a fixed money sum and not a fraction of the property passing to the spouse. Were it the latter, the amount of the exemption could not be determined until death. The Committee prefers, in any event, that the exemption should be of a fixed money sum.

24.32. If the exemption is made available in relation to gifts as well as bequests, there will be a measure of complexity, especially if the
exemption in respect of a gift is made optional and any bequest on death is not sufficient to absorb the exemption. There are problems also in the operation of the exemption where the spouse who has received a gift dies or the marriage is dissolved and the donor remarries. There would need to be a separate exemption for each successive legal spouse.

24.33. The Committee is inclined to favour the availability of the spouse exemption in relation to both gifts and bequests. It does not propose that it be available to a de facto wife since, if the spouse exemption is available in relation to gifts during life, it will be impossible to define a de facto spouse in a manner that can be administered.

24.34. The size of the additional exemption for property passing to a spouse needs careful consideration. An amount of the order of $60,000 might be contemplated at today's level of prices, additional to the amount subject to zero rate referred to in paragraph 24.24. If the general exemption and the spouse exemption were each to be $60,000, the total exemption available to a surviving spouse would be $120,000.

24.35. The principal exemption proposed is that in favour of a surviving spouse, but other dependants of the deceased ought to attract some relief as well. The relief in the Committee's view should be based on dependency, not consanguinity. Also, it should be available only in respect of property passing on death: an exemption of a gift made to a dependent young person would provide a tax incentive for lifetime giving of a kind that would be difficult to justify. At present prices an exemption of $1,000 for each full year that a child is below the age of 18 years might be appropriate. The exemption should be available to the widow, to the extent that it is not absorbed on property passing to the child, if the child will be dependent on the widow.

24.36. There is no entirely satisfactory way of defining dependency. Dependency determined by age will fail to deal with many cases—the dependent parent of the deceased, for example. It would probably be best that relief be available where the Commissioner is satisfied, having regard to specified tests, that a beneficiary was dependent on the deceased.

Other Concessions

24.37. In the Committee's view it is the size of the estate, not its composition, that matters. An estate should not attract special treatment merely because it includes assets of a particular class, such as a house, a farm or superannuation benefits. Such treatment directed towards particular asset distorts resource allocation and discriminates between estates by reference to what may be the fortuitous composition of the estate at the
time of death.

24.38. The 1974 amendment to Commonwealth estate duty legislation providing for a limited exemption for an interest in a matrimonial home passing to a surviving spouse runs counter to these principles. Under the new law an interest in a matrimonial home is wholly exempt from tax where the value does not exceed $35,000; and there are shading-out provisions affording some exemption up to a value of $85,000. Curious consequences arise: where, for example, the matrimonial home is valued at $50,000 in an estate of $100,000, the duty concession is worth $4,300; but where the matrimonial home is valued at $35,000 in an estate of $200,000, the concession is worth $16,500. The Committee recommends that the concession in respect of a matrimonial home be withdrawn.

24.39. A claim for special treatment is often made on behalf of the illiquid estate, for example a grazing property or family business. Problems arise where an estate contains a high proportion of assets that cannot be realised easily and cash has to be found to meet the tax liability. These problems will tend to be accentuated in those cases where a liability for payment of capital gains tax also arises on death under the Committee's proposals in relation to capital gains tax. As some protection against forced realisation, provision should be made in the law giving executors a right, where illiquid assets form a significant part of the estate, to spread the payment of at least that portion of duty relating to such assets. The spreading of payment of duty in this way, permitted in a number of overseas countries, would be subject to interest and be limited to a specific period, say up to five years. Alternatively, the law could provide that the Commissioner shall extend the time of payment in circumstances specifically defined. However, the Committee favours the former alternative.

24.40. A person ought not to be obliged to account for the minor gifts he makes. Nor should he be charged duty in respect of moneys paid for the maintenance, education or support of persons dependent on him. Hence there should be an annual exemption, possibly of the order of $3,000, and an exemption in respect of gifts made by a person for the maintenance, education or support of dependants. The application of gift and estate duties to gifts and bequests to charities is dealt with in Chapter 25.

Adjustments for Inflation

24.41. The Committee believes that a regular review of any rate structure set in the future for an integrated duty is fundamental to its proposals. When the rate of inflation is high, as at present, an annual review might not
be too frequent. The effect of inflation in the past has been to cause values to rise and thereby render estates dutiable that would not, when the rate was set, have been liable for duty. In the case of larger estates, it has meant a greater fraction of the estate being taken in duty than would have been taken on the basis of earlier values. It has eroded exemptions. The effect of inflation is further considered in Chapter 6.

24.42. Under an integrated system, it is essential that gifts made at one time can be meaningfully related to gifts made at another time. A gift of $1,000 made now should have the same fiscal consequences, so far as possible, as a gift made ten years hence of the sum that is equivalent to $1,000 in present currency. It follows that gifts made and assessed to tax should be regarded as fractions of a slice or slices for the purposes of determining the rate of tax on each subsequent gift. It also follows that any change in the rate structure should be made in relation to existing slices. An adjustment to the rate structure to take account of inflation should widen each slice. A decision to vary the weight of the tax should be reflected in the rates applying to slices. An illustration of adjustments to take account of inflation and to vary the weight of the tax is given in Appendix B to this chapter.

Advance Provision for Payment of Tax

24.43. The prime concern of a person who seeks to provide in advance for payment of estate duty is the assurance that a fall in the value of money will not erode the value of this provision. One possibility would be a government issue of bonds whose redemption return is increased by reference to an index of general prices, the increase not being subject to income tax or capital gains tax. If bonds of this kind were more generally available, there would be no cause to introduce a special security offering protection against inflation for an investment intended to provide for payment of estate duty.

24.44. On the assumption that indexed bonds are not generally available, the Committee sees merit in a proposal that special probate bonds, indexed in an appropriate way, be issued. The method of indexation might take the form of the application of an index of general prices. Alternatively, it might be related to the rate structure of the integrated estate and gift duty, the redemption value of a probate bond being increased in conditions of inflation by reference to the change made to the rate structure. This redemption value would be available only on death and only to the extent that the redemption value does not exceed the estate duty payable. Where this redemption is available, the bonds would be included in the deceased's
estate at that value. The bonds would carry interest at a lower rate than non-indexed government securities.

24.45. Probate bonds could be confined to the function envisaged for them if the special redemption value is available solely for the payment of duty in the estate of the original investor. Redemption for any other purpose would involve repayment only of the original investment.

24.46. There will be a nominal gain in the value of the bond due to the indexation applied to it. The element of nominal gain might, it is true, be obscured by the method of indexation that involves changes in the rate structure of the integrated estate and gift duty; but it would be evident if indexation by reference to general prices were used. The Committee's proposal to tax a fraction only of capital gains is intended to go some way towards excluding from tax gains that are only nominal, an objective which it is administratively impossible to achieve generally in any precise fashion. In the present context the objective can be achieved precisely by excluding from capital gains tax the nominal gain on the deemed realisation of a probate bond on death. The Committee recommends that the nominal gain be exempt from capital gains tax and from income tax.

**Quick-succession Relief**

24.47. Quick-succession relief is intended to lessen the impact of estate duty in circumstances involving property passing as a result of two or more deaths within a short period. Extensions of the tax base proposed by the Committee will increase the number of occasions where property is brought to tax. In the result there may be a need for more generous relief than is provided at present. The principle adopted by the Committee is that all property should be taxed at least once each generation, but the operation of provisions necessary to ensure this should be mitigated when the result is more frequent tax. The relief should not be so framed that it is available only against the tax on a particular item of property. It would be wrong, for example, to provide relief for the estate of a widow who inherits a house she retains, and to deny relief if the widow sells the house shortly before her death and purchases a home unit and shares with the proceeds. The relief should take the form of a credit against the tax payable on the death of the person who inherits, and it should be related to the tax that was imposed on the inherited property on the occasion of the earlier death.

24.48. Where assets have been the subject of an inheritance and the estate of the person who inherits those assets includes on his death at least an amount equivalent to the value of those assets, a fraction of the tax already paid on the assets inherited should be credited against tax payable on that
amount. The credit should be determined by spreading total tax on assets subject to tax over those assets. The whole of the tax should be available for credit where the death occurs within five years of the inheritance. It should be scaled down by one-tenth for each further year elapsing, so that there would be no relief available where death occurs more than fifteen years after the inheritance. The tax for which credit is available should not exceed the tax on the amount in the estate of the deceased equivalent to the inheritance. Illustrations of the relief are to be found in Appendix B to this chapter.

24.49. Problems arise in determining whether there has been an inheritance requiring the application of the relief provisions. In paragraphs 24.64–24.66 reference is made to cases where what might be called notional estate is subject to estate duty. Quick-succession relief provisions should identify the person who may be treated as inheriting such an estate. Thus the person who becomes absolutely entitled to assets that were the subject of a life estate should be treated as having inherited those assets from the deceased life tenant. Where there is a succession of life tenants, provisions will be necessary to deem inheritances of the assets by each succeeding life tenant.

24.50. Quick-succession relief provisions have generally been thought of in terms of succession on death. The Committee's recommendations for integration of estate and gift duties raise the possibility of applying relief provisions where a gift is followed by a succession on death of the donee. (The possibility of relief provisions applying to a succession followed by a gift or to a series of gifts is excluded from consideration on the ground that the second occasion of transfer is in the discretion of the donor.) The Committee sees no reason in principle why relief should not be available where a gift is followed by a succession. The tax on the gift that may be the subject of credit would be determined by spreading the tax on all gifts in the relevant year of return over gifts made in that year.

24.51. In paragraph 24.42 proposals were made by which in conditions of continuing inflation gifts made at one time can be meaningfully related to gifts made at another. The Committee considers there should be measures to bring about an equivalence in value between tax paid on the inheritance and tax against which relief is allowable. These measures, based on the proposal in paragraph 24.42, are illustrated in Appendix B to this chapter.

**Fall in Value of Assets after Death**

24.52. Estate duty may give rise to hardship when an estate includes assets, which, though worth a great deal on the death of the owner, have
fallen significantly in value. Under the present law, duty is assessed on the value of assets as at the date of death. The problem does not arise where property is valued for gift duty purposes, as the donor can select the time of the making of the gift and the assets are immediately available to the donee. To permit the sale price of an asset to be substituted for the value of the asset on death raises problems, as the personal representative may be expected to realise those assets that have fallen in value after death and to retain those assets that have risen in value. There is no easy solution to the problem. Nevertheless, it has to be recognised that the present law can produce inequitable results and ought to be modified so that the estate is protected from the impact of tax resulting from the inclusion of a particular asset in the estate the value of which diminishes significantly after death.

24.53. Where the personal representative decides to retain an asset of which he is free to dispose, the operation of the law is not unfair if the asset later falls in value. Likewise, if the personal representative decides to dispose of an asset and fails to avail himself of whatever means are open to him to prove his title to the asset and to free it for realisation, the beneficiary ought not to complain if the asset, when finally realised, produces an amount less than the value on death. But for one reason or another, it may be impossible for the personal representative to realise the asset at the time most advantageous to the estate.

24.54. An alternative valuation date provides one solution, though a solution which is not always satisfactory. If the market is volatile, the value of the relevant asset on the alternative valuation date may be as arbitrary as the value on death. If the alternative date is a considerable time after death, the personal representative is likely to defer the administration of the estate to see if the value of the estate falls. The calculation of capital gains tax payable on death will be complicated where an alternative valuation date is allowed. An alternative valuation date could not be available in relation to stock or to other assets of a business which change as the business is conducted. An option to elect for valuation on an alternative valuation date would have to be limited to assets that are not subject to frequent change: these would include real estate, shares listed on a recognised stock exchange and significant holdings in companies whose shares are not so listed and whose affairs are not conducted between the date of death and the alternative valuation date so as to produce a reduction in the worth of the holding.

24.55. Another proposal considered by the Committee is a rule that the tax payable in respect of any asset in an estate of a deceased person be limited to the net amount received on realisation of the asset within three years of death or within such longer period as the Commissioner may
approve. To determine the tax payable in respect of any asset, the total tax payable on the whole estate would be apportioned between the assets in the estate on the basis of the values of the assets on death. The rule would be limited to the kinds of assets described in the previous paragraph, and the realisation principles outlined in paragraph 24.58 would apply. The rule avoids the problems of recalculating capital gains tax payable on death which an alternative valuation date involves.

24.56. Nevertheless, of the two proposals the Committee favours an alternative valuation date and recommends its adoption.

24.57. The alternative valuation date should be the first anniversary of the date of death. The onus of electing for valuation on the alternative valuation date should rest on the legal personal representative. Where the legal personal representative elects, all real estate, shares in listed companies and substantial holdings in unlisted companies of the estate should be revalued.

24.58. Where an asset is realised during the twelve months following death in an arm's length transaction, the net proceeds of the realisation should be deemed to be the value of the asset on the alternative valuation date. In determining the realised value of an asset, the cost of realisation should be deducted from the proceeds of realisation. If a realisation during the twelve months following death is not an arm's length transaction, the Commissioner should have power to substitute, for the actual proceeds, the proceeds that might have been expected on a sale conducted at arm's length. There will be problems where the asset has changed in some way between death and realisation, and account will need to be taken of improvements and changes made to property. But these problems should not be insurmountable.

24.59. The amount of a gift for purposes of duty should be determined by valuation at the date of the gift, irrespective of what happens subsequently.

Valuation of Assets

24.60. The Committee has given consideration to the methods currently used in Australia in valuing assets for estate and gift tax purposes, and in Appendix A to this chapter rules are suggested for valuing particular assets. Section 16A of the Estate Duty Assessment Act (which contains provisions relating to the valuation of shares) should be repealed. It should be replaced by a provision enabling a person valuing shares in a company to take into account, in an appropriate case, the net value of the assets of the company on the date at which the valuation is made.

Jurisdiction of Integrated Estate and Gift Duty
24.61. The base of an estate and gift duty should include the real and personal property, wherever situated, of a deceased person or donor domiciled in Australia, and such of the real and personal property of a deceased person or donor domiciled outside Australia as is situated in Australia. Domicile, in broad terms, depends on where a person intends to reside permanently. In the case of a married woman, however, it depends on the domicile of her husband and this may be thought to make it less appropriate than residence as the basis of jurisdiction. However, domicile has a number of distinct advantages over residence. In other countries domicile is generally preferred and it will therefore assist in preventing double taxation problems if Australia retains domicile. Domicile is more difficult to change than residence and the retention of domicile will protect the Revenue against a change in place of living made to avoid Australian tax. The position of the married woman could perhaps be accommodated by allowing an exemption in respect of property outside Australia if a married woman has for a period of years before gift or death been ordinarily resident outside Australia.

24.62. In the past, reliance has been placed on the common law rules to determine the situs of property. These rules largely depend on considerations of convenience and are not always appropriate in a taxation concept and sometimes permit avoidance. The Committee recommends that detailed rules be adopted. These rules are discussed in Appendix C to this chapter.

24.63. Where property is situated outside Australia and the law of that place has a gift or death tax, the amount of any such tax which is imposed in relation to that property on a donor or deceased estate should be allowed as a credit against any Australian gift or estate tax which is imposed in relation to that property on that same person, the credit being limited to the amount of the Australian tax.

Incidence of Integrated Estate and Gift Duty

24.64. Since the base of the estate duty will include property not actually owned by the deceased at his death, it would be unfair to require that the whole estate duty be paid out of the property actually owned by the deceased which passes to his personal representative. The appropriate general principle is that duty should be apportioned between the actual estate and each item in what might be called the notional estate; and the personal representative and the Commissioner should, in respect of the duty attributable to the notional estate, have rights of recovery such that duty will fall on the person who might be said to be the beneficiary in that
estate.

24.65. The application of the principle will be clear enough where the assets of a trust in which the deceased had a life interest are treated as part of his estate. Duty will be recoverable from the trustee. It will also be clear enough where assets over which the deceased had a general power of appointment that lapsed at his death are treated as part of his estate. Duty will be recoverable from the person who is or becomes owner in default of appointment. Where, however, shares are included in the estate at the value they would have had if rights attaching to them had not ceased on death, it may be difficult to identify the relevant property and the person who may be said to be the beneficiary. If ultimate liability to duty is to fall in any case on some person other than the personal representative, there should be a specific provision determining the incidence of duty.

24.66. Where a gift is made, the donor and the donee should have the choice as to who will pay any tax that may be attracted by the gift and an election should be made when the duty return is lodged by the donor. If the donor elects to bear the tax and the Commissioner is unable to recover the tax payable by the donor, he should have the right to assess the donee; conversely, if the donee elects and the Commissioner is unable to recover, he should be able to assess the donor. Where the tax base is extended in accordance with Appendix A to include deemed gifts, there should be a provision, wherever possible, identifying the donee.

24.67. Where the duty is assessed against the donor, then, as indicated in paragraphs 24.25–24.26, the gift must be grossed up by the amount of the duty. Where the duty is assessed against the donee, the tax should be assessed on the gift at the donor's rate. Neither a donor nor a donee who has paid tax should have any right to reimbursement from the other.

24.68. Where the legal personal representative is not resident in Australia and has no assets in Australia, it may be impossible under the present law for duty to be recovered because of the rule that the revenue laws of one country will not be enforced by another. This rule has been exploited in the past to the detriment of the Revenue, and the Committee recommends that steps be taken to prevent, as far as possible, its exploitation in the future. Where the Commissioner is otherwise unable to recover duty, each beneficiary should become personally liable for the whole of the duty up to the limit of the value of the property received by the beneficiary and interest should accrue on the unpaid tax. The legislation giving effect to this rule should be widely drawn.

Assessment Procedures
24.69. Details of gifts made in each income tax year should form part of the annual income tax return, at least to the extent that gifts made in that year exceed the annual exemption recommended in paragraph 24.40. Gift duty assessments would be made on the basis of the details thus shown in income tax returns.

24.70. Procedures on objections and appeals from assessments for estate duty and gift duty should be the same as those for objections and appeals against income tax assessments.

A National Estate and Gift Duty

24.71. Criticism of the present death taxes on grounds of the complexity of separate Commonwealth and State taxes and the considerable costs in administration and compliance that result has force. A national estate and gift duty system, administered by one authority, is clearly desirable.

24.72. A national system could be achieved by the Commonwealth and the States each enacting uniform legislation which would be administered by the Commonwealth. The Commonwealth would also enact uniform legislation to apply, in addition to its legislation for the country as a whole, in the Commonwealth Territories. Under such a national system, there would be a set of rates for the whole country under the principal Commonwealth legislation, and there might be a different set of rates in each of the States and Territories. The jurisdiction of the legislation of the States and Territories would depend on the domicile of deceased persons and donors within the State or Territory and on property within the State or Territory of donors and deceased persons domiciled outside Australia.

24.73. The obstacles to the achievement of such a national system are the limited constitutional powers of the States and the difficulties of obtaining uniform legislative action by the Commonwealth and the States. If the constitutional powers of the States are extended, there will remain the difficulty of obtaining uniform action.

24.74. A satisfactory national system in present circumstances can only be achieved by a single piece of legislation enacted by the Commonwealth. State shares of the revenue raised by the Commonwealth would be distributed to the States, the shares being determined by reference to the domicile of deceased persons and donors within the State and property within the State of deceased persons and donors domiciled outside Australia. These shares need not be less than the revenue currently raised or which it may be proposed to raise by the State taxes displaced.

24.75. The Committee would not wish the Commonwealth to vacate the field of estate and gift taxation in favour of the States. It is true that if the
powers of the States were extended it would be possible to have a national system which involves uniform legislation by the States, by the Commonwealth in relation to the Commonwealth Territories, but not by the Commonwealth for the country as a whole. The Committee however considers that taxes in this area have a necessary role to play in the overall Commonwealth tax structure.

24.76. In the event of the Committee's recommendations for a national scheme being adopted, it would be necessary to establish a system of transitional provisions for the orderly introduction of that scheme.

Chapter 24: Appendix A: The Base of an Integrated Estate and Gift Duty

24.A1. In this appendix the term ‘estate duty’ is used to refer to the tax that may be imposed in relation to the estate of the taxpayer on his death and the term ‘gift duty’ is used to refer to the tax that may be imposed on a disposition of property by a taxpayer made during his life. The Committee has recommended that gift duty and estate duty be fully integrated. It follows that the base for each should correspond as closely as possible.

24.A2. One of the inequities of the present Commonwealth estate and gift duties is that it is relatively easy so to arrange one's affairs that the tax is reduced to a small amount or avoided completely. The intention of the Committee is that the estate and gift duties recommended by it should have a tax base sufficiently broad to remove this inequity. The Committee concedes that some of its recommendations for defining the tax base are arbitrary to a degree. The very diversity of the legal techniques available to taxpayers who seek to avoid tax does not always allow of a demonstrably fair and consistent approach.

24.A3. All real and personal property owned by a taxpayer at the date of his death should form part of his estate subject to estate duty and, in addition, the base must be broad enough to include the extensions recommended by the Committee.

24.A4. A gift for purposes of gift duty should include the conferring of any property, benefit or advantage on another person otherwise than by will (whether with or without an instrument in writing, and whether as a result of any action or inaction) without consideration in money or money's worth or for a consideration less than the value of the property, benefit or advantage that is the subject of the gift. The extent of the gift should be:

(a) the value of the property, benefit or advantage given, where there is no
The definition must be broad enough to cover the extensions to the tax base recommended by the Committee.

I. Powers Over Property

24.A5. Where a taxpayer has power (for example, under a trust, will or contract) to acquire property, whether on or prior to death, such property should be treated as property of the taxpayer. Examples include property the taxpayer can acquire by the exercise of a power of appointment or by the revocation of a trust. It is arguable that such a principle is too wide and that it is unfair to impose a tax in relation to property if the taxpayer has not enjoyed the ownership of the property or at least the yield of income from it. The answer to such an argument is that it was always open to the taxpayer, had he so chosen, to acquire the ownership of the property.

24.A6. A power to appoint property may be described as a power held by a person which enables that person to determine the entitlement to property. The grant of such a power may be seen as a disposition of the property to which it relates and may constitute a gift by the grantor. Where the holder of a power can appoint the property to himself, the grant of the power may be seen as a disposition to the holder of the power coupled with a power in the holder to divest himself of the property in favour of any other person who may be considered under the power. Once it is accepted that a power to acquire property must be regarded as equivalent to ownership of the property for the purpose of imposing a tax, then property subject to a power held by a taxpayer, which enables him to appoint to himself, should be treated as property of that taxpayer for duty purposes.

24.A7. The Committee thus sees justification for imposing a tax in relation to the exercise or failure to exercise a power where the holder of the power can appoint to himself. A taxpayer should, however, be regarded as being able to appoint to himself if he can appoint to his creditors, and thereby discharge his debts, or to a company he controls or of which he is a shareholder or debenture-holder, or to a trustee of a trust (including a discretionary trust) in which he has an interest, or to his estate. The provision should extend to the cases where a company or a trustee holds a power and, by way of illustration, the company can appoint to its major shareholder or the trustee can appoint to a person who has power to remove him from office. If a taxpayer can appoint property between, say, three
other persons and the relevant instrument provides that the property shall pass to the taxpayer if no appointment is made, the taxpayer should be treated as being able to appoint to himself.

24.A8. Assuming that a taxpayer has a power under which he may appoint to himself, questions arise as to the manner in which tax should be assessed in each of the following cases:

(a) the exercise of the power, whether during life or on death by will;
(b) the relinquishing or disclaimer of the power;
(c) a valid assignment or a similar dealing with the power;
(d) the expiry of the power by effluxion of time, the power not having been exercised; or
(e) the death of the holder of the power, the power not having been exercised.

In case (e), the property should be treated as part of the deceased's dutiable estate. On each of the other occasions, the holder should be deemed to have made a disposition of so much of the property concerned as does not pass to him. Subject to the following exceptions, the disposal should be treated as being a disposal for no consideration. If the holder is required to pay any consideration on the exercise of the power in his own favour, then, in determining the extent of the gift, such consideration ought to be set off against the value of the property. If the holder is paid a sum in consideration of his exercising or failing to exercise the power or his relinquishing or assigning the power, the consideration ought to be set off against the value of the property in question in determining the amount of the gift.

24.A9. Special provisions are required in relation to a settlement of property that is subject to a power in the settlor to appoint the property to himself, or to revoke the settlement except where the revocation is for the purpose of re-settling the property on trusts under which the settlor is not a beneficiary. A power to revoke in these circumstances is a power to appoint property to oneself. The Committee considers that, in determining the amount of the gift involved in making the settlement, one should ignore the power to appoint or revoke. The manner in which the amount subject to tax should be determined, at a later time, in any of the circumstances considered in paragraph 24.A8 will require that the amount be limited to any increase in the value of the property between the date on which it was settled and the date of exercise, relinquishment, assignment, expiry or death.

24.A10. A power to appoint income should be treated in the same way as a power to appoint capital. If A can appoint income to himself or to B or C
and appoints the relevant income to B, A should be treated as having made a gift to B of the income appointed, irrespective of how the income may be treated under income tax legislation.

24.A11. There remain questions as to powers exercisable jointly or exercisable only with the consent of another person. If one or more of the holders of a power are members of the class of possible beneficiaries, then each such holder should be treated as owning a part of the property that is subject to the power, such part being the whole of the property divided by the number of holders. For example, if A and B hold a power jointly and the possible beneficiaries are A, C and D, the whole of the property subject to the power should be taxed in A's hands and not in those of B; if A and B hold a power jointly and the possible beneficiaries of the power are A, B, C and D, half the property should be taxed in A's hands and half in B's. A more sophisticated approach would be to determine the dominant party, where possible. The United States legislation attempts to do this. However, joint powers that include one of the holders as a possible beneficiary are fairly unusual, and the Committee doubts if the additional complications that would be involved in adopting the United States approach are justified.

24.A12. A consent may be required to the exercise of a power or to the selection of the objects or to both exercise and objects. The power is, in one view, tantamount to a joint power. On the other hand, it may be thought inappropriate to treat a right to withhold consent in the same way as a power under a joint power. The Committee prefers the former view, that a consent to the exercise of a power, where the person whose consent is required is an object of the power, ought to be recognised as equivalent to a power to appoint to oneself. The other view affords opportunity for avoidance.

24.A13. There should be a provision by which, if certain conditions are met, a power to appoint or a power to consent will be disregarded for the purpose of the taxing Act. The conditions would be that a taxpayer who has become the holder, or one of several holders, of a power to appoint or consent has, within a reasonable time after becoming aware of the existence of the power, taken all necessary steps to disclaim the power.

II. Options

24.A14. The Committee proposes that special provisions should apply defining the tax base of the integrated estate and gift duty in relation to options. An option normally involves a right in the option holder to call on the owner of property to which it relates to convey the property to him on the option holder paying the consideration specified in the terms of the
option. But for purposes of defining the tax base it should extend to rights that are the same in substance. In the following paragraphs, the term ‘option transaction’ refers to any contract or series of contracts by which a person has a right to acquire property if the completion of the contract (that is, the acquisition of the property) might occur more than six months after the making of the contract.

24.A15. The application of any special provisions relating to option transactions should be limited. The special provisions should apply only where the parties to the option transaction are related and only where the option transaction is not an ‘ordinary commercial transaction’, by which is meant a transaction that people, dealing at arm's length in a bona fide commercial transaction, would be likely to enter into. The definition of ‘relative’ in section 6 (1) of the Income Tax Assessment Act may be used to determine if parties are related but should be supplemented so that a taxpayer is deemed to be related to a company in which he or his relatives hold shares or debentures and to a trust in which he or his relatives are beneficiaries.

24.A16. An option transaction, in the narrower sense referred to in paragraph 24.A14, may involve a gift by the person whose property is to be acquired if he receives inadequate consideration for the option. It may involve a gift by the person who takes the option if he pays an amount for it greater than its value. An option transaction amounting to a contract to buy property may constitute a gift by one or other of the parties to the contract if the amount agreed to be paid, taking into account the time at which it may be paid, is greater or less than the present value of the property. If it were sought in all cases to determine the amount of the gift at the time an option transaction is entered into, near impossible problems of valuation would arise. In the Committee's view, it is more appropriate to delay the determination until the option transaction is completed by the acquisition of the property or until the rights to acquire the property lapse. If, however, one of the parties dies before completion or lapse, the determination should be made at the time of death.

24.A17. Where property is acquired on completion of the option transaction, any gift will be calculated by comparing the total of amounts paid by the person acquiring the property with the value of the property at that time. Any amount paid before the time of completion should be treated as increased by the application of an appropriate rate of interest. (In calculations in succeeding paragraphs amounts paid for options that are allowed to lapse or are disposed of should be similarly valued.)

24.A18. If a right to acquire property under an option transaction is allowed to lapse by effluxion of time (other than by reason of a legal
disability or impediment that prevents the person who has the right to acquire the property from completing the transaction), there will be a gift by the person who had the right to acquire the property. The gift will be (i) any amount by which the value of the property at the time of the lapse exceeds the amount payable by him at that time to acquire the property, plus (ii) the amount, if any, by which the value of what was paid for the option exceeds the amount in (i). The same principles should be applied when an option lapses by reason of the death of the person who had the right to acquire the property.

24.A19. If the person who has the right to acquire property under an option transaction dies and the option does not lapse on his death, the value of the right should be included in his estate plus the amount, if any, by which the value of what he paid for the option exceeds that value. The value of the right will be calculated by reference to the value of the property at the time of death.

24.A20. These principles will need modification if the person who has the right to acquire property under an option transaction disposes of his right. Where the disposition is in the course of a bona fide commercial transaction, a gift will arise if the amount received on the disposition is more or less than the value of the amount paid to acquire the option. Where it is more the gift will have been made by the person who gave the option. Where it is less the gift will have been made by the person who took the option. Thereafter, the special provisions will be inapplicable.

24.A21. If the disposition is not in the course of a bona fide commercial transaction, the person who takes the option under the disposition will be treated as the person who originally acquired the option under the option transaction though the special provisions should not give rise to a gift by him if he completes the acquisition. They would, however, apply on completion to determine any gift made by the person who gave the option. Where the option lapses the gift by the holder of the option will be the value of the property less the amount payable at that time to acquire the property. If the option does not lapse upon death and the holder dies the value to be included in his estate will be similarly calculated.

24.A22. The disposition of the option referred to in the previous paragraph will involve a gift by the person making the disposition of the amount, if any, by which the value of the amount paid to acquire the option exceeds the value of the option at the time of disposition. There will also be a gift by that person of the amount, if any, by which the value of the option exceeds the amount of the consideration received. There will be a gift by the person who takes the option under the disposition of the amount, if any, by which the consideration given exceeds the value of the
24.A23. If the person whose property may be acquired by some other person by virtue of an option transaction dies, the value of the property, less any amounts already paid by that other person, should be included in his estate. Any amounts payable under the option transaction after the death of the owner should not be included.

24.A24. The gift, in each case, should be deemed to have occurred at the time of completion, lapse, disposition or death, and not at the time the option transaction was entered into.

III. Settled Property

24.A25. Under Australian law, it is possible to settle property on trusts lasting for many years. There are rules against lengthy accumulations and perpetuities; but generally there is no difficulty in creating a trust extending over two generations of a family, and sometimes a trust can be effectively extended into the third generation. While such a trust continues, the rights of the beneficiaries to income or to capital can be stated in precise terms (for example, to A for life, then to his children B and C for life and then to such of the children of B and C as live to attain 21 years) or can be left to be determined during the life of the trust under discretionary powers conferred upon the trustees or other persons. A trust can be created to last for upwards of 80 years under which the income is directed to be accumulated, or distributed among a specific class, such as the descendants of A, at the discretion of the trustee. Until the trust comes to an end, no beneficiary has any right, as a rule, to an identifiable part of the trust property, although he may receive some of the income or may expect to receive some of the capital. Clearly, such a device lends itself to tax avoidance.

24.A26. Generally, the creation of a trust, whether by settlement or will or otherwise, gives rise to no difficulties. (One exception is a settlement where the settlor retains an interest; this case is dealt with later in this appendix.) If the trust is created by will, the property subject to the trust will form part of the estate of the deceased; if created during the taxpayer's life, the property will be caught by the gift duty provisions. Thereafter, however, there is no easy solution to the problem of taxing property held in trust.

Life Estates

24.A27. The Committee has come to the conclusion that, in determining the tax base, property the taxpayer did not own but whose yield of income
he had the right to enjoy ought to be included. In the case of a life estate, this means that the corpus supporting the life estate should be taxed as part of the estate of the life tenant on his death. It can be argued that such a principle is too wide, that it is unfair to tax the corpus in the hands of the life tenant since he did not have the right to dispose of the corpus during his life and he was never the owner of it. A fairer solution, in the case of a life estate, might be to tax the life tenant on his death on part of the corpus, such part being the actuarial interest of the life tenant in the corpus when he first became entitled to the life estate. However, this solution would permit part only of the wealth subject to successive life estates held by members of successive generations to be taxed. If the life tenant is taxed on part only of the trust estate on his death, there is unlikely to be anyone else to whom the balance may be appropriately attributed. One cannot tax the persons ultimately entitled to the corpus, as they may not be known. To tax the trustee on the balance, the whole of the estate will be brought to charge but the aggregate of duty payable will usually differ from what would have been payable had the whole estate been taxed in the hands of the life tenant. The actual difference will depend on the rates. Unless a special rate is imposed on trustees, there will be a tax advantage in creating a life estate or a number of life estates. In the Committee's opinion, an estate bequeathed by X to his son for life and then to the son's children, should bear broadly the same duty as the estate would have borne had it been bequeathed by X to his son and had the son then bequeathed it to his children. The Committee recommends that, on the death of a life tenant, the assets supporting his life estate should form part of his dutiable estate and the duty on it should be paid out of those assets.

24.A28. A life tenant may bring his life estate to an end while he is alive by a surrender or a partition or by some other means. It would hardly be fair to tax assets subject to a life estate on the death of a life tenant but not to tax assets where a life tenant has surrendered his interest immediately before his death. In the Committee's opinion, where a life estate is terminated other than by disclaimer the life tenant should be taxed as if he had disposed of the whole of the assets subject to the life estate for a consideration equal to the consideration in fact received by him. The difference between the value of the assets and the consideration should be taxed as a gift.

24.A29. Where a life interest (whether vested or contingent) is disclaimed, there should be no such deemed disposal. A disclaimer is a rejection of an interest by a beneficiary before he takes any benefits to which he may be entitled by virtue of the interest. The Committee considers that this treatment of a disclaimed interest should be extended to
a surrender by a beneficiary of an interest where the surrender is made within six months of the date on which the beneficiary receives the first benefits to which he was entitled under the interest. This treatment should only be available if all benefits received by virtue of the interest are repaid to the trustee to be held by the trustee as if the interest had been disclaimed.

24.A30. It seems arbitrary to treat an assignment differently to a surrender or a partition. An assignment, other than by charge, should be treated on the same basis as a surrender or partition; that is to say, the life tenant should be deemed to have disposed of the assets supporting his life estate for a sum equal to the consideration, if any, received by him from the assignee. The difference between the value of the assets and the consideration should be taxed as a gift.

24.A31. The foregoing principles need to be supported by other rules:

(a) If there is a merger of the life estate by reason of the life tenant acquiring the remainder, the transaction should not attract any duty (unless the consideration paid is greater or less than the value of the remainder). Provided the assets comprising the corpus are still owned by the life tenant on his death, the whole will then be taxed.

(b) Sometimes a life estate is not in the whole of the assets held subject to the trust, but in part only of those assets. Where the part is a fraction of the whole, for example an interest in half the income from the estate for the life of X, the same fraction can be used to determine the extent of any liability for duty when the life tenant dies or deals with his interest in some way. Thus, if X is entitled to half the income from Blackacre during his life, half the value of Blackacre will be taxed on X's death. Sometimes the entitlement is fixed in money terms. For example, a settlor may direct that the first $5,000 of the income derived by the estate each year be paid to his daughter for her life, that half the balance be paid to his son for his life and that the remainder of the income be accumulated. The income from the estate may vary and, in a particular year, be less than $5,000. Where the entitlement is fixed in this way, the fraction $A \div B$ should be employed to determine the interest in the corpus of the life tenant on his death or at some earlier point of time, where $A$ is the total income that the life tenant became entitled to receive from the trust over the previous $N$ years (or, if the entitlement has been for a lesser period, then that lesser period) and $B$ is the total income derived by the estate during this period. The period of $N$ years should be reasonably long—say ten years—to enable a clear picture to emerge. In applying the fraction, the income of the trust estate should be determined by principles of trust law rather than income tax law.

(c) For the purpose of applying the foregoing rules, distributions out of corpus should be disregarded unless there is undistributed income in the trust. Where there is undistributed income, applications from corpus should be deemed to be distributions of income to the extent of the amount of the undistributed income.
24.A32. If the assignment or surrender relates to a contingent life interest, that is to say, if a person assigns or surrenders his life interest before the interest vests, the transaction ought not to attract duty under the provisions recommended in paragraphs 24.A28 and 24.A30. If the consideration received on the assignment or surrender is greater or less than the value of the contingent interest at that time, there will be a gift of the difference.

24.A33. Once a life interest has been taxed, no further tax should be payable in relation to any subsequent dealings with the life interest for full consideration or on the death of the life concerned.

24.A34. The recovery of duty from the trustee of an estate in which a life interest is held is considered in paragraphs 24.64–24.65. Where the life tenant has died, it will be necessary to calculate what part of the estate duty is referable to the settled estate. In the Committee's view, the duty applicable to the settled estate should be the average rate of tax charged on the whole of the property owned or deemed to be owned or to have been disposed of by the deceased life tenant on his death. Where the person entitled to the estate next following that of the life tenant is a person in respect of whom an exemption is available, then so much of the exemption as is not absorbed by the actual estate of the deceased life tenant should be available against the duty charged on the corpus of the settlement.

Estate for a Term of Years or for the Life of Another Person

24.A35. Regard must be paid also to estates for a term of years and estates for the life of another person. If the legislation fails to deal with these kinds of interest, avenues of avoidance of the life estate provisions will be opened up. For example, instead of settling assets on his daughter (aged 30) for life, a settlor may provide her with an estate for a term of 60 years. Other illustrations are mentioned in the following paragraphs.

24.A36. One approach would be to treat the estate generally in a similar manner to a life estate, that is to say, to deem the relevant assets to have been disposed of by the holder of the estate on the expiration of the term or on an earlier assignment or surrender, but to bring to charge a fraction only of the assets. The fraction would be the ratio of the term of the interest to the life expectancy of the original holder of the interest at the time the interest was created, such fraction not to exceed one. An alternative approach would be to bring to tax the whole of the assets. This the Committee considers too drastic. It prefers that the former approach be adopted. There should be a provision, however, that if successive terms are created which have the effect of giving the holder of the terms a life estate,
the whole of the assets will be taxed on the expiration, assignment or surrender of the last such term or on the death of the holder, credit being allowed for any tax paid on the expiration of the earlier terms. The rules mentioned in paragraphs 24.A28–24.A34 in relation to life estates should be applied to interests for terms of years and interests for the life of another.

Discretionary Trusts

24.A37. Discretionary trusts require further consideration. (‘Discretionary trust’ refers to a trust under which the trustee or some other person has a discretion as to how the trust income is to be distributed among persons entitled to be considered.) If

(a) a person is entitled to be considered in the exercise by another person of a discretion in relation to the distribution of income of a trust estate, and
(b) that entitlement ceases for any reason whatsoever (for example, the expiration of a term of years, the assignment of any future entitlement, the exercise of a discretion in relation to corpus or the death of the person entitled), and
(c) the person so entitled has received income as a result of the exercise of the discretion during a specified period of years (N years) preceding the date on which the entitlement ceases,

he should be deemed to have disposed of a fraction of the assets of the discretionary trust, such fraction being: (income received by that person over the N years) ÷ (total income of the discretionary trust during this period). The choice of an appropriate figure for N poses some difficulties. On the one hand, if N is small, say 5, one may expect that elderly beneficiaries will be phased out of income distributions as they advance in years, thus significantly reducing the fraction. But if the figure for N is large, there will be other problems. For example, if N is set at 50 and one person has received all the income from the estate during the last 20 years but little or nothing during the earlier 30 years, then only two-fifths of the assets would be brought to tax on the cessation or assignment of the interest. Conversely, it would seem somewhat unfair to tax the person who received the income during the earlier 30 years on a basis that would bring three-fifths of the value of the assets to tax at a date 20 years after he received the last benefit from the estate. In addition, a large figure for N will create administrative difficulties for the trustee and the Revenue. On balance, a smaller figure for N seems preferable, though it has to be recognised that this may encourage the establishment of discretionary
trusts. The Committee suggests that a period of ten years be adopted; if the trust subsists for a lesser number of years, N should be equal to that number. For the purpose of determining the total income of the discretionary trust, concepts of trust law rather than income tax law should be employed and any applications from corpus should be deemed to be income to the extent that there is accumulated undistributed income in the trust.

Accumulating Income

24.A38. The foregoing rules do not deal with the case where income is accumulated. There are limitations in most jurisdictions on the extent to which income can be accumulated but some tax-haven countries have deliberately removed such limitations. To the extent that accumulation is permitted, the policy of levying duty at least once each generation is open to defeat since all the recommendations above depend on income being distributed.

24.A39. An estate may include non-income-producing assets such as works of art and land suitable for residential development purposes, or the gross income produced by or derived from an asset may be exactly set off by interest on borrowings or other outgoings. The concepts of income and outgoings can be defined by the relevant trust instrument in such a way that, though there is income for income tax purposes, there is no income for trust law purposes. A trust may have been established by a settlor with a view to deriving gains of a capital rather than of an income nature. The capital gains could be distributed to beneficiaries by means of distributions from time to time out of corpus. If the estate is wholly comprised of such assets, the rules suggested in paragraphs 24.A27–24.A37 will not be effective in relation to that estate.

24.A40. The Committee recommends that where during a relevant period (defined later) the trust has derived income and the income has not been wholly distributed during that period, the assets of the trust, or an appropriate part, should be brought to tax at the end of the relevant period. The fraction will be that part of the estate which is not brought to tax during the relevant period. Assume, for example, that a trustee has a discretion to accumulate the income or to make distributions to A or B during A's life and the trustee has, at all times, distributed one-third of the income to A and accumulated the balance. If A dies during the relevant period, one-third of the estate will be brought to tax on the death of A under the rule in paragraph 24.A37 and, at the end of the relevant period, the remaining two-thirds will be taxed. Alternatively, if A dies after the
end of the relevant period, the whole estate will be brought to tax on the expiration of the relevant period. One-third will again be taxed on A's death, but here quick-succession relief will be available.

24.A41. In the case of a trust which, at any time during a relevant period, has held assets belonging to the class of assets described in the first sentence of paragraph 24.A39, the following rules should be applied:

(a) If a beneficiary who is a life tenant or who has an interest for the life of another has had the use or benefit of the asset during the term of his interest, the asset should be taxed on the expiry of his interest, or on a prior dealing, in the same way that it would have been taxed had the beneficiary received income from the asset.
(b) In any other case, the whole or part of the asset should be brought to tax at the end of the relevant period. Tax should be levied on that part of the asset not brought to tax during the relevant period.

A beneficiary should be regarded as having the use and benefit of an asset if the asset is dealt with or used in accordance with the beneficiary's directions.

24.A42. In the case of trusts existing when any legislation giving effect to these recommendations comes into force, the first relevant period referred to in paragraphs 24.A40–24.A41 should be twenty-five years from date on which the legislation comes into force. In the case of trusts arising after any such legislation comes into force, the first relevant period should be twenty-five years from the date on which the trust comes into existence. The second relevant period would commence on the day following the last day of the first period and so on, each relevant period being twenty-five years. If the trust comes to an end and all the assets are distributed during any such period of twenty-five years, then the relevant period should end on that day. However, the deemed disposal should be part only of the fraction mentioned above, such part being: (number of years and fractions thereof in the relevant period) divided by 25.

24.A43. Rate of duty on assets brought to tax by virtue of the provisions recommended in paragraph 24.A40 and under (b) in paragraph 24.A41 should be set sufficiently high to discourage the use of trusts as a means of avoiding tax.

Special Cases

24.A44. Three cases that would be caught by the foregoing rules require special consideration.
24.A45. The first case relates to the situation where a taxpayer settles
property on himself for life with the remainder to other persons. Where the life interest is in the whole of the settled property, the property will be taxed on the death of the settlor or on an earlier dealing by him with the life estate and no tax need be imposed when the settlement is created. If the life interest is not in the whole of the settled property, then the value of that part to which the interest does not relate should be taxed as a gift at the time of the settlement.

24.A46. The second case is where an existing interest is enlarged. For example, assume that A, B and C are each entitled to a third of the income from Blackacre during the life of C and that A and B are entitled to half of Blackacre on the death of C. Under the Committee's recommended rules, the whole or a fraction (greater than a third) of the value of Blackacre would be brought to tax on the death of C, half on the death of A and half on the death of B. The Committee recommends that where

(a) an interest (whether for life, for a term of years or for the life of another or as a potential beneficiary under a discretionary trust) is determined, and
(b) the whole or any part of the corpus is taxed to the person who was the holder of that interest, and
(c) that person is absolutely entitled to the whole or a fraction of the corpus,

the amount of the corpus brought to tax should be limited to the amount by which the corpus deemed to have been disposed of by that person exceeds the amount of corpus to which that person is actually entitled. Under this exception, in the example given above, a third only of Blackacre will be brought to tax on the death of C, and a half on each of the deaths of A and B. The exemption ought not to be available if the entitlement to corpus is contingent or can be defeated by some means.

24.A47. The third case is the protective trust. Such trusts are established for the benefit of a beneficiary (herein called the 'protected beneficiary') who is unable to manage his affairs properly or may be unduly influenced to his own disadvantage. Generally the trustee has a discretion as to distribution of income. If, on the death of a protected beneficiary who has had a life estate, three-quarters of the income derived during the life of the protected beneficiary has been distributed, three-quarters of the corpus will come to be taxed under the provisions recommended in paragraphs 24.A27 and 24.A31. In the meantime, the accumulated income will have resulted in tax being imposed by virtue of the provisions recommended in paragraph 24.A40. Such treatment, in the Committee's view, is inappropriate. In the case of a protective trust, the whole of the assets subject to the trust should be taxed on the occasion when the interest of the
protected beneficiary is taxed under the provisions recommended in paragraph 24.A27. No tax should be imposed prior to this occasion by virtue of the provisions recommended in paragraph 24.A40.

24.A48. In this discussion of limited interests it has been assumed that the holder acquired the interest in circumstances that did not involve his giving any consideration for the interest: he may have acquired the interest under a will or in an inter vivos settlement. If purchased interests are excluded from the proposed provisions, opportunities for tax avoidance will be created. Assume, for example, that a grandfather is near death and is giving instructions in regard to his will. If, by his will, he leaves a life estate in property to his son with remainder to the grandson, estate duty will be paid on the full value of the property on the death of the grandfather and again on the death of the son. If, instead, the son acquires, by purchase, a life estate in the property from the grandfather, and the grandfather leaves a legacy to the son of the amount paid for the life estate and the remainder interest to the grandson, estate duty will be paid on the full value of the property (the value of the remainder plus the amount paid by the son for the life interest) on the death of the grandfather but no estate duty will be paid on the value of the property on the death of the son. In the Committee's view the treatment should not be varied merely because consideration was in fact given.

24.A49. Where a life estate or an estate for the life of another or an interest in a discretionary trust is assigned, the estate or interest will be taxed at that point. No further tax need be charged on the expiry of the estate or interest or on any further dealing with it for adequate consideration.

24.A50. The notion of limited interest is very wide and will include interests, for example that of a lessee of property, which arise in ordinary commercial transactions. It will be necessary to exclude from the operation of the proposed provisions interests that have been acquired by persons dealing with each other at arm's length in ordinary commercial transactions.

IV. Annuities

24.A51. An annuity involves a right to payments of money during the life of the annuitant or for a term of years. Where the annuity is charged on the income to be derived from assets, it may be indistinguishable from a life estate or an estate for a term of years. Clearly it should not be possible to escape the operation of the limited interest provisions by describing rights as an annuity, and the provisions defining interests should be wide enough
to cover any situation in which a person has a right to income from property.

24.A52. Where the limited interest provisions are not applicable, an annuity will be treated like any other valuable rights. Where a person purchases an annuity, a question arises as to the adequacy of the consideration he has paid. This should be determined and any gift taxed at that point. Particular attention should be paid to the situation where the annuity is purchased from a relative or from an entity in which a relative is interested. Tables of life expectancy give only an average figure for the whole population. They may present a distorted picture in a particular case and should not necessarily determine the value of the annuity.

24.A53. A person may be entitled to an annuity under a will or settlement. Estate duty or gift duty on the property of the deceased or the property settled will of course have been paid. Where the bequest or gift of the annuity takes the form of a direction to the trustee to purchase an annuity for the taxpayer, the annuity will clearly not involve a limited interest. If the direction takes any other form, the annuity may involve such an interest. Thus a direction to pay an annuity from income of the trust, but to have recourse to capital if necessary, should be treated as giving rise to a limited interest.

V. Gift of Services

24.A54. Gifts do not always take the form of a transaction in property. A person who provides his services for the benefit of another is making a gift as effectively as someone who gives a sum of money sufficient to procure the performance of the same services by a third party. The law should not be concerned with the provision of services for the maintenance, support or education of members of a taxpayer's family or with services for philanthropic organisations or, more generally, for those in need. But if, for example, a businessman acts as the full-time managing director of a company and draws an annual salary of $5,000, whereas an appropriate salary, negotiated at arm's length, would be of the order of $20,000, it cannot be disputed that he is making a gift to the shareholders of the company (or to whoever else will receive the benefits) of the difference between what he could obtain and what he is obtaining. The same may be said of comparable services provided to another individual, or to a trust, or to a partnership. If there are no provisions to deal with such cases, there must be some loss of equity, which taxpayers may be more conscious of under a system that allows a much lower annual exemption than the present system.
24.A55. The problem is to identify a gift of services with which the law ought to be concerned. The administration of the tax law cannot depend upon a determination of work value every time the provision of services is involved. It would be convenient to limit the operation of any provisions taxing a gift of services so that they apply only to the benefit of services performed for a related person. The notion of ‘related’ for this purpose would be wide enough to cover cases where one of the parties to the transaction involving services is an entity such as a trust, partnership or company and a relative of the other party has an interest in that entity or where a person has an interest in an entity which is one of the parties and a relative of his has an interest in an entity which is the other party.

24.A56. Moreover, in view of the exemptions proposed by the Committee in paragraph 24.40, it would be appropriate to limit any provisions so as to apply only to services given to an individual, partnership, trust or company in relation to business operations conducted by that individual, partnership, trust or company.

24.A57. Nevertheless, the question remains whether the administrative costs of applying the provisions, notwithstanding these limitations on their operation, would be warranted. The Committee inclines to the view that the administrative costs in applying provisions extending to gifts of services involving all related persons would not be warranted.

VI. Use of Property

24.A58. Special provisions need to be made regarding the permitted use (as distinct from the right to use for a fixed term which a person may be entitled to) by one person of property owned by another where the former pays inadequate consideration for such use and the use does not fall within the exemption allowed for maintenance and support provided by a taxpayer for members of his family.

24.A59. Where, under a lease or some other legally binding arrangement, an owner gives another a right to use property for a fixed term, it is possible to determine the existence of a gift at the time the lease or arrangement is made. This approach is not appropriate, however, in the case where the right to use can be determined by the owner at will or on notice. The owner of a grazing property may make a gift by allowing a relative, or a partnership in which the relative is a partner, to work the property without any charge by way of rent. A father who buys a house and allows his daughter and son-in-law to have the exclusive use of the house at a nominal rent subject to one month's notice is making a gift no different from the father who gives to his daughter money to pay the rent of a house
that she and her husband have leased. Of course, many such gifts will be exempt by reason of the operation of the annual exemption of $3,000.

24.A60. In cases of this latter kind, the gift is the value of the use of the asset during the actual period of use less any amount received by the owner for that use. It should be provided, however, that a gift will be deemed to be made in each year in respect of the use during that year.

24.A61. Where the party who receives the benefit of the use of the property is unrelated to the owner of the property, such use should be excluded from the provisions. The notion of ‘related’, for this purpose, should be wide enough to cover cases where one of the parties to a transaction involving use of property is an entity such as a trust, partnership or company and a relative of the other party has an interest in that entity or where a person has an interest in an entity which is one of the parties and a relative of his has an interest in an entity which is the other party. In addition to the normal exemptions, there should be an exemption where the use of property is allowed as an ordinary act of social or family duty.

24.A62. A gift may be made by a loan of money interest-free or at a low rate of interest. Similar principles should apply to such a gift as are applied to a gift of the use of property. If the loan is for a fixed term and the rate of interest cannot be varied by the lender, it is possible to determine the existence of a gift at the time the loan is made. The amount of the gift will depend on the rate of interest charged and the commercial rate prevailing for a loan of that kind at the time the loan is made.

24.A63. Where the amount of the loan is repayable on demand or on notice given by the lender or the interest rate can be varied by the lender on notice to the borrower, it should be provided that a gift will be deemed to be made in each year in respect of the period of that year in which the loan subsists. The amount of the gift will depend on the rate of interest in fact charged for the loan and the commercial rate prevailing during the year for a loan of that kind.

24.A64. The exemption recommended in paragraph 24.A61 should apply in relation to all loans of money as well as to the use of property.

VII. Debts

24.A65. A taxpayer may lend a sum of money under a loan agreement which provides that the debt is repayable on demand made orally by the taxpayer or on a written demand signed by the taxpayer or, if no demand is made, by instalments over a long term. No gift duty is payable when the loan is made; however, if the taxpayer dies without having made a demand
for repayment, the instalments remaining to be paid are discounted in
determining the value of the debt included in the taxpayer's estate. This is a
special instance of the kind of option considered in paragraph 24.A18. If
the right to call for repayment of a debt is allowed to lapse, the creditor
should be deemed to have made a gift equal to the difference between the
value of the debt had the right been exercised and the value of the debt
after the lapse. Thus, in the case of the loan agreement referred to above,
the undiscounted amount of the unpaid instalments will be included in the
estate.

24.A66. The release of a recoverable debt for inadequate consideration
should constitute a gift of the amount of the debt by the creditor. A debt
that becomes unenforceable should be deemed to have been released for no
consideration at the time it becomes unenforceable if the Commissioner
has reasonable grounds for believing that the debt was allowed by the
creditor to become unenforceable in order to avoid gift duty. If,
subsequently, the debtor makes a payment to his former creditor which,
had the debt not become unenforceable, would have been consideration to
which the creditor was entitled on account of the debt, the payment should
not be deemed to be a gift by the debtor to the creditor. Any gift deemed to
have been made by the creditor when the debt became unenforceable
should be reduced by the amount of any such subsequent payment and an
appropriate refund of tax allowed.

VIII. Partnerships

24.A67. A partner who receives a return from a partnership which is less
than a fair proportion of the profits of the partnership, having regard to his
contribution of property and capital, has made gifts to the other partners.
The provisions necessary in this context to identify and determine the
amount of the gifts are special applications of the general principles that it
is proposed should apply to gifts involving the use of property and loans of
money for inadequate consideration.

24.A68. It is not uncommon for a partnership agreement to contain a
clause that the interest in the partnership of a partner may be acquired by
the remaining partners on his retirement or death at a price determined in
accordance with the agreement. The provisions regarding options, outlined
in paragraphs 24.A14–24.A24, would have some application. In the
Committee's view, it is more appropriate that there should be special
provisions to govern the effect of such a clause. These special provisions
would follow the principles adopted in relation to limited interests and
those proposed later, in paragraph 24.A89, in regard to shares. They would
require that the clause by which the remaining partners are entitled to acquire the interest should be ignored in determining the value of the interest of the retiring or deceased partner.

24.A69. A partnership agreement may require that the value of goodwill should be ignored in fixing the price payable by the remaining partners in respect of the interest of the retiring or deceased partner. There is a strong argument that in the case of a professional partnership goodwill is personal to the retiring or deceased partner so that it adds nothing to the value of his interest in the partnership, whether or not the partnership agreement has any requirement that it be treated as having no value.

IX. Companies

Transfer of Assets to a Company

24.A70. One of the methods of minimising estate duty without incurring gift duty is for the taxpayer to transfer part of his property to a company for full consideration. The purchase price often remains outstanding as a debt due from the company and the amount of the debt is not varied as a consequence of fluctuations in the value of the property transferred. The benefit of an increase in value accrues to the company and thus to the equity shareholders, who commonly are the relatives or dependants of the taxpayer. (Of course this method of minimising duty carries the risk of defeat if the property transferred falls in value.) The taxpayer may effectively control the company, in which event he will continue to control the transferred assets. The taxpayer may procure for himself benefits from the assets during the remainder of his life.

24.A71. If the retention of control of the assets after the transfer and the receipt of benefits from the assets after the transfer are disregarded, there remains a sale of the taxpayer's assets for full consideration. If the purchase moneys are outstanding as a loan, the provisions proposed in paragraphs 24.A62–24.A64 will bring to tax any gift involved in the terms of the loan. There is, in the Committee's view no justification under an integrated estate and gift duty for seeking to trace the assets transferred and to tax at some later time any increase in their value. Tracing is, in any event, a near impossible exercise if it is to be done fairly. The company may not own the assets on the taxpayer's death: they may have been sold and the sale price merged with other moneys of the company, or they may have been given away. And even should the assets be owned by the company at the time of the taxpayer's death, the increase in their value may at least in part be due to improvements made by the company.

24.A72. The question remains whether there is need for special
provisions in relation to the retention of control after transfer of assets to a company or the receipt of benefits after such transfers.

**Power or Control in Relation to Companies**

24.A73. The Committee has recommended that, where a person has power under an agreement or an instrument to acquire property for himself and fails to do so, he ought to be taxed as if he had acquired the property. Such a principle might be thought applicable to the power or control that a taxpayer may have over a company and thus over its assets. The nature of a company is such that its affairs can be controlled in many different ways. The problem is to identify what should be regarded as control for present purposes. It may be possible to spell out in legislation what constitutes control in a particular situation, but taxpayers will no doubt then organise their affairs so that they do not appear to have such ‘control’. While it is one matter—often very simple—to recognise the situation in which control of the affairs of a company is effectively held by a taxpayer, it is another matter to describe all such situations in general terms.

24.A74. In any case, it may be questioned whether the control of a company is an appropriate basis for the imposition of a tax any more than the control, for example, that attends the office of a trustee. The mere enjoyment of a power to do or refrain from doing some act is not an appropriate basis. To find any such basis one must look to the benefits that could have been obtained by the taxpayer. This raises its own problems which must now be considered.

**Benefits from a Company**

24.A75. On the principle asserted by the Committee in relation to settled property, a taxpayer can be deemed to be the owner of an asset actually owned by a company where the taxpayer is entitled to the benefits to be derived from that asset. In the context of shareholding in a company, this principle would involve including only the value of the shares carrying the entitlement. If the principle were to be extended to include benefits the taxpayer could have taken for himself by virtue of the powers he has over the company's affairs, substantial difficulties would arise in applying the principle, especially when the taxpayer does not receive any benefits, or receives some benefits and directs others elsewhere. These difficulties arise because directors and majority shareholders of companies are obliged to act bona fide for the benefit of the company as a whole. These duties must be taken to impose some limitation on the amount of benefits that a taxpayer could have directed to himself, though it is not uncommon for a
taxpayer to treat a company he controls as his own and for the other shareholders to accept this situation without complaint. A general rule that a taxpayer who ‘controls’ a company in some defined sense is to be deemed to be entitled to all benefits to be derived from a company's assets cannot be reconciled with basic company law.

24.A76. The Committee does not, therefore, propose that any attempt be made to impose duty by reference to control of a company or the power to take benefits for oneself. Apart from the difficulties mentioned, there would be a major problem under an integrated estate and gift duty of determining the time at which duty should be imposed. No doubt a person relinquishes control or the power to take benefits when he dies, and it is possible to look to the situation that obtained during a period before death to determine what control or power he has relinquished. But a gift duty requires finding a moment of gift during life by the relinquishment of control or power. The Committee is aware that the United Kingdom has legislation that seeks to tax by reference to control and power. But this legislation has been criticised by the Courts and seems rarely to be invoked; moreover, it was introduced at a time when there was no gift duty in that country.

Gifts in Transactions Involving Companies

24.A77. Basically, there are seven ways in which a company may be used by a taxpayer to effect a gift:

(a) The taxpayer may make a gift to a company.
(b) The company may make a gift of part of its assets.
(c) The company may allot shares in its capital, such allotment being at an undervalue.
(d) The rights attaching to issued shares in the capital of the company may be changed.
(e) Rights attaching to issued shares in the company may change.
(f) An obligation may arise to sell shares in a company to specified persons at a price specially determined.
(g) The company may declare and pay dividends on some shares but not on others, so that the income of the company is directed to particular persons.

24.A78. Gift to a company. A taxpayer may make a gift of property to a company. There may be a gift by allowing the company to use property belonging to the taxpayer. There may be a gift arising from an interest-free loan. These gifts should be treated as any other gifts by the taxpayer. However, if the taxpayer has an interest in the company he will, to the
extent of his interest, be making a gift to himself and some allowance might be made for his interest in the company in computing the amount of the gift. The Commissioner might be given a discretion in this regard.

24.A79. Gift by a company. The present Commonwealth Gift Duty Act expressly applies to companies (section 11). Gifts for most patriotic or charitable purposes are exempt (section 14, paragraphs (c), (d) and (h)) as are some gifts incurred in connection with the business of a company (section 14, paragraphs (a), (b) and (f)). All other gifts within the present definition of gift are caught and the company bears the tax.

24.A80. Subject to appropriate exemptions, a gift by a company should be taxed if it takes any of the forms of gift already considered in this appendix. Thus there may be a gift of property or a gift by allowing the use of the company's property or a gift by an interest-free loan or a loan at nominal interest. Several questions arise: On whom should the duty be imposed? If the duty is imposed on the company, what should be the rate?

24.A81. If the duty is imposed on the company, it follows that:

(i) The burden of the duty will be borne, in effect, by the shareholders of the company who are the real donors, though some of them may be involuntary ones.
(ii) If the rate structure of gift tax applying to a company is the same as that applying to an individual, a person who has made substantial gifts will be able to obtain a fiscal advantage by arranging his affairs so that subsequent gifts are made by a company (whose shares he may own) of property transferred for full consideration by him to the company for this purpose.
(iii) If the company is incorporated abroad and has no property inside Australia and the gift is made outside Australia, there will be no jurisdiction to tax the gift even though the company may have been set up by a person domiciled in this country to be the medium of his gifts.

Quite apart from the question of fairness raised in (i) or that of enforcement raised in (iii), the policy of an integrated estate and gift duty will be thwarted if taxpayers can make gifts through the medium of a company and the tax is imposed on the company. The use of a series of companies involves gift splitting which will defeat the progressive element in the rate scale. Gift splitting would be prevented if a high flat rate of duty were applied to company gifts. However, this might be thought unfair when one of the real donors is a minority shareholder who is an involuntary party to the gift.

24.A82. An alternative approach is to deem the gift as being made by the person who controls the company. The problem of identifying control has already been discussed, and the Committee sees little merit in this
approach. Fairness requires that the real donors be taxed as if they had made the gift. This is the approach in section 4 (11) of the Victorian Gift Duty Act. By virtue of section 4 (11), a gift will be made if:

(a) the total property or the value of the total property of a person (the donor) is diminished;
(b) the total property or the value of the total property of another person (the donee) is or may be increased; and
(c) such increase is the direct or indirect result of anything done or omitted to be done: (i) by a company of which the donor is a director, shareholder or creditor or in which the donor has a pecuniary interest; or (ii) by a donor as a director, shareholder or creditor of the company.

The Committee favours applying this approach generally. The possibility, under it, of giving some relief to the involuntary donor is considered later in this appendix.

24.A83. Provisions drafted on the Victorian model will not be wide enough to apply to cases where there has not been any actual diminution in the value of the donor's property. If the company allows the use of its property without charge, or lends money interest free, the donor's property will not have diminished in value: it will simply have failed to increase. In a case of this kind there seems no alternative to taxing the company at a deterrent rate.

24.A84. Allotment of shares. The present Commonwealth gift duty provides that an allotment of shares is a disposition of property which may constitute a gift. It has been held that an allotment of shares by a company at an under-value is a gift by the company. It seems to the Committee that this is a case where the duty should be imposed not on the company but on the real donor. Taxing the company is subject to all the objections raised in paragraph 24.A81. The provisions framed on the Victorian model referred to in paragraph 24.A82 should be wide enough to extend not only to an allotment of shares but also to any other kind of company restructure, including a redemption or forfeiture of shares.

24.A85. Variation in share rights. A taxpayer may acquire shares or other interests in a company and, later, the rights attaching to them may be varied in a way that diminishes their value and increases the value of other interests in the company. Where the variation is the result of company action taken during the life of the donor, there does not seem to be any serious problem in taxing the donor. The provisions proposed in paragraph 24.A82, drafted on the Victorian model, should be adequate to ensure that the real donor is taxed.
24.A86. *Change in share rights without concurrent company action.* A more difficult problem arises where there is a variation in the rights attached to the shares or other interests in a company, either by virtue of company action taken some time previously or by reason of the terms on which the shares were originally taken up. The most common example of this technique is to be found in the so-called ‘Robertson’ case: in that case the shares held by the deceased which were valuable prior to death become shares of little value on death by the operation of a provision in the articles of association of the company. The holder of the valuable shares is sometimes given the power to prevent the change in rights (and hence in value) taking place on his death, the power being exercisable only during his life. Clearly, it will be insufficient to make new provisions solely in relation to the situation where the rights change on death, as taxpayers will then arrange matters so that the change occurs at some other time. For example, a person in his fifties could subscribe for shares in a company which entitle him to all of the dividends and the voting power for the next thirty years. These shares will be worth, when they are taken up, slightly less than the value they would have if the rights were not subject to any change. On death, say 25 years later, the shares will be worth considerably less. Moreover, the provision should be wide enough to cover a case where the rights attaching to the shares do not themselves change, but are nonetheless affected in some way so as to diminish their value, for example by a change in the rights attaching to the other shares that increases the value of those other shares.

24.A87. The method proposed by the Committee for dealing with the ‘Robertson’ case is for the relevant shares to be valued on the footing that the rights attaching to them or to other shares have not changed and will not change. Clearly it is not sufficient merely to provide for the inclusion in the deceased's estate of the difference between the value before the change and the value after it. The shares immediately before the change will have been depressed in value by the prospect of the change. The method proposed could be adapted to meet the case where the rights change at some point prior to death by providing that the taxpayer will be deemed to have made a gift of an interest in the shares to the extent of the difference between the value of the shares assessed on the assumption just mentioned and the actual value. There should be an exception where the fall in value is due to a change in rights attaching to shares issued in an ordinary commercial transaction between persons dealing with each other at arm's length.

24.A88. The method proposed will be effective where the change in rights is to occur after death. The shares will be valued at death and on the
occasion of any dealing in the shares before death as if they were not subject to the prospect of change.

**24.A89. An obligation to sell shares to specified persons at a price specially determined.** The Committee has recommended that a life interest should be treated as ownership of the assets supporting the life interest. The interest in a corporate enterprise represented by a share in the enterprise should, in some respects, be treated as part ownership of that enterprise. At least, it is appropriate that restrictions on the transfer of shares and on the price which can be obtained for shares should be ignored. The Committee has taken a similar approach in relation to restrictions on the disposal of an interest in a partnership.

**24.A90.** The Committee recommends that, where shares subject to restriction on transfer are dealt with by the shareholder or are included in his estate on his death, they should be valued on the assumption that they are not held subject to those restrictions.

**24.A91. Declaration of dividends.** Under company law it is possible to create and issue shares carrying all kinds of different entitlements to dividends: thus the directors of a company may be given a discretion to pay a dividend on some shares without at the same time paying a dividend on others. Under such a corporate structure, a company may be used by a person to make gifts of income to others (the income being what he himself would have derived, but for the arrangement) without incurring a liability for gift duty under the present Commonwealth legislation. Some State legislation attempts to deal with the problem but not, in the opinion of the Committee, in a wholly satisfactory manner.

**24.A92.** Some would claim that arrangements of this kind are justified as constituting legitimate arrangements between members of a family. Such arrangements may be made with an aim that is not solely the reduction of taxation. However, it is apparent that, by this means, income tax payable is being significantly reduced and gifts effected in this way escape duty. If a taxpayer wishes to provide for members of his family, the Committee sees no reason why he should not do this by making a gift to the person concerned or establishing a trust for that person's benefit.

**24.A93.** The identification of the donor where a differential dividend has been declared raises a number of issues. Under some legislation an endeavour is made to identify the donor as being the person who ‘controls’ the company or who instigates the payment of the dividend. This kind of endeavour carries with it a number of problems already discussed. The better approach, in the Committee's view, is to look to the persons whose property is affected. Where a dividend is paid by a company on shares whose rights to dividend in relation to other shares are not fixed by the
company's constitution, or by agreement made when the shares were acquired, and the amount received by a shareholder is less than the amount he would have received had the dividend been paid to all shareholders in proportion to the capital paid by them, the shareholder should be treated as having made a gift of the difference. The notion of ‘fixed by the company's constitution’ may pose difficulties of definition but they should not be insurmountable. Differential dividend rights that serve an evident commercial purpose should be excluded from the operation of the provisions. There will be shareholders who were not consulted when the declaration and payment of the dividend were made, and could not have prevented the declaration and payment. The problem of the involuntary donor will thus arise here as under the Committee's proposals in paragraph 24.A82. Further observations in this regard are made in paragraph 24.A95.

**Definition of a ‘Family’ or ‘Closely Controlled’ Company**

24.A94. Estate and gift duty legislation in some Australian States and elsewhere seeks to define those companies (identified as ‘family’ or ‘closely controlled’ companies) which are likely to be used by a taxpayer or by a group of taxpayers to avoid or minimise their taxes, and to confine special provisions of the kind discussed in previous paragraphs to transactions involving such companies. These attempts have not achieved their purpose, and the Committee therefore proposes that its recommendations be applied to all companies. It believes that bona fide business transactions need not be prejudiced by its recommendations. In paragraph 24.A93 a specific provision is proposed in regard to ordinary commercial transactions. Specific provisions of this kind may also be helpful in other contexts involving companies: for example, in regard to a gift by allotment of shares.

**X. Involuntary Gifts**

24.A95. Several references have been made in previous paragraphs to the problem of the ‘involuntary donor’—a person who is treated as having made a gift though he has not intended this result. Most often the problem arises in a transaction involving a company; but there may be other occasions, for example in a transaction involving a partnership. The Committee considers that some relief should be given. The donee only should be liable for the tax, and the gift should not be aggregated with other gifts for the purpose of determining the rate of tax on subsequent gifts by the donor.
XI. Insurance and Superannuation

24.A96. In the Committee's view, proceeds of life insurance policies and premiums paid in respect of such policies, under an integrated estate and gift duty, should be treated as follows:

(a) Where the deceased owned the policy on his life at the time of death, the whole of any proceeds should be taxed as part of his estate on his death, irrespective of who paid the premiums during his life.
(b) Where the policy was not owned by the deceased at the time of his death, the proceeds should not form part of his estate even though the deceased may have paid some or all of the premiums during his life.
(c) Premiums paid on a policy owned by another person should be treated as gifts and taxed accordingly.

24.A97. The Committee, in paragraph 24.37, rejects any concession for specific assets and in so doing rejects any general concessional treatment of superannuation benefits in relation to estate duty. A lump sum received by a beneficiary on the death of a member of a superannuation scheme should not be treated differently from a lump sum received by a member on retirement which forms part of his estate on death.

24.A98. There may, however, be justification for according special treatment to an annuity or a pension that becomes payable to one spouse on the death of another, whether under a life policy or a superannuation scheme. To tax the actuarial value of the annuity or pension may present liquidity problems and it is relevant that the annuity payments will be subject to income tax in the hands of the surviving spouse. The matter has already been considered in Chapter 21.

XII. Joint Ownership

24.A99. In the Committee's view, the interest of a joint tenant that passes to another joint tenant on the former's death should be included in his estate. Provided it is a beneficial interest, no part of the surviving joint tenant's interest should be included. Thus if husband and wife own a house as joint tenants, half only will be taxed on the death of the first spouse. Any gift that may have been made by the deceased joint tenant of funds applied in acquiring the surviving tenant's interest should be taxed when made and should not affect the manner in which a joint tenancy is taxed on death.

XIII. Exempt Transactions
24.A100. Certain transactions that might conceivably fall within the ambit of the tax base, as defined in earlier paragraphs, should be expressly exempt from tax.

24.A101. A disposition under a void contract should not constitute a gift. Further, where property is re-conveyed to the taxpayer under a void contract, no liability for duty should arise. However, the Committee recognises that these exemptions, if unqualified, could afford opportunity for avoidance. The exemptions should be available only where it is apparent that the contract was not entered into for the purpose of evading or avoiding duty.

24.A102. A contract for the sale of property may give rise to a gift and any such gift should be taxed at the point when the contract is made. There is usually an interval between the date of the contract and the date on which the transfer is effected. During this interval the property may have increased in value. In general, a transfer under a contract should not involve a gift of this increase in value. However, an exception to this principle is referred to in paragraph 24.A17.

24.A103. A disposition by a trustee to a beneficiary, whether giving effect to a resulting trust or otherwise, should not give rise to a gift where it is in accordance with the beneficiary's entitlement to the trust property. This exemption should be available in the case where assets are distributed in specie, even though the trust instrument calls for the trust assets to be converted into cash and for the cash to be distributed.

24.A104. Any transaction between a company and an associated company should be exempt from duty. An associated company ought, for this purpose, to be defined sufficiently widely so as at least to include:

(a) a company which is in substance the wholly-owned subsidiary of another company; and
(b) a company which is another wholly-owned subsidiary of the company of which the donor is a wholly-owned subsidiary.

Where there is a minority interest involved at any point, the principle in paragraph 24.A82 should apply.

XIV. Interrelation of Income Tax and Gift Tax

24.A105. In Chapter 7, the Committee has recorded its decision not to include gifts as such in the income tax base. In some circumstances, however, a donor may make a gift and the property given or benefit conferred will be income of the donee under existing principles. The fact
that the property or benefit is taxed as income does not preclude the liability of the gift to gift duty. A number of situations may be distinguished:

(a) Where there is an assignment to a donee of royalties or interest, each payment to the assignee should be treated as a gift of the amount of the payment, reduced by the amount of the income tax that would be payable by the donee.
(b) The donor who carries on a business may make an excessive payment to the donee for goods supplied or services rendered by the latter. The gift is the amount by which the payment exceeds the consideration given, diminished by an amount equal to the income tax payable by the donee.
(c) The donor who does not carry on a business may make an excessive payment to the donee for services supplied by the donee. The fairest outcome will follow if the Commissioner does not treat the excess remuneration as income of the donee (assuming that it is open to him to go behind the form of the transaction), in which case the amount of the excess is the gift.
(d) The donor may supply goods for an inadequate price to a donee who carries on a business. In this case the amount by which the value of the goods exceeds the consideration should be treated as a gift, diminished by any income tax assessed against the donee.
(e) The profits distributed to a member of a partnership may exceed a fair return for the partner's contribution of capital or the use of his property. The amount of the excess, after deducting the income tax payable by that partner, should be treated as a gift by the other partner.
(f) Differential dividends paid within a company may operate to divert income from one shareholder to another. The gift should be determined in accordance with the rule proposed in paragraphs 24.A91–24.A93, but the deemed gift should be reduced by the amount of the income tax payable by the shareholder receiving the dividend.

Some of the foregoing illustrations are likely to be part of an income splitting arrangement. The Commissioner may, in certain of these cases, have power to deny the reduction in income tax sought by the arrangement. Nevertheless, if the gift tax legislation is to be effective, gifts of the kinds described above must be subjected to gift tax, irrespective of what action the Commissioner may be empowered to take in relation to the gift under income tax legislation.

Chapter 24: Appendix B: Rate Structure

I. Present Duties and Grossing-Up

24.B1. The present Commonwealth estate and gift duties favour lifetime giving as against bequeathing property on death. This may be illustrated as follows. Assume that a taxpayer dies domiciled in Australia and by his will
bequeaths all of his estate to persons who are not related to him, and that the value of the estate is $600,000. The total duty payable, ignoring duties at the State level, will be $161,400. Assume that another taxpayer with an estate of $600,000 makes a gift of cash of $400,000, three months before death, to a person not related to him, files a gift duty return, is assessed and pays the duty. Assume also that the value of the remainder of his property does not change between the gift and death. In this case the total duty payable will be $131,683, calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift</td>
<td>400,000</td>
</tr>
<tr>
<td>Gift duty</td>
<td>105,600</td>
</tr>
<tr>
<td>Actual estate after gift</td>
<td>200,000</td>
</tr>
<tr>
<td>less Gift duty paid out of estate</td>
<td>105,600</td>
</tr>
<tr>
<td>Actual estate on death</td>
<td>94,400</td>
</tr>
<tr>
<td>plus Notional estate</td>
<td>400,000</td>
</tr>
<tr>
<td>Estate on death</td>
<td>494,400</td>
</tr>
<tr>
<td>Gross estate duty</td>
<td>131,683</td>
</tr>
<tr>
<td>less Credit for gift duty</td>
<td>105,600</td>
</tr>
<tr>
<td>Estate duty liability</td>
<td>26,083</td>
</tr>
</tbody>
</table>

Total estate and gift duty is thus $29,717 less than the duty on the estate of the first taxpayer. There would, of course, be no tax saving in the second case if the notional estate were grossed up, for estate duty purposes, by the amount of gift duty on the gift.

II. Illustration of a Scale of Integrated Duty

24.B2. The Committee does not wish to recommend a particular rate scale for an integrated estate and gift duty. The following rate scale is illustrative only: it was necessary to devise a scale for the purpose of constructing the examples of inflation adjustment and quick-succession relief presented later in this appendix.

<table>
<thead>
<tr>
<th>Value of estate</th>
<th>Marginal rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>per cent</td>
</tr>
<tr>
<td>0–60,000</td>
<td>0</td>
</tr>
<tr>
<td>60,001–120,000</td>
<td>20</td>
</tr>
<tr>
<td>120,001–200,000</td>
<td>30</td>
</tr>
<tr>
<td>200,001–300,000</td>
<td>40</td>
</tr>
</tbody>
</table>

The amount of tax that would be imposed by such a scale on estates of varying sizes is as follows:
III. Adjusting the Rate Scale

24.B3. In paragraph 24.42, the Committee has indicated the principles that must be followed in changing the rate structure and in relating gifts made at different times. These principles are now illustrated.

24.B4. If it is decided to adjust the rate structure to take account of inflation of say, 10 per cent, each slice would be increased by 10 per cent. The scale in paragraph 24.B2 would become:

<table>
<thead>
<tr>
<th>Former slice</th>
<th>Rate per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–60</td>
<td>0</td>
</tr>
<tr>
<td>60–120</td>
<td>20</td>
</tr>
<tr>
<td>120–200</td>
<td>30</td>
</tr>
<tr>
<td>200–300</td>
<td>40</td>
</tr>
</tbody>
</table>

24.B5. If it is then decided to increase the weight of the tax, the marginal rates would be increased. The scale would then become:

<table>
<thead>
<tr>
<th>Value of estate</th>
<th>Rate per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–66</td>
<td>0</td>
</tr>
<tr>
<td>66–132</td>
<td>22</td>
</tr>
<tr>
<td>132–220</td>
<td>33</td>
</tr>
<tr>
<td>220–330</td>
<td>44</td>
</tr>
</tbody>
</table>

24.B6. If a person makes a gift of $92,000 when the scale in paragraph 24.B2 applies (all previous gifts being exempt), the duty will be $8,000. A gift of $92,000, when grossed up, will represent the whole of the first slice and two-thirds of the second slice. Thus, if the scale is revised in the manner indicated in paragraph 24.B5, the balance of the second slice available to the donor will be one-third, i.e. $22,000. If the donor dies when the scale in paragraph 24.B5 is in force without having made any other taxable gifts and with an estate of $40,000, the estate (assuming no exemptions apply) will attract duty as follows:

| $ | 22 per cent of $22,000 | 4,800 |
| $ | 33 per cent of $18,000 | 5,940 |
It will be noted that the gift duty on any gift is finally determined at the
time of the gift and expresses the weight of tax then applying.

IV. Quick-Succession Relief

24.B7. The principles to be followed in granting quick-succession relief
are outlined in paragraph 24.48. The application of the principles is
illustrated below:

Example 1

Assume that the estate of John Smith, on his death, is made up as
follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>House: value on death</td>
<td>$60,000</td>
</tr>
<tr>
<td>Shares: value on death</td>
<td>$120,000</td>
</tr>
<tr>
<td>Moneys on deposit or in hand</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Total: $210,000

Net value of the estate: $190,000

Assume that Smith, during his life, gave $50,000 to his wife and made no
other non-exempt gifts. Assume that Smith leaves the whole of his estate to
his wife. Duty will be assessed on $180,000, i.e. $190,000 less the
remaining $10,000 of the wife's exemption (paragraph 24.34), all but
$10,000 of the exemption having been used before death. Duty, on the
basis of the scale in paragraph 24.B2, will be $30,000. Assume that Mrs
Smith dies 3 years later, leaving an estate with a net value of $230,000.
The house and share portfolio bequeathed to Mrs Smith may form part of
the estate or may have been sold. This will not affect the quick-succession
relief. The full relief will be available in that Mrs Smith has died within 5
years of her husband's death and because the estate (net value $230,000)
may be assumed to include an amount equivalent to the value of the
inherited assets ($190,000). Assume that the scale in paragraph 24.B2 has
not been changed and that the whole estate is left to the adult children of
Mr and Mrs Smith:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty on $230,000</td>
<td>$48,000</td>
</tr>
<tr>
<td>less Relief</td>
<td>$30,000</td>
</tr>
<tr>
<td>Duty payable on Mrs Smith's estate</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

24.B8. In example 1, it was assumed that no change in the rate scale
occurred between the deaths of Mr and Mrs Smith. As indicated in paragraph 24.51, where there has been a change in the width of slices in the rate scale to take account of inflation, the Committee favours measures to bring about an equivalence in value between tax paid on an inheritance and tax against which relief is available. These measures should relate a gift or an estate to slices and parts of slices in the rate scale so that, if the scale has thus varied, so too will the quantum of the gift or estate. The following examples of quick-succession relief illustrate the principle.

**Example 2**

Assume that, in example 1, Mrs Smith dies exactly 9 years and 1 month after her husband and that, on her death, the rates are those in paragraph 24.B5. The tax on the death of Mr Smith was $30,000, assessed on an estate of $190,000. The equivalent of an estate of $190,000, under the scale in paragraph 24.B5, is one of $205,333, and the equivalent tax on such an estate is $38,720. Mrs Smith's estate (net value $230,000) can be assumed to include an amount equivalent to the value of the inherited assets ($205,333), so that the whole of the $38,720 less four-tenths of it (9 complete years having elapsed since the death of Mr Smith) will be available as a credit:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty on $230,000</td>
<td>47,960</td>
</tr>
<tr>
<td>less Relief (6/10 x $38,720)</td>
<td>23,232</td>
</tr>
<tr>
<td>Duty payable on Mrs Smith's estate</td>
<td>24,728</td>
</tr>
</tbody>
</table>

**Example 3**

Assume that, in example 1, Mr Smith left half his estate to his wife and the other half on trust for his wife during her life and thereafter to his adult son. Assume that Mrs Smith dies 9 years and 1 month after her husband and that, on her death, the rate scale in paragraph 24.B5 applies, that the value of the assets in the trust fund is $120,000, that the value of Mrs Smith's actual estate is $30,000, and that Mrs Smith leaves her actual estate to her adult son. The equivalent of an estate of $95,000 (i.e. 1/2 x $190,000) under the scale in paragraph 24.B5 is an estate of $104,500, and the equivalent tax on such an estate is $19,965 (i.e. 1/2 the tax on 2 x $104,500). Mrs Smith's estate will be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual</td>
<td>30,000</td>
</tr>
</tbody>
</table>
The trust estate (net value $120,000) may be assumed to include an amount equivalent to the inherited assets ($104,500)—indeed, unless the trustee has made distributions from corpus it can always be assumed to include such an amount—so that part of the relief will be available:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty on $150,000</td>
<td>$20,460</td>
</tr>
<tr>
<td>Duty attributable to trust estate $120,000/$150,000</td>
<td>$16,368</td>
</tr>
</tbody>
</table>

Mrs Smith's actual estate ($30,000) cannot be assumed to include all of the inherited assets ($104,500), so that the relief will be limited as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty on Mrs Smith's actual estate $30,000 x $20,000</td>
<td>$4,092</td>
</tr>
<tr>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>less Relief</td>
<td>$3,434</td>
</tr>
<tr>
<td>$104,500</td>
<td></td>
</tr>
<tr>
<td>Duty payable on actual estate</td>
<td>$658</td>
</tr>
</tbody>
</table>

### Chapter 24: Appendix C: Situs of Assets

24.C1. The common law has various technical rules for determining the situs of an item of property. These rules are based largely on considerations of convenience. Some Australian taxing legislation has relied exclusively on the common law rules: the present Estate Duty Assessment Act, for example, contains no rules as to the situs of assets. Other Australian taxing legislation has modified the common law rules to some extent by introducing rules applying in particular situations: section 13 of the Gift Duty Assessment Act contains a number of rules of this sort.

24.C2. In the Committee's view the common law rules are not always appropriate in this context: in certain areas, including speciality debts and interests in trust estates, they have been used in the past to avoid tax. The modifications to the common law rules in the Gift Duty Assessment Act are inadequate in some instances and go too far in others. For example, the Act ignores the problem of determining the situs of a trust estate, yet treats shares in a company incorporated outside Australia as being situated in this country if the shares are listed on a branch register of a company in Australia. Shares in a company incorporated in Australia should be taxable...
under Australian law irrespective of where the register on which the shares are listed is kept, since the company is substantially dependent on Australian law for its existence and continuance. For the same reason, shares in a company incorporated outside Australia should not be treated as being situated in this country even where they are listed on a register in Australia. In the case of a trust estate, the common law rules, which depend on how far the administration of the trust estate has proceeded, should not be followed. An interest in a trust estate, fully administered or otherwise, ought to be treated as situated in Australia only in so far as any of the assets of the trust estate are, on the relevant date, situated in Australia. In determining the extent of the Australian assets, those liabilities of the trust estate not charged against particular assets should be apportioned over all the assets. The Committee can see no justification for imposing a tax on an asset merely because one or more of the trustees reside in Australia or for making the liability for tax depend on whether or not a trust estate has been fully administered.

24.C3. The rules contained in Article III of the estate duty convention between the United States and Australia provide a reasonable balance. The Committee therefore proposes the following rules, based on that convention:

(a) Immovable property (held otherwise than by way of security) should be deemed to be situated at the place where the land concerned is located.
(b) Tangible movable property (held otherwise than by way of security and other than property for which specific provision is made) and bank or currency notes and other forms of currency recognised as legal tender at the place of issue should be deemed to be situated at the place where that property or currency is located, or, if in transitu, at the place of destination.
(c) Debts (including bonds other than those referred to in (d), bills of exchange and promissory notes, whether negotiable or not), secured or unsecured and whether under seal or not, excluding the forms of indebtedness for which specific provision is made elsewhere in these recommendations, should be deemed to be situated at the place where the debtor is resident. However, if the debtor, at the time when the debt is to be valued, has an established place of business in the country in which the owner of the debt was domiciled and the debts were incurred in carrying on the business of that establishment, the debts so incurred should be deemed to be situated in that country.
(d) Bonds, stocks, debentures, and other debts being securities, issued by any government, municipality or public authority should be deemed to be situated at the place where that government, municipality or public authority is located.
(e) Bank accounts should be deemed to be situated at the place where the bank or branch thereof, at which the account was kept, is located.
(f) Moneys, payable under a policy of insurance or under an annuity contract, whether under seal or not, should be deemed to be situated where the policy or annuity contract provides that the moneys are payable; or, if the policy or annuity contract does not provide where the moneys are payable:

(i) at the place of incorporation, in the case of a company; or
(ii) at the place of residence of the person by whom the moneys are payable, in any other case.

(g) A partnership should be deemed to be situated at the place where the business of the partnership is carried on, but only to the extent of the partnership business at that place.

(h) Ships and aircraft and shares thereof should be deemed to be situated at the place of registration of the ship or aircraft.

(i) Goodwill as a trade, business or professional asset should be deemed to be situated at the place where the trade, business or profession to which it pertains is carried on.

(j) Patents, trade-marks and designs should be deemed to be situated at the place where they are registered.

(k) Copyright, franchises, and rights or licences to use any copyrighted material, patent, trade-mark or design should be deemed to be situated at the place where the rights arising therefrom are exercisable.

(l) Rights or causes of action ex delicto surviving for the benefit of an estate of a deceased person should be deemed to be situated at the place where such rights or causes of action arose.

(m) Judgment debts should be deemed to be situated at the place where the judgment is obtained.

(n) Shares in a company should be deemed to be situated at the place where the company is incorporated.

(o) An interest in a trust estate, whether fully administered or otherwise, should be deemed to be situated in Australia only in so far as any of the trust assets are situated in Australia; provided that the liabilities of the trust estate which are not charged against any particular asset may, if the trustee so elects, be apportioned between the Australian and ex-Australian assets on the basis of their respective values but, if the trustee does not so elect, shall be treated as being charged against the ex-Australian assets.

**Reservation to Chapter 24: Estate and Gift Duty**

**R. W. Parsons**

My reservation relates to the Committee's proposals in regard to gifts of services. In paragraph 24.A57 the Committee declined to commit itself to a recommendation that the base of the gift duty should include, to the extent that they are unrewarded, the value of services given to an individual,
partnership, trust or company, where the services concern business operations conducted by that individual, partnership, trust or company, and the parties are related persons. In my view the base of the gift duty should be extended in this way. If a father employed by an unrelated person wishes to make a gift to his children, he must make a gift out of the salary he has received and his gift will be subject to gift duty. A father who is a member of a family partnership, or is employed by a trust or company in which his children have interests, may make a like gift by taking as his share of partnership profits or his salary an amount less than the value of his services, but this gift will not be subject to gift duty unless the base of the duty is extended in the way proposed.

Valuation of services is already undertaken in the administration of the income tax to determine whether a reward for services paid to a relative is excessive. And in paragraph 24.A 105 the Committee proposes that an excessive reward in these circumstances will involve a gift. The valuation called for is no different when the purpose is to determine whether a reward is inadequate.

The taking of an inadequate reward for services should be treated as a gift for gift duty purposes within the limits explained in paragraphs 24.A55 and 24.A56 and subject to an allowance for income tax in accordance with paragraph 24.A105. The gifts referred to in paragraphs 24.A67 (relating to partnerships) and 24.A78 (relating to gifts to companies) should include gifts of services.

R. W. Parsons

Reservation to Chapter 24: Estate and Gift Duty

K. Wood

My reservation refers to the Committee's proposals in relation to partnerships and in particular to its view, stated in paragraph 24.A68, that a clause in a partnership agreement to the effect that the interest of a retired or deceased partner may be acquired by the remaining partners at a price determined in accordance with the agreement should be ignored in valuing this interest for estate and gift duty purposes.

It is my understanding that the present law as determined by judicial interpretation provides that, for estate duty purposes, the value of an interest in a partnership held by a deceased partner at the time of his death is its value as fixed by the terms of the partnership arrangements because this is its realisable value. Were the value to be fixed at a figure in excess of its realisable value and duty assessed on the higher figure serious
hardship may be suffered by the widow and dependants of the deceased partner. In addition, the value agreed upon by unrelated members of a partnership for the amount which the continuing partners shall pay for the interest of an outgoing partner is normally fixed by arm's length negotiation having regard also to other partnership provisions. In these cases it would be inappropriate for the law to provide that the agreement should be ignored when valuing an interest for estate and gift duty purposes.

Accordingly, in my view, the Committee's proposal in paragraph 24.A68 should apply only to interests in partnerships where the outgoing partner is related to one or more of the continuing partners.

K. Wood

1 Reservations to conclusions reached in this chapter are appended.
Chapter 25 Charities

25.1. The term ‘charity’ does not readily lend itself to definition. The popular meanings of ‘charity’ and ‘charitable’ are not the meanings generally given to those words by the law. In its strict legal sense ‘charity’ comprises four principal divisions: the relief of poverty, the advancement of education, the advancement of religion, and other purposes beneficial to the community. In the field of taxation, however, ‘charity’ is not restricted to its technical legal definition.

25.2. In a number of earlier chapters passing reference has been made to the implications of the tax system for charities. The present chapter looks more closely at the treatment of charities under the Income Tax Assessment Act, the Gift Duty Assessment Act, and the Estate Duty Assessment Act.

I. Deductibility from Income of Gifts to Charities

25.3. Gifts to the funds, authorities and institutions listed in section 78 (1) (a) of the Income Tax Assessment Act are deductible from the donor's income before income tax is assessed. The gift must not be testamentary and it must be to the value of two dollars or more; if in the form of property, the property must have been purchased by the taxpayer within twelve months of the gift being made.

25.4. The list of funds, authorities and institutions, set out in full in Appendix A to this chapter, covers a variety of categories, including public or non-profit hospitals, public benevolent institutions, public authorities engaged in research for certain purposes, public universities, and certain individual funds such as the Australian Elizabethan Theatre Trust, the Australian Academy of Science, the National Trust of Australia, and the Productivity Promotion Council of Australia. Many are of long standing, dating back in some cases to the earliest years of Federal income tax. Since 1962, when a general review was made, no new categories have been added, though individual causes have been approved. Before launching an appeal involving a new fund, sponsors usually seek the opinion of the Commissioner on whether gifts to it will be an allowable deduction, and it is inevitable that some organisations which have failed to gain approval believe they have been harshly treated.

25.5. Institutions of a purely religious nature are not included in the list. Donations to a church as such are not deductible, though donations to organisations founded and supported by a church body, such as a home for
the aged, may qualify.

25.6. In all the countries mentioned below, it appears to be generally accepted that gifts to charities, and the private philanthropy behind such giving, should be encouraged. The method of encouragement has been reviewed recently in several countries, leading in some instances to amendment of the law.

25.7. The general provisions in New Zealand are broadly similar to those in Australia, gifts to religious bodies not being deductible. But there are two significant differences: deductions are available only to individuals, and the maximum amount any individual may claim in a year is $100. The Ross Committee (1967) recommended no changes.

25.8. The system in Canada is similar in many respects to the Australian, the chief differences being that a taxpayer's total claim is limited to 20 per cent of his income, except in the case of a corporation where the limit is 10 per cent. The Carter Commission (1966) considered the possibility of substituting tax credits. The maximum credit suggested was 20 per cent for gifts totalling $1,000, the percentage to decline as the total gifts declined and no allowance to be made for gifts in excess of $1,000. The suggestion was rejected by the Commission, on the ground that a change would tend to stifle donations by high-income groups. It ended up recommending no fundamental changes to the system of deductions though it did propose that the limit of allowable claims be increased.

25.9. The origin of the treatment of gifts to charity in the United Kingdom, where the term is used in its legal sense, lies in annual payments made under covenant being treated for tax purposes as income of the recipient and in the general exemption of charities from income tax. The relief applies only if the subscriber covenants to pay a certain annual net sum for not less than seven years. The subscriber executes under seal a document committing him to pay a notional gross sum before tax which, when tax is deducted at the standard rate, leaves a net sum. Each year he gives the net sum to the charity which then claims from the Revenue the tax paid on the notional gross sum. The charity thus in effect receives the total gross sum: if, for example, the donor gives a net sum of £300 and the standard rate of tax on individuals is 40 per cent, the charity receives £300 directly from the donor plus £200 from the Revenue.

25.10. The United Kingdom Royal Commission (1955) had certain misgivings about the covenant system. It saw some merit in allowing a deduction from taxable income for gifts to charity, subject to a maximum limit. However, it did not feel able to recommend to this effect. It feared that the immediate result would be a sharp falling off in gifts to charities. Moreover, the administrative burden in checking claims for deductions
would be much heavier than the work of returning tax on covenants to the charities themselves.

25.11. In the *United States* individuals may deduct up to 50 per cent of taxable income in the case of gifts to religious, educational and other non-profit organisations, and up to 20 per cent in the case of gifts to foundations and other organisations not regarded as ‘public’ institutions. A corporation's deductible gifts are limited to 5 per cent of net income. Before 1969 gifts could be claimed up to the total of taxable income.

**II. Income of Charities**

25.12. Section 23 (e) of the Income Tax Assessment Act exempts ‘the income of a religious, scientific, charitable or public educational institution’ from tax and section 23 (j) (ii) exempts a trust for charitable purposes. One major difference between section 23 (e) and section 78 (1) (a) is immediately apparent: the approved bodies listed in the latter section do not include religious institutions. The whole of the income of such institutions is exempt from income tax whatever its source or nature. These institutions are not infrequently associated with such activities as hospitals, bookshops, laundries and food processing, which have varying degrees of affinity with the essential aims of the institution and which may compete with ordinary trading firms not eligible for special tax treatment.

25.13. Income tax exemption for charities has attracted attention and comment in a number of other countries. In *New Zealand*, the Ross Committee recommended that the trading profits derived by charitable institutions should not, with some qualifications, be exempt from tax. It proposed that profits from trading and dividends from any company substantially owned should be assessable at normal rates; all other income, including normal investment income and rents from property, would remain exempt. A company substantially owned was defined as one in which the institution had an interest entitling it to 40 per cent or more of the company's income. However, these recommendations have not been adopted.

25.14. The Carter Commission in *Canada* came to the conclusion that charitable organisations should not be given a competitive advantage in business activity. It recommended that business income and income from non-portfolio investment should be assessed at the full rate of corporation tax, defining business income for this purpose as income flowing from any interest of 10 per cent or more in a business, and including the ownership of real property as a business. It seems, however, that as long as an institution has been established exclusively for charitable purposes and its
funds used for such purposes, its total income continues to be exempt in Canada.

25.15. The Royal Commission in the United Kingdom appears to have been more concerned with limiting the application of the legal term ‘charity’ in relation to ‘other purposes beneficial to the community’ than with questioning the exemption from tax of the income of charitable institutions. As it is, a charity is exempt from tax in respect of the profits of a trade carried on by it provided the profits are applied solely to the purposes of the charity and either:

(a) the trade is exercised in the course of the actual carrying out of a primary purpose of the charity; or
(b) the work in connection with the trade is mainly carried on by the beneficiaries of the charity.

Any yearly interest or other annual payment forming part of the income of a charitable body is exempt: for this purpose, the profits of a trade paid over by trustees to a charity are regarded as an annual payment.

25.16. The United States law exempts the income of certain institutions from tax, except for that portion of the income known as ‘unrelated business income’. A trade or business is unrelated if the conduct of it is not substantially related to the exercise by the organisation of its essential charitable function. Unrelated income does not include: (i) the first $1,000 of business income; (ii) dividends, interest or annuities; (iii) royalties; and (iv) rents from real property.

III. Charities in Relation to Gift and Estate Duties

25.17. Section 14 (d) of the Gift Duty Assessment Act states that duty shall not be payable in respect of

‘any gift to, or wholly for the benefit of, an institution, organisation or body of persons, whether corporate or unincorporate not formed or carried on for the profit of any individuals.’

This sub-section in general covers religious, scientific, charitable or public educational institutions which are specifically mentioned in section 23 (e) of the Income Tax Assessment Act. In addition, gifts to those institutions commonly known as ‘nonprofit organisations’ are exempt from duty.

25.18. Under section 8 (5) of the Estate Duty Assessment Act duty is not payable on so much of the estate as is devised or bequeathed or passes by gift inter vivos or settlement for various purposes or for the benefit of one
or more of the institutions listed in Appendix B to this chapter. While the Act does not use the word ‘charity’, it more than covers the four divisions of charity noted in paragraph 25.1, but stops short of including all those non-profit organisations exempt from gift duty. Thus the test for exemption from estate duty is not simply that an organisation is non-profit-making, but that it falls into one of the listed categories.

25.19. In New Zealand gifts during life or on death to institutions of a charitable kind do not respectively attract gift or estate duty. Until the late 1960s, lifetime gifts were exempt from duty while charitable bequests formed part of the dutiable estate, one of the grounds for the different treatment being that during lifetime a donor loses possession of the property, whereas a gift made by will involves the donor retaining the property in his possession until he dies. In the United States, a deduction is allowed to the donor for the value of the property transferred to a charity, subject to certain qualifications. These qualifications are aimed at denying the exemption if the organisation contravenes certain regulations, including participating in a political campaign. The United Kingdom proposes to introduce a capital transfer tax. It is expected that bequests to charities, which are now exempt from estate duty up to a limit of $50,000, will not be treated any less favourably than at present.

IV. Issues of Principle

25.20. Charitable organisations are regarded in most developed countries as playing an important part in the social structure and many have existed for a long time. They perform community welfare services which State instrumentalities financed from revenue would otherwise be called on to provide. They are supported by a large amount of voluntary work by private citizens who are sufficiently public-spirited to devote a significant part of their time and resources to causes they espouse, incurring expenses for which no tax deduction is claimed.

25.21. It would not be denied, therefore, that there is a case for subsidising charitable organisations from public funds. Tax concessions, by way of allowable deductions from the tax base or exemption of the income of the charitable organisation, are forms of subsidy. It is important to consider, however, whether they are the most appropriate ways of encouraging and supporting private philanthropy.

Subsidy by Deduction

25.22. If gifts are deductible from income for tax purposes, the
government in effect reimburses the donor for a larger share of the gift the higher the donor's income, and this may be thought vertically inequitable, even though the donor does not reap any personal material benefit from the making of the gift. A tax credit would overcome any suggested inequity between taxpayers, but there is no empirical evidence to show at what percentage rate the credit would have to be set if the present incentive effect of deductibility were not to be reduced for high-income donors. If the percentage were put at 67, the incentive to the top marginal rate taxpayer would be unchanged, lower marginal rate taxpayers would have greater tax incentive, and there would be an increase in the total subsidy. If the percentage were put at a figure lower than 67, some higher rate taxpayers would have less tax incentive to give, some lower rate taxpayers would have more, but the outcome for total contributions to charity, and the resulting total subsidy, would be difficult to estimate.

25.23. In the United States it has recently been proposed by some that, in place of the allowing of deductions to the donor, there should be a matching subsidy from public funds equal to the whole or part of the donor's gift, the subsidy going directly to the charity. This would be similar in principle to the United Kingdom system, but would have a wider operation. Under a deduction system, as already explained, a donor on a 60 per cent marginal rate who makes a gift of $100 in effect gives $40 to the charity himself and acts as agent in the giving of a further $60 from public funds. If the allowable deduction were withdrawn, the donor would presumably still be prepared to give $40; and in that he might give more than $40, say $50 or $60, the government grant to the charity could be reduced to $50 or $40 to produce the same yield to the charity. Surveys in the United States of the effect on donors of replacing deductibility by government grants have produced varying evidence, the point being to determine by how much of the tax subsidy the donor would reduce his gift in the absence of the subsidy. The donor might feel less secure about the direct grant than he does about the tax subsidy, and this factor, together with a fear of more government intervention, would affect the extent to which donors would reduce contributions in the changed circumstances envisaged. It should be borne in mind too that whenever a donor contributes, the charity receives the gift there and then. With pay-as-you-earn and deductibility, the donor waits until he is assessed before getting the subsidy, whereas under a direct grant system the charity must wait to receive the grant. The possibly greater administrative costs of a direct grant system over a deduction system must also be considered.

25.24. Similar considerations bear on the question of whether the exemptions of gifts from the gift and estate duties are appropriate ways of
subsidising charities.

25.25. In summary, a change from the present deduction system to a rebate system would overcome the objection by some to the deduction system that it is vertically inequitable. A change to a direct grant system would not only overcome this objection but could give government much greater flexibility in settling the amounts of subsidies going to particular charities. However, any change is likely to involve a smaller subsidy than at present in the case of a gift by a high-income or large-fortune taxpayer, and he will thus have less encouragement to make gifts. And it is fair to assume that these taxpayers are the principal source of donations.

25.26. The objection in terms of vertical equity is, in the Committee's view, not a strong one, because a donor cannot be said to obtain a personal material benefit from the making of a gift. And the lesser flexibility in setting amounts of subsidies which a deduction system involves compared with a direct grant system may be seen as offset by the greater encouragement to make gifts which a deduction system may involve. Until empirical evidence is forthcoming showing how far a change would encourage or discourage the making of gifts, the Committee believes that the present deduction system should be retained.

**Subsidy by Exemption of Income**

25.27. Two objections might be made to exemption of income as a method of subsidising the activities of a charity. The first is that the amount of subsidy given by the exemption depends on the amount of income derived by the charity and not on a judgment as to the charity's worth and needs. The second relates to the case where commercial activities are undertaken by charities: other organisations engaging in similar commercial activities are placed at a competitive disadvantage.

25.28. The first objection is answered by saying that, except in the special cases with which the second objection is concerned, charities are non-profit organisations with little or no income apart from investment income. The exemption of investment income is a further encouragement to donors whose gifts when invested generated that income, and an addition to the subsidy from public funds which accompanied the gifts to the charities.

25.29. In the Committee's view the exemption of the investment income of a charity can be justified as flowing from the encouragement to donors to give to charities and the supporting of the subsidies which are the method of encouragement.

25.30. The objection in terms of competitive disadvantage of other
organisations engaged in similar commercial activities has led, as mentioned in paragraphs 25.13–25.16, to measures being considered, and in some countries taken, to tax certain parts of the income of charities.

25.31. In considering the points for and against levying tax on income, the Committee is aware that some charities conduct activities such as schools, hospitals and laundries which are staffed wholly or partly by those whose everyday work reflects both their charitable calling and their professional training, supported in some cases by those who need rehabilitation or special supervision. Other charities conduct distinct activities such as food processing or book selling which are business undertakings though they may have some features distinguishing them from their competitors.

25.32. In many instances an element of unfair competition no doubt exists, but dealing with it poses problems. One method would be to bring to tax all income of all business activities. This would be inappropriate, however: it would cover, for example, the income of a public hospital conducted by a charity, when such a hospital is unlikely to be competing in any significant way with a private enterprise.

25.33. A second method would be to bring to tax income from business operations not carried on as part of the principal activities of the charity. On this basis, the public hospital income might escape but the income from a sheltered workshop manned by the physically handicapped, whose gainful employment is necessary for medical therapy, might not.

25.34. A third method would seek to tax income from activities competing with ordinary enterprises. Such a basis would be undesirable: the Commissioner would be required to rule on competition which might vary from one situation to another and over the course of time.

25.35. A fourth method would tax business income not applied for the main purposes of the institution. This method accords with the British law referred to in paragraph 25.15. It would tend to limit the business activities of charities generally.

25.36. Any method which brings to tax part of the income of a charity will involve difficulties, both for the charity and for the Commissioner, in segregating those items of expenditure to be allowed as deductions.

25.37. There is, however, a need for a close examination of the activities of charities to determine whether business income should continue to be exempt. If it appears that unfair competition with non-exempt persons results from exemption, specific measures should be introduced to qualify the exemption. These measures would limit the exemption to income from business activities directly related to the carrying out of the purpose for which the charity was established and which is the reason for its exemption.
from tax. There might be a proviso which would allow the exemption where the work in connection with the business is mainly carried out by the beneficiaries of the charity. If such measures are adopted, it will be necessary to qualify the exemption of investment income so that it does not extend to income received from another body in which the charity holds more than a specified interest; and it might also be necessary to deny a deduction to that body for gifts to the charity. Otherwise a company might be set up by the charity to conduct business activity and its profits escape tax because of interest payments to the charity or because of gifts made to the charity. There would not be any need to deny the exemption in relation to dividend income received from that company. The income from which that dividend will have been paid would have been taxed in the hands of the company. In any case to deny the exemption would bring about a discrimination between a trust for charitable purposes which would pay tax on its dividend income and a charity which is a company which would be entitled to a rebate of tax on dividends received.

V. Uniformity of Tax Treatment

25.38. There are differences between the categories of institutions accorded tax assistance under the various statutes referred to in this chapter. Appendix A sets out the funds, authorities and institutions, gifts to which are deductible under section 78 (1) (a) of the Income Tax Assessment Act. Section 23 (e) of the Act exempts the income of a religious, scientific, charitable or public educational institution from tax. Thus under this section religious bodies are put on the same footing as the institutions listed in section 78 (1) (a). Section 14 (d) of the Gift Duty Assessment Act, exempting from duty gifts to non-profit institutions, covers many bodies such as sporting and political associations which fall outside the scope of charities. Section 8 (5) of the Estate Duty Assessment Act, reproduced in part in Appendix B to this chapter, lists institutions and funds bequests to which are exempt from estate duty: they differ from those listed in section 78 (1) (a) of the Income Tax Assessment Act. Appendix C summarises the main features of the different statutes.

25.39. Complete uniformity of treatment would be difficult to achieve. The differences may reflect deliberate choices about the amount of subsidies it is thought proper that different charities should receive. One of the chief problems is that section 78 (1) (a) of the Income Tax Assessment Act does not include religious bodies. Another is that section 14 (d) of the Gift Duty Assessment Act, covering all non-profit organisations, exempts from duty gifts to political organisations and sporting bodies. The
Committee expresses no opinion on whether it is appropriate that an exemption as wide as that in the Gift Duty Assessment Act should be included in the other statutes dealing with charities, or whether it is appropriate that gifts to religious bodies should be deductible under section 78 (1) (a) of the Income Tax Assessment Act. It would, however, be convenient if a common list of organisations which it is thought should be entitled to all the concessions given to charities by the Income Tax Assessment Act, the Gift Duty Assessment Act and the Estate Duty Assessment Act were established and adopted by each of these Acts.

Chapter 25: Appendix A: Extract from Income Tax Assessment Act

78 (1). The following shall, subject to section 77B, sub-section (11) of section 77D and section 79C, be allowable deductions:—

(a) Gifts (not being testamentary gifts) of the value of Two dollars and upwards of money or of property other than money which was purchased by the taxpayer within twelve months immediately preceding the making of the gift, made by the taxpayer in the year of income to any of the following funds, authorities or institutions in Australia:—

(i) a public hospital, or a hospital which is carried on by a society or association otherwise than for the purposes of profit or gain to the individual members of that society or association;
(ii) a public benevolent institution;
(iii) a public fund established before 23rd October, 1963 and maintained for the purpose of providing money for hospitals or institutions specified in sub-paragraph (i) or (ii), or for the establishment of such hospitals or institutions, or a public fund established and maintained for the relief of persons in Australia who are in necessitous circumstances;
(iv) a public authority engaged in research into the causes, prevention or cure of disease in human beings, animals or plants, where the gift is for such research, or a public institution engaged solely in such research;
(v) a public university or a public fund for the establishment of a public university;
(vi) a residential educational institution affiliated under statutory provisions with a public university, or established by the Commonwealth;
(vii) a public fund established and maintained for providing money for the construction or maintenance of a public memorial relating to the war that commenced on 4th August, 1914 or to the war that commenced on 3rd September, 1939, being a fund that was established on or before 21st August, 1973;
(viii) a public institution or public fund established and maintained for the comfort, recreation or welfare of members of the armed forces of any part of His Majesty's dominions, or of any allied or other foreign force serving in association with His Majesty's armed forces;
(ix) the Commonwealth or a State, when made for purposes of defence;
(x) a university, college, institute, association or organization which is an approved research institute for the purposes of section 73A, where the gift is for purposes of scientific research as defined in that section;
(xi) the United Nations Appeal for Children [before 1 July 1963];
(xii) the Queen Elizabeth the Second Coronation Gift Fund;
(xiii) the Australia Elizabethan Theatre Trust;
(xiv) the Australian Academy of Science;
(xv) a public fund established and maintained exclusively for providing money for the acquisition, construction or maintenance of a building used or to be used as a school or college by a government or public authority or by a society or association which is carried on otherwise than for the purposes of profit or gain to the individual members of that society or association;
(xvi) the Duke of Edinburgh's Study Conference Account maintained by the Department of Labour and National Service;
(xvii) the Australian and New Zealand Association for the Advancement of Science;
(xviii) the Australian Administrative Staff College;
(xix) the Commonwealth, when made for the purposes of research in the Australian Antarctic Territory;
(xx) the Royal Australasian College of Surgeons;
(xxi) the Royal Australasian College of Physicians;
(xxii) the Australian Regional Council of the Royal College of Obstetricians and Gynaecologists;
(xxiii) the New South Wales College of Nursing;
(xxiv) the College of Nursing, Australia;
(xxv) the Council for Christian Education in Schools;
(xxvi) the National Trust of Australia (New South Wales), the National Trust of Australia (Victoria), The National Trust of Queensland, The National Trust of South Australia, The National Trust of Australia (W.A.), the National Trust of Australia (Tasmania), the Northern Territory National Trust and the Australian Council of National Trusts;
(xxvii) a public library, public museum or public art gallery, or an institution consisting of a public library, public museum and public art gallery or of any two of them;
(xxviii) the Sydney Opera House Appeal Fund;
(xxix) the Sidney Myer Music Bowl Trust;
(XXX) the Industrial Design Council of Australia;
(XXXI) a public fund established and maintained exclusively for the purpose of providing money to be used in furnishing persons in Australia with marriage guidance through a voluntary organization or through a branch or section of such an organization, being an organization, branch or section that the Attorney-General, upon being satisfied that the organization,
branch, or section is willing and able to engage in marriage guidance and that marriage guidance constitutes or will constitute the whole or the major part of its activities, has approved in writing for the purposes of this sub-paragraph;

(xxxii) the Australian National Committee for World Refugee Year [before 1 July 1963];

(xxxiii) the Council for Jewish Education in Schools;

(xxxiv) the Art Gallery Society of New South Wales;

(xxxv) the Productivity Promotion Council of Australia;

(xxxvi) the Australian Postgraduate Federation in Medicine, the College of Radiologists of Australasia, the Australian College of General Practitioners and the College of Pathologists of Australia, where the gift is for the purpose of education or research in medical knowledge or science;

(xxxvii) the Ian Clunies Ross Memorial Foundation;

(xxxviii) the Australian National Committee for the Freedom from Hunger Campaign [before 1 July 1964];

(xxxix) the Australian Institute of International Affairs;

(xl) the Australian National Travel Association;

(xli) the National Safety Council of Australia;

(xlii) the Winston Churchill Memorial Trust;

(xliii) a prescribed institution of advanced education, where the gift is for certified purposes of the institution or for the provision of certified facilities for the institution;

(xlv) the Australian Conservation Foundation Incorporated . . . ‘.

Chapter 25: Appendix B: Extract from Estate Duty Assessment Act

8.–(5) Duty shall not be assessed or payable upon so much of the estate as is devised or bequeathed or passes by gift inter vivos or settlement—

(a) for religious, scientific or public educational purposes in Australia;

(b) to or for the benefit of any of the following institutions in Australia:—

(i) a public hospital;

(ii) a hospital which is carried on by a society or association otherwise than for the purposes of profit or gain to the individual members of that society or association;

(iii) a public benevolent institution;

(iv) a public library;

(v) the Australian Council for Educational Research;

(vi) The National Trust of Australia (New South Wales), National Trust of Australia (Victoria), The National Trust of Queensland, The National Trust of South Australia, The National Trust of Australia (W.A.), National Trust
of Australia (Tasmania) or Australian Council of National Trusts; or
(vii) the Winston Churchill Memorial Trust; or

(c) for the establishment and maintenance of a Fund, or to a fund established and maintained:—

(i) for the purpose of providing money for the benefit of an institution referred to in the last preceding paragraph; or
(ii) for the purpose of providing money for the relief of persons in necessitous circumstances in Australia.

Chapter 25: Appendix C: Tax Treatment of Charities

<table>
<thead>
<tr>
<th>Income tax (a)</th>
<th>Gift duty (b)</th>
<th>Estate duty (c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>2.</td>
<td>3.</td>
</tr>
<tr>
<td>ITAA 78 (1) (a) 9</td>
<td>ITAA 23 (e)</td>
<td>GDAA 14 (d)</td>
</tr>
<tr>
<td>Contributions to listed bodies deductible</td>
<td>Duty on lifetime gifts to Duty on bequests to</td>
<td>bodies exempt from bodies exempt as under:</td>
</tr>
<tr>
<td>from income</td>
<td>tax, viz:</td>
<td>listed bodies exempt</td>
</tr>
</tbody>
</table>

Categories listed: e.g. public hospitals; ‘non-profit’ hospitals; public benefit institutions; charitable and public educational institutions in necessitous circumstances; public fund for relief of persons in Australia; religious, scientific and educational institutions; public university; public library, museum or art gallery

Individual bodies listed: e.g. Australian Elizabethan Theatre Trust; Sydney Opera House Appeal; Industrial Design Council; Australian National Travel Association

Note: Religious bodies not listed

Note: This section has
(a) Income Tax Assessment Act (ITAA)  
(b) Gift Duty Assessment Act (GDAA)  

(c) Estate Duty Assessment Act (EDAA)
Chapter 26 Wealth Tax

26.1. A wealth (or net worth) tax is usually regarded as an annual tax on net wealth (i.e. the total value of assets minus liabilities). It differs from a land tax and local property rates in being levied by reference to a taxpayer's total net wealth rather than by reference to his holdings of particular classes of assets.

26.2. The Committee has received a number of submissions about the possibility of a wealth tax for Australia. In some, the tax is not recommended—indeed is strongly criticised; in others, it is favoured on various grounds. Advocates of a negative income tax often suggest the need for wealth to be assessed in the determination of eligibility (as already occurs, with respect to some portion of wealth, in the means-testing of social service benefits). It is therefore a tax that deserves and has received serious consideration by the Committee even though, as foreshadowed in the previous chapter, the Committee does not propose recommending its introduction.

I. Overseas Experience

26.3. Fourteen countries are known to have a wealth tax at the present time. Nine of these are in Europe (Sweden, Norway, West Germany, Austria, Finland, the Netherlands, Denmark, Switzerland and Luxembourg), and the remaining five in Asia and South America (India, Pakistan, Sri Lanka, Colombia and Uruguay). Japan, which introduced a wealth tax in 1950, abolished it three years later. A wealth tax has not been imposed in Canada, the United Kingdom, New Zealand or the United States. In Canada, the Carter Commission considered the tax but rejected its introduction because of the major problems inherent in it. A recent Green Paper has proposed a wealth tax for the United Kingdom. One has been proposed too in Ireland but is meeting with opposition. In the meanwhile, however, the European experience may serve as a background although the tax in its application is by no means uniform in the various countries.

26.4. The aggregate net wealth of the husband and wife (and sometimes of dependent children too), rather than that of the individual, is adopted by all European countries as the basis of the tax, which is imposed on both residents and non-residents. Residents are generally taxed on all their property whether at home or abroad; non-residents are subject to tax only on property situated in the taxing country. In addition, West Germany,
Switzerland, Austria, Norway and Luxembourg impose a tax on all corporations, while Sweden and Finland impose one confined to non-resident companies.

26.5. A comprehensive net wealth tax would in principle be imposed on all wealth irrespective of whether it consisted of savings from taxed income or obtained from any other sources. It would be assessed on assets net of liabilities. Taxable assets would include all real property such as land and buildings, and all personal property such as jewellery, motor vehicles, annuities, bonds, shares, cash, bank deposits, mortgages, goodwill, etc. Common exclusions in practice, however, are household effects, life insurance policies and/or pension rights, and works of art, while a number of other exemptions are provided in each of the individual countries, mainly for administrative reasons.

26.6. Apart from these specific exemptions from the tax base, a general statutory exemption of wealth frees from tax those persons or businesses below a certain total property value. Except in the case of Denmark, additional personal concessions are also allowed for dependents and/or elderly persons and invalids.

26.7. Rates of tax are low, typically in the 0.5–2.0 per cent range. In five countries the tax is proportional, in the other four progressive. There are special provisions in nearly all countries designed to ensure that the combined burden of income tax and wealth tax does not exceed a certain ceiling of income. These vary greatly. For instance, the total of the two taxes is subject to a ceiling of 70 per cent in Denmark, 80 per cent in the Netherlands and Norway, and 85 per cent in Sweden. In West Germany, the wealth tax has been allowed as a deduction from taxable income, so that the total tax cannot exceed the income from capital unless the taxable yield of capital is itself less than the rate of wealth tax. Denmark applies a reduction in the percentage if income from wealth is low. Switzerland uses a similar but more complicated sliding scale.

26.8. With the exception of Luxembourg and Switzerland, which raise considerable sums from the wealth tax on companies, revenue from wealth tax represents a very small proportion of total tax collections, ranging from 0.5 per cent in Finland and Denmark to 1.7 per cent in West Germany. The yields in Luxembourg (3.1 per cent) and Switzerland (5.4 per cent) are somewhat higher, but still rather modest as a contribution to overall revenue.

26.9. The extent of reliance on other capital taxes varies considerably, but it is significant that in Norway and Sweden no capital gains tax is imposed on assets held for more than five years; similarly, West Germany has no long-term capital gains tax.
II. Appraisal

26.10. In all appearance wealth tax is a broad-based levy upon capital. There is a case for having such a levy upon capital in a progressive tax system as a supplement to the taxation of current income, chiefly because it provides a convenient mode of indirectly taxing ‘imputed’ incomes and because it may put a brake on the accumulation of excessive personal fortunes.

26.11. The Committee agrees that the Australian taxation system should contain a method by which capital is taxed. The question is then whether capital taxation should take the form of an integrated estate and gift duty and a capital gains tax (both of which are being recommended by the Committee) or an annual wealth tax or some combination of these taxes.

26.12. As regards the objective of limiting the excessive accumulations of personal wealth, it is important to note one feature of existing wealth taxes. In all the European countries in which they have been in operation their rates have been set so low that, it has been stated, ‘the net wealth tax is really intended to tax the annual yield of capital rather than the principal itself as do death duties or a capital levy’. Thus despite their form they are in practice no more than additional income taxes, as is made especially clear when ceilings are placed in terms of a fraction of income on the combined total of the two taxes.

26.13. For a wealth tax to have a significant effect in breaking up large estates in the lifetimes of their owners it would have to be at far higher levels than any adopted overseas. Even if this were administratively practicable (which for reasons discussed later is much to be doubted), the effects upon incentives to work and save, not only among those already in the high wealth brackets but among those who are still seeking to achieve wealth, would be extremely serious. The Committee believes that the taxation of wealth at death has much less disincentive effect than taxation during life.

26.14. It is often argued that, from the point of view of economic efficiency, the tax is a way of improving the structure of community asset holdings. Property owners, so the argument runs, have a stronger inducement than under an income tax and estate duty to shift from assets yielding little or no money return—cash balances, idle land, works of art and the like—to assets with a greater money yield. However, this contention is subject to considerable qualifications. Firstly, the tax would tend to deter both the investment of capital in new enterprises, large and small, from which no immediate return or only an inadequate return can be expected for some indeterminate period and also the injection of fresh
capital into existing enterprises which, though on past performance not showing an adequate return, have the possibility of future profitable operation. Secondly, the inducement provided by the tax to turn to high-yielding investment is one that cannot be said to be a sound stimulus except for those who are skilled in the management of monetary affairs for it is probably a general rule that a high return reflects the element of risk of loss of the investment. Thirdly, the trustees of deceased estates and inter vivos trusts in many cases have not the liberty to shift the trust capital into any form of investment they choose: because of the desirability of ensuring security for widows, infant children, the elderly and the incapacitated, they are restricted by the provisions of the trust instrument to investments which, owing to their low risk rating, usually return a low yield. Even where the range of investment is unrestricted, trustees may be open to attack by their beneficiaries under the general law if they incur losses in jettisoning security for the prospect of high income returns. The same type of situation confronts those who have the management of superannuation funds; and there are other categories, such as retired persons, who depend upon the safety of a regular income from low-yielding assets rather than run the risks which are usually inherent in high-yielding investments.

26.15. One argument used for preferring a wealth tax to estate and gift duty, or for having one as a mere supplement to the latter, is that it provides a check against the evasion of income tax. It does not seem to the Committee to be cogent. Without all the complications of actually taxing assets, it is open to the authorities to require a list of assets to be included with an income tax return if this were thought helpful in checking the return. But it is doubtful whether in practice it would be of much assistance. The hardened tax-dodger would find it as easy to conceal assets as income, or indeed easier, and the honest taxpayer might well feel it to be an intolerable intrusion of his privacy.

26.16. Though the arguments just used for preferring an estate and gift duty to a wealth tax on grounds of equity and economic efficiency may perhaps be disputed, there can in the Committee's view be no doubt where the balance lies when the two varieties of capital tax are compared in terms of administrative simplicity and compliance costs. In these respects, the Committee's view is decisively against a wealth tax and in favour of relying on an integrated estate and gift duty coupled with a capital gains tax to achieve the purposes of capital taxation.

26.17. Whatever be the complexities of an integrated estate and gift duty, the administrative difficulties and compliance costs of wealth tax, if the experience of overseas countries is any guide, are likely to be substantially greater, particularly because the tax must be assessed on an annual
It is true that a gift duty may have to be paid from time to time by the same taxpayer, but estate duty is paid once and for all and on an occasion when estates must in most cases be valued for the purposes of their own administration. A capital gains tax is paid whenever a gain is realised on the disposal of an asset.

26.18. The administrative problems would be especially acute if considerations of equity and economic efficiency were paramount since, among other things, that would entail the identification and consistent valuation of all forms of wealth which may be subject to the tax and, if the tax were a progressive one, a definition of the taxpaying unit that minimises scope for tax avoidance by, for example, wealth splitting. Certain kinds of assets, such as cash, paintings, antiques and jewellery, would be difficult for tax administrators to track down.

26.19. The greatest administrative difficulties lie in the annual valuation of assets, and in times of inflation these difficulties are compounded. In principle, valuation should accord with the fair market value of assets, that is to say, the price assets would fetch if sold in the market at the time of assessment. Valuation of liquid assets such as cash balances, listed shares and debentures would not be difficult but other more illiquid assets such as real estate, farms, shares in private companies, works of art, antique furniture and stamp and coin collections, about which there may be wide differences of opinion as to value, would present major problems both with regard to assessing fair market values and revaluing these assets annually. These latter valuations would be required if an annual wealth tax were to be levied on an equitable basis as between the owners of wealth held in liquid and illiquid forms. Such valuation of land as exists in Australia is not on a uniform basis and would rarely be suitable for wealth tax purposes. Characteristically, some countries use values determined only periodically or by some special valuation procedures in dealing with real estate. In West Germany, for example, land values (apart from farmlands) were assessed, up to 1973, on values prevailing in 1935; they are now based on a method that produces a figure estimated to be only about 35 per cent of current market value. In the Netherlands, the method of valuation produces a figure of about 40 per cent of current market value.

26.20. Farmland in European countries imposing wealth tax tends to be valued well below its market price. Even in Norway, where the wealth tax hits farmland hardest, the land is valued by boards manned by both tax officials and locally-elected members of the community to ensure that few farms are assessed at even two-thirds their market value. In Sweden agricultural land is assessed at three-quarters of the market value based on the statistical average of free market prices in the two years before the
assessment. In the Netherlands land is separately assessed in discussion between the taxation authorities and organisations representing owners and farmers and always at a large discount on real values so that the tax can be paid out of the profits of the land; and there are exemptions for farms operating at a loss. Forestry land is assessed in most countries at about half its true market value despite large increases in timber values in recent years. In addition to farmland, associated assets tend to be brought to tax well below market price. In Denmark, for example, livestock is valued at approximately half its market price and farm machinery at its book value.

26.21. The administrative complexities of the tax can thus produce substantial inequities and non-neutralities in its operation. This can be illustrated by reference to Swedish experience. There, those holding wealth in the form of bank balances, quoted stocks and shares, and cash pay on the full market value of their wealth. Wealth held in certain other forms, however, is generally not taxed at its full value. For instance, the value of real property is invariably below market value because the assessment board's valuation is deliberately cautious as prices may fall between assessment dates, while in practice inflation has widened the gap between assessed and fair market value over the five-year period between assessments. Similarly, personal chattels are taken at the taxpayer's valuation which is rarely challenged by the authorities, although it is realised that these assets (when declared at all) are generally included in the taxpayer's return at a nominal rather than a true value. Unquoted shares receive yet another treatment. Where, for example, such shares are held in a private company with a small number of shareholders, valuation is based on the tangible assets with no attempt to include goodwill or other intangibles. This procedure generally results in undervaluation. Where the number of shareholders is large, the method used is to multiply the dividends of the company by the reciprocal of the average dividend yield of listed companies in the same industry, with a very small reduction then being made for the lower price at which unlisted shares normally sell compared with listed ones. The results of this valuation process are necessarily arbitrary. One Swedish study has concluded that valuations of unquoted shares for wealth tax purposes are generally substantially below the realised values on sales of such shares that have taken place within a short period of the time of assessment.

26.22. It would be unrealistic to imagine that inequities and non-neutralities such as these could be avoided in Australia. Particularly because of the large rural sector, more wealth is probably held in an illiquid form in Australia than is the case elsewhere.

26.23. From the point of view of the implementation of the wealth tax
there are difficulties in the case of both inter vivos trusts and trusts created for the administration of deceased estates. Problems in the valuation of the trust assets will arise where the trust estate or some part thereof is held for a life tenant and remaindermen. To cast the whole of the liability for the annual payment of the tax on the life tenant seems clearly unjust and in many cases will be impractical. The difficulty is to arrive at some fair allocation of that liability between the life tenant and remaindermen when the time of death of the life tenant is uncertain and, as frequently occurs, the identity of the remaindermen ultimately entitled to the capital may not be known until that death occurs. Even where the identity of the remaindermen can be established the question will arise as to the source of the income with which to meet the tax; as infants are those who are so constantly entitled in remainder, this is a serious obstacle to overcome. There are various other problems for a wealth tax in the area of trusts but enough has been said to indicate that its application to trusts would require compromise and arbitrary rules which would add to the complexities, inequities and non-neutralities already referred to.

26.24. As has been repeatedly emphasised, the effective discussion of taxation policy in this country is hampered at every turn by the lack of reliable data about the distribution of income and wealth. Without information about the latter, neither the effect of the widened estate duty base nor what a wealth tax could produce can be at all accurately estimated. For these and many other purposes a merely statistical inquiry into the distribution of wealth, quite divorced from any immediate tax liability for those providing data, would be valuable. A sample investigation (supplementary to the new investigations of expenditure) should in the Committee's view be considered as a first step. Apart from the statistical information it would yield, the collection process itself would clarify some of the problems of the definition and valuation that a wealth tax would face were its introduction ever to be re-examined at some future date.

III. Conclusion

26.25. Rather than a net wealth tax, the Committee concludes that it is better to concentrate on improving the estate and gift duty and to introduce a capital gains tax as these taxes can achieve broadly the same objectives as a wealth tax. In its view:

(a) an estate and gift duty can be made to serve the equity purposes of a capital tax
more efficiently than a wealth tax.
(b) A reformed gift and estate duty would have substantially less adverse effects upon incentives to work and save, fewer liquidity problems, and a less disturbing effect upon investment patterns than a wealth tax.
(c) Above all, an efficient annual levy upon wealth would involve administrative problems of insuperable difficulty and be extremely costly to collect.
Chapter 27 Taxation of Goods and Services

27.1. The discussion of broad principles in Chapters 3–5 reached the general conclusion that the taxation system should place greater reliance on taxes on goods and services by the inclusion of a broad-based tax. In this chapter the Committee looks at these levies in some detail.

27.2. Section I examines the existing excise duties and sales taxes and comes to the conclusion that excises have an eventual role of a limited kind. The rates at which they are imposed should be related to specific purposes which justify their retention and which would need to be evaluated following analysis not presently available to the Committee. In Section II, various kinds of broad-based taxes are discussed and a value-added tax covering a wide range of goods and services is recommended. Section III describes the transitional problems accompanying the introduction of this tax.

I. Existing Taxes on Goods and Services

27.3. The present structure of taxes on goods and services rests on two main taxes: the wholesale sales tax, which is a single-stage tax designed substantially to fall on sales to retailers by manufacturers and wholesalers; and excise duties, including the equivalent component of customs duties levied on imported commodities subject to excise duty when home produced. These are important taxes, excises accounting in 1973–74 for over $1,555 million (14.2 per cent) and sales tax for $969 million (8.9 per cent) of the Australian Government's tax revenue of $10,938 million.

27.4. Excise duties are levied at a rate per unit of quantity, not on an *ad valorem* basis. The total amount raised therefore depends on the rate of levy and the volume of production, not on price. Ninety-eight per cent of all revenue raised from excises is derived from six products: beer, potable spirits, tobacco, cigars and cigarettes, diesel fuel and petrol. Commodities in these groups bear a heavy weight of tax as is shown by the figures in Table 27.A. In addition 1970–71 total expenditure on tobacco products estimated at $547 million had a tax content of $285 million and total expenditure on alcoholic drinks of $1,306 million a tax content of $436 million.

27.5. The wholesale sales tax is imposed on an *ad valorem* basis, so that, conveniently in a time of inflation, the revenue yield adjusts automatically to changing prices. The share of the wholesale sales tax in total revenue has declined since 1953–54, largely because of the rapid rise in collections...
of personal income tax, and partly because of continual narrowing of the sales tax base. In the last twenty years, exemptions and reclassification of goods to lower rated categories have significantly reduced the base on which the wholesale sales tax rests.

27.6. The wholesale sales tax structure, described and evaluated at greater length in Appendix A to this chapter, is designed so that all goods produced in, or imported into, Australia bear the tax at the general rate, currently 15 per cent, unless they are specifically exempted from it or required to bear tax at a rate different from the general rate. Exemptions and classifications of goods bearing different rates are shown in four schedules to the sales tax legislation:

TABLE 27.A: TAXES ON GOODS AND SERVICES, BY CATEGORIES OF EXPENDITURE AND ESTIMATED SPLIT BETWEEN EXCISE DUTY AND SALES TAX, 1970–71

<table>
<thead>
<tr>
<th>Category</th>
<th>Expenditure $ million</th>
<th>Excise duty (b) $ million</th>
<th>Sales tax $ million</th>
<th>Percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal consumption expenditure (a)—</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food</td>
<td>3,850</td>
<td>21</td>
<td>21</td>
<td>1.2</td>
</tr>
<tr>
<td>Tobacco</td>
<td>547</td>
<td>285</td>
<td>285</td>
<td>16.4</td>
</tr>
<tr>
<td>Alcoholic drinks</td>
<td>1,306</td>
<td>436</td>
<td>(c) 27</td>
<td>26.7</td>
</tr>
<tr>
<td>Clothing, footwear</td>
<td>1,790</td>
<td>1</td>
<td>1</td>
<td>0.1</td>
</tr>
<tr>
<td>Chemists’ goods</td>
<td>564</td>
<td>26</td>
<td>26</td>
<td>1.5</td>
</tr>
<tr>
<td>Electrical goods</td>
<td>559</td>
<td>44</td>
<td>44</td>
<td>2.5</td>
</tr>
<tr>
<td>Furniture, carpets etc.</td>
<td>478</td>
<td>9</td>
<td>9</td>
<td>0.5</td>
</tr>
<tr>
<td>Hardware</td>
<td>390</td>
<td>30</td>
<td>30</td>
<td>1.7</td>
</tr>
<tr>
<td>Newspapers, books</td>
<td>331</td>
<td>6</td>
<td>6</td>
<td>0.4</td>
</tr>
<tr>
<td>Toys, sporting and travel goods</td>
<td>530</td>
<td>57</td>
<td>57</td>
<td>3.3</td>
</tr>
<tr>
<td>Operation of motor vehicles</td>
<td>1,009</td>
<td>62</td>
<td>74</td>
<td>136</td>
</tr>
<tr>
<td>Purchase of motor vehicles</td>
<td>1,025</td>
<td>124</td>
<td>124</td>
<td>7.2</td>
</tr>
<tr>
<td>Other personal consumption services</td>
<td>7,076</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19,455</td>
<td>783</td>
<td>419</td>
<td>1,202</td>
<td>69.3</td>
</tr>
<tr>
<td>Business and capital expenditure</td>
<td>n.a.</td>
<td>319</td>
<td>(d) 214</td>
<td>533</td>
</tr>
<tr>
<td>Total</td>
<td>n.a.</td>
<td>1,102</td>
<td>633</td>
<td>1,735</td>
</tr>
</tbody>
</table>

(a) At retail prices. (b) Including excise component
of customs. (c) Imposed on spirits and imported wines. (d) Includes $ 126 million sales tax on commercial vehicles.

**Note:** The figures for 1970–71 are used in this table, and more generally throughout the present chapter, because a similar breakdown of revenue for these taxes is not available for later years. Revised expenditure figures are now to hand for 1970–71; but as the tax estimates (which it has not been possible to revise) are based on the original expenditure data, the latter have been retained for the sake of comparability.

**Source:** Australian Bureau of Statistics publications; *Commonwealth Taxation of Goods and Services*. Treasury Taxation Paper No. 5 (Canberra, October 1974).

the First lists items that are exempt, including virtually all food and clothing; the Second lists certain consumer durables such as television sets, record players and other items such as jewellery, cosmetics and furs: the rate on items in this schedule is 271/2 per cent;
the Third lists furniture and household equipment which items bear tax at 21/2 per cent;
the Fifth, there being currently no Fourth, lists motor cars designed principally for
the transport of persons, on which the rate is 271/2 per cent.

27.7. A general picture of the impact of the two taxes is given in Table 27.A which shows the tax imposed on various categories of goods falling
within the ambit of personal consumption expenditure. The message of the
table is clear. Motor vehicles and parts, together with the main excise
items, yield about 80 per cent of the total paid by persons, while
representing only 16 per cent of net personal consumption expenditure.
The remaining 20 per cent comes chiefly from categories like chemists’
goods, electrical goods, hardware and toys and travel goods which
represent a further 10 per cent of net personal consumption expenditure.
Sixty per cent of personal consumption expenditure, including virtually all
that on food, clothing and services, is not directly subject to tax.

27.8. Most countries levy an extra burden of tax on those commodities
that produce the bulk of the revenue from excise and sales taxes in
Australia: alcoholic beverages, tobacco products and petrol. A case for
differential treatment of these goods is widely admitted. The first two have
been taxed for centuries in Europe. There have been relatively few
submissions to the Committee criticising them. They excite less
antagonism among the taxpaying public than most other taxes. To some
extent this may be attributable to their relative invisibility and taxpayer
ignorance of their magnitude.

27.9. In 1971, among OECD countries, the excises imposed on alcohol,
tobacco and petrol, at all levels of government, produced percentages of
total tax revenue varying from about 9 per cent in Austria, Belgium and the
United States, up to 17 per cent in the United Kingdom and 30 per cent in
Ireland. Australia’s figure of 13 per cent puts it in the middle of the list,
being in the upper half as far as the excises on tobacco and alcohol are
concerned and near the bottom in the case of petrol.

27.10. Excises excel in administrative simplicity and ease of
enforcement. They are currently the least expensive to collect and
administer, per dollar of revenue collected, of all the taxes in the Australian
armoury. There is much less simplicity in the wholesale sales tax, and the
Committee has received a number of submissions about points of
administration to which further reference is made in Appendix A. But even
with the variety of rates it embodies, it appears to operate smoothly.

27.11. Though they bear such a large share of the load, excises are, by
contrast with their simplicity, among the most inequitable and non-neutral
of taxes presently levied. If, as is generally agreed, the demand for
products subject to excise is relatively insensitive to price changes, the tax will fall predominantly on their consumers: to assess their impact, it is sufficient to look at the consumption pattern of those goods. Some complications are however unavoidable. Petroleum products, raising about one-third of total excise revenue, are consumed directly and also affect the cost of production and distribution of many other consumption goods. Thus the excise on petrol is borne partly by consumers of goods which use petrol as an input, and the total incidence of the tax will reflect the consumption pattern of these goods, as well as that of petrol itself. In this sense, the petrol excise is partly reflected in higher food prices, higher prices of travel and so on.

27.12. Information is not available about the consumption patterns of individual commodities subject to excise duties. However, the 1966–68 Macquarie survey referred to in Chapter 4 throws some light on the subject. In lower income groups, at the time of the survey, the excises on tobacco and alcoholic drinks amounted to over 4 per cent of income, a figure which declined to less than 2 per cent in higher income groups. Similarly the taxes on motor vehicle operation declined from about 0.8 per cent of low incomes to about 0.25 per cent of high incomes. The conclusion is inescapable that excise duties are regressive, falling more severely on lower than on higher incomes.

27.13. The greater part of sales tax is levied, as Table 27.A shows, upon goods concerned with motoring and thus far shares the inequity and non-neutrality just ascribed to the excise on petrol. The remaining sales tax is scattered in small packets over other categories of consumption expenditure and constitutes a small but uneven levy upon them, too modest to deserve much consideration. Outside the area of motoring, drink and tobacco, taxes on goods and services at the Federal level can be dismissed as a trivial relic.

27.14. It will be seen later that the Committee does not regard the existing excises and wholesale sales tax as a foundation upon which the broad-based taxation of consumption goods and services can be erected. But it does consider special taxation of motoring and drinking, and, with less conviction, smoking, to be fully justifiable as deliberate non-neutrality in the tax system, designed for specific purposes of intervention. This is a field for what have been called ‘efficiency taxes’ in Chapter 3.

27.15. There is an overwhelming case in principle for the taxation of motoring, whether by levies on petrol or on vehicles or by registration fees or some combination of all three, on the grounds of charging for the use of roads (a most expensive publicly-provided facility), for their policing, for
limiting congestion and accidents (which cost the community great sums), and as an anti-pollution measure. But the form and the scale of such taxation must be considered in relation to its adequacy and its efficiency for these specific ends, and not simply as a matter of revenue-raising. This is an area in which some calculations can be made with reasonable accuracy and others (such as valuations of the cost of accidents and pollution) in only very arbitrary fashion. Nor would it be easy to suggest the right distribution of charges. The Committee has not explored this difficult area in detail, and does not consider itself qualified to undertake the task. But it recommends that decisions involving any great change in existing revenue from motoring should be made in the light of such special studies.

27.16. Similar considerations apply to the taxation of alcoholic drinks. It cannot be doubted that drinking imposes substantial costs upon the community as a whole in terms of health, road toll, crime and disturbance of the peace. But again the form and level of imposts designed to meet their costs, or to prevent some of them arising, are most difficult matters to decide, and the Committee has no specific recommendation to make other than that expert studies are desirable before any substantial change is introduced.

27.17. The costs to the community of tobacco consumption are as hard to assess as those of motoring and alcohol. From such surveys as have been made, however, it is clear that a substantial amount of ill health and consequent absenteeism is due to smoking. Quantification of costs awaits further studies outside the Committee's scope, and any large variation in the volume and method of tobacco taxation should be decided on the basis of these studies.

27.18. The Committee therefore recommends that special taxation should continue in these three areas; but that its eventual form and level should be reviewed in the light of the specific purposes it serves. If a broad-based consumption tax, on the lines to be next discussed, is introduced, it would of course be necessary to take account of the level of that tax on these activities. Steps that might be taken are outlined in paragraph 27.40.

II. Broad-Based Taxes

27.19. In considering a broad-based consumption tax it is as well to start with a reminder of how personal consumption expenditure is divided between various categories of goods and services. As the figures in Table 27. A show, out of the total in 1970–71 of some $19,500 million, about $7,100 million was spent on services; of the remining $12,400 million,
excisable goods together with motor vehicles and their operation accounted for about $3,900 million. If these goods are thought to be sufficiently taxed, there remain various retail categories of which the most important are food ($3,850 million) and clothing ($1,790 million). Broadening the base of the tax compels us to face the problem of including food and clothing.

27.20. As these figures indicate, the exemption of food and clothing would significantly reduce the base, with a consequent loss to revenue. Furthermore, if the tax is to have as wide a coverage as possible, exemptions must be kept to a minimum: once they are allowed, a precedent is set and pressures will develop to apply them on a wider scale. To keep all goods in the base and to apply a uniform rate are aims not to be relinquished.

27.21. While the taxing of food has raised much debate in the past, its acceptability has gradually increased. European countries in the main levy taxes on food and clothing, sometimes at concessional rates but not uncommonly at a standard rate applying to most other goods. The majority of American States tax food uniformly at the retail level. Where, as in Australia, food has not been taxed, problems of classification are unavoidable when items such as nuts and confections, vitamin tablets and dietary foods are being considered. Exemption of food causes difficulty in retail outlets, especially in those providing meals on and off the premises, for the provision of restaurant meals rarely fails to attract tax. Food exemption is also discriminatory in favour of those families who spend a high proportion of their incomes on such foods as are in no sense necessary for a reasonable living standard. The same arguments apply to clothing. The Committee therefore recommends that food and clothing be taxed at the uniform rate.

27.22. Apart from tangible commodities, personal consumption expenditure has a large services component. The composition of this component is shown in Table 27.B. It covers medical and hospital expenses, rent (including an imputed figure for owner-occupiers), gas and electric power, fares, postal services, education, life insurance, entertainment, and other services such as hairdressing, restaurant meals and hotel accommodation. If tangible goods are taxed, services connected with such goods should logically be taxed also. If services are taxed, it would again be desirable that the base be as broad as possible, though some items would undoubtedly need to be excluded.

**TABLE 27.B: ESTIMATED PERSONAL EXPENDITURE ON SERVICES AT RETAIL LEVEL, 1970–71**
27.23. In considering any individual tax, account must be taken of its place in the tax structure as a whole. If a broad-based tax covering food and clothing introduces an element of regressivity, that element can be counterbalanced by increasing the progressivity of other taxes in the system. The Committee is satisfied that, either by special measures by way of transfer payments or by other more progressive taxes, or by a combination of both, the progressivity of the structure as a whole can be maintained or adjusted to the required degree.

27.24. Given that the tax is to be as broadly based as possible, there are four forms which it might take. These are:

(a) turnover tax
(b) wholesale sales tax
(c) retail sales tax
(d) value-added tax.

27.25. The arguments against taxes on turnover throughout the whole range of manufacturing and distribution are strong. A turnover tax is not neutral because it falls differently on different products according to the number of steps in their manufacture. A commodity that has only one stage in its manufacture will bear the tax once, while another that has two stages

<table>
<thead>
<tr>
<th>$ million</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical, hospital and funeral expenses</td>
<td>810</td>
</tr>
<tr>
<td>Imputed rent of owner-occupiers</td>
<td>1,810</td>
</tr>
<tr>
<td>Other rent</td>
<td>734</td>
</tr>
<tr>
<td>Gas, electricity, fuel</td>
<td>485</td>
</tr>
<tr>
<td>Rail, tram and bus fares</td>
<td>245</td>
</tr>
<tr>
<td>Other fares</td>
<td>410</td>
</tr>
<tr>
<td>Postal and telephone services</td>
<td>203</td>
</tr>
<tr>
<td>Education</td>
<td>173</td>
</tr>
<tr>
<td>Life insurance</td>
<td>161</td>
</tr>
<tr>
<td>Entertainment</td>
<td>310</td>
</tr>
<tr>
<td>Other services</td>
<td>(a) 1,735</td>
</tr>
<tr>
<td>Total</td>
<td>7,076</td>
</tr>
</tbody>
</table>

(a) Includes net overseas expenditure of $14 million.

*Source: Australian Bureau of Statistics publications.*
will pay tax at both stages: at the second stage tax will be levied on a total value including the tax levied at the earlier stage. The final weight of tax thus varies greatly from commodity to commodity. The tax has been replaced in most countries where it was once levied.

27.26. A new broad-based wholesale sales tax merits serious consideration. Unlike the turnover tax, tax is levied only once in the total production-distribution process, and the tax on tax problem and the associated incentives towards vertical integration are minimal. One primary virtue, which would be shared by a manufacturers sales tax, is that the number of firms legally obliged to collect the tax is smaller than under a retail sales tax, and these firms are in most cases better equipped administratively to handle the tax commitment. It has been argued that Australia has extensive experience of the operation of wholesale sales tax, and good reasons are needed to change it.

27.27. The disadvantages of levying a broad-based tax at the wholesale level are twofold. The more serious is that because a wholesale sales tax explicitly excludes the value added at the retail stage it will both encourage a relocation of activity to the retail level where it will escape tax, and also discriminate between goods according to whether a large or small proportion of their value is added at the retail level. The importance to be placed on this problem depends very much on the rate at which the broad-based tax is imposed. If the tax is to be levied at a rate high enough to permit a significant change eventually in the tax mix towards taxing goods and services, then the issue is important enough to provide a case against the wholesale sales tax.

27.28. A second somewhat related disadvantage is that a number of goods and services do not have a wholesale value in any market sense. This is especially true of services. If services are to be treated in the same way as goods traded at the wholesale level, some wholesale value must be imputed to them. To do this would involve arbitrary judgment and considerable administrative difficulty. A tax on services would have to be levied at the retail stage and the rate should be lower than the wholesale sales tax rate to preserve neutrality between the two.

27.29. A broad-based tax on tangible goods at the wholesale level does not fit comfortably with a tax on services at the retail level and, on the face of it, an improvement might lie in also levying retail sales tax on goods. While it is assumed that any sales tax ultimately comes to rest on the member of the public consuming the taxed good or service, a tax confined to the retail level raises administrative and compliance problems not found when a tax operates only at an earlier stage: the number of taxpayers increases and small traders unused to making returns are required to do so.
27.30. For revenue purposes, a tax at the retail stage is to be preferred to one that stops short of it as retail margins increase the base. Single-stage retail taxes are by no means uncommon and are the most significant source of State tax revenue in the United States. The system is usually based on the registration of all traders selling at retail, together with the licensing of businesses that buy goods for business use or resale so that the retailer has to keep separate records of sales to licensed buyers. The system is open to evasion: the licensed buyer would be able to apply to private consumption goods bought free of tax as though for business use or resale. The temptation to evasion grows as the tax rate increases; and if the broad-based tax is to play an important part in raising revenue, the Committee believes that its collection should start at an earlier stage than the retail.

27.31. To overcome some of the defects described above, value-added tax (VAT) has been adopted by many countries particularly in Europe and South America. Only an outline of the main attributes of the tax can be given here. It is a way of levying an ad valorem tax on final consumer spending. The whole of the sales value of consumption goods and services, less those that are specifically exempt, is taxed by stages as the goods and services pass from one supplier to the next in the chain of production and distribution. Each supplier pays the tax, calculated at the VAT rate, on his sales during a period, claiming as a deduction VAT invoiced to him during the period. The final consumer, not being a supplier, bears the whole tax and can claim no deduction.

27.32. To illustrate the way VAT works, let it be supposed that the VAT rate is 10 per cent in a simple sequence of goods supplied to manufacturer (M), to wholesaler (W), to retailer (R), and to consumer (C). The set of figures below shows that the supplier to M, selling at a basic (i.e. VAT-exclusive) price of $100, is required to pay $10 VAT to the government. The supplier charges M the VAT-inclusive price of $110; and when M comes to sell the goods to W he has a credit of $10 to deduct from the VAT he is liable to pay on the VAT-exclusive price appearing on his invoice. W and R proceed in similar fashion.

<table>
<thead>
<tr>
<th>Product</th>
<th>VAT—exclusive price</th>
<th>VAT at 10 per cent</th>
<th>VAT payments to government</th>
</tr>
</thead>
<tbody>
<tr>
<td>M buys goods for</td>
<td>$100</td>
<td>plus $10</td>
<td>VAT of $10 already paid by M’s supplier $10</td>
</tr>
<tr>
<td>M sells goods to W for</td>
<td>$160</td>
<td>plus $16</td>
<td>M pays VAT of $16 less credit of $10 = $6</td>
</tr>
<tr>
<td>W sells goods to R for</td>
<td>$200</td>
<td>plus $20</td>
<td>W pays VAT of $20 less credit of $16 = $4</td>
</tr>
<tr>
<td>R sells goods to C for</td>
<td>$250</td>
<td>plus $25</td>
<td>R pays VAT of $25 less credit of $20 = $5</td>
</tr>
<tr>
<td>Total VAT paid</td>
<td></td>
<td></td>
<td>$25</td>
</tr>
</tbody>
</table>
The example shows that each supplier pays to the government tax on his output less tax on his input. M's supplier, together with M, W, and R, are known as ‘taxable persons’. They are liable for tax at successive stages, but they are reimbursed for the tax they pay in the price they charge and, in the outcome, the consumer bears the whole of VAT. The taxable person acts as an agent for collecting part of the ultimate tax incurred on the goods sold to consumers.

27.33. Some countries have found it necessary to give special treatment to a limited number of goods and services and to certain traders, through either ‘exemption’ or ‘zero-rating’, to use the British terms. For example, consider again the sequence in the last paragraph. If the retailer had only a small annual turnover (less than £5,000 in the United Kingdom), he would qualify to be exempt from VAT and he would then not have to make a VAT charge of $25 or lodge a return with the VAT authority; but at the same time he would not be able to obtain a refund of prior-paid tax. If the wholesaler had exported the goods, he would not be required to charge $20 VAT, exports being zero-rated, and could claim from the government the $16 VAT component in the price he had paid to the manufacturer. So he could sell the goods free of VAT for $200 in the export market rather than for $220 on the home market. The concept of zero-rating complies with the rules of the General Agreement on Tariffs and Trade that amounts of identifiable tax may be eliminated from export prices. This method of dealing with VAT thus increases the competitiveness of exporters.

27.34. Table 27.C indicates how rates of VAT vary in some European countries, the date of introduction, taxes replaced and percentage of total tax revenue and social security contributions raised by VAT in 1971.

<table>
<thead>
<tr>
<th><strong>TABLE 27.C: VALUE-ADDED TAXES IN EUROPE</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Italy</td>
</tr>
<tr>
<td>Belgium</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Country</td>
</tr>
<tr>
<td>--------------</td>
</tr>
<tr>
<td>Luxembourg</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Denmark</td>
</tr>
<tr>
<td>Norway</td>
</tr>
<tr>
<td>Sweden</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Austria</td>
</tr>
<tr>
<td>Ireland</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

(a) f shows the rate applicable to foodstuffs.

(b) Some countries zero-rate a limited number of goods and services. Ireland and the United Kingdom also apply a zero-rate to foodstuffs.

(c) Percentage contribution of VAT to total revenue from all taxes and social security
Much been published about the operation of VAT which need not be summarised here. The countries of the European Economic Community aim to harmonise tax rates, but there is still considerable diversity. Goods and services that do not bear VAT are however kept to a minimum everywhere, and in most countries food is taxed though usually at a lower rate than the standard one.

The tax charged on purchases made by a trader must be shown on contributions, 1971.

(d) Selective employment tax.

(e) From November 1974 a rate of 25 per cent applies to petrol.


27.35. Much been published about the operation of VAT which need not be summarised here. The countries of the European Economic Community aim to harmonise tax rates, but there is still considerable diversity. Goods and services that do not bear VAT are however kept to a minimum everywhere, and in most countries food is taxed though usually at a lower rate than the standard one.

27.36. The tax charged on purchases made by a trader must be shown on
the invoice supplied to him, and this invoice is evidence for the trader to claim a credit. The invoice is an important instrument in control and enforcement and the prevention of tax evasion.

27.37. VAT is seen to have many advantages over other systems described if widely based at a uniform rate. Its chief disadvantage is that the large number of suppliers to be covered increases the administrative task, which would be modified if small suppliers of goods and/or services, as mentioned above, are exempt from VAT.

27.38. In some countries certain government services are exempt, but where there is competition between these services and private ones subject to VAT, equity can be maintained only if all are liable. Financial institutions are invariably exempt because of the difficulty of applying VAT to them: in its place in some countries a separate profits tax is charged to preserve equity between those who use such institutions and those who do not. Services rendered by schools, doctors, and hospitals are often exempt, though it could be argued that where charges are made they should bear VAT. Special regulations may be necessary in connection with hire-purchase arrangements, second-hand goods and charitable organisations.

27.39. While the Committee recognises that the introduction of VAT would have to be preceded by further discussion of the exact base and by a lengthy government information campaign, it has concluded that, despite its cost of administration, VAT is the most appropriate type of broad-based tax on goods and services.

III. Level of Vat and Transitional Problems

27.40. To achieve simplification of the tax system by the development of VAT would take some time. It would be possible to make the first moves in this direction by widening the wholesale sales tax and gradually making uniform the present varying rates, a retail sales tax restricted to services being brought in at the same time. But it would be preferable to introduce VAT as soon as possible, the simultaneous steps being to:

(a) cancel wholesale sales tax and introduce VAT on a wide base at a comparatively low level;
(b) adjust duty on excisable goods so that when VAT is levied on them at prices embodying excise the combined effect of excise duty and VAT on the prices of the goods in question is equal to that of current excise duty; and
(c) impose an excise tax on motor vehicles so that when VAT is imposed on vehicles which have already paid excise duty, the total levy is equal to current wholesale
27.41. The aim of these steps would be to obtain from excise duty and VAT at least as much revenue in toto as excise duty and sales tax together raise at present, and not to increase the total revenue from currently excisable goods. After the change to VAT, the price of excisable goods would remain unaltered, the prices of some goods such as those as in the electric and hardware categories would be reduced, and the prices of others, particularly food and clothing, would increase. A possible exception to the unchanged price of excisable goods might be made in the case of beer, which may be thought now to carry an unjustifiably high amount of excise duty.

27.42. If all tangible goods and all other personal consumption expenditure except rents and certain financial services were to be taxed, the base would be equivalent in 1970–71 to about $16,000 million at retail level, excise duty and wholesale sales tax included. If VAT were to be levied at a uniform rate of 5 per cent, very approximate estimates indicate that, on the basis of the steps in paragraph 27.40, $2,000 million would be raised from it and excise duties—an increase of $250 million over the revenue raised from wholesale sales tax and excise duties in 1970–71.

27.43. The above estimates are based on the assumption that the supply of goods and services in different categories would not be affected. As the change will increase personal consumption expenditure—$19,500 million in 1970–71—by less than 2 per cent overall, any inaccuracy in the assumption may be ignored for this discussion.

27.44. VAT on goods and services puts those on low incomes at a disadvantage and some countervailing measures would have to be taken. Purely by way of illustration, let it be assumed that a family consisting of husband, wholly dependent wife and two children spends its entire after-tax income of $100 a week, plus child endowment of $1.50 a week, on goods and services that rise in price by 5 per cent when VAT at that rate is imposed. To maintain the family's consumption level, expenditure on an annual basis will need to rise from $5,278 to $5,542, an increase of $264. One way of ensuring that the family is not made worse off would be for the husband to receive an extra $407 a year in pre-tax income, assuming 1974–75 income tax rates apply. A second way would be to reduce the amount of income tax the family has to pay from $604 to $340 by adjusting the income tax scale. Alternatively, the same income tax relief might be given by lifting the dependant allowance for wife and children from $832 to $1,494. Another possibility is to increase child endowment for two children from $78 a year to about $340, for example by raising the weekly
rate for the first child from 50 cents to $3.00 and for the second from $1.00 to $3.50. (Were child endowment to be made taxable in the father's hands, the amount of endowment for two children would have to be increased still further.) The choice of compensating measures is obviously wide.

27.45. VAT has some common ground with payroll tax and with company income tax. When VAT was introduced in Britain in 1973, it replaced purchase tax, which was a wholesale sales tax, and selective employment tax, a type of payroll tax based on the wages of certain categories of employees and paid by employers. In Australia payroll tax was handed over to the States in 1971; at the current rate of 5 per cent on all payrolls, it could raise as much as $1,000 million in 1974–75. The introduction of VAT might need to be accompanied by discussions between the Australian Government and the States about the future of payroll tax. A VAT running alongside such a tax would involve an element of tax on tax that would be difficult to avoid.

27.46. The effect of VAT on company profits will depend on the extent to which VAT can be regarded as an addition to wage costs and be shifted forward in the price of goods and services. In some VAT systems, it is mandatory for VAT to be shown as the stipulated percentage of the selling price. Any absorption of the tax, leading to a lower selling price and to less revenue for the government, would necessitate reduced profits or reduced payments to suppliers. VAT can be beneficial to exporting firms: as noted earlier, VAT is an identifiable tax which the General Agreement on Tariffs and Trade allows suppliers to deduct when goods for export reach the border.

27.47. Under the aegis of a prices and incomes policy a government introducing a VAT, with or without other tax changes affecting suppliers, can estimate justifiable price changes and control them. The control should be seen to work in both directions for some prices might be capable of reduction in circumstances of other tax decreases. In the absence of a prices and incomes policy, a government can advertise prominently how the prices of certain categories of goods should be affected by the measures being taken. In much the same way, a government can state to the arbitration authorities and to the public in general how it expects wages to be adjusted in the presence of any alleviative measures taken at the same time. As VAT is meant to be a tax on private consumption expenditure, prices of goods and services are expected to increase; but in that the contribution of VAT to revenue may be balanced by a reduction of other imposts, the effect of the whole restructuring of the system need not be inflationary. Should the government require increased revenue in otherwise stable conditions and the imposition of VAT is the only measure taken,
adjustments to prices and social service grants would be unavoidable.

27.48. In the preceding paragraphs the discussion has centred on the problems of the initial introduction of VAT, and a very low rate of tax has been used in the illustration. But the whole trend of the Committee's argument presupposes that, thereafter, it should be steadily raised with concomitant upward adjustments to social service payments and downward adjustments to the income tax. The Committee sees VAT as doing much more than helping to remedy the defects of the existing taxes on goods and services: its prime role lies in allowing, in turn, a major switch from existing direct taxation and a large-scale simplification of the whole taxation system. It believes that once Australian taxpayers become used to a VAT, and once its teething troubles are over, they will see its advantages and be willing to encourage its extension.

27.49. As and when a broad-based consumption tax was raised from its initial low rate, it would of course continue to be imperative, for the preservation of vertical equity, to adjust social service grants and personal income tax rates in a compensating way. But it would become increasingly difficult to achieve greater simplification of the fiscal system—the prime objective of the increase—through these means as personal income tax virtually ceased to be levied on persons earning up to little more than minimum wages. Further progress in this direction might only become possible if the regressive effect of an increasing VAT were recognised as justifying specially favourable treatment to low-income earners in the wage awards handed down by the Arbitration Commission and in other wage negotiations. There may be sound reasons why, in such negotiations, questions of tax should usually play only a minor role. But if the government were engaged upon a deliberate and explicit restructuring of the taxation system for widely accepted and welcomed ends of simplicity and efficiency, it would not, in the Committee's view, be in any way inappropriate for employers, unions and the Commission to assist by eliminating obstacles arising from considerations of equity. This seems to the Committee one of the areas in which objectives of tax reform call for the co-operation and understanding of non-government agencies.

27.50. The introduction of any major new tax such as VAT is a major task for government, and the Committee is under no illusions that its proposals in this chapter are administratively easy. The opinions of those who have written submissions on the subject of sales taxes in general have been divided and no clear view emerges. The somewhat extreme opinion that a VAT cannot be administered in Australia has, however, to be rejected.

27.51. The unavoidable difficulties accompanying the introduction of
VAT will be reduced if the Government makes its intentions clear well in advance. Once an official decision has been made, staff has to be recruited and trained and a widespread education programme will be necessary to prepare the public and the business community. It is to be hoped that in the preparatory period much ill-informed criticism would be quelled and the ancillary benefits of VAT become increasingly appreciated. There is much evidence of overseas experience to show that, after initial troubles, VAT can become a readily accepted tax and be allowed to play an increasing part in revenue-raising.

Chapter 27: Appendix A: Sales Tax as a Continuing Tax

27.A1. The Committee has recommended that the existing wholesale sales tax be replaced with a broad-based VAT. But at least a brief review of the present levy is called for, since there can be no certainty that this recommendation will be acted upon in the immediate future.

I. Tax Base and Rates of Tax

27.A2. Sales tax was initially a broad-based levy; over the years, however, the base has been eroded through the granting of exemptions. A single rate of tax was imposed from 1930 to 1940, when the Second and Third Schedules were included in the Sales Tax (Exemptions and Classifications) Act. At present there are three rates of tax (see paragraph 27.7).

27.A3. In paragraph 27.40 the Committee has expressed the view that VAT should be introduced as soon as possible. But in the meanwhile certain transitional steps might perhaps be taken, including widening the base of the existing sales tax and bringing rates of sales tax into greater uniformity. However, while steps of this kind would serve to cushion the impact of VAT at the time of its adoption, any withdrawal of exemptions and realignment of tax rates as an interim measure would no doubt be criticised as discriminatory and unfair by those adversely affected: in the result, an unnecessary degree of hostility to VAT might be engendered in the preliminary stages.

27.A4. Where the range of exemptions and the classification of goods under the different schedules has been allowed to vary over the years in piecemeal fashion, it is inevitable that anomalies will occur. There are difficulties, however, in reversing the process by stages. While gradual reversal would correct some of the anomalies and inequities, there would inevitably be complaints of discrimination by those first affected, whatever
the order of reversal adopted.

27.A5. The widening of the base of the present tax and unification of rates should be important objectives if a change to VAT is not to be made in the foreseeable future. But the Committee would not favour the gradual reversal of exemptions and a move towards uniformity of tax rates solely for the purpose of facilitating transition to VAT.

II. Structure and Administration of the Law

Simplification of the Law

27.A6. The sales tax law comprises nine assessment Acts and regulations, nine rating Acts, an exemptions and classifications Act and regulations, and a procedure Act and regulations. When first enacted, the nine assessment Acts each contained schedules of exempt goods, while the nine rating Acts levied a single rate of tax on all taxable goods. In 1935, with the increase in the number of exempt items, the exemptions were removed from the assessment Acts and included in the Sales Tax Exemptions Act. Later, when different rates of tax were applied to particular classes of goods, schedules of such goods were included in the Act and its title was changed to the Sales Tax (Exemptions and Classifications) Act.

27.A7. The Sales Tax Procedure Act was introduced in 1934 primarily to simplify procedures relating to the classification of goods and recovery of tax under nine assessment Acts. Provisions were subsequently added setting out the circumstances under which refunds of tax are permitted and authorising the remission of tax in cases where the Commissioner alters a ruling he has previously given.

27.A8. It was thought necessary at the time to enact nine separate assessment Acts because of the requirement of the Constitution that a law imposing taxation shall deal with one subject of taxation only. This remains one of the reasons for not amalgamating the present enactments; another is that a restatement of the law using different words would create new problems of interpretation, the meaning of the law as expressed in the nine assessment Acts being now well settled. The Committee is therefore not prepared to recommend any change in the present structure of the law.

27.A9. It has been suggested in submissions that procedures would be simplified and collection costs reduced if sales tax were converted into a manufacturers tax. The Committee does not favour such a step: it would reduce the base of the present tax by omitting the wholesaler's margin of profit, thus conflicting with the principle that a commodity tax should have as broad a base as possible.
Time for Lodgment of Returns

27.A10. Persons liable to pay sales tax are required to lodge a sales tax return within twenty-one days of the close of each month disclosing the sale value of goods sold during that month and the tax payable on them. Tax is also payable within the same twenty-one days, remittance of tax normally accompanying the return. There are similar requirements regarding the lodgment of returns and payment of tax where goods are applied to a taxpayer's own use or, in the case of a manufacturer, are transferred by him to stock for sale by retail. It has been said that these requirements are unfair and that the time for payment of tax should be considerably longer than the twenty-one days now allowed. The contention is that taxpayers should not be required to pay tax before they have received payment for the goods sold. With a levy of this nature, however, it is inevitable that taxpayers will be called upon to pay at least part of the tax before being reimbursed by their customers: this, after all, is a feature of most commodity taxes. Granting wholesalers further time to pay tax will not assist retailers who, in many instances, have to hold tax-paid goods for considerable periods before selling them and obtaining reimbursement of the tax component in the price paid by them to the wholesaler.

27.A11. The suggestion has been put that returns should not have to be lodged until twenty-eight days after the end of the month and that payment of tax should not become due until sixty days later. However, the administrative problems of collection and recovery of tax would be substantial if both these requests were granted. The Committee nevertheless sees some merit in extending the time for lodgment and payment to the last day of the month following the month in which the taxable transactions occur.

Objections and Appeals

27.A12. Sales tax, being a self-assessed tax, does not normally call for the issue of an assessment. However, where a taxpayer is dissatisfied with the amount or value of sale value upon which he is required to pay tax, the Commissioner will issue an assessment enabling the taxpayer to exercise his rights of objection and to refer the Commissioner's decision on objection, if unfavourable, to a Board of Review. Objection may be taken within forty-two days of the first day on which a taxpayer is required to pay sales tax. This period differs from the time allowed for lodgment of objections against income tax, estate duty and gift duty assessments. The Committee has recommended in Chapter 22 that the time for lodgment for objections and appeals under all relevant enactments be made uniform.
27.A13. One ground of objection is that the goods have no sale value under the Act: it may be argued, for example, that goods are not ‘goods’ as defined in the Act. However, objection cannot be taken on the ground that the goods should be exempt or taxed at a lower rate because they come within a description of an item in one of the schedules of the Sales Tax (Exemptions and Classifications) Act.

27.A14. Where reference to a Board of Review involves a question of law, the Commissioner or the taxpayer may request the Board to refer the matter to the High Court for its opinion. Either party may appeal against the Board's decision if a question of law is involved.

27.A15. The Acts do not make an assessment conclusive evidence of liability. Therefore, instead of following the appeal procedures, a taxpayer may refuse to pay the tax and raise the point of his objection before a Court when he is sued by the Commissioner for recovery of the tax. This is what a taxpayer must do if he wishes to contest a ruling by the Commissioner bearing on the classification of goods: for example, where the Commissioner denies a taxpayer's claim that the goods are exempt from tax or that they should be taxed at a lower rate of sales tax.

27.A16. It was suggested in several submissions that taxpayers should be given the right of objection and reference to a Board of Review against decisions of the Commissioner concerning the classification of goods. There are practical difficulties, however, in extending the right of reference in such cases.

27.A17. A large staff of taxation officers is employed in classifying goods. The procedure then followed is that, if there has been no previous ruling, a ruling in writing is given to the taxpayer by a Deputy Commissioner. If the taxpayer is dissatisfied with that ruling, the Deputy Commissioner in turn will refer the matter to the Commissioner who will review the Deputy Commissioner's decision and give a final ruling. By this time all the taxpayer's submissions will have received thorough consideration. Apart from this the Commissioner reviews all cases where competitive anomalies are involved. Each Deputy Commissioner is required to submit such cases to him as they arise.

27.A18. Many thousands of rulings are given to taxpayers each year. Only a relatively small number are referred to the Commissioner, who is accepted by most taxpayers as the final arbiter. Occasionally, however, official rulings are disputed before a Court when action has been taken to recover the tax.

27.A19. Because sales tax affects day-to-day transactions, rulings as to the classification of goods must be given expeditiously. If rulings were subject to review by a Board of Review there would inevitably be delays
and uncertainty. The failure of a commodity tax law to provide for an administrative review of the classifications of goods by an independent tribunal is not unusual: the same is true, for example, of customs and excise classifications. While it might be fairer if these decisions were referred to a Board of Review, substantial practical difficulties would be involved.

**Freight Charges**

27.A20. In contracts for the sale and delivery of goods, the sale value will include any delivery charges. Thus where goods are sold by wholesale to a retailer, tax is payable not only on the price charged for the goods but also on other charges such as freight and insurance incurred up to the time delivery takes place. If a retailer purchases goods ex factory or ex warehouse and makes his own arrangements for the delivery and insurance of the goods, the cost of delivery and insurance will not form part of the taxable sale value.

27.A21. Taxpayers and consumers in districts that are at a considerable distance from the main manufacturing and importing centres claim that they are unfairly treated by the inclusion of freight and other charges in the sale value. The complaint goes deeper than merely the inclusion of delivery charges where goods are purchased, with tax included, from a manufacturer or a wholesale merchant in the capital city. What is also objected to is the increase in sale value where goods are supplied to country retailers by country wholesalers who take delivery charges from the city to their country depots into account when fixing a wholesale selling price for the goods sold in the country.

27.A22. If freight were to be excluded from the sale value of a taxable sale by wholesale only in those cases where the cost of delivery is separately charged, the exclusion could not apply where a country wholesale merchant sells goods ex warehouse in the country. If it were desired to exclude his cost of delivery from the city to his country warehouse, problems of identification and apportionment would arise, since a wholesaler normally buys in bulk and sells in smaller lots. He would be required not only to identify the inward consignment from which the goods were taken, but also to show that the amount to be excluded was an appropriate proportion of the delivery cost of that consignment. Further complications would arise if a wholesale merchant purchased goods from another wholesaler in a country centre or from the country warehouse of a manufacturer who had freighted the goods from a city.

27.A23. If delivery charges were to be excluded from the sale value of
goods it appears that under section 51(ii) of the Constitution, which prohibits any discrimination in tax laws between States or parts of States, such exclusion could not be limited to deliveries made in only certain parts of a State: it would have to be applied to all delivery charges made both in the city and the country. In a number of industries, mostly located in cities, manufacturers and wholesalers make deliveries in their own vehicles. Delivery costs are reflected in the price for which they sell their goods and are absorbed in their general overhead costs. It would be extremely difficult for these taxpayers to allocate a cost of delivery to such sales.

27.A24. In the Committee's view equity cannot be achieved in the matter of freight charges without sacrificing simplicity and certainty and unduly increasing compliance costs and the costs of collection of the tax. It therefore does not recommend any change in the present law.

Avoidance of Tax

27.A25. A wholesale sales tax tends to encourage activity at the retail level with a view to minimising tax. For example, if an importer sells goods to retailers, he accounts for tax at the price for which he sells the goods; but if he sells by retail himself, under Sales Tax Assessment Act (No. 5) he accounts for tax on a lower sale value: the value for duty of the goods plus duty plus 20 per cent. By making arrangements for retailers to sell the goods as his agent, he thus pays tax on a sale value substantially lower than the net proceeds (exclusive of tax) he receives from the retailer: the equivalent of the amount that would have been the sale value had there been no agency arrangement.

27.A26. A similar advantage can be obtained by a manufacturer or wholesale merchant who makes some sales by wholesale at lower prices than he is prepared to charge when he sells goods to retail merchants generally. If these retailers are made his agents, he will pay tax on notional sale values based on the lower wholesale prices in respect of all sales made through them.

27.A27. While no objection can be taken to agency sales by retailers where the arrangement between the taxpayer and the retailer has a proper commercial basis, arrangements entered into for the sole purpose of avoiding sales tax require scrutiny. Taxpayers who do not enter into agency schemes could be placed at a competitive disadvantage compared with those that do. The Committee takes the view that where sales from stocks in a retail store purport to be agency sales, the law should lay down conditions which will ensure that there is a true commercial relationship of principal and agent. Where those conditions are not complied with, the law
should fix a sale value equal to the money proceeds the taxpayer receives for the goods sold (i.e. the tax exclusive retail selling price less costs of selling including the agent's commission).

27.A28. Another arrangement which purports to have the effect of reducing sale value is undertaken by manufacturers who advertise their products nationally and in some cases carry out after-sales service. Under this arrangement a separate company is formed, which invoices charges for advertising, delivery and after-sales service and certain other charges. The manufacturer excludes those costs from the price he charges for the goods when invoicing retailers and thus pays tax on a lower sale value. It is common practice for manufacturers to advertise their own products. If arrangements such as the one just described are effective in reducing sale value, those manufacturers undertaking such an arrangement will gain an advantage over their competitors. There would be problems of excluding the cost of advertising and warranty charges from sale value similar to those described in paragraphs 27.A20–27.A24 in relation to freight, and it would not be administratively practicable to exclude any of these charges from the sale value of a normal sale of goods by wholesale. In view of this, the Committee considers that in cases where charges connected with the sale of goods are invoiced by a separate company the law should specify that the sale value will be the same as it would have been had no arrangement been entered into.
Chapter 28 Conclusion

28.1. In keeping with the wide range of its terms of reference, the Committee has attempted to examine the structure of the Commonwealth taxation system in accordance with clause 1 of those terms always bearing in mind the requirements of clause 2. The aim of the Committee has not been to propose ad hoc amendments to the legislation which constitutes the taxation system. It has endeavoured to indicate the directions in which changes might best be made if the Australian Government is eventually to have a system of taxation which will be both a flexible structure so that, without the need for drastic changes, it may be readily adapted to changing conditions and needs in the future and also one which will be fairer, simpler and more efficient than the one that has grown by a multitude of particular amendments. The report should accordingly be regarded in its entirety.

28.2. The Committee also recognises that a number of the changes it would wish to see brought about in the future are of a fundamental nature. In order to avoid disruption both to the Revenue and to the affairs of the taxpayers, many of these will need to be phased into the system on a gradual basis accompanied by appropriate transitional measures.

28.3. Since the Committee commenced its work in 1972 there have been some important statutory alterations to the taxation legislation which have had to be taken into consideration by the Committee in the course of its examination. A list of these alterations to the law appears at the end of this report, before the index. The Committee has reviewed the legislation up to and including the amendments enacted by the Australian Parliament in December 1974.

28.4. During the course of the Committee's work the rate of inflation has grown very steeply and has reached a level which has had special effects upon the operation of the taxation system. For example, by consequential salary and wages rises, inflation has produced large increases in the intake of revenue and has translated taxpayers into brackets of taxation scales not hitherto contemplated by them or, it may be said, by the Revenue. This has not eased the task that has confronted the Committee. Some account of inflation's effects has been taken in Chapter 6, but it is not within the Committee's terms of reference to propose counter-measures for the cure of inflation itself. The Committee welcomes the recent announcement by the Australian Government of the setting up of an independent panel to make an inquiry into inflation and taxation.

28.5. It should be emphasised that it is not within the Committee's terms
of reference to fix the rates or scales of taxation determining the amount of revenue to be derived from each form of tax. Where there are references in this report to figures exemplifying rates or scales of taxation, these are intended as illustrations of the working of the various matters discussed or of recommendations to which they are relevant. Clause 2 of the Committee's terms of reference refers to the need to ensure a flow of revenue sufficient to meet the Government's requirements; and what that need is from time to time is a matter for the Government of the day to determine. The Committee has envisaged in its recommendations a flexible structure which, by appropriate rate changes made from time to time, will enable current revenue requirements to be fulfilled by a fair distribution of the impact of the taxes.

28.6. The short historical and descriptive accounts in Chapters 1 and 2 explain why, in the Committee's view, the broad approach made by the Committee to its functions as set forth in the terms of reference is necessary and timely.

28.7. Such an approach entails an argument that must go back to the basic facts of the place of taxation in the lives of individual members of the community and to the first principles of tax policy as they apply in a prosperous democratic society with a large and growing public sector. Chapters 3 to 5 contain what the Committee has been able to offer about these fundamental matters.

28.8. The conclusions and much of the analysis in these chapters are less clear-cut than could have been wished. Firstly, there has been the obstacle of insufficient statistics. The excellent quality of Australian official statistics is generally recognised, but there are great gaps in the information available about many matters central to precise discussion of taxation policy, for example about the distributions of income and wealth and their trends, and about the apparent incidence upon individuals of many kinds of tax. The Committee regards the household expenditure survey now being undertaken by the Bureau of Statistics as a very useful step in closing one of the gaps in necessary statistical information. Secondly, in a thorough review of the economic consequences of large-scale taxation, intricate and controversial issues of economic analysis and general economic policy cannot be evaded; and so long as they are unsettled among the specialists, the Committee has been able to make only provisional judgments about them. Thirdly, the Committee has recognised, more willingly, that in the final evaluation of alternatives, appeal must be made to moral, social and political judgments about which well-meaning and serious men and women will always differ.

28.9. Nevertheless the Committee has reached one recommendation that
it believes should be acceptable to a broad spectrum of public opinion and is consistent with a wide range of attitudes to social policy. It believes that the weight of taxation should be shifted towards the taxation of goods and services and away from the taxation of income. The Committee judges that, in combination with the reforms it proposes in the taxation of capital and capital gains, a strategy of change in this direction would in time go far towards achieving the principal aims set for it in its terms of reference.

28.10. The separate discussions of existing and potential taxes which are contained in this report have been written with this strategy in mind. Some, though by no means all, of the proposals made depend on it. The reader should be again reminded that the discussion relates to a revision of the entire tax structure for the future and that it would be consistent with the acceptance of the proposals that immediate necessities may justify quite another action in the short term.

28.11. Consistently with its broad objectives, the Committee has not concerned itself with the detailed drafting of legislation to embody its proposals. It would recommend that these be incorporated in entirely newly-drawn statutes rather than made the subject of further amendments to existing legislation already overburdened with the numerous changes that have been effected over a very lengthy period.

28.12. This report contains a comprehensive chapter index and a detailed general index. Hence in this concluding chapter it will be necessary to make brief references only to some of the more important subjects with which the report deals. To attempt to summarise the Committee's recommendations out of their context by way of a conclusion might lead to an inadequate understanding of their true effect. Further, it should be borne in mind that, with reference to some of the recommendations in the chapters themselves, certain reservations have been made by one or more members of the Committee. These reservations appear at the end of the chapters in question.

28.13. In Chapter 7 the Committee has considered some general issues in regard to the base of the income tax and made recommendations on certain specific issues.

28.14. A number of questions relating to the determination of the net income of a business or profession are examined in Chapter 8. In seeking to give effect to a principle that net income should as far as possible accord with the true profits of a business or profession, the Committee makes proposals, amongst others, for the allowance of deductions for long-service leave and for depreciation of buildings.

28.15. Chapter 9, in dealing with employment income, proposes that the law in regard to the taxation of fringe benefits be strengthened and that a
standard deduction be allowed in respect of some employment expenses. In order to provide some relief from the tax on ‘illusory’ gains when *interest income* is taxed, a suggestion is made for a limited concessional treatment of interest income.

28.16. In discussing *personal income tax* in Chapters 10 to 14 the Committee makes a number of proposals. It rejects the compulsory aggregation of the incomes of husbands and wives but suggests that the possibility of introducing an optional family unit basis of taxation should be opened up for detailed public discussion. It is proposed that, in general, the unearned income of a minor child should be taxed at a rate which has regard to the parents’ incomes. Measures are proposed to cope with avoidance of tax by income-splitting. A recommendation is made that the rate scale should be simplified by replacing the present multiplicity of steps by fewer wider ones, and be reduced especially in the lower ranges, as the taxation of goods and services is increased. The Committee notes with approval the recent reduction in the number of steps in the scale as a move in the direction it has proposed. The future of existing arrangements for dependent spouses and children is examined, and it is suggested that the possibility of simplifying and phasing out many of the concessional deductions by parallel adjustments on the expenditure side of the public finances and in the rate scale should be explored. A study is proposed of the desirability of making social service benefits taxable, in some cases at a special rate in substitution for existing means tests. While thoroughly convinced of the unwelcome impact of inflation upon the personal income tax and the need to adjust for it, the Committee is unconvinced of the case for automatic statutory indexation.

28.17. A number of proposals are made in Chapter 15 as to the taxation of the income of trusts and partnerships. It is proposed that the accumulating income of a trust should, in general, be taxed at the maximum marginal rate of individual tax.

28.18. The Committee believes the present system of *company income tax* to be inequitable in its final impact upon shareholders at different income levels. After exploring the principal alternatives, it suggests the introduction of a partial imputation system (Chapter 16).

28.19. In Chapter 17, *international aspects of income tax* are considered. It is proposed that, in general, a system of including foreign-source income in the income subject to tax of a resident and allowing credit for foreign tax should replace the present system of exempting foreign-source income that has been taxed abroad. A number of proposals are made in regard to the taxation of Australian-source income of non-residents. Suggestions are put forward directed to strengthening the rules by which income may have an
28.20. The present provisions relating to *income from primary production* are examined in Chapter 18 and a number of proposals made, including an amendment to the law intended to preclude the deduction of losses arising from ‘hobby farming’.

28.21. In Chapter 19 the *income taxation of the mining and quarrying industries* is considered and observations are made on recent amendments to the law relating to mining taxation.

28.22. Aspects of the *income taxation of general insurance companies* are dealt with in Chapter 20. The *exemptions from income tax* given to a number of organisations are also reviewed, and consideration is given to the *income taxation of co-operative companies and friendly society dispensaries*.

28.23. *Income taxation affecting superannuation and life insurance* is the subject of Chapter 21. Proposals in regard to the law as it affects superannuation and retirement benefits are set out in the form of two views as to the reform of the law.

28.24. Chapter 22 deals with problems that arise in relation to the *administration of the Income Tax Assessment Act* and includes such topics as the Commissioner's discretionary powers, powers of and procedures before Boards of Review and appellate Courts, objections to and amendment of assessments, hardship, general procedures and taxpayer compliance and payment of tax, and a suggestion for the appointment of an independent Standing Committee to examine and report upon proposed amendments to the Act.

28.25. The *taxation of capital gains* is proposed, by the method of part-inclusion of gains in income with arrangements for spreading. Closer attention to what would constitute income and what would be a capital gain, and a study of the special taxation of development gains, are recommended (Chapter 23).

28.26. The present *taxation of gifts and deceased estates*, which is the subject of legislation at both Federal and State levels, is discussed in Chapter 24. By virtue of its duplication and differences between the States, the present situation is thoroughly unsatisfactory. The integration of the Federal gift and estate duty legislation is proposed as well as the replacement of the various separate statutes by a single national Act.

28.27. The *treatment of charities* for purposes of income tax and gift and estate duties is covered in Chapter 25.

28.28. Proposals for a separate *wealth tax* are considered but rejected in Chapter 26.

28.29. Chapter 27 deals with the *taxation of goods and services* and
proposes a broad-based value-added tax and the abolition of the wholesale sales tax.

28.30. In the chapters dealing with specific taxes the Committee has of necessity devoted considerable space to anomalies and weaknesses in the present legislation and has made recommendations in many instances for their correction. This has tended to lessen the emphasis on its principal objective of formulating a long-term plan for a major restructuring of the revenue-raising measures of the Australian Government.

28.31. At the same time, it will have been made even more evident that income tax, estate and gift duty and capital gains tax need to be extremely complex to be effective and are costly in their operation both from the taxpayer's and the Revenue's point of view. This must reinforce the case, in terms of achieving simplicity and reductions in compliance and collection costs, for relieving as many taxpayers as possible from these taxes by lifting exemption levels below which they will cease to apply.
Commonwealth of Australia: Taxation Review Committee

The Independent non-parliamentary Committee established by the Commonwealth Government to inquire into and review the overall operation of the taxation system of the Commonwealth of Australia invites interested persons, companies and organisations who wish to place information or representations before the inquiry relative to matters within the Terms of Reference to make submissions thereon for the consideration of the Committee.

The Terms of Reference of the inquiry are as follows:

“1. The functions of the Committee of inquiry are—

(a) to examine and inquire into the structure and operation of the present Commonwealth taxation system;
(b) to formulate proposals for improving the Commonwealth taxation system, either by way of making changes in the present system, abolishing any existing form of taxation or introducing new forms of taxation; and
(c) to report to the Treasurer of the Commonwealth accordingly.

2. The Committee of Inquiry shall, in carrying out its functions, do so in the light of the need to ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth and have regard to—

(a) The effects of the present Commonwealth taxation system and of any proposals formulated by the Committee, upon the social, economic and business organisations of the community and upon the economic and efficient use of the resources of Australia; and
(b) the desirability of the Commonwealth taxation system being such that, so far as is practicable, there is a fair distribution of the burden of taxation, and revenue is raised by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense.

3. For the purposes of these terms of reference, the present Commonwealth taxation system shall be taken to be the system under which the Commonwealth raises revenue
by means of the following forms of taxation: income tax; sales tax; estate duty; gift
duty; duties of excise imposed for the purpose of raising general revenue, and duties
of customs that correspond with duties of excise so imposed.”

**It would assist the Committee if those who intend to make submissions notify the Secretary of their intention as soon as practicable.**

Typewritten submissions (1) bearing the name and address of the person, company or organisation by or on whose behalf the submission is made (2) should be forwarded to The Secretary. Taxation Review Committee, Box 5346, G.P.O, Sydney, New South Wales, 2001, no later than 31 March 1973.

Any material contained in a submission marked “Confidential” will be treated as such by the Committee.

Each submission should indicate whether the author of the submission desires or is willing to attend before the Committee either personally or by some accredited representative and whether such attendance is requested to be in public or in private. The Committee in its discretion may then make arrangements for the attendance of such persons and their representatives before the Committee at a convenient date and place.

for the Taxation Review Committee
(M. C. KAHL) Secretary,
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Further information is available on request from the Secretary, telephone 25-5804.
Persons, Organisations and Companies who made Submissions to the Committee

Abbott, Ronald E. G.
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Alcoa of Australia Limited
Allen, A.
Allison, Arthur
Amalgamated Prospectors and Leaseholders Association of W.A. (Inc.)
Amdal, J. David
Anderson, Arthur & Co.
Anderson, Donald R. and Doreen
Anderson, L. L.
Anderson, Dr Thomas W.
Andrews, S. V.
Annett, Norman L.
Antalfy, Michael L. A.
Antcliffe, T. M.
Apps, Dr P. F. and P. H.
Armstrong, F. A.
Arthur, E. L. and J.
Arthur, K. and N. L.
Arthur Webster Pty Ltd
Ash, Stanley C.
Associated Chambers of Manufactures of Australia, The
Associated Steamships Pty Ltd
Association for the Study of Women and Society
Association of Independent Life Offices
Association of Superannuation Funds of Australia, The
Atroshenko, Paul
Attwood, Elaine J.
Attwood, P.
Aujard, E. M.
Auld, Frederick J.
Australia Party of S.A. Inc.
Australian Associated Brewers, The
Australian Associated Stock Exchanges
Australian Association for the Mentally Retarded Inc.
Australian Association of Permanent Building Societies, The
Australian Bakels (Pty) Ltd
Australian Bank Officials’ Association, The
Australian Bankers Association and the Commonwealth Trading Bank
Australian Chamber of Commerce, The
Australian Chemical Industry Council
Australian Chiropractors’ Association, The
Australian Coal and Shale Employees’ Federation
Australian Council for the Arts
Australian Council of Retailers, The
Australian Council of Social Service
Australian Council of Soft Drink Manufacturers
Australian Council of Trade Unions
Australian Dental Association Incorporated
Australian Dental Plans Limited
Australian Farmers’ Federation
Australian Federation of Air Pilots
Australian Federation of Credit Union Leagues Limited
Australian Forest Development Institute
Australian Gallery Directors Conference
Australian Gas Association (Vic.)
Australian Hotels Association
Australian Institute of Agricultural Science (N.S.W. Branch)
Australian Institute of Launderers and Linen Suppliers
Australian Insurance Association
Australian Labor Party Rural Committee of Tasmania
Australian Medical Association
Australian Mining Industry Council
Australian National Committee for UNICEF, The
Australian Paper Manufacturers Limited
Australian Raw Sugar Manufacturing Industry, The
Australian Retired Persons Association
Australian Shareholders Association (N.S.W. Branch)
Australian Society of Accountants
Australian Society of Authors, The
Australian Timber Producers’ Council
Australian Union of Students, The
Australian Veterinary Association
Carman, S. H.
Carpenter, Warren B.
Carruthers, H. George
Carter, A.
Carter, M. E.
Catholic Women's League of Tasmania
Cave, Thomas W.
Chappell, J. C.
Chapple, Victor A. R.
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Cochran, Keith F.
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Committee for Economic Development of Australia
Commonwealth Industrial Gases Limited, The
Commonwealth Scientific and Industrial Research Organisation Offices’ Association, The
Condon, M. A.
Confectionery Manufacturers of Australia
Conservation Council of South Australia Inc.
Conservation Council of Victoria
Cook, Verco A.
Coombe, J.
Coombs, Dr H. C.
Co-operative Federation of Australia
Co-operative Housing Society Limited
Corner, C. F. S
Corporate Planning and Acquisition Service Pty Ltd
Council of Australian Humanist Societies
Council of Commonwealth Public Service Organisations
Council of Fire and Accident Underwriters of Australia
Council of Professional Associations
Council for the Single Mother and her Child (Vic.)
Country Shire Councils’ Association of W.A., The
Cowell, D. F.
Craig, Len
Crawford Productions Pty Ltd
Cridland, Frank
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Crofts, M.
Crommelin, Michael
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Dash, Janet A.
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Davis, Malcolm J.
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Donnelly, R. P.
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Ecob, A.
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Edwards, N. J.
Edwards, T. M.
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Emerson, Ronald J.
Evans, Guy G.
Everett, A. C. & Sons
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Federated Fur Trade Council of Australia, The
Federated Taxpayers’ Associations of Australia, The
Federation of Australian University Staff Associations
Federation of Queensland Chambers of Commerce
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Ferguson, Don
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Field Naturalists Society of South Australia Incorporated (Herpetology Group)
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Flour Millers’ Council of Australia, The
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Garnaut, H. C.
Gaudry, G. I.
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Hampson, Norma
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Henry George League of Victoria
Henry George League of W. A.
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Humanist Society of Victoria
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I.C.I. Australia Limited
Idle, G. C.
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Institute of Actuaries of Australia and New Zealand
Institute of Chartered Accountants in Australia, The
Institute of Chartered Secretaries and Administrators, The
Institute of Directors in Australia, The
Institute of Foresters of Australia (Tasmanian Division), The
Institute of Public Affairs (N.S.W.)
International Air Transport Association
International Commission of Jurists (Victorian Branch)
Irvin and Associates
Isolated Childrens’ Parents Association
Issuing Houses Association of Australia
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Jenkins, The Hon. Glyn
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Jones, G. E. and Co.
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Kambalda Minerals N.L.
Keast, T. D.
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Kent, Dr Norma
Knight, Dr R. John
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Landfield, C.
Land Values Research Group
Lapsa, Leonids
Law Council of Australia
Law Society of New South Wales
Law Society of South Australia Incorporated
Law Society of Western Australia, The
Lee, Alex. and Company
Lee, Chi Keung John
Lewis, Arthur
Lewis, B.
Lewis, H.  
Life Offices’ Association for Australasia  
Linton, Robert G.  
Little, J. A.  
Lloyd's Underwriters  
Loane, I. T.  
Local Government Association of New South Wales  
Local Government Association of Queensland, The  
Local Government Association of W.A. (Inc.)  
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Lomas, Keith W.  
Longworth, John W.  
Lubrano, Helen  
Luehman, A. C.  
Lyppard Chemical Pty Ltd  
M. A. I. Limited  
McAlpine, D. R.  
McBriar, E. M. and Daily, B.  
McCallum, A. I.  
McCormick, Ian and Nethercott, L. J.  
McGarrity, Sidney  
McKaughan, C. W. B.  
McLean, William R.  
McMahon, Robert A.  
McNamarra, Robert  
McQuarrie, F. G.  
Macintosh, William Alexander  
Magellan Petroleum Australia Limited, with Magellan Petroleum Corporation—Brisbane Branch, Magellan Petroleum (N.T.) Pty Ltd, United Canso Oil & Gas Company (N.T.) Pty Ltd, Magellan Petroleum (Qld) Pty Ltd  
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Manners, V. J.  
Mason, W. R.  
Master Builders Federation of Australia  
Mathison, A.  
Medical & Associate Professions Superannuation Plan  
Mendes, J. Y.  
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Mildura Chamber of Commerce
Millard, E. B. G.
Miller, Joan C.
Miller, Marjory B.
Mitchell, R. S.
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Morrison, R. H.
Mount Lofy Ranges Association Inc., The
Muirden, P. H.
Muirhead, David S.
Murphy, W. E.
Murray Bridge Field Naturalists Society
Muskens, P. E.
National Council of Independent Schools
National Council of Women of Australia, The
National Council of Wool Selling Brokers of Australia, The
National Fitness Council of South Australia
National Library of Australia
National Trust of South Australia, The
Natural History Society of South Australia Incorporated
Nature Conservaton Society of South Australia, The
Negus, The Hon. Senator S.A.
Nelson, R. G.
Neureiter, Hans
New South Wales Ambulance Transport Service Board
New South Wales Bar Association, The
New South Wales Broiler Growers’ Association
New South Wales Council of Professions and the Australian Council of Professions
New South Wales Social Credit Political League
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Noel, David G.
Norman Bros Pty Limited
Northern Territory Reserves Board
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Olarenshaw, G. T.
Oliver, Ray M.
Ovenstone, Thelma
Padgham, Allan R.
Palmer, Trahair, Owen and Whittle
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Paulusz, C. L. H.
Pawsey, Charles K.
Payne, N.
Peko-Wallsend Ltd.
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Penna, M. J. and R. H.
Penning, H. J.
Perenyi, C.
Petver Group, The
Pharmaceutical Council of W. A., The, and the Pharmacy Guild of Australia (W.A. Branch)
Pharmacy Guild of Australia (Federal Branch), The
Phelps, D. E.
Piercy, Richard R.
Pomroy, H. A.
Potter, E. M.
Powell, Gladys A. and Kenney, Ernest L.
Powell, W. B.
Pratt, B. and R. S.
Printing and Allied Trades Employers Federation of Australia, The
Problems of the Independent Aged
Proprietary Dairies Factories Association of Australia, The
Public Service Association of N.S.W.
Public Service Board of N.S.W.
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Queensland Cane Growers’ Council, The
Queensland Conservation Council Inc.
Queensland Law Society Incorporated
Queensland State Service Union
Queensland Tax Agents Association
Queensland Teachers Union
Ransley, R. I.
Rawlings, Dr. J. F.
Reader's Digest Association Pty Ltd, The
Redei, Andor
Reece, B. F.
Regan, D.
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Retired State Employees’ Association (Victoria)
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Robinson, Athol A.
Robinson, G. F. J.
Robinson, John D. G. & Associates Pty. Ltd.
Robinson, Ross D.
Roden, Edward
Roennfeldt, A. J.
Rosser, John
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Royal Australian Institute of Architects, with Royal Australian Planning Institute, Australian Institute of Landscape Architects
Russell, I.
Ryan, Michael R.
Ryan and Williams
Sabine, Dr T. M.
Sandwith, P. G.
Sarina, R. G.
Scott, E.
Second Division Officers Association (Federal Council), The
Selby, J.
Selden, E. L.
Shadforth, P. S. & Son
Shallue, M.
Sharpe, Ian G.
Sharpe, J. P.
Sheehan, W. J. and Johns, B. L.
Shiels, K. F.
Simons, A. N.
Sims, R. E.
Smith, Helen M. and Wedemeyer, M. L.
Smith, I. J.
Smith, Sydney F.
Smyth, John
Social Welfare Department (Vic.)
Society for Growing Australian Plants, S. A. Region Inc.
South Australian Apiarists’ Association
South Australian Institute of Teachers
South Australian Mountain Activities Federation Conservation Panel
South British Insurance Co. Limited, with National Insurance Co. of New Zealand Ltd, New Zealand Insurance Co. Ltd.
Southern Districts Environment Group
Spatt, Nathan
Spence, Edith
Spry, Dr I. C. F.
State School Teachers’ Union of W. A. (Inc.)
Stennett, W. E.
Stepanek, Francis L.
Stirna, G.
Stokes, John L.
Stone Cartage Pty. Ltd.
Strathalbyn Naturalists Club
Stretton, John E.
Stringer, R. K.
Stump, Eric L.
Sutton, D. T.
Sutton, P. R. N.
Sweeney, C. A.
Symons, D. M.
Symons, E. F.
T. & G. Fire and General Insurance Company Limited
Tasmanian Environment Centre
Tattersall, Edith M.
Taveira, J.
Tavender, G. K.
Taxation Institute of Australia, The
Taxpayers Association of Queensland
Telfer, G.
Thiele, Reg H.
Thomasz, A. E. and H. J. L.
Thompson, P. G.
Tippett, L. S.
Trans Australia Airlines
Trump, B.
Trustee Companies Association
Tucker, B. J.
Unicomb, Ivan
University of Newcastle Department of Commerce
University of Western Australia Academic Staff Association
Valder, G. E. and I. W. H.
Valder, P. G.
Vary Brothers Pty. Ltd.
Victoria Racing Club
Victorian Apiarists’ Association
Victorian Employers’ Federation
Victorian National Parks Association
Vine, K. H. J.
W. A. Chiropractic Patients Association Inc.
W. A. Council for Equal Pay and Opportunity
Wales Unit Investment Limited and the Wales Superannuation Funds Limited
Walker, Peter D. & Co.
Wallace, H. A.
Walley, S.
Walsh, E. P.
Walsh, F. M.
Walton, J. J.
Walton, Donovan & Co.
Weaver, Geoff
Weissmann, G.
Westwood, Betty R.
Wildana Forests (Aust.) Pty Limited
Wildlife Preservation Society of Queensland Inc.
Wilkin, W. J.
Williams, L.
Williams, L. E.
Williams, Sheila Mary
Winnips, J.
Wise, J. C.
Women Active Politically
Women Lawyers Association of New South Wales, The
Women's Electoral Lobby (Australia)
Women's Electoral Lobby (N.S. W. Branch)
Women's Electoral Lobby (Peninsula Branch)
Women's Electoral Lobby (Victorian Branch)
Wood, Brian R. A.
Wood, R. G. W.
Woodrow, T. W.
Worsley, Michael D.
Worthley, S. R.
Wright, V. S.
Wyeth, C. A.
Wylie, A. K.
Young, Arthur & Co., and Edwin V. Nixon & Partners
Zaetta, A.
Zero Population Growth Australia
Zuidersma, S.
Studies Prepared for the Use of the Taxation Review Committee Which Their Authors Agree may be Published

Study No.

1. Aggregation of Income of Husband and Wife in Family Unit Taxation—The Honourable Mr Justice K. W. Asprey, B.A., LL.B, Q.C.
3. Death and Gift Duties—D. Graham Hill, B.A., LL.B., LL.M.
4. Distribution and Redistribution of Household Income in Australia—Dr N. Podder, M.A., Ph.D. and Professor N. C. Kakwani, M.A., Ph.D.
5. History of Mining Taxation in Australia—J. A. Timbs, B.A., LL.B., LL.M.
7. Incidence of Indirect Taxes and Company Income Tax—Dr N. Podder, M.A., Ph.D. and Professor N. C. Kakwani, M.A., Ph.D.
8. Section 26(a) and Section 26AAA of the Income Tax Assessment Act—The Honourable Mr Justice K. W. Asprey, B.A., LL.B., Q.C.

These studies are not part of the Committee’s Report and the Committee takes no responsibility for their contents which represent the personal views of their authors.
# Treasury Taxation Papers

<table>
<thead>
<tr>
<th>Title</th>
<th>Date received by the Taxation Review Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1 Taxation Reform: Problems and Aims</td>
<td>22. 1.73</td>
</tr>
<tr>
<td>No. 2 The Level and Composition of Taxation in Australia</td>
<td>29. 3.73</td>
</tr>
<tr>
<td>No. 3 Personal Income Tax: The Income Base</td>
<td>19. 4.74</td>
</tr>
<tr>
<td>No. 4 Personal Income Tax: The Rate Scale</td>
<td>19. 4.74</td>
</tr>
<tr>
<td>No. 5 Personal Income Tax: The Income Base</td>
<td>10. 5.73</td>
</tr>
<tr>
<td>No. 6 Personal Income Tax: The Tax Unit</td>
<td>31. 1.74</td>
</tr>
<tr>
<td>No. 7 Personal Income Tax: Personal Allowances</td>
<td>22. 4.74</td>
</tr>
<tr>
<td>No. 8 Negative Income Tax and Tax Credit Systems</td>
<td>30.11.73</td>
</tr>
<tr>
<td>No. 9 Company Income Tax Systems</td>
<td>18. 1.74</td>
</tr>
<tr>
<td>No. 10 Capital Gains Taxes</td>
<td>25. 1.74</td>
</tr>
<tr>
<td>No. 11 Estate and Gift Duty: Purpose and Rationale</td>
<td>28.11.73</td>
</tr>
<tr>
<td>No. 12 Net Wealth Taxes</td>
<td>25. 1.74</td>
</tr>
<tr>
<td>No. 13 Summary of Issues</td>
<td>29. 5.74</td>
</tr>
</tbody>
</table>
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Blake & Rigall, Melbourne.
Coopers & Lybrand, Melbourne.
Freehill, Hollingdale & Page, Sydney.
Mann Judd & Co., Melbourne.
Reserve Bank of Australia, Sydney.
Swinburne College of Technology, Melbourne.
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Seale, Mrs. Beryl L.
Thierjung, Miss Judith A.
Traini, Mrs. Lea
### Important Statutory Alterations to the Taxation Legislation Since the Taxation Review Committee Commenced its work

## INCOME TAX

<table>
<thead>
<tr>
<th>Subject of the alteration</th>
<th>Short description of the purpose of the amendments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax Assessment Act 1973—No. 51 of 1973—Assented to 14.6.73</td>
<td>Section 53G inserted to allow an outright deduction for expenditure on converting plant for use under the metric system of measurement.</td>
</tr>
<tr>
<td></td>
<td>Converting plant for use under the metric system:</td>
</tr>
<tr>
<td>Company bad debts:</td>
<td>Amended to ensure that deductions otherwise available to a company for debts owed to it and written off as bad are not to be available unless the company satisfies the ‘continuing ownership test’ or the ‘same business test’.</td>
</tr>
<tr>
<td>Company losses:</td>
<td>The purpose of the changes was mainly to strengthen the ‘continuing ownership test’ in relation to deductions for company losses and to strengthen safeguards against devices designed to avoid the operation of the test.</td>
</tr>
<tr>
<td>Life insurance premiums:</td>
<td>Amended so that premiums paid on a new life insurance policy would only be tax deductible if benefits other than death benefits are not payable under the policy within a period of 10 years after its commencement.</td>
</tr>
<tr>
<td>Undistributed profits tax—private companies:</td>
<td>Amended to provide that a private company is required to satisfy the ‘continuing ownership test’ or the ‘same business test’ as a condition of its being able to take into account for purposes of tax on undistributed income, any amount which may have been paid in excess of a sufficient distribution of the income of a previous year.</td>
</tr>
<tr>
<td>Export promotion expenditure:</td>
<td>Amended to extend to 30 June 1974 the operation of the provisions under which a rebate of tax is allowable in respect of certain expenditure to promote exports.</td>
</tr>
<tr>
<td>Australian Government benefits and assistance:</td>
<td>Amended to exempt from income tax, payments received by way of domiciliary nursing care benefit under the National Health Act 1953–1972 and to exempt from income tax, Commonwealth assistance given in connection with the education of isolated children. The amendments also covered the effect of those payments on concessional deductions.</td>
</tr>
<tr>
<td>Experts visiting Australia:</td>
<td>Amended to withdraw the income tax allowances which were available to certain visiting experts from overseas.</td>
</tr>
<tr>
<td>Capital subscribed to mining companies:</td>
<td>Amended to withdraw the deduction available to shareholders for calls or other share moneys paid to companies engaged in mining or prospecting for minerals (including oil and natural gas) in Australia or Papua New Guinea.</td>
</tr>
<tr>
<td>Income tax appeals:</td>
<td>Amended to provide that income tax appeals falling within the single justice jurisdiction of the High Court will now come within the jurisdiction of the State Supreme Courts.</td>
</tr>
</tbody>
</table>

*Note: The dates in brackets indicate the assent date of the acts.*
Norfolk Island and other territories: Amended to make the income tax law apply to Norfolk Island, Cocos (Keeling) Islands and Christmas Island as if they were part of Australia but to continue, by new provisions, to exempt Island and other ex-Australian source income of people genuinely living on the Island, and of companies wholly owned and controlled by such people.

Undistributed profits: In order to prevent avoidance of Australian tax, the amendments had the effect that a dividend paid by an Australian private company to a private ‘repository’ company resident in Papua New Guinea will not be counted as a dividend for the purpose of calculating whether the Australian company has a liability for undistributed profits tax.

Income Tax Assessment Act (No. 5) 1973—No. 165 of 1973—Assented to 11.12.73

Income of a bona fide prospector: Amended to withdraw the exemption of income derived by a bona fide prospector from the disposal of rights to a mine.

Australian Government pensions: Withdrawal of the exemption from tax of age pensions.

Profit on sale of property: To provide for the inclusion in a taxpayer's assessable income of profits arising from the sale, within 12 months of purchase, of property purchased after 21 August 1973.

Trading stock of a winemaker: Winemakers are now being required progressively to value their trading stock on one of the three bases available to taxpayers generally, i.e. at the option of the taxpayers, its cost price, or market selling value or the price at which it can be replaced.

Dividends from certain mining profits: Amended to withdraw the exemption of dividends paid out of profits from gold mining and certain other mining profits generally exempt in the hands of the company.

Withholding tax flowing to Papua New Guinea: The system of withholding tax on dividends and interest going to Papua New Guinea was introduced.

Primary producers—depreciation: Amended so that accelerated depreciation is no longer available for primary production plant and structural improvements. General depreciation rates will apply to such plant.

Investment allowance: Amended so that investment allowance which permitted a deduction from assessable income of 20 per cent of capital expenditure on specified new plant no longer applies.

Rates and taxes: Amended so that the deduction for payments for private rates is only available in respect of a taxpayer's principal residence, and is limited to $300 per year.

Certain expenditure on primary production land: Amended so that certain capital expenditure incurred by primary producers which was immediately deductible, is no longer deductible on this basis. Such expenditure is now deductible either by way of ordinary depreciation or over 10 years.

Gifts: Amended so that gifts made for the construction or the maintenance of public war memorials are no longer tax deductible.

Public companies: Amended so that the Commissioner may use his discretionary power to declare a company a public company for tax purposes, when a company fails in some insignificant way to qualify as a public company under the specific tests in section 103A, but which company is essentially public in character.

Undistributed profits: Amended so that the provisions introduced by Act No. 164 of 1973 are extended to cover dividends paid by private companies to private ‘repository’ companies set up in any country outside Australia, e.g. in a tax haven. The retention allowance in relation to trading income was increased to a flat rate of 50 per cent.

Life assurance companies: Amended so that the special deduction allowable to life assurance companies is reduced from 3 per cent of calculated liabilities to 2 per cent of calculated liabilities. The amount of dividends in respect of which a life assurance company is allowed a rebate of tax under section 46 is to be reduced by an appropriate part of the deductions allowable for expenses of general management and in relation to calculated liabilities.

Export promotion expenditure: Amended so that a rebate of tax will not apply for export market development expenditure incurred to develop export markets for meat.

Company tax instalments: The first stage of the scheme to collect company tax in quarterly payments was introduced.
Tax instalment deductions: Amended so that certain payments of workers’ compensation, sickness pay and accident pay made to an employee will be subject to tax instalment deductions under the pay-as-you-earn system.

*Income Tax Assessment Act 1974—No. 26 of 1974—Assented to 1.8.74*

Members of the Defence Force: Amendments of the income tax law to bring the Act, in so far as it relates to the taxation of Defence Force allowances, into harmony with the current pay structure of the Defence Force.

Interest withholding tax: Amended to ensure that interest paid to non-residents from Australia through an overseas branch of a business conducted by an Australian resident will be subject to withholding tax.

Company tax instalments: Amended to complete the phasing in of the system of collecting company tax by quarterly payments.

*Income Tax Assessment Act (No. 2) 1974—No. 126 of 1974—Assented to 6.12.74*

Mining activities on the continental shelf: Amended so that exploration or mining and associated activities for minerals other than petroleum carried out on the continental shelf are treated for income tax purposes as though the activities were conducted on the mainland.

Exemption of certain mining income: The exemption from tax of one-fifth of the profits earned from mining prescribed metals or minerals was withdrawn.

Credit unions: Amended to exempt qualifying credit unions from income tax on interest derived from loans to members.

Cars available to employees for private use: Amended to prescribe a formula to ascertain the value of a benefit which arises where an employee has available for his private use a car owned or held on lease by another person.

Employee share acquisitions: A new provision was included to govern the taxing of employee benefits associated with the acquisition of shares in companies or of rights to acquire shares.

Club fees and leisure benefits: Amended to prohibit the allowance of income tax deductions for sporting and social club fees and, in certain circumstances, for expenditure relating to boats and other leisure facilities such as holiday cottages.

Child-care facilities: Provision made for the allowance of depreciation on plumbing fixtures and fittings provided by employers for use in the care of employees’ children.

Dependants: Amended to remove the requirement that a dependant be a ‘resident’ of Australia or Papua New Guinea in order that a taxpayer may claim a concessional deduction for the maintenance of the dependant.

Education expenses: Amended so that the maximum deduction claimable for education expenses of a student or for self-education expenses be reduced from $400 to $150.

Interest on home loans: Provision made for an income tax deduction for interest paid on home loans.

Life assurance companies: Amended so that the special deduction allowable to life assurance companies under section 115 is reduced from 2 per cent of calculated liabilities to 1 per cent of calculated liabilities.

Mining for other than oil or natural gas: Amended so that capital expenditure, other than exploration expenditure, will be deductible by reference to the estimated life of the mine or, in the case of plant, as depreciation allowances, if the taxpayer so elects. Previously much capital expenditure could be deductible outright in the year it was incurred or, in the case of housing and welfare, over a 5-year period.

Also amended so that amounts expended on exploration and prospecting are immediately deductible from the net mining income of the year of expenditure, and where there is excess expenditure it will be allowable as a deduction against the net mining business income (including income from associated activities) of the taxpayer in the next year in which such income is derived. If the income of that next year is insufficient to offset all of the excess, the balance will be carried forward for deduction successively against the net mining income of the subsequent year or years. Previously the excess was deductible over the life of the mine.
Transport of minerals: Amended so that the period over which expenditure incurred on a railway, road, pipeline or other facility for transporting minerals (including petroleum) and mineral products is deductible is changed from 10 years to 20 years.

Prospecting and mining for petroleum: The new provisions allow capital expenditure incurred in developing a petroleum field to be deducted over the estimated life of the field against net assessable income from petroleum. Under the previous provisions the expenditures were immediately deductible. Plant expenditure may be claimed by claiming ordinary depreciation allowances if preferred.

Low-income taxpayers with families: Provision made for taxpayers whose tax saving from the concessional deductions for the maintenance of dependants is less than 40 per cent of the amount of those deductions to be allowed a rebate of tax to give them an overall tax saving, by means of the dependants deduction and tax rebate, of 40 per cent of the deductions.

Estate Duty

Matrimonial home: Provision made for a deduction of up to $35,000 in the assessment of estate duty payable where an interest in the matrimonial home passes to a surviving spouse.

Release from liability in cases of hardship: Amendments made to establish a board with power to release a person in whole or in part from liability to pay estate duty where extraction of the full amount would entail serious hardship to a beneficiary.

Sales Tax (Exemptions and Classifications) Act (No. 2) 1973—No. 181 of 1973—Assented to 14.12.73

Exemptions: Amended to withdraw the exemption of carbonated beverages containing a specified quantity of Australian fruit juices.
Abnormal income, averaging 14.66 See also Averaging of income
Accessions taxes 3.38 See also Estate and gift duty
Accident funds, tax treatment of 7.96
premiums and benefits
Accounting, re fluctuating incomes 14.69
Accounting periods
—annual accounting 7.23–7.26
—inflation 6.66–6.67
—trusts 15.9
Adjustment sheets 22.65–22.67
Administration, complexities
—concessional deductions 12.25
—cost of travel to and from work 7.64
—fringe benefits 9.8
—imputed rent of the owner-occupied home 7.46, 7.48
—income earning activities in the home 7.76, 7.77
—surcharge on property income 14.13
Administration, savings in 9.70
Administration, income tax 22.1–22.140, 28.24
—adjustment sheets 22.65–22.67
—advance exposure of proposed legislation 22.62
—amendment of assessments 22.14–22.15
—appeals 22.1, 22.35–22.39
—Boards of Review 22.11, 22.20–22.34, 28.24
—certainty of liability for tax 22.5, 22.7, 22.10
—company tax 22.129–22.138
—costs of appeals, reviews and objections 22.40–22.42
—hardship relief 22.55–22.61
—High Court 22.28, 22.35
—independent standing committee, proposal for 22.63
—information supplied by 22.68–22.73, 23.2
Commissioner
—international comparisons 22.5, 22.17
—losses, assessment procedures 22.74–22.78
—non-taxable assessments 22.74–22.78
—objections to assessments 22.16–22.21
<table>
<thead>
<tr>
<th>Topic</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>—payment of tax</td>
<td>22.89–22.139</td>
</tr>
<tr>
<td>—prosecution procedures and penalties</td>
<td>22.45–22.54</td>
</tr>
<tr>
<td>—provisional tax</td>
<td>22.109–22.128</td>
</tr>
<tr>
<td>—registered tax agent</td>
<td>22.83–22.88</td>
</tr>
<tr>
<td>—statistics</td>
<td>22.16</td>
</tr>
<tr>
<td>—Supreme Court</td>
<td>22.6, 22.21, 22.35</td>
</tr>
<tr>
<td>—taxpayer compliance</td>
<td>22.79–22.82</td>
</tr>
<tr>
<td>—withholding tax</td>
<td>22.139–22.140</td>
</tr>
<tr>
<td>Administration of deceased estate</td>
<td>16.89 See also Estate and gift duty.</td>
</tr>
<tr>
<td>Adoption expenses</td>
<td>as 12.17</td>
</tr>
<tr>
<td>concessional deductions</td>
<td></td>
</tr>
<tr>
<td>Advance payment of income</td>
<td>22.43–22.44</td>
</tr>
<tr>
<td>tax, interest on</td>
<td></td>
</tr>
<tr>
<td>Agents, registered</td>
<td>See Registered tax agents</td>
</tr>
<tr>
<td>Agricultural associations</td>
<td>20.22, 20.27</td>
</tr>
<tr>
<td>Alimony</td>
<td>7.22, 10.30–10.32</td>
</tr>
<tr>
<td>Amortisation</td>
<td>See Depreciation</td>
</tr>
<tr>
<td>Annual accounting</td>
<td>3.13–3.15, 7.23–7.26, 8.4, 8.6–8.8, 8.27–8.47</td>
</tr>
<tr>
<td>Anti-bunching</td>
<td>See Averaging of income</td>
</tr>
<tr>
<td>Appeals</td>
<td>22.1, 22.35–22.39</td>
</tr>
<tr>
<td>—against Commissioner's discretionary powers</td>
<td>22.38</td>
</tr>
<tr>
<td>—costs of</td>
<td>22.40–22.42</td>
</tr>
<tr>
<td>—powers and jurisdiction of Courts</td>
<td>22.35</td>
</tr>
<tr>
<td>—procedures</td>
<td>22.38–22.39</td>
</tr>
<tr>
<td>—recommendations</td>
<td>22.38–22.39</td>
</tr>
<tr>
<td>Assessments, non-taxable</td>
<td>22.74–22.78</td>
</tr>
<tr>
<td>Australian tax systems</td>
<td></td>
</tr>
<tr>
<td>—complexity</td>
<td>2.5</td>
</tr>
<tr>
<td>—criteria for tax systems</td>
<td>3.1–3.49</td>
</tr>
<tr>
<td>—distribution of taxes</td>
<td>4.6–4.16, 5.10</td>
</tr>
<tr>
<td>—historical perspective</td>
<td>2.1–2.5, 28.6</td>
</tr>
<tr>
<td>—international comparison</td>
<td>1.8, 2.6–2.11</td>
</tr>
<tr>
<td>—need for review</td>
<td>1.1–1.10</td>
</tr>
<tr>
<td>Austria, wealth tax</td>
<td>26.3, 26.4</td>
</tr>
<tr>
<td>Authors and inventors, averaging of income</td>
<td>14.66, 14.83</td>
</tr>
<tr>
<td>Averaging, income tax</td>
<td>3.13, 7.24</td>
</tr>
<tr>
<td>—temporal</td>
<td></td>
</tr>
<tr>
<td>Averaging of income</td>
<td>14.60–14.85</td>
</tr>
<tr>
<td>Term</td>
<td>Pages</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>authors and inventors</td>
<td>14.66, 14.83</td>
</tr>
<tr>
<td>block averaging</td>
<td>14.72</td>
</tr>
<tr>
<td>capital gains tax</td>
<td>23.35</td>
</tr>
<tr>
<td>cumulative averaging method</td>
<td>14.71</td>
</tr>
<tr>
<td>drought bonds</td>
<td>14.62, 14.64</td>
</tr>
<tr>
<td>existing law</td>
<td>14.62–14.66, 14.70</td>
</tr>
<tr>
<td>income equalisation schemes</td>
<td>14.69, 14.80–14.83</td>
</tr>
<tr>
<td>inflation</td>
<td>14.69</td>
</tr>
<tr>
<td>marginal adjustment scheme</td>
<td>14.73</td>
</tr>
<tr>
<td>recommendations</td>
<td>14.69, 14.77–14.79, 14.82–14.84</td>
</tr>
<tr>
<td>United States system</td>
<td>14.74, 14.76–14.77</td>
</tr>
<tr>
<td>Aviation associations</td>
<td>20.22</td>
</tr>
<tr>
<td>Avoidance</td>
<td>22.7, 22.100, 28.16</td>
</tr>
<tr>
<td>estate and gift duty</td>
<td>24.2, 24.10</td>
</tr>
<tr>
<td>income-splitting</td>
<td>11.1, 11.6, 11.42–11.44 p. 157</td>
</tr>
<tr>
<td>shape of personal income tax</td>
<td>14.31–14.32, 14.37</td>
</tr>
<tr>
<td>rate scale</td>
<td></td>
</tr>
<tr>
<td>superannuation</td>
<td>21.49–21.51</td>
</tr>
<tr>
<td>unit of taxation</td>
<td>10.26</td>
</tr>
<tr>
<td>wholesale sales tax</td>
<td>27.A25–27.A28</td>
</tr>
<tr>
<td>Beneficiaries</td>
<td>See Trusts</td>
</tr>
<tr>
<td>Blind persons, medical expenses</td>
<td>12.49–12.51</td>
</tr>
<tr>
<td>Block averaging</td>
<td>See Averaging of income</td>
</tr>
<tr>
<td>Board of Relief</td>
<td>See Hardship relief</td>
</tr>
<tr>
<td>Boards of Review</td>
<td>22.11, 22.20–22.34, 28.24</td>
</tr>
<tr>
<td>appeals from</td>
<td>22.35–22.39</td>
</tr>
<tr>
<td>constitution of</td>
<td>22.34</td>
</tr>
<tr>
<td>costs of appearance before</td>
<td>22.30, 22.40–22.42</td>
</tr>
<tr>
<td>discretion of</td>
<td>22.21, 22.25, 22.30</td>
</tr>
<tr>
<td>evidence before</td>
<td>22.32, 22.33</td>
</tr>
<tr>
<td>grounds for appeal to</td>
<td>22.20</td>
</tr>
<tr>
<td>immunity of members and</td>
<td>22.28</td>
</tr>
<tr>
<td>representatives</td>
<td></td>
</tr>
<tr>
<td>powers and procedures</td>
<td>22.22–22.34</td>
</tr>
<tr>
<td>'pre-trial' procedure</td>
<td>22.27</td>
</tr>
<tr>
<td>quorum</td>
<td>22.29</td>
</tr>
<tr>
<td>recommendations</td>
<td>22.21, 22.24–22.34</td>
</tr>
<tr>
<td>Borrowing, government</td>
<td>1.8, 3.3</td>
</tr>
<tr>
<td>Business income, and inflation</td>
<td>6.66–6.67, 6.69, 6.70</td>
</tr>
<tr>
<td>Business and professional income</td>
<td>8.1–8.212, 19.1, 28.14</td>
</tr>
<tr>
<td>accounting principles</td>
<td>8.4, 8.6–8.8, 8.27–8.29, 8.45–8.47, 8.88, 8.178–8.179, 8.182</td>
</tr>
<tr>
<td>accruals tax accounting</td>
<td>8.9, 8.27–8.47</td>
</tr>
<tr>
<td>annual accounting</td>
<td>8.4, 8.6–8.8, 8.27–8.47, 8.155</td>
</tr>
<tr>
<td>anti-pollution expenses</td>
<td>8.14, 8.207–8.208</td>
</tr>
</tbody>
</table>
—building depreciation 8.11, 8.71, 8.82–8.109, 28.14
—capital raising costs 8.71, 8.110–8.112
—cash or accruals basis 8.9, 8.16–8.26
—concept of profits 8.1–8.2, 8.4, 8.29, 8.45–8.47, 28.14
—deductibility of expenses 8.4
—depreciation 8.11, 8.33, 8.71–8.112, 8.185, 8.186, 8.196
—doubtful debts 8.10, 8.48, 8.50, 8.69–8.70
—holiday pay 8.10, 8.48
—inflation, effects of 8.5, 8.13, 8.175–8.193
—know-how, cost of acquiring 8.71, 8.110–8.112
—and held for resale, holding 8.37
charges
—leasehold improvement 8.71, 8.105–8.109
—lease transactions 8.195–8.197
—long-service leave 8.10, 8.33, 8.48, 8.50, 28.14
—loss carry forward 8.113
—loss from impending lawsuit 8.68
—losses, recoupment of 8.12, 8.155–8.174
—matching of income and expense
—obsolescence, depreciation 8.76–8.78, 8.81
—plant and equipment 8.75–8.71
—professional libraries 8.202–8.204
—professional work in progress 8.34, 8.38–8.44
—provisions and accrued expenses 8.10, 8.48–8.70
—recommendations 8.19–8.22, 8.24, 8.25, 8.37, 8.41, 8.47, 8.55, 8.57, 8.63, 8.67, 8.68, 8.70, 8.81, 8.93, 8.100, 8.109, 8.117, 8.118, 8.121, 8.133, 8.135, 8.138, 8.139, 8.144–8.145, 8.146, 8.151, 8.163, 8.168, 8.171, 8.174, 8.200, 8.204
—repairs expenditure 8.14, 8.198–8.201
—revenue implications 8.43, 8.55, 8.104, 8.160
—sick leave 8.10
—statistics 8.52, 8.55, 8.58, 8.62
—trading stock 8.12, 8.113–8.154, 8.187–8.188
—transitional provisions 8.24–8.26, 8.44, 8.55, 8.63–8.65, 8.104
—travelling and entertainment 8.14, 8.205–8.206
expenses
—warranties, product 8.10, 8.48, 8.50, 8.66–8.67
Canada
—averaging of income 14.72, 14.75–14.76, 14.79, 14.81
—capital gains tax 23.20, 23.25, 23.33, 23.41
—charities 25.8, 25.14
—hobby farming 18.33, 18.34
—income tax, international 17.51, 17.96
aspects

Capital gains tax 23.1–23.82, 28.9, 28.25, 28.30
— and wealth tax 26.10, 26.11, 26.17, 26.25
— at death 23.52–23.54, 24.54
— arguments for and against 3.36, 23.9–23.10
— bunching and spreading 23.14, 23.26, 23.35–23.38, 23.82
— capital losses 23.71
— chattels 23.63–23.64
— companies 23.26, 23.40–23.44, 23.69
— company tax 16.10, 16.20, 16.28, 16.43
— deferral of introduction 23.4, 23.5, 23.82, p.435
— depreciable assets 23.67
— development gains 2.11, 23.78–23.82, 28.25
— exemption provisions 23.55–23.66
— gifts 23.51
— indexation 23.22, 23.82
— inflation 3.16, 6.68, 6.69, 6.70, 23.4, 23.22–23.24, 23.29, 23.30, 23.82, p.435
— information bulletins, need 23.2–23.3, 23.5, 23.20 for
— intangible assets 23.68
— life assurance policies 23.65
— lock-in effect 23.21
— on death 23.55
— overseas systems 2.10–2.11, 23.8, 23.20, 23.25, 23.27, 23.33, 23.41
— proportion of gain to be taxed 23.28–23.29, p.435, p.438
— rate of tax 23.25–23.29, 23.82, p.438
— realisation 23.14, 23.21
— recommendations 23.5, 23.21, 23.35, 23.40, 23.51, 23.52, 23.53, 23.64, 23.65, 23.66, 23.67, 23.68, 23.69, 23.74, 23.75, 23.76, 23.82, p.435, p.436, p.438
— recent amendments 23.2–23.3, 23.5–23.6, 23.29, 23.54, 23.56, 23.60, 23.62, 23.70, 23.72, 23.77
— reservations by Committee pp.435–437, p.438
members

—residence, principal 23.57–23.59, 23.82
—retirement, exemption on 23.55
—roll-over 23.58, 23.69
—sections 26(a), 26AAA, 52 23.74–23.77, pp.436–437
—spreading of gains 23.35–23.38
—superannuation rights 23.66
—systems, alternative 23.21–23.30
—transitional provisions 23.31–23.34
—trusts 23.26, 23.45–23.50
—‘valuation day’ 23.31–23.34
—valuation, method of 23.34

Carter Report

—business and professional 8.129 income
—charities 25.8, 25.14
—company tax 16.44, 16.81
—death tax 24.7
—integration of personal and 14.27 company income tax
—maximum marginal rate of 14.32 personal income tax
—primary production losses 18.34
—unit of taxation 10.12
—wealth tax 26.3

Cash or accruals basis, change 8.9, 8.16–8.26 of method

Charities 20.21, 25.1–25.39, 28.27
—classes 25.4–25.5
—deductibility of gifts to 12.30, 25.3–25.11, 25.22–25.26
—definition 25.1
—encouragement of 25.6, 25.20–25.37
—income, treatment of 25.12–25.16, 25.27–25.37
—in competition with private 25.12, 25.27, 25.29–25.31, 25.34, 25.37 enterprise
duty
—recommendations 25.26, 25.37, 25.39
—role of 25.20
—subsidisation of 25.21–25.37
—uniformity of tax treatment 25.38–25.39, Appendix 25C

Chemist expenses, concessional 12.43

deduction for

Child, concessional deduction 12.13–12.16

for

Child endowment 4.11, 5.3, 7.22, 12.13, 12.14, 12.15, 12.16

—aggregation with parental 12.15 See also Social service grants
income
Child-minding expenses 7.18, 7.66–7.75
—deduction for housekeeper 7.68
—in relation to education 7.71, 7.72
expenses
—practical considerations 7.70, 7.73
—rebates for 7.73
—recommendation 7.69, 7.70
Children, See Child endowment; Child minding expenses; concessional deductions; Dependants; Income-splitting; Unit of taxation.
Chiropodists 12.46
Colombia, wealth tax 26.3
—and tax avoidance 22.7
—appeals from exercise of 22.13, 22.38
—expenses of income earning activities in the home 7.80
—guidelines, need for 22.9–22.10
—limitations in 22.6, 22.10, 22.18, 22.19, 22.20
Commission of Inquiry into Poverty 12.14
Commissioned studies for xviii
Committee of inquiry
—advertisement inviting xviii submissions
—appointment of xvii
—composition xvii–xviii
—staff xix
—terms of reference xvii, xx, 1.8, 1.14, 3.1–3.6, 19.5, 28.1, 28.4, 28.5, 28.6
Committee of Inquiry into Compensation and Rehabilitation in Australia 7.36
Companies
—capital gains tax 23.26, 23.40–23.44, 23.69
—estate and gift duty 16.3
—growing significance of 16.1–16.3
—trusts and partnerships 15.2, 15.29 See also Company tax; Distributions; Dividends; Private companies
Company groups 16.22–16.35
—holding and subsidiary companies 16.132–16.133
—loss transfer 16.126, 16.128
—proposed basis of assessment 16.131–16.133
—trading and consortium companies 16.134–16.135
Company income See Business and professional income
— and capital gains tax 16.10, 16.20, 16.28, 16.43
— and inflation 6.22
— and personal income tax 14.26–14.27, 16.8, 16.10, 16.17, 16.34, 16.40, 16.41
— and VAT 27.45
— assessment of company groups 16.122–16.135
— bonus issues of shares 16.25
— continuity of ownership 16.137–16.144
— convertible notes, treatment of 16.147–16.149
— criticisms of present system 16.16–16.20
— distributions See Distributions
— dividends 16.12, 16.13, 16.14
— efficiency, economic 3.35, 16.20
— election to be treated as partnership 16.24, 16.79–16.96
— high gearing, treatment of 16.150–16.152
— imputation system, proposal 16.52–16.74, 28.18
— incidence 3.33, 16.5–16.8, 16.32
— justification for 16.5–16.11
— loan and share capital 16.145–16.152
— losses, carry forward of 16.136–16.144
— present system 2.10, 16.2–16.15, 16.102–16.152
— private company 16.13, 16.15, 16.62, 16.102, 16.130
— public company 16.13
— rebate 16.14, 16.107
— separate ('classical') system 16.12, 16.16, 16.17, 16.20, 16.117
— shifting of 16.7, 16.9, 16.75–16.78
— small enterprises 16.97–16.101
— split rate system 16.32–16.39
— subvention payments 16.133, 16.144
— unacceptable alternatives 16.21–16.31
— undistributed profits tax 16.15, 16.62, 16.112, 16.124, 16.130, 16.148 See also Company groups; Income tax; Tax mix
Company tax, collection of 22.129–22.138
— and imputation system 22.136, 22.138
Compensation
—present legislation 22.129–22.130, 22.133

Compensation
—for injury to reputation 7.41, 23.17
—for loss of office 7.5–7.9, 21.15
—for physical injury 1.10, 7.5, 7.10, 7.34–7.40, 23.17
—periodical payments 7.36
—recommendations 7.40, 7.41

Complexity
—capital gains tax 3.36, 23.10
—concessional deduction 12.17
—estate and gift duty 3.38
—income tax, international 17.37–17.38, 17.49, 17.52

Concessional allowances
See Concessional deductions; Concessional rebates

Concessional deductions 12.1–12.62, 28.16
—adoption expenses 12.17
—and inflation 6.52–6.59
—and unit of taxation 10.25
—anomalies 12.7, 12.8
—child-minding expenses See Concessional rebates
—children 6.53, 6.54, 6.55, 7.21, 12.13–12.16, 28.16
—criticisms of 12.3, 12.4, 12.5, 12.6, 12.7, 12.12
—dental expenses 12.17
—dependent adults 12.11
—dependants 12.3–12.16
—duplication of other benefits 12.22, 12.23, 12.25
—education expenses 7.21, 12.17, 12.30–12.34
—effect on demand 12.21
—efficiency and equity 12.19, 12.20, 12.26, 12.27, 12.29
—funeral expenses 12.17, 12.52
—gifts 12.17
—housekeeper 7.67, 12.12
—housekeeper in relation to child-minding expenses 7.75
—inter-relationship of benefits 12.20

VAT 27.50

Wealth tax 3.39 See also Simplicity

—president system 2.5
—surcharge on property income 14.10, 14.12–14.13

Present legislation 22.129–22.130, 22.133

—capital gains tax 3.36, 23.10
—concessional deduction 12.17
—estate and gift duty 3.38
—income tax, international 17.37–17.38, 17.49, 17.52

Simplicity

—capital gains tax 3.36, 23.10
—concessional deduction 12.17
—estate and gift duty 3.38
—income tax, international 17.37–17.38, 17.49, 17.52

Pension 2.1

—present legislation 22.129–22.130, 22.133

Pension
—present legislation 22.129–22.130, 22.133

Pensions
—present legislation 22.129–22.130, 22.133

—present legislation 22.129–22.130, 22.133

—present legislation 22.129–22.130, 22.133

—present legislation 22.129–22.130, 22.133

—present legislation 22.129–22.130, 22.133
—medical expenses 7.21, 12.71, 12.30, 12.35–12.51
—mortgage interest 12.17, 12.21
—optical expenses 12.17
—rates and land taxes 7.42, 12.17
—recommendations 12.4, 12.6, 12.8, 12.11, 12.12, 12.14, 12.15, 12.16, 12.29
—self-education expenses 12.17, 12.30
—spouse 6.53, 6.54, 6.55, 7.21, 12.3–12.10, 28.16
—statistics 12.1, 12.18
—student 12.16
—subscriptions 12.17
—superannuation 7.21, 12.17, 21.30–21.32
—travelling costs 7.58, 7.59
—travel to and from work 7.56, 7.61
—zone allowances 7.21, 12.17, 12.53–12.62

Concessional rebates
—and family unit taxation 12.9
—blind persons 12.50
—child-minding expenses 7.66–7.75
—child-minding expenses in relation to education expenses 7.71, 7.72
—child-minding expenses in relation to housekeeper deduction
—dependent adults 12.11
—education expenses 12.32, 12.33
—housekeeper 12.12
—invalids 12.50
—recommendations 12.4, 12.6, 12.8, 12.11, 12.12, 12.14, 12.15, 12.16, 12.32, 12.33
—self-education 7.100
—spouse 12.4
—student 12.16
—zone allowance 12.58–12.59

Contributions
See Subscriptions

Coombs Task Force 19.47

Co-operatives 7.27, 20.29–20.37, 28.22
—degree of concessional 20.31–20.34 treatment
—government loan repayments 20.37
—present legislation 20.29–20.30
—recommendations 20.36, 20.37
—secondary activities 20.36

Credit unions 7.27

Criteria for tax systems 3.1–3.49 See also Goals of tax reform

Cultural societies 20.22, 20.24

Cumulative averaging method See Averaging of income

Customs duties 17.30

Death taxes See Accessions taxes; Estate and gift duty; Inheritance taxes
Deceased estates  

**See trusts**

Deductions  

**See Concessional deductions: Concessional rebates**

Deduction, standard  

**See Standard deduction**

**Denmark**

—rate scale, adjustment of  

14.54

—wealth tax  

26.3, 26.6, 26.7, 26.8, 26.20

**Dental expenses, concessional**  

12.17, 12.45

**Dependant allowances**

—erosion of inflation  

14.42

Dependants

—estate and gift duty  

24.29–24.36, 24.40

—wealth tax  

26.6 **See also Child endowment; Concessional deductions; Unit of taxation**

**Depreciation**

8.11, 8.33, 8.71–8.112, 8.185, 8.186, 8.190, 15.21, 19.63–19.70, 19.89, 28.14

—buildings  

8.82–8.109

—change of ownership  

8.98–8.102

—demolition and damage  

8.103

—inclusion of existing  

8.94–8.97

—leasehold improvements  

8.105–8.109

—qualifying classes  

8.93

—Hulme Committee  

8.83–8.85

recommendation

—in international comparison  

8.86–8.87

—’nothings’ and other capital  

8.110–8.112

costs

—in on home office equipment  

7.82

—in plant and machinery  

8.75–8.81

**Development gains tax**

2.11, 4.20, 23.78–23.82, 28.25

**Distribution of income and taxes**  

4.6–4.16 **See also Fairness; Progressivity; Redistribution**

Distributions

—minimum  

16.15, 16.39, 16.41, 16.47–16.48, 16.62–16.63, 16.102–16.115 **See also Company tax; Dividends; Private companies**

Dividends  

1.3, 16.12, 16.13, 16.14, **See also Distributions**

Drought bonds, averaging of  

14.62, 14.64

**Economic growth**

3.28, 4.26, 5.5

**Economic management**

3.27, 28.8

**Education,—policies towards**  

4.22

Education expenses

—concessional deduction  

12.17, 12.19, 12.30–12.34

—in relation to child-minding  

7.71, 7.72

expenses

—present law  

12.31

—recommendation  

12.32, 12.33

**Education, self**  

**See Concessional deductions; Concessional rebates; Education expenses; Self-education**
—and other objectives 3.45–3.49
—concessional deductions 12.19, 12.25, 12.29
—income tax, international 17.29–17.35, 17.40, 17.42, 17.66–17.67
aspects

Election
—family unit treatment 10.15, 10.17, 10.21, 10.26, 10.27–10.28, 10.33, pp.140–141
—partnership treatment for companies 16.24, 16.79–16.96

Employment contract, payment 9.67–9.69
for release from

Employment income
—fringe benefits 9.2–9.45, 28.15
—living away from home 9.60–9.62
allowances
—relating to other years 9.46–9.49
—standard deduction 9.70–9.73, 28.15
—study leave 9.63–9.66
—travel and removal expenses 9.50–9.59

Employer associations 20.22

Equalisation, income See Averaging of income

Equity
—and the personal income tax 14.4, 14.17, 14.60
rate structure
—and wealth tax 26.26, 26.18, 26.21, 26.22
—concessional deductions 12.19, 12.20, 12.26, 12.27, 12.29, 12.33, 12.54, 12.56, 25.22, 25.26
—income splitting 10.4, 11.2
aspects
—social service payments 13.6, 13.9
—superannuation 21.62, 21.65 See also Fairness

—accessions taxes 24.7, 24.8
—advance payment of 24.43–24.46
—assessment procedures 24.69–24.70
—avoidance 24.2, 24.10
—base 7.7, 24.11–24.16, 24.22, 24.61 See also Estate and gift duty, proposed integrated base of
—charities, gifts to 25.17, 25.19
—concessions 24.29–24.39
—deductions 24.22
—dependants 24.29–24.36, 24.40
—discretionary trusts 24.12, 24.19
—domicile 24.61
See also

—estate planning 24.14, 24.30
—inflation 6.60–6.64
—inheritance taxes 24.7, 24.9
—integration of Commonwealth and State duties 24.71–24.76, 28.26
—life interests 24.12, 24.19, 24.49, 24.65
—liquidity of estate 24.39
—loans 24.13, 24.18
—options 24.13, 24.18
—personal representative 24.53, 24.54, 24.57, 24.64
—purposes 24.4
—recovery of duty 24.64–24.68
—reservations by Committee p.485, p.487 members
—revenue yield 24.1, 24.2
—rights, valuation 24.11, 24.13, 24.18
—'slab' or 'slice' system 24.23
—surviving spouse 24.29–24.31
—transitional provisions 24.76
—types of 24.7
—valuation of assets 24.14, 24.52–24.59
—See also Tax mix

integrated base of
—'closely controlled company' 24.A94
from
—company, gifts to 24.A78
—discretionary trusts 24.A37
—enlargement of existing 24.A46 interest
—inequities under present 24.A2 system
—involuntary gifts 24.A95
—lease of property at reduced 24.A59 rates
—power to consent 24.A13
—protective trusts 24.A47
—reservations by Committee p.485, p.487 members
—settlement of property on self 24.A45
—shares, allotted at undervalued 24.A84
—tax haven 24.A38
—transfer of assets to a 24.A70–24.A72 company
—transitional provisions 24.A42
<table>
<thead>
<tr>
<th>Topic</th>
<th>Page(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate planning</td>
<td>See Estate and gift duties</td>
</tr>
<tr>
<td>Evasion</td>
<td>11.1</td>
</tr>
<tr>
<td>—income splitting</td>
<td></td>
</tr>
<tr>
<td>—shape of personal income tax</td>
<td>14.31, 14.32, 14.37 See also Avoidance</td>
</tr>
<tr>
<td>—rate scale</td>
<td></td>
</tr>
<tr>
<td>Exempt bodies</td>
<td>20.20–20.28</td>
</tr>
<tr>
<td>—charitable institutions</td>
<td>20.21</td>
</tr>
<tr>
<td>—recommendation</td>
<td>20.20, 20.21, 20.26</td>
</tr>
<tr>
<td>Excise duties</td>
<td></td>
</tr>
<tr>
<td>—merits and defects</td>
<td>27.8, 27.10–27.12, 27.14–27.18</td>
</tr>
<tr>
<td>—present system</td>
<td>2.10, 27.3–27.4, 27.7, 27.9</td>
</tr>
<tr>
<td>—recommendations</td>
<td>27.14–27.18, 27.40–27.41 See also Goods and services, taxation of; Tax mix</td>
</tr>
<tr>
<td>Exempt income</td>
<td>7.22 See also Social service grants</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
</tr>
<tr>
<td>—adoption</td>
<td>12.17</td>
</tr>
<tr>
<td>—dental</td>
<td>12.17</td>
</tr>
<tr>
<td>—education</td>
<td>12.17, 12.30–12.34</td>
</tr>
<tr>
<td>—for release from employment contract</td>
<td>9.67–9.69</td>
</tr>
<tr>
<td>—funeral</td>
<td>12.17</td>
</tr>
<tr>
<td>—insurance for income protection</td>
<td>7.89–7.96</td>
</tr>
<tr>
<td>—medical</td>
<td>12.17, 12.35–12.37</td>
</tr>
<tr>
<td>—of income earning activities in the home</td>
<td>7.76–7.83</td>
</tr>
<tr>
<td>—optical</td>
<td>12.17</td>
</tr>
<tr>
<td>—self-education</td>
<td>7.97–7.100, 12.17</td>
</tr>
<tr>
<td>—subscriptions to trade and professional associations</td>
<td>7.84–7.88 See also Concessional deductions; Concessional rebates</td>
</tr>
<tr>
<td>Expenses of employment deduction of</td>
<td>7.2, 7.16–7.21, 28.15</td>
</tr>
<tr>
<td>Fairness</td>
<td>3.45–3.49</td>
</tr>
<tr>
<td>—and other objectives</td>
<td></td>
</tr>
<tr>
<td>—capital gains tax</td>
<td>3.36, 23.13</td>
</tr>
<tr>
<td>—company tax</td>
<td>3.33</td>
</tr>
<tr>
<td>—horizontal equity</td>
<td>3.7–3.18, 3.30–3.31, 23.13</td>
</tr>
<tr>
<td>—personal income tax</td>
<td>3.30</td>
</tr>
<tr>
<td>—vertical equity</td>
<td>3.7–3.9, 3.16–3.18, 23.13 See also Equity; Distribution of income and taxes; Progressivity</td>
</tr>
<tr>
<td>Family unit</td>
<td>See Unit of taxation</td>
</tr>
<tr>
<td>Ferguson Committee</td>
<td></td>
</tr>
<tr>
<td>—business and professional</td>
<td>8.83, 8.91</td>
</tr>
<tr>
<td>—income</td>
<td></td>
</tr>
<tr>
<td>—company tax</td>
<td>16.104, 16.109</td>
</tr>
<tr>
<td>—income splitting</td>
<td>11.28, 11.29</td>
</tr>
<tr>
<td>—life insurance</td>
<td>21.142, 21.145</td>
</tr>
<tr>
<td>Finland, wealth tax</td>
<td>26.3, 26.4, 26.8</td>
</tr>
<tr>
<td>Fluctuating income</td>
<td>See Averaging of income</td>
</tr>
</tbody>
</table>
Foreign source income 7.33

France
—income tax, international 17.94
aspects
—unit of taxation 10.11
Friendly societies 20.22, 20.23
—tax treatment of premiums 7.96
and benefits
—present legislation 20.39
—recommendation 20.43, 20.44, 20.45
Fringe benefits
—adequacy of present law 9.4, 9.7–9.13, 28.15
—as part of income 4.28, 7.15
—as part of job 9.8, 9.9
—basis of calculation 9.11, 9.12, 9.13
—allowances, lump sum 9.42
—education of employee 9.35
—education of employee's children 9.34
—entertainment 9.36–9.39
—goods and services at discount 9.21–9.24
—housing 9.15, 9.16
—low interest loans 9.26, 9.27
—motor vehicles 9.19, 9.20
—prizes and gifts 9.29–9.30
—stock options and share purchases 9.32
—travel 9.36–9.39
—classes of benefits 9.14–9.45
—allowances, lump sum 9.40–9.42
—board and lodging 9.17
—education of employee 9.35
—education of employee's children 9.34
—entertainment 9.36–9.39
—goods and services at discount 9.21–9.24
—housing 9.15, 9.16
—low interest loans 9.25–9.28
—motor vehicles 9.18–9.20
—personal expenses 9.33–9.39
—prizes and gifts 9.29, 9.30
—stock options and share purchases 9.31–9.32
—travel 9.36–9.39
—disclosures by employer 9.45
—for taxpayer's dependants 9.7, 9.34

Funeral expenses
—deductions for 12.17, 12.52, 24.22

Gambling and lottery winnings 7.5, 7.8

General insurance industry 20.1, 20.2–20.19, 28.22
—catastrophe fund 20.11–20.12
—claims incurred but not reported, deduction for 20.9–20.10
—determination of earned premiums 20.4–20.8
—recommendations 20.8, 20.12, 20.19
—reinsurance with non-residents 20.13–20.19

General mining See Mining industry

Germany
—company tax 2.11
—imputed rent of the owner-occupied home 7.43
—income tax, international aspects 17.94
—integration of company and personal income tax 14.27
—primary production losses 18.33

Gift duty See Estate and gift duty

Gifts
—as income 7.5, 7.7
—capital gains tax 23.51
—concessional deductions 12.17, 12.19, 12.30 See also Charities; Fringe Benefits; Income Splitting


Gold mining, concessions to See Mining industry

Goods and services, taxation of 3.7, 3.40–3.43, 27.1, 27.51, 28.9, 28.16, 28.29 See also Excise duties; Retail sales tax; Tax mix; Turnover tax; Value-added tax; Wholesale sales tax

Government expenditure, rising trend 1.5, 1.7–1.10

Grants to low income earners, 12.10

taxation of

Hardship relief 22.55–22.61, 28.24
—Board of Relief 22.55, 22.56
—procedure for 22.55–22.56
—scope of 22.59, 22.60
—statistics 22.57

Holiday pay 8.10, 8.48, 8.50, 8.51–8.65, 21.15, 21.26

Home, expenses of income earning activities in
—administrative complexities 7.76–7.77
—deductibility, tests to be 7.77–7.80
applied
—recommendation 7.81–7.83

Home-ownership
—encouragement of 7.44, 12.20
—interest payments 12.17, 12.21

Home-ownership, concessions to
—capital gains tax 23.57–23.59, 23.82
—personal income tax 7.44, 7.56 See also Imputed income

Hospital and medical benefits, 12.38
concessional deductions for
Hospitals 20.21
Housekeeping deduction 7.67
—concessional debate 12.12
—in relation to child-minding 7.75

Hulme Committee
—business and professional 8.3, 8.72–8.73, 8.77, 8.83–8.85, 8.89, 8.91, 8.98

Imputation system See Company tax
Imputed income 7.5, 7.11–7.15

Imputed rent of the owner-occupied home 7.42–7.53
—bases of calculation 7.45
—criticisms of 7.46–7.52
—history of 7.42
—recommendation 7.53
—taxability 7.42 See also Rent payments, deduction for

Incentives
—home ownership 7.44
rate scale
—to work 3.24, 4.24–4.25

Income
—charities See Charities
—employment See Employment income
—partnerships See Partnerships
—trusts See Trusts

Income, assessability of certain receipts
—imputed rent 7.42, 7.46–7.52
—lump sum payments 7.34, 7.38, 7.41
—periodic payments 7.36

Income averaging See Averaging of income

Income splitting 10.4, 10.17, 10.26, 10.29, 11.1–11.48, 24.A105
—aggregation of income 11.8, 11.9–11.11, p.157
—efficiency, economic 17.29–17.35, 17.40, 17.42, 17.66–17.68
—foreign source 7.33, 17.2, 17.3, 17.4, 17.5, 17.12–17.55, 17.56, 17.77, 28.19
—France 17.96
—Germany 17.96
—Italy 17.96
—Japan 17.21, 17.96
—jurisdiction 17.1, 17.2, 17.6, 17.7, 17.9, 17.10, 17.38, 17.42, 17.53, 17.56, 17.60–17.61, 17.63, 17.101, 17.104
—New Zealand 17.5, 17.96
—non-residents—justification for taxing 17.63–17.68
—O.E.C.D. model convention 17.96, 17.99
—origin of income See Source of income
—Papua New Guinea 17.20, 17.27, 17.35, 17.37, 17.38
—permanent establishment 17.7, 17.61
—residence of companies 17.13–17.15
—revenue implications 17.41
—royalties See Interest and royalties
—simplicity 17.36–17.41, 17.42, 17.43, 17.68, 17.A10
—Singapore 17.21, 17.96
—tax-haven companies and trusts 17.9, 17.10, 17.15, 17.16, 17.26, 17.46–17.55, 17.71, 17.73, 17.76, 17.82, 17.90, 17.93
—transactions between residents and non-residents 17.84–17.90
—treatment of income derived from
—domestic manufacturing 17.A5
—domestic sale of domestic goods 17.A3
—know-how 17.A19–17.A21
—overseas sale of domestic goods 17.A4
—performance of non-employee services 17.A12
—rental of chattels 17.A14–17.A16
—sale of Australian real property 17.A6
—sale of commercial or industrial property 17.A18
—sale of shares 17.A7–17.A9
—use of commercial or industrial property
—United Kingdom 17.13, 17.37, 17.88, 17.96, 17.101, 17.A1
—United States 17.37, 17.48, 17.51, 17.96, 17.101, 17.102, 17.104, 17.A1

Indexation
—and inflation 6.34
—capital gains tax 23.22, 23.82
—estate and gift duty 24.44, 24.46
—personal income tax 2.11 See also Rate scale, adjusting
India,—wealth tax 26.3

Industries Assistance 19.5, 19.49, 19.55, 19.70

Commission
Inflation 6.1–6.72, 28.4
—and averaging of income 14.69
—capital gains tax 3.16, 6.68, 6.69, 6.70, 23.22–23.24, 23.29, 23.30, 23.82
—company tax 6.22
—concessional allowances 6.52–6.59
—cost push theory 6.7, 6.9, 6.10, 6.11
—demand pull theory 6.7, 6.8, 6.10
—distribution of income and wealth 6.3
—effects on taxes 6.5, 6.36–6.72
—erosion of personal allowances 14.42
—indexation, wage 6.34
—indirect taxes 6.23
—investment income 9.77–9.78
—payroll tax 6.23
—personal income tax 2.11, 6.15–6.21, 6.35, 6.42–6.51
—professional income 8.5
—property income 6.69, 6.70
—recommendations re 6.32, 6.51, 6.64, 6.72
—savings, effect on 6.3, 21.164
—tax as a tool to control 6.7–6.35
—method 6.26, 6.33
—problems re 6.27–6.32
—taxation, effect of on 6.4, 6.7–6.35
—tax base 6.36, 6.65–6.71
—tax drift 6.36, 6.39–6.64
—tax mix 6.41
—tax payment 6.36, 6.37–6.38
—total tax receipts 6.40
—wealth tax 26.18–26.19
Inflation, business income 6.66–6.67, 6.69, 6.70, 8.5, 8.13, 8.175, 8.193
—accelerated depreciation 8.185
—committees of inquiry, other 8.172, 8.180, 8.184
—replacement cost depreciation 8.186
Information supplied by Commissioner 22.68–22.73
—advance rulings 22.73
—information bulletins 22.70–22.72, 23.2–23.3, 23.5, 23.20
—return forms 22.68–22.69
Information, penalties for failure to supply 22.49–22.50
Inheritance taxes 2.11, 3.38 See also Estate and gift duty
Instalment deductions See Tax instalment deductions
Insurance industry 7.27, 20.1, 20.2–20.19 See also Life Assurance
Insurance premiums
Insurance premiums, for income protection 7.89–7.96
—justification for deductibility 7.93–7.95
—recommendation 7.93–7.95
Interest on home loans, deductibility of 7.17–7.21, 7.44, 7.54, 12.30
International aspects of income See Income tax, international aspects, also under individual countries tax
Invalid dependants, concessional rebate for 12.11
Invalids, medical expenses 12.49–12.51
Inventors See Authors and Inventors
Investment income 9.74–9.81, 16.3
—and inflation 9.77, 9.78
—need for concessional treatment 9.74–9.81
—basis of concession 9.79–9.80
—justifications 9.75, 9.76
—recommendations 9.78–9.81 See also Property income Ireland
—company tax 16.52
—wealth tax 26.3
Italy, income tax, international aspects 17.96
Japan
—income tax, international aspects 17.21, 17.96
—wealth tax 26.3
Land taxes See Rates and taxes, deduction for
Legislative drafting 28.4
Library, professional 8.202–8.204
Life insurance 21.1–21.9, 21.78, 21.134
—and capital gains tax 23.65
—superannuation contributions
  —annuity 21.136
  —companies, taxation of 21.140–21.147
  —contributions to 7.21, 12.30
  —international comparisons 21.150–21.157
  —observations 21.150–21.164
  —policy proceeds, taxation of 21.148–21.149
  —premiums, deductibility of 21.134–21.139
  —present legislation 21.134–21.157
  —superannuation funds 21.46
  —‘30/20’ requirement 21.147
Ligertwood Committee
  —business and professional 8.3, 8.54, 8.61, 8.67, 8.72, 8.107, 8.119, 8.122, 8.129, 8.157
  income
  —friendly society dispensaries 20.39
  —superannuation and life insurance 21.24, 21.33, 21.36, 21.41
  —trusts 15.30
Living away from home 9.60–9.62
allowances
  —concessional deduction 12.17, 12.30
  —recommendation 9.62
Local governing bodies and public authorities
Long service leave 7.26, 8.10, 8.33, 8.48, 8.50, 8.51–8.65, 21.15, 21.26, 21.70
Losses
  —capital gains tax 23.71
  —company tax 16.136–16.144
  —income tax 7.25 See also trusts, company tax
Losses, recoupment of 8.12, 8.155–8.174
  —and exempt income 8.169–8.171
  —carry back 8.156–8.163
  —carry forward 8.113, 8.164–8.168
  —effect of dividend income 8.172–8.174
  —international comparisons 8.156, 8.166
  —recommendations 8.163, 8.168, 8.171, 8.174
Lump sum payments
  —compensation for injury 7.34, 7.35
Luxembourg, wealth tax 26.3, 26.4, 26.8
Manufacturing associations 20.22
Marginal adjustment scheme See Averaging of income
Medical and surgical appliances
—concessional deduction 12.44

Medical expenses
—blind persons 12.49–12.51
—concessional deduction 7.21, 12.17, 12.30, 12.35–12.51
—encouragement of 12.20
—equity 12.38
—invalids 12.49–12.51
—possible anomaly 12.36
—present law 12.35
—travel 12.47
—travel by ambulance 12.48

Mining industry 7.29, 19.1–19.115, 28.21
—accelerated depreciation 19.63–19.70
—anti-pollution and ecological 19.30–19.35 expenditure
—capital raising and company formation expenditure
—conduct of mining operations 19.8–19.12
—depletion allowance 19.36–19.41
—development and infrastructure expense
—housing and welfare 19.71–19.72 expenditure
—immediate write-off 19.63–19.70 provisions
—overseas exploration and prospecting
—pre-tax profits 19.1
—processing and treatment of minerals
—purchase of rights or information
—recent legislative amendments 19.48–19.74
—site restoration 119.31–19.35
—special treatment of 19.1, 19.4, 19.15, 19.16
—wasting assets 19.12, 19.37, 19.41 See also Petroleum mining; Quarrying industry

Mortgage interest—concessional 12.17, 12.21
deductions for
Mutual funds 7.27
Mutuality principle 20.25, 20.33, 20.41
National health insurance scheme, medical expenses
National superannuation committee of inquiry
Naturopaths 12.46
Negative tax system
—and social security payments 13.15
—and wealth tax 26.2
Netherlands
—and rate scale, adjustment of 14.54
Net wealth (net worth) tax See Wealth tax
New Zealand
—and averaging of income 14.81–14.82
—and business and professional income
—and charities 25.7, 25.13, 25.19
—and company tax 16.126
—and income splitting 11.42
—and income tax, international aspects
—and investment income 9.80
—and personal income tax rate structure
—and property speculation tax 2.11
—and rebate for overtime earnings 6.19
—and standard deduction 9.71, 9.72
—and superannuation 21.53, 21.54, 21.56
—and tax rebate, non-reimbursable 14.19
—and unit of taxation 10.2
—and wealth tax 26.3
Non profit clubs and societies 20.25
Non-residents 7.22, 7.33, 23.26
Norway, wealth tax 26.3, 26.4, 26.7, 26.9, 26.20
'Nothings’ 8.71, 8.110–8.112
Objections to assessments 2.5, 22.16–22.21, 28.24
—and cost of 22.40–22.42
Oil and gas mining See Petroleum mining
Optical expenses, concessional deduction for
Pakistan, wealth tax 26.3
Parent, concessional rebate for 12.11
allocation of income 15.3, 15.41, 15.45
—change from cash to accruals basis 8.26
—character of income 15.47–15.48
—difference to companies 15.2
—foreign source income 15.63
—international aspects 15.63
—loss treatment 15.49–15.50
—net income 15.41, 15.42, 15.44–15.48
—non-resident partner 15.63
—profits 15.41, 15.44
—recommendations 15.48, 15.51, 15.52, 15.53, 15.63
—retired partners 15.51–15.53
—tax credit, dividends 15.47 See also Business and professional income

P.A.Y.E. See Tax instalment deductions

Payment of tax 22.89–22.139
Payments, apportionment composite 7.102
Payroll tax 1.3, 2.9, 27.45
—and inflation 6.23
Penalties 22.45–22.54
—failure to make return 22.51–22.53
—failure to supply information 22.49–22.50
—imprisonment 22.46
—time for payment of 22.48
Personal allowance, universal 14.19
—company tax 14.26–14.27, 16.8, 16.10, 16.17, 16.34, 16.40, 16.41
—complexity of 3.31, 14.2, 14.3–14.16
—concessional deductions: 7.21, 12.3–12.6
dependants
—concessional deductions: 7.21, 12.30–12.62
others
—indexation 2.11, 6.34
—indexation and the rate scale 2.11, 6.15–6.21, 6.35, 6.42–6.51
—negative tax system 13.15, 26.2
—principles relating to concessional deductions 12.17–12.29
rate structure 14.1–14.85, 27.44
—simplification of rate structure 3.21, 3.31
—social service payments, taxation of 5.15, 7.22, 13.1, 13.3, 13.10–13.12, 27.44
unit of taxation 2.11, 3.11, 10.1–10.33 See also Income tax; Rate structure; Shape of personal income tax rate scale; Tax mix

Personal Representative as trustee 15.8
Petroleum mining 19.75–19.91
—amortisation 19.88
—depreciation allowances 19.89
—development expenditure 19.86–19.88
—exploration and prospecting expenditure 19.78–19.85
—purchase of right or information 19.90–19.91
—recommendations 19.82, 19.84, 19.87, 19.91
—wasting assets 19.88 See also Mining industry; Quarrying industry
Pollution and ecological expenditure
—business and professional income 8.14, 8.207–8.208
—mining industry 19.30–19.35, 19.110
Primary production 7.24, 7.27
Primary production, taxation of 18.1–18.35, 28.20
—averaging of income 18.19–18.21
—bunching of income 18.19
—capital expenditure 18.22–18.28
—cost price valuation 18.9, 18.10, 18.11–18.12, 18.13, 18.14, 18.15, 18.16
—depreciation 18.22–18.28
—eligibility 18.3–18.4
—forest operations 18.5–18.8
—hobby farms 18.33, 18.35, 28.20
—losses 18.29, 18.33, 18.34
—market selling price valuation 18.9, 18.10, 18.13, 18.16
—present system 18.1–18.2
—recommendations 14.77, 14.79, 18.8, 18.18, 18.19, 18.20, 18.21, 18.28, 18.35
—restriction of benefit of tax provisions applying 18.30–18.35
—spreading of profits 18.19–18.21
—valuation of livestock 18.9.18.18
—investment companies 16.116–16.121 See also Companies; Company tax
Professional income See Business and professional income
Progressivity
—effects of 4.23–4.29
—estate and gift duty 24.4, 24.24
—issues re 3.18, 4.1–4.5
—personal income tax rate 14.1
structure
—statistics 4.6–4.16 See also Fairness; Redistribution
Property income 4.31, 16.116, 16.117
—inflation 6.69, 6.70 See also Investment income; Surcharge on property income
Prosecutions 22.1, 22.45–22.54
—onus of proof 22.47
—present position 22.45
—recommendations 26.46, 22.47, 22.48, 22.53, 22.54
Provisional tax 22.109–22.128
—criticisms of 22.118–22.122
—international comparisons 22.117
—present system 22.109, 22.113, 22.114
—recommendations 22.116, 22.123
Quarrying industry 19.92–19.115, 28.20
—anti-pollution and ecological expenditure
—depreciation of quarrying plant 19.100–19.101
—development expenditures 19.104–19.109
—expenditure incurred in 19.96–19.99
—exploration expenditure 19.102–19.103
—international comparison 19.98, 19.99
—nature of, compared to mining 19.93–19.95
—present legislation 19.97
—purchase and sale of a quarry 19.111–19.115
—transport facilities 19.108
—wasting assets 19.92, 19.95, 19.111, 19.115 See also Mining industry; Petroleum mining
Rate scales, units of taxation 10.20–10.22
Rate scale, adjustment of
—by statutory or discretionary mechanism 14.47–14.52
—procedure 14.52–14.59
—purposes of 14.44–14.46
—recommendation 14.52, 14.59
Rate structure, personal income tax 14.1–14.85
—averaging of income 14.2, 14.60–14.85
—basic characteristics 14.1
—complexity 14.2, 14.3–14.5
—dependant allowances 14.42
—frequency of adjustment 14.2, 14.40–14.59
—surcharge on property income 14.2, 14.6–14.14
Rate scale, personal income tax See Averaging of income; Complexity of personal income tax rate structure;
Rate scale, adjustment of; Shape of personal income tax rate scale;
Surcharge on property income

Rates and land taxes 26.1
—concessional deduction 12.17, 12.30
Rates and taxes, deductions for 7.42
—recommendation 7.54
Receipts, composite 7.101
apportionment of
Records, keeping of for travel 9.39
and entertainment expenses
Redistribution
—non-tax policies 4.17–4.22
—objective 4.32–4.38
—through taxation 4.17, 4.23–4.31 See also Fairness; Progressivity
Registered tax agents 22.83–22.88
—constitution of board 22.86
—declarations by 22.87–22.88
—present position 22.83–22.85
—recommendations 22.85, 22.86, 22.88
Rent payments, deduction for 7.56, 7.57 See also Imputed rent
Repairs 8.13, 8.198–8.201
Retail sales tax 27.29, 27.30
Retirement benefits 7.5, 7.9
Retiring allowances 21.3, 21.25–21.29, 21.43 See also Superannuation and retiring allowances
Returns, penalties for failure to 22.51–22.53
make
Revenue, losses from 12.18
concessional deductions
Review and appeal See Appeals
Ross Committee (1967), 25.7, 25.13
Charities
Salary and wages income See Employment income
Sales Tax See Retail sales tax; Wholesale sales tax
Saving incentives See Incentives
Savings
—bias against 21.5–21.6
—encouragement of 9.75, 21.6, 21.7
—inflation, effect of 6.3, 21.164
Self education
—concessional deduction 12.17, 12.30
—expenses 7.97–7.100
—recommendation 7.100
Senate Standing Committee on 24.2
Finance and Government Operations (1973)
Shape of personal income tax
rate scale
—avoidance and evasion 14.31–14.32, 14.37
effect on incentives 14.26, 14.28–14.30, 14.37
high range 14.25–14.33
in relation to company income tax
intermediate range 14.34–14.39
low range 14.16–14.24
maximum marginal rates 14.26, 14.33
recommendation 14.21, 14.33
revenue yield 14.25, 14.35
Simplicity
and other objectives 3.45–3.49
averaging of income 14.69
company tax 3.21, 3.34
concessional deduction 12.25, 12.29
criteria of tax reform 3.19–3.22
excise duties 27.10
goals of tax reform 5.1, 5.16
income tax, international 17.36–17.41, 17.42, 17.43, 17.68, 17.A10
aspects
personal income tax 3.21, 3.31
public expenditure v. 3.44
concessional deductions
surcharge on property income 14.6
wholesale sales tax 27.A6 See also Complexity
Singapore, income tax 17.21, 17.96
Social security See Child endowment; Social security contributions; Social service payments
Social security contributions 2.7–2.9, 13.1, 13.17–13.27
Social service payments 1.10, 3.4, 5.3, 13.2–13.16
alternatives to concessional 3.44
deductions
and negative tax system 13.15, 26.2
and progressivity 3.44, 4.11–4.12
and VAT 27.47, 27.49
as income 13.3, 28.16
eligibility for 13.3–13.5, 13.13
incorporation in the tax base 5.15, 7.22, 13.1, 13.10–13.12, 27.44
reference numbers 13.14 See also Child endowment
South Africa
unit of taxation 10.10
Spare parts 8.118–8.120
Split-rate system See Company tax
Spooner Committee
business and professional 8.3, 8.54, 8.72, 8.129, 8.149, 8.157, 8.165
income
—company tax 16.105
—excess profits tax 6.30
—friendly society dispensary 20.38–20.39, 20.43
—quarrying 19.112
—retiring allowances, 21.20–21.23, 21.80

recommendations

Sporting societies 20.22, 20.27, 20.28

Spouse
—concessional deduction for 12.3
—concessional rebate for 12.4, 14.23
—earnings of 12.7
—estate and gift duty 24.29–24.31 See also Concessional deduction; Unit of taxation

Sri Lanka, wealth tax 26.3

Stabilisation See Economic management

Standard Deduction 9.70–9.73, 28.15
—recommendation 9.73

Statistics
—business and professional 8.52, 8.55, 8.58, 8.62

income
—concessional deductions 12.1, 12.18
—distribution of income and 4.6–4.16

taxes
—historical perspective 2.1–2.5
—inequity 4.6, 14.15, 14.20, 26.24, 28.8
—international comparison 2.6–2.11
—superannuation and life insurance 21.10, 21.139

Student
—concessional allowance for 12.16

Study leave 9.63–9.66
—recommendation 9.66

Submissions
—administration 22.1, 22.2–22.4, 22.11, 22.15, 22.16, 22.40, 22.43, 22.45, 22.49, 22.51, 22.59, 22.64, 22.74, 22.107, 22.110, 22.139
—advertisement inviting xviii
—business and professional 8.3–8.4, 8.11, 8.27–8.28, 8.78, 8.79, 8.130, 8.167, 8.175

income
—company tax 16.122–16.124
—criteria of tax system 3.5
—estate and gift duty 24.2
—exempt bodies and mutual 20.28, 20.30, 20.36, 20.40

associations
—general insurance 20.8, 20.11, 20.18
—goods and services, taxation 27.A9, 27.A11, 27.A16

of
—income tax base 7.27
—income tax, international 17.95

aspects
—inflation 6.42, 6.66
—numbers received xviii, 1.5
—personal income tax rate 14.15
structure
—primary production 18.26, 18.28, 18.30
—reform of tax system 1.5
—social security 13.2
—superannuation 21.105
—unit of taxation 10.3–10.4
—wealth tax 26.2
Subscriptions 7.84–7.88
—distinction between employed 7.84, 7.85 and self employed person
—concessional deduction 12.17, 12.30
—recommendation 7.88
Superannuation 21.1–21.133
—alternative methods of 21.58–21.133
—treatment
—and capital gains tax 23.66
—annuities 21.48, 21.55, 21.75, 21.78
—arm's length transactions 21.28, 21.43, 21.74
—avoidance of tax 21.49–21.51
—benefits from funds, taxation of 21.47–21.51
of
—concessional deduction 12.17, 12.19, 21.30–21.32
—contributions to 7.89, 7.21, 7.95, 12.30
—international comparisons 21.52–21.57
—Canada 21.53, 21.55
—New Zealand 21.53, 21.54, 21.56
—present position 21.10–21.51
—restricted covenants 21.74
—vesting of contributions 21.111, 21.131
Superannuation and Life 21.1–21.9
Insurance, General considerations
—concessional treatment 21.8
—savings, encouragement of 21.6–21.7
—special treatment, case for 21.4–21.9
—transitional provisions 21.9 See also Concessional deductions
Surcharge on property income
—personal income tax rate 14.2, 14.6–14.14 structure
—recommendation 14.14
Sweden
—imputed rent of the owner-occupied home 7.43
—rate scale, adjustment of 14.55
—travel to and from work 7.60
—unit of taxation 2.11
—wealth tax 26.3, 26.4, 26.7, 26.9, 26.20, 26.21
Switzerland, wealth tax 26.3, 26.4, 26.7, 26.8
Tax Avoidance See Avoidance; Trusts
Tax base, erosion of 6.36, 6.65–6.71, 12.27
Tax credits 2.11
—for gifts to charities 25.22, 25.25
Tax drift 6.36, 6.39–6.40, 14.40
—concessional allowances 6.52–6.59
—estate and gift duties 6.60–6.64
—income tax rates 6.42–6.51
—tax mix 6.41
—total tax receipts 6.40
Tax havens 17.9, 17.10, 17.15, 17.16, 17.26, 17.46–17.55, 17.71, 17.73, 17.74, 17.82, 17.90, 17.93, 24.A38
Tax instalment deductions 9.6, 9.43–9.45 22.89, 22.91–22.108
(PAYE)
—averaging of income 14.69
—concessional deductions 22.92
—dual employment 22.100–22.101
—excess deductions 22.91–22.95
—extension of system 22.97–22.102
—false claims 22.106
—fringe benefits 22.102
—home loan interest 22.92
—identity of taxpayer under 22.100, 22.104–22.105
PAYE system
—interest on excess instalments 22.107–22.108
—limitations on effectiveness 22.96–22.103
—variation in 22.92, 22.94–22.95
Tax mix
—actual 2.4, 2.9–2.10, 6.41
—proposals re 1.6, 3.45–3.49, 5.1–5.16
Tax payment, and inflation 6.36, 6.37–6.38
Tax planning 16.96, 16.118–16.119, 24.2 See also Trusts
Tax rebate, non-reimbursable 14.19
Terms of reference xvii, xx, 1.8, 1.14, 3.1–3.6, 28.1, 28.4, 28.5, 28.6
Trade unions 20.22, 20.27
Trading stock 8.12, 8.113–8.154, 8.187–8.188
—cost price valuation 8.124–8.155, 8.126–8.135
—definition of 8.166–8.122
—disposal of 8.140–8.154
—land held for resale 8.177
—market selling valuation 8.136–8.138
—methods of valuation 8.123, 8.139
—net realisable value 8.137–8.138
—plant spares and consumable stores 8.118–8.120
—present provisions 8.113–8.114, 8.116–8.117
—recommendations 8.117, 8.118, 8.121, 8.133, 8.135, 8.138, 8.139, 8.144–8.145, 8.146, 8.151
—replacement price 8.139
—shares and debentures 8.119–8.121
Transfer payments See Child endowment; Social service grants
Travel and removal expenses 9.50–9.59
—recommendations 9.51, 9.56, 9.58
—removal within employment 9.35–9.56
—temporary travel within employment 9.51–9.52
—to new employment 9.57–9.59 See also Living away from home allowance; Study leave
Travel to and from work, 7.58–7.65
— arguments against 7.64
— arguments for 7.61–7.63
— recommendation 7.65
Treasury, assistance of xviii
Treasury/Tax papers xviii
— accounting period 15.9
— accumulating income 15.25–15.35, 15.55, 15.59, 15.60, 28.17
— allocation of income 15.3, 15.7
—and capital gains tax 23.26, 23.45–23.50
—annuity 15.13
—assignment of interest 15.57
—beneficiaries presently entitled 15.4, 15.5, 15.7, 15.8–15.13
—beneficiaries, presently entitled but under disability 15.14–15.15
—bonus shares 15.18
—character of income 15.6
—credit for tax paid by 15.28–15.29
—deceased estates 15.8, 15.23, 15.31, 15.33, 15.35, 24.12, 24.19
—depreciation 15.21
—difference to companies 15.2
—discretion, exercise of 15.10–15.11
—double taxation relief 15.60
—foreign source income 15.55, 154.56, 15.58, 15.60, 15.61
—income received in advance 15.5
—international aspects 15.54–15.62
—lease premiums 15.20
—losses 15.36–15.40, 8.163
—net income 15.16–15.24
—personal representative 15.8
—rates of tax 15.30–15.32
—recommendations 15.5, 15.6, 15.8, 15.10, 15.12, 15.15, 15.18, 15.22, 15.32, 15.34, 15.35, 15.40, 15.56, 15.61
—resettlement of trust incomes 15.12
—residence of beneficiary 15.55, 15.56
—residence of trust 15.58, 15.59
—residence of trustee 15.55, 15.56
—tax avoidance 15.30–15.32, 15.34
—trustees, allocation of income 15.7

—trust income 15.16–15.24 See also Business and professional income; Estate and gift duty; Estate and gift duty, proposed integrated base of

Trustees See Trusts

Turnover tax 27.25

Undistributed profits tax 16.15, 16.62, 16.112, 16.124, 16.130, 16.148 See also Company tax; Private companies

United Kingdom
—business and professional 8.187

Income
—capital gains tax 23.20, 23.25, 23.27, 23.33, 23.41, 23.43, 23.62, 23.80
—charities 25.9, 25.15, 25.19, 25.35
—hobby farming 18.33
—income splitting 11.12, 11.15
—income tax, international 17.13, 17.37, 17.88, 17.96, 17.101, 17.103, 17.A1

Aspects
inflation 6.18
personal allowance, universal 14.19
personal income tax rate 14.3
structure
—superannuation 21.56
—travel to and from work 7.60
—surcharge on property income 14.6
—unit of taxation 10.6–10.7, 10.20
—wealth tax 26.3
United Kingdom Royal 19.38, 25.10, 25.15
Commission on the Taxation of
Profits and Income (1955)
United States
—averaging of income 14.74, 14.76–14.77
—business and professional 8.67
income
capital gains tax 23.43–23.44
charities 25.11, 25.15, 25.19, 25.23
child minding expenses 7.68
estate and gift duty 24.A11
hobby farming 18.33
income tax, international 17.37, 17.48, 17.51, 17.96, 17.101, 17.102, 17.104, 17.A1
aspects
information, dissemination of 22.69, 22.72
life insurance 21.151, 21.155, 21.157
partnerships 15.53
personal allowance, universal 14.19
personal income tax rate 2.11, 14.3
structure
—superannuation 21.53, 21.57, 21.76
surcharge on property income 14.6
—unit of taxation 10.8–10.9, 10.20
valuation of livestock 18.16, 18.17
wealth tax 26.3
Unit of taxation 10.1–10.33, pp.157–158, 28.16
aggregation of income pp.140–141, 28.16
almimony 10.30–10.32
and child endowment 10.25, 12.15
and dependent spouse 10.23, 12.9
arguments for reform of 10.14–10.19
avoidance of tax 10.26, p.140
children 10.24, 10.25, 28.16
compulsory family rate 10.15, 10.16, 11.4
concessional deduction 10.25
—de facto spouses 10.29
—family 10.1–10.33, pp.140–141
—income splitting 10.4, 10.19, 10.21, 10.26, 10.29, 11.1–11.48
—international comparisons 10.5–10.13
—optional family 10.15, 10.17, 10.21, 10.26, 10.27–10.28, 10.33, p.140, p.158
—personal income tax 2.11, 3.11, 10.1–10.33
—public examination of 10.33, pp.140–141
—rate scale 10.20–10.22, p.141
—recommendation 10.25, 10.27, 10.33, pp.140–141
—reservation by Committee pp.140–141
—separated or divorced spouse 10.30–10.32
—working wives 10.23
Uruguay, wealth tax 26.3
VAT
—business and professional 8.23
income
—and company tax 27.45
—and income tax 27.44, 27.49
—and payroll tax 27.45
—and social service payments 27.47, 27.49
—base 27.31–27.35, 27.38, 28.29
—exemptions 27.33, 27.38
—food and clothing 27.20–27.21, 27.23
—merits and defects 27.37
—overseas systems 2.10, 27.31, 27.33–27.38
—rate of tax 27.34, 27.42, 27.48–27.49
—recommendations 27.39–27.51 See also Goods and services, taxation of; Tax mix
Wasting Assets See Mining industry; Petroleum mining, Quarrying industry
Wealth tax 3.39, 4.31, 24.6, 26.1–26.25, 28.28
—and capital gains tax 26.10, 26.11, 26.25
—and estate and gift duty 24.6, 26.11, 26.15, 26.16, 26.17, 26.23, 26.25
—consideration of 26.10–26.24
—exemptions 26.5, 26.6
—overseas experience 2.10, 26.3–26.9, 26.19, 26.20, 26.21
—property included 26.1, 26.5
—rate of tax 26.7
—recommendations 26.16, 26.25
—revenue yield 26.8
Wholesale sales tax
—broad-based 27.26–27.28
—freight charges 27.A20–27.A24
—objections and appeals 27.A12–27.A19
—present system 1.3, 2.5, 2.10, 27.3, 27.5–27.6, 27.10, 27.13–27.14, 27.A2, 27.A7–27.A8,
27.A10, 28.29
—simplicity 27.A6
—transitional provisions 27.A3–27.A5 See also Goods and services, taxation of
Withholding tax 17.1, 17.6, 17.53–17.62, 17.67, 17.68, 17.69, 17.71–17.76, 17.82, 17.86,
17.91, 17.94, 17.95, 17.A22, 17.A25, 22.139–22.140
Wives See Concessional deductions; Dependents; Unit of taxation
Women, Canadian Royal Commission on the Status of (1970)
Work incentive See Incentive
Zone allowances
—boundaries 12.55–12.57
—concessional deductions 7.21, 12.17, 12.19, 12.53–12.62
—deduction or rebate? 12.58–12.59
—qualifying period 12.61–12.62
—recommendations 12.57, 12.59, 12.61–12.62

* Roman numerals refer to pages of preface; P refers to page number