Will Tax Havens Survive in the New International Legal Environment?

A thesis submitted in fulfilment for the degree of Doctor of Philosophy

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DECLARATION

I certify that:

Except where due acknowledgement has been made, this thesis is mine alone. The work has not been submitted previously, in whole or part, to qualify for any other academic award. The content of the thesis is the result of work that has been carried out since the official commencement date of the approval of the research programme.

John Andrew McLaren
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ABSTRACT

Tax havens and Offshore Financial Centres (OFCs) are seen as facilitating the avoidance and evasion of tax revenue that should rightly be paid to the country of the residence of the taxpayer. For example, it has been estimated that for the 2008 year the United States would have lost USD 100 billion in revenue and that over the past decade, USD 1.027 trillion.\(^1\) The problem of lost tax revenue due to the existence of tax havens and OFCs has been estimated as costing governments worldwide USD 255 billion each year.\(^2\) Moreover, it is estimated that 15 percent of the world’s nations are tax havens and half of the world trade passes through them although they only account for 3 percent of the world’s GDP.\(^3\)

The Organisation for Economic Cooperation and Development (OECD) has been very active for the past ten years trying to make tax havens and OFCs more transparent in their taxation arrangements with individuals and Multi-National Enterprises (MNEs) as well as amend their bank secrecy laws so that information about non-resident taxpayers can be made available to other countries. Recently, as a result of the ‘Global Financial Crisis’, the G20 nations have threatened to impose sanctions on tax havens and OFCs in order to require those nations to exchange information on foreign investors and MNEs and to amend their bank secrecy laws. As a result of this action, all tax havens have cooperated with the OECD in terms of exchanging tax information and reducing their bank secrecy laws. In fact, as at 1 April 2010, the OECD was able to report that there were no countries that had not agreed to the ‘internationally agreed tax standard’ on exchange of information and transparency.\(^4\)

The main question raised in this thesis is whether tax havens and OFCs will survive in the new international legal environment. Chapter Ten of the thesis provides a

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\(^2\) Ibid, 708.

\(^3\) Ibid, 711.

conclusion that supports the contention that tax havens will survive, although with a reduced volume of business. The main reasons for this conclusion are that tax havens do provide many legitimate uses for their banking and financial services that are used by foreign governments as well as individuals and MNEs. The fact that all governments still have a great deal of difficulty in identifying their own resident taxpayers that use tax havens is also a strong reason for believing that tax havens and OFCs will still continue to provide banking services in the future. This reason still applies even though countries such as Australia, the US and the United Kingdom have strengthened their laws in order to detect and deter their residents from locating capital and business in tax havens and OFCs.

The thesis then examines four subsidiary research questions that have a direct bearing on the survival of tax havens. The first question asks whether the international income of Australian residents should be taxed on a ‘worldwide’ or ‘territorial’ basis. The simple basis for this question was that if it was so difficult for the Australian Taxation Office to detect Australian resident taxpayers that were using tax havens then why spend millions of dollars trying to achieve an almost impossible task. For example, ‘Project Wickenby’ has been provided with funding of more than $300 million and yet, has only collected about $160 million in actual cash.5 Currently, Australia imposes income tax on its resident taxpayers on their worldwide income except for MNEs that generate active business income, which is exempt when repatriated to Australia. One of the main reasons for looking at this question was to see if it would be more equitable, efficient and simpler to adopt a territorial basis of taxation. Under a territorial basis only income generated within the state is subject to tax and all foreign income is not taxed in the home state. The research indicated that a territorial system of taxation was inherently inequitable as those taxpayers that could arrange their affairs in such a way that much of their income was generated in a foreign country paid very little income tax. Moreover, it appeared that both tax systems required complex anti-avoidance laws to combat tax avoidance by their resident taxpayers. Therefore, the conclusion contended that the current

5 Assistant Treasurer, The Honourable Nick Sherry, ‘Crackdown on Tax Crime’, Newsletter, 16 February 2010. The government and the ATO contend that they have been successful because they included the amount of almost $300 million as a ‘compliance’ dividend. In other words the $300 million represented an amount that would have been lost to revenue if Project Wickenby had not deterred taxpayers from using tax havens and OFCs.
Australian system was good in that it was equitable and yet exempted active foreign business income from further tax in Australia.

The second subsidiary research question asked whether the OECD’s ‘harmful tax competition project’ was now part of the current international taxation law. In this context the issue was that if it is ‘soft’ international law is that one of the main reasons why many tax havens and OFCs were complying with the guidelines on transparency and exchange of information. The research examined the philosophical basis for international law and the concept of hard and soft international law. More importantly, it examined the concept of how international law became part of the domestic law of a country. This issue is important because many tax havens may not be able to convince their own Parliament to amend their bank secrecy laws even though the government has entered into an exchange of information agreement with another country. If the bank secrecy laws are not amended to allow for the exchange of information on non-resident taxpayers then tax havens and OFCs will continue to operate unfettered.

The third subsidiary research question concerned the reason why the Australian government has deliberately blurred the distinction between tax avoidance and tax evasion; the former being a legal activity and the later being unlawful. The conclusion was that one of the main reasons for the blurring of the distinction was to overcome any concerns on the part of tax havens and OFCs that all banking and financial activities by Australian taxpayers constituted criminal conduct and, therefore, should be disclosed to the ATO. The overwhelming desire to break down the bank secrecy requirements of tax havens has resulted in the Australian Government treating all measures to avoid income tax as amounting to tax evasion and, hence, a criminal offence and this aspect is examined in detail in the thesis. This issue has implications for the future of tax havens and taxpayers wishing to use foreign banking services.

The fourth subsidiary research question focuses on the rights of taxpayers that use tax havens and OFCs to hold their wealth when these nations are now entering into tax information exchange agreements (TIEAs). It became clear from the research that taxpayers are able to protect the confidentiality and privacy of their financial details
only if they are able to show that the information is protected by legal professional
privilege. This privilege extends to legal advice obtained from a foreign lawyer. The
future of tax havens and OFCs is arguably dependent upon them being able to protect
the confidentiality of the financial details of non-resident taxpayers through their
bank secrecy laws. If the tax havens and OFCs repeal their laws and allow requests
for information to be complied with, then the rights of the non-resident taxpayers are
severely affected. This in turn impacts on the survival of tax havens.
CHAPTER 1 INTRODUCTION TO THE THESIS

1.1 Introduction

The aim of the thesis is to critically assess the future of tax havens and Offshore Financial Centres (OFCs) in face of the concerted effort of the Organisation for Economic Cooperation and Development (OECD), the European Union (EU), the G20 Nations and the Australian Government to combat tax havens and harmful tax competition on the basis of perceived tax avoidance and tax evasion. As the movement of mobile capital between countries with different income tax rates increases, the ability of governments to impose tax on the earnings from that capital becomes harder. As developed countries impose high rates of income tax in order to sustain a welfare state with an ageing population and, more recently, to reduce budget deficits as a result of the global financial crisis, the activities against tax havens have increased. To put the role of tax havens and OFCs in context, it has been estimated that for the 2008 year the United States (US) would have lost USD 100 billion in revenue and over the past decade, USD 1.027 trillion as a direct result of taxpayers using the banking and financial services being provided by tax havens. The problem of lost tax revenue due to the existence of tax havens and OFCs has been estimated as costing governments worldwide USD 255 billion each year. Moreover, it is estimated that 15 percent of the world’s nations are tax havens and half of the world trade passes through them although they only account for 3 percent of the world’s GDP. In the Oxfam report, Tax Havens: Releasing the Hidden

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1 The term ‘tax havens’ is a generic term used to describe a country with low or no income tax rates and is also commonly referred to as an ‘offshore financial centre’ (OFC). A ‘tax haven’ is defined in section 1.2 below.
2 Terry Dwyer, ‘The New Fiscal Imperialism’ (2002-03) 19 Policy 12. On page 12, the first page of the article, Terry Dwyer states that ‘it is not surprising that Japan, the most rapidly ageing OECD country instigated the OECD work against tax havens in 1995’.
3 The OECD and the EU have been mounting their campaign against tax havens since the mid 1990s and over the last few years Australia has been very outspoken against tax havens and has started to prosecute Australian taxpayers for ‘Defrauding the Commonwealth’.
5 Ibid, 708.
6 Ibid, 711.
Billions for Poverty Eradication, Oxfam estimated that the loss of taxation revenue from taxpayers using tax havens amounted to at least US$50 billion a year.\(^7\)

According to the OECD report on *Harmful Tax Competition - an Emerging Global Issue*, which was published in 1998, there were six Pacific nations on a ‘black’ list of tax havens that were considered to have harmful tax practices. That list was used by the Australian Taxation Office (ATO) in its report on *Tax Havens and Tax Administration*, which was published in February 2004. Since then further work has been undertaken by the OECD in having many of the tax havens on the list agree to be less secretive and to provide transparency in terms of the details of the people and corporations using the financial services provided by the tax havens. The OECD was able to report that there were no countries that had not agreed to the ‘internationally agreed tax standard’ on exchange of information and transparency as at 1 April 2010.\(^8\) At a meeting of the OECD member countries, which met in Melbourne Australia in November 2005, the delegates to the meeting discussed the ways in which tax havens could be convinced to act as de facto tax collectors for the wealthier and more powerful nations and, at the same time, provide details of those using tax havens so as to deter anyone from placing their capital in those countries.

This thesis will consider the adequacy of the existing Australian law to impose income tax on a ‘worldwide’ basis on its citizens. It will then focus on the OECD and its role in the development of ‘soft’ international law that impacts on tax havens\(^9\) and whether or not tax havens can survive as separate sovereign states, which means having the ability to make their own taxation laws without interference from other countries. For centuries, countries have been competing with each other to attract investment capital by offering foreign investors and foreign businesses tax concessions in order to attract them to establish their business or to place their money within that particular country. This thesis will show that many OECD member nations provide tax concessions in order to attract mobile capital. For example, the

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\(^9\) The concept of international law and the distinction between ‘hard’ and ‘soft’ international law will be discussed later in this thesis.
US does not impose income tax in the form of withholding tax on interest earned in bank accounts by foreign investors. In fact, the income earned is not reported to the US Internal Revenue Service. Moreover, the US allows the State of Delaware to provide foreign taxpayers the ability to incorporate a company that allows money to be channelled to another country without any tax implications in the US. The United Kingdom (UK) allows wealthy individuals to live in the UK as non-domiciled residents and pay no income tax on their worldwide income. Australia also allows temporary residents to live in Australia but pay no income tax on their worldwide income.

Australia has a taxation system that imposes income tax on its residents on a worldwide basis. This means that if an Australian resident earns income anywhere else in the world they must disclose that income in Australia and be subject to income tax on that profit. However, some Australian taxpayers have realised that if they earn income in a low or no income tax country, such as a ‘tax haven’, then little or no income tax will be imposed on that income in the ‘source’ country and, if it is not disclosed in Australia, then no income tax is payable in Australia. The act of non-disclosure can amount to either tax evasion or tax avoidance according to the existing Australian statutory taxation law. It is this exact problem that the Australian Government, the OECD, the G20 and the EU are trying to stop.

The thesis will analyse whether recent reforms to the law, in both Australia and internationally, can curb the incidence of taxpayers using tax havens to eliminate income tax being paid in Australia and other OECD countries. The opening of a bank account in a tax haven by an Australian resident is not contrary to the law but the failure to account for the income derived from funds placed in the bank account in a tax haven is an offence under the existing taxation law. The recent actions by the Australian Government and the OECD to proscribe activities by taxpayers that may

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10 Australia imposes income tax on a world-wide basis on those taxpayers considered to be residents of Australia for taxation purposes. Income tax is not based on the nationality of the taxpayer in the same way as the US imposes income tax on all of its nationals no matter where they live and work.

11 The Income Tax Assessment Act 1997 (Cth), s 6-5 and s 6-10 imposes income tax on a world-wide basis on resident taxpayers.

12 The introduction of the Anti-money Laundering and Counter-Terrorism Financing Act 2006 (Cth) which is similar to the Patriot Act (USA) that was introduced in response to the terrorist attacks on the World Trade Centre on 11 September.
only constitute tax avoidance as amounting to tax evasion would appear to blur the
distinction between tax avoidance and tax minimisation, which is considered to be
legal, and tax evasion, which is illegal. The thesis will critically examine the reasons
why the government is deliberately blurring the distinction.\(^\text{13}\)

The thesis will explore whether international criticism of tax havens is warranted and
whether existing Australian taxation law is sufficient to impose income tax on
Australian taxpayers investing in tax havens or conducting their business through a
tax haven. In this respect the thesis will critically examine the current law and
comment on its effectiveness in imposing income tax on Australian residents on their
worldwide income.

### 1.2 What is a Tax Haven?

Tax havens are sometimes referred to as ‘Offshore Financial Centres’\(^\text{14}\) and the
OECD describes countries that have little or no income tax as ‘engaging in harmful
tax competition’.\(^\text{15}\) In this thesis, the generic term of ‘tax havens’ will be used to
cover the range of taxation practices that are considered by the OECD and the G20
nations, in particular, to not be in the best interests of most western countries that
impose progressive rates of tax on income and that maintain a welfare system
requiring substantial tax revenue.

Tax havens take a variety of forms and, according to Kudrle and Eden,\(^\text{16}\) there are
four types of tax havens. The first, a ‘production haven’ is where foreign investors
actually produce goods or services as a result of low taxes and tax concessions being
offered by the host country. Ireland was considered to be a ‘production haven’
because many multi-national companies set up operations in Ireland because of the
tax regime. Singapore also offers very generous tax concessions for businesses to set
up production facilities or service companies. The second category is a ‘headquarters
haven’ where companies are encouraged to incorporate their company in the tax

\(^{13}\) For a more detailed discussion of this issue see Dwyer, Terry, (2002-2003)19(4) Policy 15.
\(^{14}\) Ibid 12.
haven even if the shareholding is located elsewhere. Singapore and Belgium are offered as examples of headquarters havens. The third category is a ‘sham haven’ where the host country imposes little or no income tax on profits generated by the foreign investor and the offshore financial centre located in the sham haven provides banking and insurance products for the foreign entity. The best examples of ‘sham havens’ are the Pacific tax havens, such as Vanuatu, and the Caribbean tax havens, such as Bermuda and the Cayman Islands. The fourth category is a ‘secrecy haven’ which ensures that details of monetary transactions are kept secret from the taxpayer’s home country. The best examples of a ‘secrecy haven’ are Switzerland, Luxembourg, Austria and Singapore. In these countries tax rates are not as important as the ability to hide investments.

The Australian Taxation Office (ATO) in its publication titled *Tax Havens and Tax Administration* \(^\text{17}\) bases its definition of what a ‘tax haven’ is on the OECD criteria which are as follows:

A country is considered to be a tax haven if it contains three factors, first; if the country imposes no or only nominal taxes, second; there is a lack of effective exchange of information between countries because of bank secrecy laws, and third; there is a lack of transparency in that special tax rates may be negotiated and not consistently between foreign enterprises. \(^\text{18}\)

The ATO goes on to state that:

having no or nominal taxes is not sufficient by itself to characterise a jurisdiction as a tax haven. The OECD recognises that every jurisdiction has a right to determine whether to impose direct taxes and, if so, to determine the appropriate rate.’ \(^\text{19}\)

It has been suggested that Australia could also regarded as a ‘tax haven’ because it provides foreign investors with tax concessions that are not available to Australian residents. \(^\text{20}\) A ‘temporary resident’ is exempt from income tax in Australia on any


\(^{18}\)Ibid.

\(^{19}\)Ibid.

foreign income derived whilst living and working in Australia. Moreover, a foreign investor in Australian shares or units in a unit trust is exempt from income tax on any capital gain derived from the sale of the investment, whereas a resident Australian investor pays income tax on the capital gain. The capital gains tax regime has been further narrowed in relation to foreign residents to only include real property and business assets held within a permanent establishment. These issues are discussed in detail in Chapter 5 of this thesis.

Tax havens and OFCs play an important role in providing a banking and financial environment for legitimate business activities such as insurance and reinsurance as well as management expertise for sovereign funds. Moreover, they provide a safe haven for the protection of assets that are owned by non-resident investors living in countries that persecute their citizens on religious, race or sexual grounds. These legitimate activities are discussed in detail in Chapter 9 of this thesis. If tax havens and OFCs ceased to exist then insurance cover for businesses and assets in non-tax havens may be either impossible to obtain or far too expensive for individuals and businesses. The impact on business, both global and national could be disastrous over time. Tax havens and OFCs employ many local people to provide financial and banking services to non-resident investors and if tax havens were not to survive then many small tax havens and OFCs would require the rest of the world to provide financial support to compensate for loss of business revenue and employment opportunities. These are but two reasons why this research is needed.

1.3 **Australia’s Approach to Tax Havens**

The Federal Treasurer, the Honourable Peter Costello, made the following observation on tax havens at the Insurance Council of Australia Conference in 2004:

> Tax havens undermine the revenue base, tax havens are not fair. And ordinary law-abiding taxpayers are rightfully outraged by the use of off-shore tax havens to avoid paying Australian tax. This is why action against tax havens has been one of my top international priorities for many years. In June of 2000 when I was the Chairman of the OECD, we approved a strategy for advancing what was then called the Harmful

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21 Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 4) Bill 2006 that was introduced into the Commonwealth Parliament on 22 June 2006.
Tax Practice Initiative against tax havens. …Unfortunately in September of 2003, Switzerland and three other OECD countries did not agree to the OECD agenda to remove bank secrecy laws. At the time I made this statement; “If you want to have a look at a weakness in the enforcement of taxation law we know where it stands: the secrecy of Swiss bank accounts.” … At my instruction, Treasury officials are attempting now to reinvigorate this work. We are asking for three commitments. One, we are asking countries to commit to making their tax systems more transparent. Two, we are asking for a commitment for the repeal of bank secrecy laws. Three, we are asking countries to enter into agreements for the exchange of information on tax matters.\textsuperscript{22}

In \textit{Tax Havens and Tax Administration},\textsuperscript{23} it is reported that in the 2001-02 financial year Australians transferred approximately $5 billion to five OECD identified tax havens, namely Bermuda, Cayman Islands, Jersey, Guernsey and Vanuatu. This information was provided to the ATO by the Australian Transaction Reports and Analysis Centre (AUSTRAC). Since 2006, the Australian Government has instituted a concerted effort against Australian taxpayers that have been using tax havens. This has resulted in the establishment of ‘Project Wickenby’ and a number of Australian taxpayers are being charged with the crime of ‘defrauding the Commonwealth’. The Government expects up to 300 taxpayers to be eventually charged with taxation offences and estimates that the tax evasion may be in the vicinity of $1.3 billion.\textsuperscript{24} These developments are examined throughout this thesis.

\subsection*{1.4 Research Problem}

The OECD, the European Union (EU), the G20 nations, the US, the UK and the Australian government have all been critical of tax havens and OFCs for providing a tax free environment for mobile capital and Multi-National Enterprises (MNEs) and ensuring through bank secrecy laws that the identity of the investor remains confidential. These two factors, no or low taxes and lack of transparency, support tax avoidance and tax evasion by non-resident investors and MNEs. As a result of the

\begin{flushleft}
\textsuperscript{22} Address by the Honourable, Peter Costello, Federal Treasurer, to the Insurance Council of Australia Conference, Canberra, 12 August 2004, <http://www.treasurer.gov.au/tst/content/speeches> at 8 August 2006
\textsuperscript{23} Australian Taxation Office, above n 17, 10.
\textsuperscript{24} Fleur Anderson and Fiona Buffini, ‘ATO targets business tax havens’, \textit{The Age Newspaper}, Melbourne, 31 August 2006, 1.
\end{flushleft}
OECD’s harmful tax competition project and the introduction of ‘tax information exchange agreements’ (TIEAs) and the G20 threatening sanctions against tax havens, the major issue facing tax havens and OFCs is will they survive and in what form? Will they as sovereign nations being able to provide financial and banking services to non-resident taxpayers and investors in a tax free environment while keeping intact their domestic bank secrecy laws? Or will they be forced to abandon their current tax and secrecy approach and undertake less reliable productive activities in an increasingly complex and fragile global economic environment? These questions have not been asked, let alone answered publically in academia or practice. The research that is undertaken by this thesis is the first attempt to provide answers. Four subsidiary research questions are also examined in this thesis as each question adds to the body of new knowledge that is required to provide an answer to the main research problem.

1.5 Research questions

The term the ‘new international legal environment’ is used to describe the international environment that has been created by the OECD, the EU, the G20 nations and countries such as the UK, US and Australia in their attempts to curtail the flow of mobile capital into banks situated in tax havens and OFCs that ultimately escapes the tax net in the country of residence of the investor or MNE. In Chapter 5 of this thesis it is contended that the OECD makes international law through its guidelines and policies. Moreover, international agreements relating to the exchange of information also constitute international law. It is within this context of the new international legal environment that the survival of tax havens is being researched.

1.5.1 Main research question - Will tax havens survive in the new international legal environment?

The thesis will focus on the fact that tax havens and OFCs provide banking and financial services to high-net-worth individuals and multi-national enterprises (MNEs). A key feature of tax havens is that they have enacted very strong domestic bank secrecy laws that prevent bank details being disclosed unless relating to criminal activity. It is for this reason that many non-resident taxpayers feel confident about moving capital and investments to tax havens and OFCs. Moreover, many
people are employed in the banking and financial services industry in tax havens and OFCs and the economy of the country involved relies on income derived from providing these services. If tax havens were to disappear, many additional economies would be reliant on foreign financial aid and unemployment would increase in those states.

The research will also discuss the many legitimate uses for tax havens, especially in the area of insurance and fund management, especially with sovereign wealth funds. Australia’s ‘Future Fund’ is invested through a tax haven. The beneficiaries of tax havens and OFCs are the established investment centres, such as the US and the UK, where the mobile capital that was initially deposited in the tax havens is eventually invested. Australia has been a beneficiary from tax havens in that it receives more money from tax havens in the form of foreign investment than the amount that flows out of Australia to tax havens; almost double the amount of money.

From a practical perspective, it has always been very difficult for tax administrators to detect their own taxpayers using tax havens. The research will examine this issue in detail. From a negative perspective, tax havens and OFCs may continue to thrive simply because it is still too difficult for the OECD member states and the G20 nations to detect their own resident taxpayers who use tax havens. The continued existence of bearer shares, nominee directors and investment trusts makes the task of finding the beneficial owner of investments particularly difficult. Even allowing for tax havens and OFCs entering into ‘Tax Information Exchange Agreements’ with OECD member countries and making some amendments to their bank secrecy laws, countries such as Australia are not permitted under current double taxation agreements and the tax information exchange agreements to engage in ‘fishing expeditions’ in an attempt to find Australian taxpayers using offshore banking services. The ATO must have specific information about a particular taxpayer and evidence of criminal activity before information will be provided by the tax haven or OFC.

The thesis will also examine steps that are being taken by different governments to strengthen laws that may help in the detection of their taxpayers using tax havens and OFCs. The US is actively engaged in introducing new laws to try to deter and detect
US citizens with offshore bank accounts being used to hide assets. Australia has, arguably, had some success with ‘Project Wickenby’ in terms of the effect prosecutions have had on deterring taxpayers from hiding assets in tax havens. The government has claimed a ‘compliance dividend’ of nearly $300 million in saved income tax as a direct result of its aggressive approach to tax havens. The thesis will also critically examine the lack of a ‘level playing field’ with developed countries. Many developed economies provide special tax concessions that, in many instances, are not transparent to encourage investment in their own country. In some instances, these tax concessions are similar to those offered by tax havens and OFCs. For example, Australia encourages foreign investment by offering tax concessions not available to ordinary residents; the UK offers non-domiciled residents tax concessions and encourages those foreign residents to use tax havens that are British dependencies in which to invest their money; the US allows for the State of Delaware to provide a haven for corporations to transfer money globally as well as encouraging investment in the US without withholding tax being imposed; and, New Zealand facilitates the flow of money to tax havens through their foreign investment trusts and still has not introduced a tax on capital gains. The extent of tax hypocrisy that exists in the developed world arguably provides tax havens and OFCs with more than sufficient ammunition to counter any actions to force them out of business by the OECD or the G20.

At the end of the research on this main question it will be possible to provide an answer as to whether tax havens will survive in the new international legal environment.

There are also four subsidiary research questions that have been identified as being of importance for the thesis. These subsidiary research questions have a direct impact on the future of tax havens and their survival in the face of determined action by the international community including the OECD, the EU, the G20 nations, and the governments of the UK, the US and Australia, to name the countries that are relevant for this thesis.
1.5.2 First subsidiary research question - Should the international income of an
Australian resident be taxed on a worldwide or territorial basis?

The first subsidiary research question is whether the taxation law that imposes
income tax on Australian residents on their worldwide income is sound law in terms
of efficiency. As a result of the fact that it is very difficult for the ATO to ascertain
the existence of income being generated by Australian taxpayers in a tax haven,
should the Australian Government therefore adopt the ‘territorial approach’ to the
imposition of income tax on foreign income?25

The research will focus on the fact that it is very difficult for any government to
detect and then deter resident taxpayers from using the financial services provided by
tax havens, particularly as labour and capital becomes more mobile in a globalised
world. This is a particular problem if the country of residence imposes income tax on
their residents’ worldwide income. For example, in Australia, resident taxpayers
must pay income tax on all income no matter where it is derived. This means that
income generated in a foreign country must be subject to tax in Australia unless an
exemption applies. Similarly, foreign tax paid on foreign income will result in a
foreign tax credit when the income is subject to tax in Australia. However, the main
problem for the Australian Government is how to detect foreign income generated in
a tax haven or OFC. Given this issue, would it be better for Australia to only impose
income tax on income generated in Australia and ignore foreign sourced income?
This would be easier and cheaper than trying to detect Australian taxpayers using
financial services in tax havens and OFCs to hide foreign income from being subject
to income tax in Australia.

The research will not simply focus on the practical problems of trying to detect and
deter non-resident taxpayers from using tax havens. The research will also consider
the philosophical issue of why governments have chosen to adopt a worldwide
system in the first place and whether it would be more equitable, efficient and
simpler to impose income tax on a country’s resident taxpayers on a worldwide or

25 The territorial basis of imposing income tax is to only tax income sourced within the country or territory. This
means that income generated by a resident taxpayer out of the territory is not subject to income tax in the home
country. This is the situation in Hong Kong, Malaysia, Philippines and Singapore.
territorial basis. A worldwide tax system is seen by commentators as being more complex than a territorial system, however, a pure territorial system, such as the one that exists in Hong Kong, is inherently inequitable, even though it is simpler. In terms of efficiency, Australia has a hybrid worldwide system in that foreign active business income, foreign non-portfolio dividends and some foreign employment income is exempt from further income tax in Australia. This hybrid system ensures that MNEs are encouraged to expand and invest their business operations in foreign countries without being disadvantaged by higher taxes in their home country. At the conclusion of the research, it may be possible to provide an answer as to what system is best and why Australia, in particular, may be better placed to continue with its hybrid worldwide system.

It is interesting to note that Australia allows ‘temporary residents’ to be taxed only on their income generated within Australia and allows foreign income to be exempt. Similarly, foreign investors only pay income tax on capital gains generated from real property and shares in land-rich companies situated in Australia; all other investments do not attract a tax on the capital gain. These two examples of Australia taxing foreign investors and temporary residents on a territorial basis can be explained as policy measures designed to maintain Australia as a competitive nation for foreign investment. New Zealand and the UK also provide tax concessions for new immigrants and non-domiciled residents. The research should provide answers as to why these measures should not be seen as advocating the adoption of a territorial system for all resident taxpayers.

One of the key issues facing any tax system is tax avoidance and tax evasion. Hong Kong, with its simpler tax system, still has complex anti-avoidance tax laws that are designed to ensure their resident taxpayers pay the appropriate amount of income tax. Both Hong Kong and Australia appear to have difficulty in detecting and deterring their taxpayers from using financial services located in tax havens and OFCs.

1.5.3 Second subsidiary research question - The OECD’s ‘Harmful Tax Project’:

Is this international law?
Since the early 1990s, the OECD had been trying to ‘name and shame’ tax havens and eliminate competitive tax practices through its ‘harmful tax competition project’. The OECD wanted to achieve a ‘level playing field’ with all nations. This was to be achieved by tax havens and OFCs eliminating their bank secrecy laws and by becoming more transparent in their dealings with other countries. The research in this area raises three questions; first, does the OECD make ‘soft’ international law and, if that is the case, has the ‘harmful tax competition project’ become part of the international taxation law? Second, if that is the situation, does this explain why many tax havens and OFCs are entering into tax information exchange agreements? The third question relates to the desirability of ‘soft’ international law being made by such organisations as the OECD.

The research will commence with a critical examination of the philosophical basis of what is ‘law’ and, in particular, ‘international law’. The OECD’s guidelines on transfer pricing, the taxpayers’ charter, the non-deductibility of bribes to foreign officials and, anti-money laundering recommendations have initially been accepted as having the status of soft international law because these guidelines have ultimately been transformed into the domestic statutory law of most OECD member countries in one form or another. The research will also focus on tax havens and OFCs in terms of their sovereign right to self-determine tax policy including tax rates. Clearly, the sovereign rights of these small nations are being affected by the OECD and the G20 but it is far too early to determine the economic and political outcome for tax havens and OFCs. Many of these nations are prepared to cooperate with the OECD member states and the G20 by entering into a number of TIEAs. It is the willingness of tax havens and OFCs to cooperate with the OECD by entering into TIEAs that is one of the main focuses of the research in this Chapter of the thesis.

The thesis will examine the OECD’s harmful tax competition project in order to assess whether it has been adopted by OECD member states and tax havens as having the status of law. It is also arguable that soft international law is desirable in a global legal environment and organisations, such as the OECD, add value to international taxation law. However, it is important that the ‘rule of law’ is not threatened by laws that are not being made by elected representatives in a Parliamentary context. This aspect of soft law is also examined in detail in Chapter 5.
In terms of the likely future of tax havens and OFCs, there is current evidence that the OECD has been successful in bringing about a high level of cooperation with tax havens. As has already been stated, as at 1 April 2010 there are no tax havens on the list of uncooperative nations that have not agreed to the ‘internationally agreed standard’ on exchange of information. The research to be undertaken in Chapter 5 should be able to assist in determining whether the OECD’s harmful tax competition project and the subsequent entering into TIEAs by tax havens has had a major impact on lessening the role of tax havens in the tax avoidance and tax evasion industry.

1.5.4 Third subsidiary research question – Why has the distinction between tax avoidance and tax evasion become blurred in Australia?

The common law in Australia has always recognised the distinction between tax avoidance, a legal activity, and tax evasion, a criminal activity. Decisions that have been made in the Federal Court of Australia and the various Supreme Courts that support this contention are examined in detail in Chapter 7. However, the Australian Government has, for many years, been deliberatively blurring the distinction so that all forms of tax minimisation can be held to constitute tax evasion and, therefore, criminal activity.26 The research into this subsidiary research question will critically examine the Australian Government’s approach to the distinction between tax avoidance and tax evasion in relation to the ‘anti-money laundering and counter terrorism financing legislation’; the legislation to ‘deter tax scheme promoters’; and, in the legislation used to establish ‘Project Wickenby’. It may be that one of the reasons why the distinction may have been deliberately blurred is so that tax avoidance and tax evasion are regarded by the government as constituting a criminal activity. If this is the case then tax havens and OFCs are required to report Australian taxpayers that are using the banking services in those countries under the ‘dual criminality’ principle. This may potentially impact on the future of tax havens and OFCs because it allows the tax authorities to access confidential financial and banking information from tax havens and OFCs, such as Switzerland. In order to overcome any reluctance on the part of tax havens and OFCs to disclose information

26 The blurring of the distinction is found in the Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth), Division 290 of the Taxation Administration Act 1953 (Cth) relating to deterring tax scheme promoters and ‘Operation Wickenby’.
about the banking details on non-resident investors and MNEs, the ATO must show that the activities of an Australian resident constitute criminal conduct. Arguably, in the current economic and political environment in Australia, the collection of tax revenue appears to have taken priority over the rights of taxpayers, especially with the activities of ‘Project Wickenby’.

1.5.5 Fourth subsidiary research question – How will the exchange of information agreements with tax havens affect the rights of non-resident taxpayers and investors?

This subsidiary research question has a direct bearing on the future of tax havens and OFCs. Taxpayers have very few rights to maintain the privacy and confidentiality of their financial affairs both within their country of residence and any foreign jurisdiction that they may have chosen to hold their investments and from where to conduct their business. Traditionally, banks had a duty to maintain the confidentiality of their customer’s financial details. However, over time, that duty has been subjected to the rights of the taxation authority to obtain information relevant to the collection of taxes. The powers that are held by the ATO to obtain information from resident taxpayers and foreign visitors to Australia are so extensive and coercive that taxpayers have very little right to maintain the confidentiality of their financial information. The research will focus on the ATO’s powers to obtain information from foreign nations, especially tax havens and OFCs as a result of entering into a TIEA.

The main source of protection from disclosure to taxation authorities is the right to claim that certain documents and communications are privileged because they are between the taxpayer and their lawyer. Under Australian common law, this right to claim legal professional privilege applies to both domestic and foreign legal advice. In some countries, such as New Zealand and the US, the privilege has been extended to include advice provided by the accountant and tax agent to their clients; at this stage, the Australian government has not introduced a similar law.

The introduction of taxation information exchange agreements between tax havens and OFCs and OECD member nations is likely to impact on the rights of a non-
resident taxpayer to maintain the confidentiality of their financial affairs in a foreign country. Even human rights declarations and human rights statutory provisions in Australia were found to be of limited use in the area of taxation law. The ATO is allowed to engage in ‘fishing expeditions’ in order to obtain confidential financial information about a taxpayer under Australian domestic law but it would appear that they are not permitted under the domestic laws of some tax havens and OFCs. With the introduction of TIEAs, non-resident taxpayers and MNEs face a greater possibility of having their financial details disclosed to the tax authorities in their country of residence. This impacts on the future of tax havens and OFCs because the greater the threat of disclosure, the less non-resident taxpayers are likely to use tax havens to invest their mobile capital or for MNEs to conduct their business from.

1.6 Outline of Research Methodology and Legal Theory

The thesis is a ‘legal thesis’ and, as such, is concerned about researching existing law. The starting point for any legal research is to discuss legal theory and its application to the examination of the existing law in Australia and internationally.

Legal Positivism is an ‘approach to legal theory which is concerned with posited law – that is, law which has been laid down, or posited, by institutions like Parliament and the courts’. The law is a set of rules made by a sovereign power, Parliament or the courts, and backed up by sanctions. This view of the law is also called ‘Black letter’ law, in that what is written in black ink is accepted as the law. From that perspective, the thesis will critically analyse the existing law in terms of how it operates, whether it is successful in its application, and if not, what could be done to improve the law. Moral values, social beliefs and religion, per se, have no place in the positivist theory of law. The thesis will examine the existing law from a ‘positivist’ approach and disregard natural theory of law which includes consideration of personal value judgments. In other words, the law relating to money laundering, tax evasion, tax avoidance and the use of tax havens will be examined without consideration of whether it is good or bad from an ethical or moral perspective.

The concept of ‘soft international law’ is examined in Chapter 5, in the context of whether the OECD makes ‘soft law’. By definition soft law is not posited law and this thesis is based on a legal positivist view of the law in analyzing the future of tax havens. The examination of the concept of ‘soft law’ is justified on the basis that the international soft law that is arguably made by the OECD has become ‘hard law’ or posited law once it has been transformed into the domestic law of the nation. In many of the instances discussed in Chapter 5, the OECD’s ‘soft law’ has eventually become part of the black letter law of the OECD member state.

1.7 Scope of the research

The thesis is not examining tax havens and OFCs from the perspective of the customer or those individuals or corporations located in tax havens and OFCs. This means that no attempt has been made to survey individuals and MNEs engaged in using the financial and banking services of a tax haven or OFC. Similarly, no attempt has been made to interview tax intermediaries and their employees engaged in providing banking and financial services located in tax havens and OFCs. The reasons for not adopting this approach to the research are as follows:

1. It would have been almost impossible to obtain information from Australian taxpayers using tax havens given the fact that they may be engaged in unlawful activities and would understandably be reluctant to disclose their financial information;

2. Dr Gregory Rawlings has already conducted face to face interviews with employees of tax intermediaries, such as banks, accounting and legal firms located in tax havens and OFCs as part of his research into mobile capital and its investment in OFCs; and

3. Professor Jason Sharman has conducted extensive interviews with government and non-government individuals from a number of Pacific Island tax havens engaged in the provision of banking and financial services.

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The thesis is looking at the future of tax havens from a whole of system perspective rather than through the lens of a particular element within the system and such a macro-perspective lends itself to investigations of big picture impacts on tax havens and OFCs. These impacts include the global financial crisis (GFC), the collective focus of the G20 during 2009 on trying to curb the activities of tax havens, and the introduction of TIEAs by the OECD. These developments support and reinforce the need for a systemic and overarching analysis of tax havens and OFCs and their role in the global economy, a need this thesis attempts to satisfy. While it will take some time to work through the particular impacts of these recent developments, they can only be understood against the drivers behind the OECD and the developed country push against tax havens that has been under way now for over a decade, and whose effects will impact on the future direction for tax havens, not their existence.

1.8 Structure of the Thesis

The thesis to be advanced is developed in the following way:

Chapter 1 provides an introduction the main research question to be examined in the thesis and the four subsidiary research questions that assist in providing an answer to the main question raised in this thesis, namely whether tax havens will survive in the new international legal environment?

Chapter 2 discusses the history and theory of taxation. The chapter utilises the three main principles of a tax system: equity, efficiency and simplicity. In this thesis these concepts are applied to the Australian tax system in order to see if the system itself is partly responsible for some Australian resident taxpayers locating assets in tax havens.

Chapter 3 briefly examines the history of taxation in Australia and the structure of the tax system within a federal system of government. It is noteworthy that Australian taxpayers have been engaged in tax avoidance and tax evasion in a significant manner at various times over the last 60 years since the introduction of a Commonwealth income tax.
Chapter 4 briefly examines the history and theory of the international taxation system. It provides an overview of the international tax environment in which tax havens and OFCs operate and the way in which taxes are shared between nations. It also provides an explanation for the difficulty being experienced by nations in trying to impose income tax on mobile capital in a competitive global environment.

Chapter 5 focuses on the first subsidiary research question and examines the work of the OECD in trying to eliminate harmful tax competition. The role of the OECD is discussed in the context of being a source of international tax law. This in turn leads to an examination of the philosophy of law; whether international law is in fact ‘law’; and the ‘legal positivist’ concept of law. The chapter also examines the concept of ‘soft law’ and its desirability in the area of taxation law and its possible threat to the ‘rule of law’.

Chapter 6 discusses the second subsidiary research question and examines the philosophical basis for a worldwide tax system and a territorial tax system. Each system is then assessed against the criteria of equity, efficiency and simplicity in order to arrive at a conclusion as to what system should be adopted in Australia.

Chapter 7 examines the third subsidiary hypothesis and examines the common law distinction between tax avoidance and tax evasion. The perceived lack of distinction that is found in recent statutory provisions such as the anti-money laundering legislation is examined in terms of its objective to deter and detect resident taxpayers using tax havens and OFCs for tax minimization purposes.

Chapter 8 discusses the fourth subsidiary research question by examining the rights that a taxpayer has to maintain the confidentiality of their financial and banking information both domestically and internationally. The examination of the non-resident taxpayers rights to maintain the privacy of their banking and financial matters in relation to assets held in a tax haven or OFC is assessed in light of the fact that all tax havens and OFCs that were originally on a list of non-cooperative nations determined by the OECD, have now entered into an agreement to exchange information on tax matters.
Chapter 9 examines the various reasons why tax havens may or may not survive in the new international legal environment. After assessing the various reasons, and taking into account the new knowledge that has been gained by the research into the various subsidiary research questions, a conclusion is made as to the future of tax havens and OFCs.

Chapter 10 provides a summary of the new knowledge that has been gained from the research into main question raised in this thesis together with the new knowledge derived from the four subsidiary research questions.
CHAPTER 2  HISTORY AND THEORY OF TAXATION

2.1  Introduction

Prior to examining the international and Australian responses to tax havens, it is necessary to examine the history of taxation and the theory behind the different types of taxes and the different rates at which taxes are imposed on the residents of a particular country. In its most simple form, taxation is often seen as the means by which governments raise funds to support their expenditure programs. The reality may be different in that many of the OECD member countries use other methods, such as public debt, foreign aid or even printing new money, in order to create revenue.\(^1\) It also follows that governments use taxes as a means of achieving policy goals beyond merely raising revenue. Governments have social and political goals that they wish to achieve through taxation and, especially, the expenditure side of taxation.\(^2\) However, there are three main issues that can be seen from a discussion of the theory of taxation. First, what should be taxed in an ideal tax system - income, consumption, wealth or a mixture; second, what should be the rates of tax applied to the various taxes in order to meet the objectives of the government in raising revenue and social equity; and third, how should the tax system be designed in order to create simplicity and certainty for taxpayers?

The main focus of this chapter will be on income tax as that is the main form of tax that is avoided by taxpayers through the use of tax havens but, to some extent, indirect taxes, such as a tax on goods and services, may also be avoided by the use of tax havens. The ‘essential criteria for assessing a tax system are equity, efficiency

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\(^2\) While governments need to raise a particular level of revenue to fund services, they also raise revenue to distribute to the less wealthy in the form of benefits associated with social goals such as raising children and promoting the family unit. These tax transfers are an important aspect of vertical equity in any tax system and are discussed later in the chapter. However, tax transfers per se and their place in the theory of taxation will not be discussed in detail in this chapter. What is important for this thesis is to attempt to determine whether or not the current tax system and current thinking about the form and rates of taxation may have encouraged residents of a country to use tax havens to avoid or evade taxes.
These three concepts are based on the seminal works of Adam Smith, J. S. Mill and a number of twentieth century economists such as Haig, Simons and Musgrave. These concepts encapsulate the notions of fairness, equality and the need for simplicity in any tax system and they will be examined separately in this chapter as they provide a useful basis on which to evaluate the tax system used by most OECD member countries as well as Australia. The Australian Government has commenced a review of the current tax and transfer system in response to the impact of globalisation and the need to remain internationally competitive as well as the impact on the government of an ageing population. The review will examine the ‘comprehensive tax system’ that exists in Australia today and the theory behind the current system. The review discusses the impact that J. S. Mill, Haig and Simons, as well as many other economists and writers, have had on the design of tax systems over the past centuries and whether or not there is a need to make changes. One of the main concerns of the government is the fact that ‘there are 125 taxes paid by Australians every year … 99 levied by the Australian government, and 25 by the States and 1 by local government’.

The review document will be examined in more detail later in this chapter where it is relevant to highlight some of the benefits and flaws in the current tax system in Australia.

This chapter will also examine in detail the reason why a tax on income was introduced in the first place and the theory behind the alternative rates of income tax to be levied on the taxpayer. Following from this question is what amount of income tax should be paid by the poor and rich alike; a flat or proportional rate for all or a progressive rate that taxes the rich more than the poor? The choice of rates to be imposed on income and wealth may be seen to be one of the main reasons why the rich try to avoid income tax. There is also some literature that suggests that an overly complex tax system is perceived to be unfair and the complexity will also lead to tax

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6 Ibid, xii.
avoidance by the wealthy. Does this help, then, to explain why the rich wish to minimise their income tax through the use of tax havens? The following detailed examination of the theory behind what is regarded as a ‘good tax system’ may also help to explain why the campaign against harmful tax competition and tax havens has been pursued by both the OECD and the Australian Government with such vigour, as the current tax systems used by most OECD member countries, including Australia, would appear to fail to meet the generally accepted criteria of being fair, efficient and simple to administer. These three maxims, namely ‘equity, efficiency and simplicity’ are discussed in detail in this chapter and throughout the thesis as representing what all tax systems strive to achieve. The following discussion may assist in explaining why taxpayers throughout the world, including Australia, wish to minimise their income tax through the use of tax havens and offshore financial centres; or it may simply raise more questions than answers.

2.2 The History of Taxation

A good starting point for an examination of the theory and history of taxation is to examine why taxes are collected by the state in the first place. This is the fundamental question asked by Professor Reuven Avi-Yonah in his paper ‘The Three Goals of Taxation’. Professor Arvi-Yonah’s three goals of taxation create an excellent context in which to examine the evolution of taxation over many centuries and the theory behind the justification for imposing taxes in the first place. It will also provide an explanation of why progressive rates of taxation have now become a settled part of modern taxation systems. The three goals, as enunciated by Avi-Yonah in his paper, can be summarised as follows.

Need for government revenue

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8 A ‘good tax system’ is defined in terms of being equitable, efficient and simple to administer. These three maxims were condensed from the work by Adam Smith and are now used in major tax reviews as a starting point. For example in the ‘Asprey Review’ in Australia the three maxims were used as the basis for the review and reviews conducted in Canada, the ‘Carter Review’.

9 Reuven Avi-Yonah, The Three Goals of Taxation, (2006-2007) 60 Taxation Law Review 1. Professor Avi-Yonah is a leading expert in this area of taxation law and his many articles are referenced throughout this thesis.
The first goal of any tax system is the need for governments to raise revenue for necessary functions such as defence, health and educational requirements of the people. Since the end of the second world war, the development of the ‘welfare state’ has lead to an increased demand for tax revenue to fund the ageing population of ‘baby boomers’ and their need for health and pension requirements.\(^\text{10}\)

A good example of where the government provides public goods is in the provision of ‘a well organised legal system without which the private sector could not enforce contracts and enter into commercial agreements’.\(^\text{11}\) It is also stated by Professor Avi-Yonah that the experience of governments with high rates of income tax has led to an increase in tax avoidance and tax evasion by taxpayers and, as a result of this, most OECD countries have reduced their marginal rates over the past 30 years by substituting income tax with a tax on consumption.\(^\text{12}\) Of the 30 OECD member countries, only one country, the United States of America, has no VAT or Goods and Services Tax.\(^\text{13}\)

Professor Krever contends that the reason why taxpayers comply with a ‘system that amounts to an appropriation of private property for public purposes’ can be answered at two separate levels and provides the following reasons for reaching that conclusion:

To begin with, taxpayers realise that the power to tax is an essential tool for most government functions. While not all taxpayers would agree … for the most part those who bear the burden of taxation agree with the need for government to assume responsibility over certain economic and social functions. A second and more fundamental answer to that question is the ultimate realisation that in essence taxation can be seen as a means by which the state is merely appropriating its due reward. Private property would not exist if it was not for the state: taxes are simply part of the price we pay for having a political and economic system in which the acquisition and accumulation of private wealth is possible. While most taxpayers

\(^{10}\) Ibid, 6.


\(^{12}\) Avi-Yonah, above n 9, 7and 8.

would like to retain as much of their wealth as possible, they recognise the desirability and need for the public functions their tax dollars fund.  

Redistribution of wealth through taxation

The second goal of taxation is to redistribute wealth from the rich to the less wealthy. The redistributive function of taxation is seen as being required with a market based economy where wealth can become too concentrated in a few and taxation assists in redistributing wealth between the rich and poor. The main tool that has been used over hundreds of years to achieve a redistribution of wealth has been through the use of progressive taxation. The rich pay more as a percentage of their income than the poor. The concept of progressivity is dealt with in detail later in this chapter but it is still seen as being central in achieving equity in society. The government is able to transfer revenue generated through taxation to the less wealthy in the form of transfer programs such as ‘family tax benefits’ as is the case in Australia. In Australia, there are 40 separate cash transfers to citizens, including the family tax benefit, that cost the government over $70 billion in the 2006-2007 financial year. It would appear that, as part of the ‘welfare state’, governments like to be seen to be helping the less fortunate in society and, at the same time, reducing the power and influence of the rich.

Tax law as a means to regulate taxpayer behaviour such as investment and spending decisions

Taxation is used by governments to direct both business and individual taxpayers in modifying their social and financial behaviour, such as choosing certain investment activities in particular areas due to the introduction of specific tax concessions. In Australia, a recent example of these types of policy can be seen in the exemption of fresh food from the Goods and Services Tax in an attempt to provide an incentive for individuals to eat a healthier diet. For business, depreciation on capital expenditure

14 Krever, above n 11.

15 In Australia a primary income earner who has an income of less than $150,000 per annum and dependant children may be eligible for a Family Tax Benefit Part B provided they satisfy an income test. Their assets are not taken into account. In effect it means that a primary taxpayer earning approximately $80,000 with three dependant children will pay income tax but will then receive virtually all of it back in the form of a Family Tax Benefit Part B from Centrelink, the government agency used to administer the Social Security Act. In the 2006 – 2007 financial year Centrelink made welfare payments to the value of $66.3 billion, accessed from <www.centrelink.gov.au> at 16 July 2008.

16 Commonwealth of Australia, above n 5, xiii.
can be claimed at 200% using the diminishing value method as an incentive for business to invest in capital equipment.

If the above three criteria are used as the context in which to map the history of taxation, it can be seen from the following examination of the historical economic writers on taxation that the very early forms of taxation recognised the need for a tax system to achieve the above three goals. A review of taxes over the past centuries will confirm that the above three goals were just as relevant to governments during the Roman Empire, Greek Empire or the Egyptians as they are today and the range of taxes and the way in which they were levied are very similar to the modern system.¹⁷

Adam Smith explains that, in Europe after the fall of the Roman Empire, merchants in Europe would travel from town to town selling goods and that:

… taxes would be levied upon the person and goods of the traveller as they passed through certain manors, when they went over certain bridges, when they carried about their goods from place to place in a fair…."¹⁸

These different taxes were known in England by the names of ‘passage, pontage, lastage, and stallage’.¹⁹ Adam Smith also states that the Doomsday Book mentions taxes paid by burghers to the king or some great lord.²⁰ The basis for the levying of taxes was payment for a level of protection provided by the king or lord.

Historically, States raised revenue by imposing a tax on goods produced by landowners and farmers as well as goods produced by merchants or on property such as land and houses. Income tax was levied on agricultural production in France in the seventeenth century because the farmers produced wealth and since ‘those not in agricultural productions did not produce wealth then they should not be taxed’.²¹

¹⁸ Smith, above n 4, 170.
¹⁹ Ibid, 170 - 171
²⁰ Ibid, 171.
John Kenneth Galbraith\textsuperscript{22} examines the ‘French’ approach to agriculture and ultimately the taxes that were levied on farmers. The ‘physiocrats or Les Economistes’ believed that agriculture was the source of all wealth of the State and that wealth originated in agriculture and, as such, was capable of being taxed.\textsuperscript{23} The theory was that the only group in society that produced wealth were the landowners and they should be the ones bearing the burden of taxes as they produced wealth. The merchants did not produce wealth and to impose taxes on them would only result in higher prices for the goods.

The Romans demanded tributes from their colonies but this, according to Graeme Cooper, was designed not just to raise revenue but to reinforce the military subjugation of the people living in the colonies.\textsuperscript{24} It is also important to remember that income was not the main source of government revenue over the past few centuries. Up until 1913, customs duties were the main source of revenue for the US Federal Government. In 1913, the Sixteenth Amendment to the US Constitution was passed by Parliament to allow for income tax to be levied on individuals and the \textit{Revenue Act} was enacted to implement income tax.\textsuperscript{25} Income tax on individuals had been introduced into the US during the Civil War in 1861 but was discontinued in 1872.\textsuperscript{26}

According to Krever, England first introduced income tax legislation in 1799 to raise revenue to fund the war against Napoleon.\textsuperscript{27} The income tax was introduced by Prime Minister William Pitt to fund the war but was repealed by Prime Minister Addington in 1802.\textsuperscript{28} The tax was repealed because the war had ended but also because it was very unpopular.\textsuperscript{29} Cooper contends that the purpose of taxation is more than just the State raising revenue to pay for its functions. Historically, States

\textsuperscript{22} Ibid.
\textsuperscript{23} Ibid.
\textsuperscript{24} Cooper, above n 1, 418, Australian Taxation Office, \textit{Tax havens and tax administration}, 2004, 2
\textsuperscript{26} Ibid.
\textsuperscript{27} Krever, above n 11, 9.
\textsuperscript{29} Ibid.
and their Sovereign printed bank notes or borrowed money to fund their functions. At that time, the main reason for raising revenue was to fund a defence force or participation in a war. It has only been in recent times that the State provides a welfare system for its citizens and needs to fund that expense.\textsuperscript{30}

Joseph Schumpeter\textsuperscript{31} discusses the ‘development of modern taxation in the fifteenth century in the Italian city-republics, Florence in particular and in the German free towns’. Taxation emanated from the need of the king to raise money to provide an army to fight wars. It is interesting to note that Schumpeter discusses the rise of indirect taxation in the fifteenth and sixteenth centuries because the nobility did not pay direct taxes, namely, a tax on income but, due to having indirect taxes, namely, a tax on the production of goods from the land and merchants, at least the nobility and ruling classes paid some form of tax. The fact that an indirect tax was borne by the less wealthy and poor was justified on the basis that at least the wealthy paid some tax.\textsuperscript{32} As a result of the problems associated with imposing a range of indirect taxes on goods and the administration that grew in response to collecting those taxes, many economic writers, such as Adam Smith and John Stuart Mill, discussed the merits of indirect taxes and a direct tax on income.\textsuperscript{33}

Schumpeter observed that the development in taxation theory during the period 1870 to 1914 and later was influenced by social imperatives in that high direct taxation, including an inheritance tax, was introduced ‘that went beyond taxing for revenue and aimed at taxing in order to change (correct) income distribution’.\textsuperscript{34} This view conflicted with the policy of Prime Minister Gladstone and his Chancellors of the Exchequer in England at that time who adopted the approach that ‘taxation was for raising revenue only and was not to exert any other effects beyond what was inevitable; and in order to keep taxes as low as possible, expenditure was to be

\textsuperscript{30} Cooper, above n 1, 418.
\textsuperscript{32} Ibid, 201.
\textsuperscript{33} Smith, Adam, above n 4, 351.
\textsuperscript{34} Ibid, 945.
confined to “necessary” purposes’. In 1909, the English Government introduced progressive income tax on the total income of individuals.

Another frequently used form of taxation was a ‘poll’ tax based on each adult at a set rate. Richard II in England introduced the tax in 1377, 1379, and 1380 to fund military campaigns. The tax was unpopular because it contradicted the three main tenets of a good taxation system, as discussed earlier in this chapter. The tax was imposed on all citizens at a flat rate at first and then a graduated tax in 1380 and was difficult to administer. It required a census first and then tax collectors to collect the tax. The tax was reintroduced by Prime Minister Margaret Thatcher in 1990 as a ‘Community Charge’ and again it proved to be very unpopular. The imposition of some taxes has been responsible for wars and rebellions such as the American Revolution against the British in 1775 and the Eureka Stockade in Ballarat Australia in 1854. The imposition of unpopular taxes have been directly responsible for civil wars and uprisings in France, the US and Australia, to name just a few.

2.3 Adam Smith and John Stuart Mill - Theory of a Tax System

The writings of Adam Smith and John Stuart Mill will be examined in detail as both had a great influence of the tax system that was developed in England in the late eighteenth century and the taxation system that exists today in Australia and most OECD member countries.

Adam Smith, in his famous book titled An Inquiry into the Nature and Causes of the Wealth of Nations, proposed four maxims with regard to taxes in general. The first maxim was:

I. The subject ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense

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36 Ibid.
37 Kobetsky, above n 28, 1.
38 Ibid, 2.
39 Ibid.
of government to the individuals of a great nation is like the expense of management
to the joint tenants of a great estate, who are all obliged to contribute in proportion to
their respective interests in the estate... every tax is necessarily unequal....

Adam Smith appears to be advocating a proportional rate of tax to be paid on the
income of every resident of a state. This means that the rich and poor pay the same
rate of tax but that the rich end up paying more than the poor because they have a
greater amount of income and wealth. Smith is not advocating a progressive system
of taxation where the rates of tax increase in proportion to the higher level of income
or wealth. It should therefore be remembered that most OECD member countries
have adopted a progressive, as opposed to a proportional, system of taxation. It
supports the concept of vertical equity, namely, that the rich should pay more in tax
than the poor and less wealthy, as discussed below.

The second maxim emphasises the need for efficiency and simplicity in the design of
a tax system as follows:

II. The tax which each individual is bound to pay ought to be certain, and not
arbitrary. The time of payment, the manner of payment, the quantity to be paid,
ought all to be clear and plain to the contributor, and to every other person. ...The
uncertainty of taxation encourages the insolence and favours the corruption of an
order of men who are naturally unpopular, even where they are neither insolent nor
corrupt. The certainty of what each individual ought to pay is, in taxation, a matter
of so great importance that a very considerable degree of inequality, it appears, I
believe from the experience of all nations, is not so great an evil as a very small
degree of uncertainty. 

Adam Smith appears to be advocating the need for an efficient and simple tax system
that does not create uncertainty in the minds of the taxpayers. It also advocates the
need for horizontal equity, namely, that all taxpayers on the same level of income
will pay the same amount of tax. However, as will be seen later in this chapter, this is
one of the reasons why taxpayers in Australia sometimes use tax havens because they

40 Smith, Adam, above n 4, 350.
41 Ibid.
believe the Australian tax system is too complex and has left the taxpayer with uncertainty.\textsuperscript{42} Large multi-national enterprises (MNEs) are able to take advantage of international tax benefits through tax havens and offshore financial centres because of the high level of complexity in the Australian taxation law.

The third maxim discusses the merits of a tax on expenditure or consumption as opposed to a tax on income or wealth, as follows:

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. ...Taxes upon such consumable goods as are articles of luxury are all finally paid by the consumer, and generally in a manner that is very convenient for him. He pays them by little and little, as he has occasion to buy the goods. As he is at liberty, too, either to buy, or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconvenience from such taxes.\textsuperscript{43}

This maxim advocates support for a tax on expenditure or consumption by the citizens of a state and should be collected at the time of purchase of the goods. In most OECD member countries there is a consumption tax as well as a tax on income.

The fourth maxim discusses the need for the collection of tax to be conducted efficiently by the tax collection agency so as not to discourage a person from engaging in paid work or seeking to increase wealth through savings because taxes are too great a burden on the citizen of the state. The maxim is as follows:

IV. Every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of


\textsuperscript{43} Smith, Adam, above n 4, 351.
business which might give maintenance and unemployment to great multitudes. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it might frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax gatherers, it may expose them to much unnecessary trouble, vexation and oppression... It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign.  

This maxim questions the value of a tax if it costs more than the money that is raised to collect the tax in the first place. This issue has been identified in Australia and discussed below. It also questions the value of imposing taxes at too high a rate so as to discourage participation in income producing activity by the taxpayer. Again this issue is examined in detail below. Adam Smith appears to be supporting the need to have an efficient tax system in order for taxpayers to have confidence in the way in which taxes are administered by the government.

These four maxims of how a taxation system should be designed have been condensed into three criteria, equity, efficiency and simplicity, and are seen by most writers on the theory of taxation as being the fundamental foundation stones of an ideal tax system. The difficulty is in achieving these fundamental goals and it may well be the reason why a failure by governments to meet these goals has encouraged the use of tax havens by individuals and MNEs.

John Stuart Mill, in his famous work titled *Utilitarianism, On Liberty, and Considerations on Representative Government*, advocated a tax system where the rich paid more in taxes than the poor. Mill was an advocate of a ‘Utilitarian Philosophy’ of morals in that those actions that produce the greatest good are the ones that should be pursued by society. The definition of utilitarianism is as follows:

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44 Ibid.
46 Cooper, above n 1, 421. In the ‘Asprey Review’ of the Australian taxation system the three maxims were used to describe what an ideal tax system should be like.
Utility or the Greatest Happiness Principle holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness. By happiness, is intended pleasure and the absence of pain; by unhappiness, pain and the privation of pleasure.\textsuperscript{47}

Applying this philosophy to an ideal ‘utilitarian’ system of taxation, Mill makes the following statement:

One opinion is, that payment to the State should be in numerical proportion to pecuniary means. Others think that justice dictates that they term graduated taxation; taking a higher percentage from those that have more to spare. In point of natural justice a strong case might be made for disregarding means altogether, and taking the same absolute sum (whenever it could be got) from everyone: as the subscribers to a mess, or to a club, all pay the same sum for the same privileges whether they can all equally afford it or not. Since the protection (it might be said) of law and government is afforded to, and is equally required by all, there is no injustice in making all buy it at the same price…This doctrine, as applied to taxation, finds no advocates, because it conflicts so strongly with man’s feelings of humanity and of social expediency; but the principle of justice which it invokes is as true and as binding as those which can be appealed to against it. Accordingly it exerts a tacit influence on the line of defence for other modes of assessing taxation. People feel obliged to argue that the State does more for the rich than for the poor, as a justification for its taking more from them: though this is in reality not true, for the rich would be far better able to protect themselves, in the absence of law or government, than the poor, and … From these confusions there is no other mode of extrication than the utilitarian.\textsuperscript{48}

Mill appears to be advocating a proportional system of taxation in that both rich and poor pay the same rate of tax even though it conflicts with principles of social justice and humanity. However, Mill is still a proponent of vertical equity because the rich pay more in tax than the poor but at the same rate of tax. He is not advocating a progressive system of taxation where the rich pay tax at a higher rate of tax than the poor.

\textsuperscript{47} Mill, above n 4, 6
\textsuperscript{48} Ibid, 55
2.4 Comprehensive or Optimal Tax System

As has been discussed above, with the examination of the Adam Smith model of a taxation system, the following three criteria of an ideal tax system are regarded by tax academics and tax philosophers as being absolutely necessary:

1. Equity – horizontal and vertical equity, the rich pay more in tax than the poor, vertical equity and those on the same income pay the same amount in tax, horizontal equity

2. Efficiency – economic neutrality and the need to have a system that does not act as a disincentive to engage in more work for reward or discouraging enterprise that will generate greater income

3. Simplicity – the lack of complexity in the calculation of the tax liability by the taxpayer and tax laws that should be relatively simple and easy to understand so as to avoid confusion.

If an ideal tax system provides the taxpayer with equity, efficiency and simplicity then two issues need to be determined; first, what source of wealth or income should be subject to tax and, what rates of tax should be applied in order to achieve those objectives? In most OECD member countries, revenue is raised through a mixture of personal income tax, company tax and a tax on consumption such as a ‘value added tax’, VAT, or a ‘goods and services tax’, GST. There are also a number of other forms of taxes on property, inheritance, wealth and the stamping of documentation. As Cooper contends, the fundamental question facing every government when designing a taxation system is ‘how is the burden of taxation to be spread across society?’ The ‘comprehensive tax base’ and the ‘optimal tax school’ each provide an insight into answering this fundamental question.

The ‘comprehensive tax system’, as championed by Professors Haig and Simons, emphasises the need to place equity concerns at the forefront of any tax system. Equity, in this context, includes both vertical and horizontal issues. Basically this means that, through progressive rates of tax, the wealthy pay more in tax than the...

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49 Cooper, above n 1, 422.

50 Ibid, 422. The ‘optimal tax school’ of thought was developed by F. Ramsey and further developed by J A Mirrlees. The concept is examined in detail later in this chapter.

51 Haig, above n 4; Simons, above n 4.
poor, hence vertical equity and that the wealthy pay the same amount of tax on equal wealth, hence horizontal equity. These concepts were originally propounded by Adam Smith and J.S. Mill and are a major part of the Haig-Simons comprehensive tax system. These concepts of equity will be discussed in detail later in the chapter, especially the related Musgrave and Kaplow approaches, as well as their role in developing tax policy. One of the main criticisms of the comprehensive tax system is that it places the main emphasis on the need to achieve equity; vertical and horizontal. This means that within tax systems the pursuit of equity may lead to efficiency problems where taxpayers will choose leisure over paid work because of the imposition of taxes. This is particularly the case when the top rate of income tax under a progressive rate system is so high that the taxpayer will substitute leisure for paid work as the after tax return becomes very small. The optimal tax school tries to put a value on social welfare, such as the pursuit of leisure instead of paid work, so that it can be taken into account when designing an optimal tax system. If taxes are too high or discriminate against some taxpayers then there is a disincentive to pursue wealth and instead pursue leisure activities as a substitute. This would appear to create inefficiencies in the tax system, as is discussed later in this chapter.

The main difference between the comprehensive tax system and the optimal tax school is the emphasis on the concept of ‘efficiency’. Cooper states that:

… the optimal tax approach explicitly included efficiency concerns and then went on to recognise the equity-efficiency trade off by making both equity concerns and efficiency costs elements in a single social welfare function.

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52 Smith, Adam, above n 4; Mill, above n 4.
53 Richard and Peggy Musgrave and Louis Kaplow have written extensively on the question of whether or not vertical equity and horizontal equity are part of the overall concept of equity required in a tax system or whether horizontal equity is a separate norm of taxation.
54 Cooper, above n 1, 436
55 Ibid.
56 Ibid, 434.
57 Ibid, 442.
The distinction between the two theories will be examined under the headings of ‘Equity’ and ‘Efficiency’; the Haig-Simons comprehensive system under Equity, and the optimal tax system under Efficiency.

2.5 Equity

Under this heading, the concept of ‘equity’ raises the following questions relating to tax policy issues that have a major bearing on the design of a good tax system:

1. If income is to be taxed, what monetary and non-monetary measures should be included in the definition of income? What is the Haig-Simons definition of income and what is the ‘comprehensive income tax system’ that they played a major role in developing?

2. What are the merits of having tax rates based on a ‘progressive’ basis rather than a ‘proportional’ basis? Does equity require or need progressive rates of tax to be imposed on taxpayers? Do progressive rates of tax support the redistributive goal of taxation?

3. What are the issues in trying to achieve vertical and horizontal equity in a tax system and are each part of the broader concept of equity? Is tax evasion and tax avoidance a by-product of the perceived lack of horizontal equity in the tax system?

4. Why do most governments have a tax on consumption as well as income and is there an argument for only a tax on consumption and not income? Is a tax on consumption regressive and in conflict with the concept of equity in taxation?

The following discussion should provide answers to the above questions and assist in providing a conclusion as to what form an ideal tax system takes and, more important, whether the current tax system that exists in Australia and many of the OECD member countries encourage tax avoidance and tax evasion which results in the use of tax havens.
2.5.1 The Haig-Simons\textsuperscript{58} definition of income and the comprehensive tax system

If the tax system intends to raise revenue through the imposition of tax on income, what is income for taxation purposes? Put simply, ‘[a] general income tax is an enforced sharing by the state of a person’s income, the states share being measured by the net income as computed after deducting the expenses incurred in producing the income’.\textsuperscript{59} Whilst this definition of income may be accurate from a practical perspective, it fails to define the term ‘income’ from a theoretical perspective. The definition of income for taxation purposes that has been widely accepted for a comprehensive tax system is the definition attributed to Professors Haig and Simons. Indeed, Graeme Cooper states that ‘[t]he Haig-Simons model is used primarily in most Western industrialised countries because it is regarded by governments, and possibly by the populace as well, as a satisfactory indicator of taxable capacity – ability to pay’.\textsuperscript{60}

Professors Robert Haig and Henry Simons worked independently on finding a definition of ‘income’ for taxation purposes. Haig provided a theoretical conceptualisation of income and contended that income was ‘a flow of satisfaction, of intangible psychological experiences’.\textsuperscript{61} The analogy used to explain this concept is ‘if a person earns a dollar and spends it to buy dinner … income is neither the dollar nor the dinner. Income is the satisfaction obtained from eating the dinner.’\textsuperscript{62} The problem with this approach is that it places too much emphasis on consumption and could then be used to define consumption and not income.\textsuperscript{63} However, Haig did acknowledge that, ultimately, income should have a practical connection with money and he arrived at the following definition:

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\textsuperscript{58} Some commentators, including Richard Musgrave and John Head hold that the ‘comprehensive tax system’ was developed by Schanz (1896), Haig (1921) and Simons (1938) and describe the definition of income as the ‘Schanz-Haig-Simons definition. The contribution in developing a definition of income as a tax base that was made by Schanz is acknowledged, but not discussed in this chapter.


\textsuperscript{60} Cooper, Graeme, above n 1, 423.


\textsuperscript{62} Ibid, 475.

\textsuperscript{63} Ibid, 476.
…the definition of income which the economist offers is this: Income is the money value of the net accretion to one's economic power between two points of time. 64

Haig was also an advocate of including any increase in the value of the assets of a taxpayer as income and today this is the case in Australia and other OECD member countries where capital gains are subject to income tax, but only once they have been realised. However, New Zealand has still not introduced a tax on capital gains. Haig also thought that the imputed value of the potential rental income from taxpayers who owned their own homes should also be included in the definition of income as this would ‘add to the desire for equity in the tax system so that those taxpayers that did not own their own homes would be at an advantage to the wealthy’. 65 Haig was not keen to include all gifts in his definition of income because he viewed most gifts being given between members of a family and he considered the family as a single tax unit—but only parents and dependant children as a separate tax unit. However, he was in favour of including gifts between parents and adult children or gifts from grandparents to children as falling within the definition of income. 66 The Haig definition of income was found to be similar to that of Henry Simons and commentators such as Professor Richard Musgrave subsequently grouped the two definitions and similar approaches to the theory of income. The similar approach has now become known as the ‘Haig-Simons’ definition of income.

The Haig-Simons definition of personal income has been distilled over many years to mean the following:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. 67

Professor Richard Vann 68 explains this definition with the following equation:

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64 Haig, above n 4, 7.
65 McCombs, above n 61, 478. It is interesting to note that Wisconsin attempted to tax the imputed income from home ownership but eventually abandoned the matter. See footnote 24 from this chapter for more detail.
66 Ibid, 479.
67 Simons, above n 4, 50.
Income (or economic gain) = consumption + change in net savings

The definition places a great deal of emphasis on consumption and accumulation but it is not a recipe for a definition of ‘consumption’ that could be used in a consumption tax. McCombs contends that ‘[b]ecause this definition finds income in consumption and in any increase in net worth, it will lead to a true income tax and not to a consumption tax’. The definition has been subject to some level of criticism because it only focuses on monetary or economic resources and ignores the value of leisure and self-provided services in consumption by the taxpayer.

Simons strongly advocated the need to include gifts and inheritances in the definition of income as well as an imputed value of rent when the taxpayer owned their own home. He made the following statement in relation to including the value of imputed rent:

[W]hen property is employed directly in consumption uses, there is the strongest case for recognizing an addition to taxable income. This is widely recognized in criticism of our federal tax for its egregious discrimination between renters and homeowners, and perhaps more strikingly in the almost consistently different practice among income taxes abroad.

Simons also strongly advocated the inclusion of gifts and inheritances in his definition of income but if a government already has an inheritance tax then he acknowledged that the tax burden may become too great. The Simons definition has been criticised by McCombs on the grounds that it is blind as to source and equally blind as to use. In other words, the definition of income ignores the source of the income, especially income generated from savings and the use to which those savings have been put. Haig and Simons also included a tax on interest from savings in their comprehensive tax system. In effect, this means that the same income is

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69 McCombs, above n 61, 471, 484.
70 Cooper, above n 1, 426.
71 Simons, above n 4, 112.
72 McCombs, above n 61, 488.
taxed twice, first; when the income has been saved after it is taxed, as principal, and second; when interest that has accumulated on the savings is taxed again. The taxation of interest on savings is generally regarded as being a regressive form of taxation as it acts as a strong disincentive to save capital.\(^{73}\)

J.S. Mill was adamant that ‘the only proper mode of assessing an income tax would be to only tax the part of income devoted to expenditure, exempting that which is saved’.\(^{74}\) The wealthy may have become wealthy through prudent investment and accumulation of after tax income but, according to the Haig-Simons approach, that accumulated wealth will then be subject to income tax when a capital gain is realised or that wealth is gifted to a family member. While this may satisfy the redistributive goal of a tax system, it may lead to inefficiencies.

### 2.5.2 Progressive income tax and vertical and horizontal equity – the Musgrave approach

Over the past centuries, different forms of taxation have been imposed on different sources of income and wealth at different rates and, in some cases, at higher rates for the wealthy than for the poor. As has been discussed above, one of the main aims of a tax system is to redistribute wealth from the rich to the poor, hence the concept of vertical equity. If tax is imposed at the same rate on the rich and poor alike, then it is considered to be contrary to vertical equity because it impacts on the poor to a greater extent than the rich. Therefore, it can be seen that a progressive rate system is crucial in achieving vertical equity, namely, that different rates of tax are imposed on different amounts of income. Musgrave and Musgrave provide a clear definition of this distinction as ‘a tax is progressive if the ratio of tax to income rises when moving up the income scale, proportional if the ratio is constant, and regressive if the ratio declines’.\(^{75}\) In effect the ‘average tax rate rises with income levels’.\(^{76}\) As Peter Groenewegen states:

\(^{73}\) Ibid, 516.


\(^{75}\) Musgrave and Musgrave, above n 4, 360.

\(^{76}\) Ibid, 363.
A proportional income tax is defined as a tax where average and marginal rates are equal for all levels of income, that is, no income is exempt, a condition necessary to distinguish it from the linear income tax with a single marginal rate for all income above the level of income exempted.\textsuperscript{77}

Modern progressive tax systems have a number of brackets at which higher marginal rates of tax apply to the amount of income within that particular bracket. For example, in Australia the top rate of income tax, namely 45 percent, applies to income over $150,000 and so the marginal rate of tax on any extra income over $150,000 is 45 percent. There are now five tax brackets in Australia as well as a low income rebate; a long way from the 29 marginal rates of forty years ago.\textsuperscript{78}

It is interesting to note that J.S. Mill was in favour of a proportional rate of tax and not a progressive rate system. He believed that a set rate was more easily applied and was based on an equal sacrifice principle.\textsuperscript{79} Proponents of a proportional rate of tax or a ‘flat rate’ of tax system believe that it still ensures that the wealthy pay more tax than the poor but also prevents wealthy people from entering into tax schemes that may amount to tax avoidance or tax evasion in order to reduce income so that it is taxed at a lower marginal rate of tax.\textsuperscript{80} It also does not act as a disincentive to engage in paid work as a result of moving into a higher tax bracket.\textsuperscript{81} Similarly, a great deal of effort by taxation professionals in Australia is placed upon the end of the financial year tax planning which, in effect, looks at accelerating tax deductions and delaying the recognition of income simply to take advantage of a lower tax bracket. With company tax having a flat rate in Australia and many OECD member countries, much of this type of effort is pointless.

Peter Groenewegen describes the early history of the use of a progressive rate system of taxation and provides the following insight into its use:


\textsuperscript{79} Ibid, Groenewegen, above n 77, 15.


\textsuperscript{81} Ibid.
It appears that progressive taxation made its debut in Athens in the time of Solon around BC 596 … sporadic use of the principle of progression … is visible in the French and English graduated poll taxes of the middle ages … the first use of graduated scale for an income tax occurs in the Florentine Republic during the fifteenth century. For 1480, this rate scale varied in nine steps from 7 to 22 per cent.\footnote{Ibid, Groenewegen, above n 77, 14}

As John Head and Richard Krever contend, ‘[t]he emergence of progressive-rate personal income taxation as a major instrument of revenue raising and of taxation policy has been one of the most important and remarkable fiscal phenomena of the 20th century’.\footnote{John Head and Richard Krever Ed., Flattening the Tax Rate Scale: Alternative Scenarios and Methodologies, (1990), v.} Professors Head and Krever are very strong advocates of progressive income tax rates on the basis that it is able to deliver a sense of fairness in taxation through vertical and horizontal equity as well as providing income redistribution and social policy.\footnote{Ibid.} It is of interest to note that within the OECD member countries, since 2000, the progressive rates of income have declined in the past seven years and are now less progressive than what they were in all countries except three out of thirty.\footnote{OECD, Taxing Wages – Special Feature: Tax Reforms and Tax Burdens 2006-2007, Edition 2007, 24.} The three countries that have increased their tax brackets are Canada, Portugal and the United States.\footnote{Ibid.} Studies have shown that when the top rates of tax have been cut this has resulted in an increase in income being reported to the taxation administrators.\footnote{Ibid.} In the US in 1981 when the top rate of tax was cut from 70 percent to 50 percent’ the IRS\footnote{Joel Slemrod, The Consequences of Taxation, (2006) Social Philosophy & Policy Foundation, 73, 78.} received an increase in income that was reported by the top 1 percent of the income distribution.\footnote{IRS is the equivalent of the ATO in Australia and the initials stand for the Internal Revenue Service.}

Put simply, the concept of equity in taxation is based on the perceived need to have taxpayers contributing to revenue based on their ‘ability to pay’, as enunciated by Adam Smith; or as expanded by J.S. Mill, the ‘equal sacrifice principle’. Those with...
more income should pay more and those with less should pay less. The principle of vertical equity is found in Adam Smith’s first maxim of a good taxation system, as discussed above. What then is vertical equity and is this approach to taxation defensible? The best advocate of vertical and horizontal equity is Richard Musgrave. Musgrave states that Adam Smith ‘can be seen as an ability-to-pay theorist’ and with ‘a mix of benefit components’.\(^90\) In other words, Smith viewed the payment of taxes as being in proportion to the benefits being obtained from the State. According to Musgrave:

J.S. Mill then separated the analysis of tax equity from the expenditure side of the budget … Mill then translated equal ability into equal sacrifice terms. Fairness, according to Mill, required tax differentials which impose *equal absolute* sacrifice across unequal incomes.\(^91\)

Richard and Peggy Musgrave have taken these concepts further by arguing that horizontal equity was linked to vertical equity. The following statement by Richard Musgrave sums up the position perfectly:

The call for equity in taxation is generally taken to include a rule of horizontal equity (HE), requiring equal treatment of equals, and one of vertical equity (VE), calling for an appropriate differentiation among unequals. HE appears non-controversial. Not only does it offer protection against arbitrary discrimination but it also reflects the basic principle of equal worth. The United States Constitution provides for ‘equal protection under the law’.\(^92\)

Musgrave acknowledges that ‘vertical equity … is inherently controversial. An appropriate pattern of differentiation must be chosen but people will disagree on its shape’.\(^93\) He goes on to hold that ‘horizontal equity appears non-controversial’. This view is endorsed by Henry Simons, of the Haig-Simons definition of income, who states that ‘it is generally agreed that taxes should bear similarly upon all people in


\(^{91}\) Ibid, 115.

\(^{92}\) Ibid, 113.

\(^{93}\) Ibid.
similar circumstances’. 94 Professor Miller raises the question as to whether it is possible to achieve equity in taxation and how can it be achieved?95 He contends that horizontal equity is only achieved if all people are treated alike and if this does not occur then people will cheat on their taxes.96 Could this be the reason why tax avoidance and tax evasion still occurs?

From the above examination of the early theories of taxation and the ideal tax system, it can be seen that taxes should be equally imposed on those of equal means, horizontal equity, and that those of little means should be taxed less than those with greater means, vertical equity. Many OECD member countries have adopted a progressive rate of personal income tax which ensures vertical equity, although this has been the subject of criticism.97

How should the burden of income tax be imposed on the taxpayer; a flat tax rate or a progressive rate of tax? The basic philosophy of taxation holds that those that have more income and wealth should pay more tax, vertical equity, and that taxpayers of equal wealth should pay the same amount of tax, horizontal equity. However, McDaniels and Repetti contend that:

Theoretically vertical equity could apply to a tax system that is progressive, proportional or regressive. Which of these designs is chosen depends upon one’s underlying theory of justice and decisions about some key economic assumptions.98

The authors then state that John Rawls, in his Theory of Justice99 advocates a flat tax rate on consumption as being the best tax system for his theory of justice. The Rawls theory of justice holds that:

94 Ibid.
96 Ibid, 543.
97 Ibid, 533.
… every person must have the largest political liberty compatible with a like liberty for all, and that inequalities in power, wealth, income, and other resources must not exist except in so far as they work to the absolute benefit of the worst-off members of society.\textsuperscript{100}

McDaniel and Repetti are critical of the Rawls approach to a tax system and argue that:

… a tax on consumption only exempts capital income from tax and capital income is concentrated in the upper income levels. Economists commonly argue that, under certain assumptions such a tax is the equivalent of a tax on wage income only.\textsuperscript{101}

The other issue that has remained unresolved is that if vertical equity is to be accepted in a good tax system then how much tax should the rich pay? Should the rate of tax be calculated by taking a proportion of the income of the tax payer or calculated on progressive rates, so that as the level of income increases so does the rate of tax that is applied; in effect, a step arrangement. It could be argued that a truly equitable approach would be to levy every taxpayer income tax as a set proportion, say 30 percent, irrespective of the level of income and wealth of the taxpayer. That way all taxpayers believe that every individual is paying the same level of tax, such as the flat rate of tax for companies in Australia, namely 30 percent. A progressive system imposes more income tax on higher incomes with the result that the rich pay considerably more in tax than the poor. As Professor Krever contends, ‘a progressive taxation is used as a vehicle for income redistribution. More is taken from the rich for the government to spend on the poor’. On the other hand, Professor Sinclair Davidson states, ‘in a progressive tax system … just as low and middle income earners pay progressively less in tax, so too they receive progressively less in tax cuts’. This fact was confirmed by the OECD report on Taxing Wages 2006-2007 where it was stated that:

In Australia, Germany, Iceland, Ireland and Luxembourg (and to a lesser extent Canada and Norway) tax reforms tended to reduce the progressivity of the tax

\textsuperscript{100} Ronald Dworkin, \textit{Taking Rights Seriously}, (1977), 150.

\textsuperscript{101} McDaniel and Repetti, above n 98, 610-611.
structure with high-earning employees benefiting from significantly higher tax reductions than those in the middle and bottom parts of the earnings range.\textsuperscript{102}

This may have been instigated as a result of two policy changes; first, the tax base was expanded to include consumption taxes and second, high tax rates had been ‘shown to lead to increased tax evasion and avoidance’.\textsuperscript{103}

The OECD report discusses the reforms that have taken place in member countries in relation to income tax schedules in a progressive tax system. The report notes that during the period from 2000 to 2005 ‘income tax schedules have tended to become less progressive with fewer tax brackets and reduced tax rate differences between the bottom and top tax bracket’.\textsuperscript{104} It is interesting to note that Iceland and the Slovak Republic have a single ‘flat’ rate of tax for incomes.\textsuperscript{105} There are some non-OECD member countries that also have a flat rate or proportional rate of tax on income and, according to Lauchlan Chipman, ‘Russia has a flat rate of 13 per cent and Latvia 25 per cent with no tax free threshold, and Estonia 26 per cent with a small tax free threshold.’\textsuperscript{106} All of these countries have a proportional system of taxation with a fixed rate for all taxpayers, similar to the tax rates imposed on companies in most OECD member countries. This fact is not that surprising given that consumption taxes, VAT and GST, are also levied at a flat or proportional rate. It has been generally regarded by governments that a flat tax on consumption is regressive because it has the same impact on the rich as well as the poor. However, GST could be imposed on a progressive rate system, if required, along similar lines to income tax.

As was discussed above and reinforced by Sinclair Davidson,\textsuperscript{107} J. S. Mill advocated a strong case for real equality in taxation only being achieved if the same proportion of tax was taken from each person, irrespective of their means. He was advocating a

\textsuperscript{102} OECD, above n 85, 26.
\textsuperscript{103} Avi-Yonah, above n 9, 1 and 7.
\textsuperscript{104} OECD, above n 85, 24.
\textsuperscript{105} Ibid.
\textsuperscript{106} Chipman, above n 80, 19.
\textsuperscript{107} Sinclair Davidson, Who Pays the Lion’s Share of Personal Income Tax?, Perspectives on Tax Reform (4), The Centre for Independent Studies, 7. 
'proportional’ system rather than a ‘progressive’ system. As evidence of this, Professor Sinclair Davidson states that because Australia had a progressive system of taxation in 2000-2001, 85 percent of Australians paid less than their fair share of taxes and the top 5 percent of income earners paid 158 percent of their fair share of net taxes. This statement is based on the fact that ‘the top 25 percent of income earners in Australia ‘voluntarily’ pay 64.1 percent of the net tax’. A proportional system would result in the top earners paying less tax and the middle to low income earners paying more. This would be getting closer to a system of real vertical equity.

Horizontal inequities in Australia and elsewhere have led to disillusionment with the tax system. Taxpayers, being able to access loopholes in the law to pay less tax, have created an environment for tax avoidance and tax evasion. As Professor Krever asserts, ‘taxpayer disillusionment in the 1970s and 1980s can be traced to horizontal inequities: taxpayers knew that other taxpayers in a position to take advantage of preferences and loopholes were able to pay substantially less tax on the same amount of income’.

2.5.3 Expenditure or consumption tax as an alternative

In recent years, a great deal of discussion has focused on the merit of imposing a tax on consumption as an alternative to a tax on income. Most OECD member countries, as well as Australia, have a mixture of taxes on income, and a consumption tax and Canada, Australia and Japan have adopted a consumption tax only quite recently. According to Professor Alan Gunn, both the US Treasury Department and the Meade Committee in England are in favour of a progressive tax on personal consumption as an alternative to income tax. However, Professor Gunn is strongly in favour of maintaining a tax on income and concedes that the current system has two main defects; first, it taxes savings twice and; second, it is administratively complex and

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109 Krever, above n 11, 12.
110 Ibid.
111 Avi-Yonah, above n 9, 1 and 2.
113 The argument that savings are taxed twice arises because savings are taxed first as income and then the interest earned on those savings is also taxed as income. There is a strong argument that interest on savings should be exempt from further taxation as income as this would act as an incentive to save. A consumption tax
costly, but he reaches the conclusion that income should remain to be taxed and not replaced completely by a tax on consumption.\(^{114}\) He does concede that a consumption tax does allow for inflation as the amount of tax increases as the value of goods and services increase,\(^{115}\) such as the present situation with the price of fuel and other products produced from oil. With the progressive income tax system, the effect of inflation is only adjusted when the tax brackets are adjusted for the inflationary effect on the price of labour.

Professors Bankman and Weisbach advocate a consumption tax over an income tax on three grounds. First, a consumption tax is more efficient because it does not discriminate between current and future consumption; second, a consumption tax can satisfy vertical equity and satisfy redistributive policies; and third, a consumption tax is easier to administer.\(^{116}\) As a result of the rise of the ‘welfare state’, with an ageing population and more demands on health resources and retirement pensions, many OECD member countries needed to broaden the tax base and a tax on consumption achieved that goal. Also, a tax on consumption was seen as one way to restrict tax avoidance on income; however, even consumption tax is being evaded and avoided by consumers and businesses.\(^{117}\) Governments have reduced the high marginal rates of tax because high rates encouraged tax avoidance but, also, high VAT rates in Europe have also led to avoidance.\(^{118}\) The debate between those that favour a tax on consumption instead of a tax on income will continue without resolution. Both forms of taxation have merits and disadvantages. As Professor Avi-Yonah states, both forms of taxation achieve his three goals of taxation; revenue collection, redistribution in order to support the social safety net, and regulation and, for this reason, he advocates the adoption of both forms of taxation in the United States of America.\(^{119}\) Many OECD member countries collect taxes from income as well as

\(^{114}\) Gunn, above n 112, 399.

\(^{115}\) Ibid, 392.


\(^{117}\) Avi-Yonah, above n 9, 1 and 8.

\(^{118}\) Ibid, 7.

\(^{119}\) Ibid, 26, 27 and 28.
consumption and there is a strong argument that the combination of the two satisfies all of the goals of taxation.

2.5.4 The Constitutional perspective – Buchanan and Brennan approach

Having examined the comprehensive tax system developed by Haig and Simons, and later refined by Musgrave, and, in particular, their combined approach to the need for vertical and horizontal equity within an ideal tax system, it is important to examine the role of government in implementing the notions of equity and the redistribution of wealth as well as efficiency and simplicity. After all, it is the government that makes the ultimate decision on what is to be taxed and at what rates of tax. In the Haig-Simons model, it was assumed that the policy makers were driven by the desire to ‘do good’ and completely ignored the political constraints. What factors does a government take into account when deciding on the choice of tax rates to be imposed and a particular tax system to be used and what are the constitution limitations on that choice and how does the ‘public choice’ approach apply to taxation? The constitution and the electorate have a major role in those decisions.

The ‘public choice theory’ of taxation, as developed by Knut Wicksell and further refined by James Buchanan, looks at the tax system and the rate of tax to be applied to taxpayers as having emanated from the political determinations of the government. The theory looked at a tax policy developed by a ‘revenue maximising Leviathan government’ and a body of taxpayers exercising some degree of control through elections and the constitution.

Professor James Buchanan was concerned about the limits on any government to impose taxes and viewed both the constitution of the country and the people through the election process as being the main forms of constraint on the government.


121 Knut Wicksell (1896) was a German economist that recognised the role of governments, and in particular the majority of members of Parliament being able to make tax law that suited their own purposes and the dangers that flowed from those consequences. Up until then all economists assumed that all governments were benevolent. Wicksell wanted to restrict the role of governments in the imposition of taxes and the spending decisions that they made as a means of controlling the ‘pork barrelling’ effect of governments in a democratic system.

122 Buchanan and Brennan, above n 120, foreword xv.
Professor Buchanan was critical of a government’s monopolistic power to tax and equates this power with the taking of property by coercion:

One of the most familiar manifestations of the government’s coercive power lies in the government’s power to tax. This power to tax is the power which the government has to secure control over resources in which individuals hold nominal property rights. In itself, the power is held independently of taxpayer’s consent and independently of any obligation to use the resources so obtained for purposes of which those taxpayers approve. In this sense, the power to tax is inherently coercive. … In the absence of specific constitutional restrictions to the contrary, the power to tax is simply the power to take.\(^{123}\)

This view on the importance of the constitution is supported by Professor Cooper where he states that:

the allocation of the burden of a tax is not entirely at the discretion of the government. In addition to substantive and political limitations, the constitutional framework of the state will often also dictate, at least in part, the procedural requirements which limit the powers of government.\(^{124}\)

The budgetary process is an extremely important part of the tax system in that it determines how and when the burden of taxation is to fall on members of the society. The government introduces a new budget each year to explain how the forecasted revenue for the year will be collected and how that revenue will be spent. Professor Head holds that:

… the tax system has long been recognised by political scientists as one of the most important economic and political institutions in a liberal democracy. It has a quasi-

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\(^{124}\) Cooper, Graeme, above n 1, 420. The manner and form conditions restrict, by procedural rules, the ability of government to enact tax laws which discriminate between states, to introduce tax legislation through the senate, the upper house of Parliament, to impose more than one tax in any taxing Bill, or to impose taxes on subordinate levels of government – ss 51, 53, 55, and 99 of the Constitution.
constitutional character in that it remains in force, usually with only minor changes over a sequence of budgetary decision making periods.\textsuperscript{125}

Professor Buchanan was also concerned about tax law made by a majority government in a democracy and the need for a constitution to ‘constrain’ any potential discrimination.\textsuperscript{126} He makes the following observation of the effect of majority rule:

Majority rule means what it says: rule by a majority coalition. And this fact alone guarantees that there must be discrimination in treatment between persons who are members of the majority coalition and those who are not unless discrimination is constitutionally constrained. This discrimination holds for the distribution of taxes as it does for all other activities under the authority of government.\textsuperscript{127}

Governments want to be re-elected and their tax policy decisions will be directed at their supporters. Without constitutional constraints, tax laws might discriminate against a portion of the population and the budget decisions might severely affect a particular group within society. It is within this environment of a public choice theory that tax law and policy is sometimes made.

\section*{2.6 Efficiency – Economic Neutrality}

The optimal tax system is a structure with a variety of taxes imposed at a range of rates that maximise the welfare of the taxpayer. Ideally, any tax should be economically neutral for the taxpayer. In other words, the existence of a tax at a particular rate should have no effect on the behaviour of the taxpayer. The taxpayer should not change his or her behaviour as a result of taxation. Graeme Cooper provides the following definition of the ‘optimal tax system’ as defined by Mirrlees:

\begin{itemize}
  \item \textsuperscript{126} Buchanan, James, ‘The Political Efficiency of General Taxation’, (1993) 46 National Tax Journal 401, 404.
  \item \textsuperscript{127} Ibid.
\end{itemize}
[A]n individual’s welfare is determined exclusively by utility derived from two items – the amount that an individual consumes (C) and the amount of leisure the individual enjoys (L). The individual’s welfare (U) is thus defined:

\[ U = u(C,L) \]

[A] person’s total utility is a function of the individual utility of each of C and L. Individuals will maximise their individual welfare by choosing the combination of leisure and consumption that yields the highest outcome.\(^\text{128}\)

Put simply, an individual can achieve their optimal happiness and welfare by either working for more money or working less and having more leisure. If tax rates are too high then the individual may choose to work less and enjoy more leisure. The problem with this scenario is that the amount of tax collected is less and the tax system had caused the individual to change their behaviour as a result of the tax rates. This is also referred to as the ‘substitution effect’ of taxation when higher taxes lead to more leisure.\(^\text{129}\) Joel Slemrod expresses his concern with any taxation that affects the behavioural response of individuals and businesses to the tax system.\(^\text{130}\) He makes the following observation in support of the optimal tax system:

\[ \text{T}he \ more \ the \ tax \ system \ induces \ individuals \ and \ businesses \ to \ alter \ their \ behaviour, \ the \ greater \ is \ the \ social \ cost \ of \ raising \ revenue. \ While, \ traditionally, \ economists \ have \ focused \ on \ the \ behavioural \ response \ of \ labour \ supply, \ savings \ and \ investment \ – \ sometimes \ called \ ‘real’ \ responses \ – \ in \ recent \ years \ the \ public \ finance \ community \ has \ recognised \ that \ all \ the \ behavioural \ responses \ to \ taxation, \ including \ avoidance \ and \ evasion, \ are \ all \ symptoms \ of \ inefficiency. \ According \ to \ this \ view, \ it \ is \ the \ responsiveness, \ or \ elasticity, \ of \ taxable \ income \ that \ determines \ the \ social \ cost \ of \ collecting \ revenue. \ The \ social \ cost, \ in \ turn, \ sets \ the \ trade-off \ between \ fairness \ of \ the \ tax \ distribution \ and \ the \ efficiency \ consequences \ of \ taxation, \ the \ trade-off \ that \ frames \ the … appropriate \ level \ of \ tax \ progressivity. \]

\(^\text{128}\) Cooper, Graeme, above n 1, 434.
\(^\text{130}\) Slemrod, above n 87, 73.
\(^\text{131}\) Ibid.
of taxation to be spread across society? Both the comprehensive and the optimal schools provide some insights into an answer.\textsuperscript{132}

The optimal tax system places emphasis on tax rates as opposed to the tax base.\textsuperscript{133} The Haig-Simons approach placed emphasis on what was going to be included in the definition of income tax, the tax base, whereas the optimal tax school, based on the writings of Ramsey in 1927 and Mirrlees in 1971,\textsuperscript{134} places the emphasis on the rates of tax to be applied in order to maximise the utility of the taxpayer. The reason why this was considered to be so important was that if equity considerations were placed first then efficiency within the tax system is at risk. Efficiency within a tax system is usually ‘defined in terms of deadweight loss’.\textsuperscript{135} A good tax policy is one that causes less deadweight cost than another. Deadweight loss can best be described as the cost associated with raising revenue through taxation. As Sinclair Davidson observes in the following statement about deadweight losses:

\begin{quote}
[T]axes have two effects; first, they exist to raise revenue, and second, they generate deadweight losses in the form of wealth that is not created as a result of the tax on outputs. High marginal tax rates may therefore impede the revenue raising effects while also imposing high deadweight losses on the economy. This means any changes in marginal tax rates need to be evaluated in terms of the change in revenue and changes in deadweight losses.\textsuperscript{136}
\end{quote}

A further example of where tax policy has had an impact on efficiency is found in the study by the UK Open University Business School report, produced in 1998, on the behaviour of companies in Britain where it was found that 18 percent of businesses ‘avoided sales to stay below the £50,000 threshold for VAT’.\textsuperscript{137}

\begin{flushleft}
\textsuperscript{132} Cooper, above n 1, 422. This is the main issue facing any government designing a tax system and the main question asked by Graeme Cooper in his paper.

\textsuperscript{133} Ibid, 436.

\textsuperscript{134} Ibid, 429. Graeme Cooper provides a detailed history of the development of the optimal tax system as first enunciated by F. Ramsey in his paper on ‘A Contribution to the Theory of Taxation’ (1927) and the adoption of this approach by Diamond and Mirrlees in 1971 with their paper titled ‘Optimal Taxation and Public Production I: Production Efficiency’.


\textsuperscript{136} Davidson, above n 129, 13.

\textsuperscript{137} Binh, above n 7, 31.
\end{flushleft}
As discussed above, achieving equity in taxation is one of the main goals of a well designed system and the issue of efficiency appears to come second. However, the ‘pursuit of equity will inevitably reduce efficiency’ and this is the main concern of those promoting an optimal tax approach. According to Graeme Cooper, the Canadian Royal Commission on Taxation (1966), known as the ‘Carter Commission’, stated that ‘equity issues were always to be given first priority, so that no trade-off between equity and efficiency was possible’. Cooper provides the following quote from the Carter Commission Report in support of this approach:

[W]hen faced with these hard choices [between competing equity and efficiency goals] we have consistently given the greatest weight to the equity objectives … We are convinced that scrupulous fairness in taxation must override all other objectives where there is a conflict among objectives.

The current Australian Government review of the tax-transfer system would appear to endorse the Carter Commission view as it specifically discusses the need for horizontal and vertical equity and the acceptances of the Haig-Simons definition of income while at the same time acknowledging that efficiencies do merit some concern as trade-offs with equity issues. One of the main focuses of the ‘theory of optimal taxation can be seen as a recipe for minimising the costs of taxation’ and this is the focus of the following goal of taxation; the need for a simplicity and certainty which should, in turn, help to minimise the cost of administration.

2.7 The Need for Simplicity in a Tax System

The third goal of an ideal tax system is that it should be simple in terms of an understanding of the law and compliance of the law by taxpayers and simple in terms of the collection of taxes and administration by the tax authority. This was one of the three criteria of a good tax system as enunciated by Adam Smith and discussed in

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139 Cooper, above n 1, 438.
140 Ibid.
141 Ibid, 438. The reference to the Carter Commission Report is Volume 1, 4.
142 Commonwealth of Australia, above n 5, 174, 179 and 312.
detail above. A complex system is perceived to lead to tax evasion and tax avoidance because of the wealthy being able to obtain advice on how to take advantage of the complexities in the law.\textsuperscript{144} The current review of the Australian tax system has noted that the income tax law contained in the various statutes is now 5,743 pages, up from 526 pages in 1975 when the ‘Asprey’\textsuperscript{145} report on the review of the tax system was produced.\textsuperscript{146} The Business Council of Australia and the Corporate Tax Association released a report in 2007 on measures to reduce compliance costs on business and found that those businesses had to deal with 21 Australian Government taxes, 33 State taxes and two Local Government taxes. It was noted that this was more than twice the number of taxes effecting businesses in the United Kingdom.\textsuperscript{147} There are two issues that require examination under this heading; first, the actual cost of collecting taxes and the resources from both the public and private sectors that are involved in this process; and second, the implications for society when the law becomes extremely complex to understand and be applied by taxpayers which may lead to an erosion of the ‘rule of law’.

2.7.1 The cost of compliance

The first of the main implications of having a complex tax system is the cost of administration. These costs are incurred by both the Taxation Administration and the taxpayers in trying to comply with the complex tax law. For example, in the 2006-2007 Annual Report of the Australian Taxation Office it was stated that they employ 22,342 staff and had a budget of $2.662 billion.\textsuperscript{148} The number of staff would be far greater if the Australian tax system did not have self-assessment and that most of the tax is collected by businesses as employers or taxpayers. Many OECD member countries have adopted a self-assessment system for the preparation of tax returns which means that the assessment of any tax liability is the responsibility of the taxpayer, either individual or corporation, and the return is not scrutinised unless any


\textsuperscript{145} The Report on ‘Commonwealth Taxation Review Committee (Asprey Committee) (1975) looked at the Australian tax system in terms of equity, efficiency and simplicity as well as the need to broaden the tax base that existed in Australia at that time.

\textsuperscript{146} Commonwealth of Australia, above n 5, 305.

\textsuperscript{147} Ibid, 307.

abnormality is detected at a later date. Similarly, more staff would be required if it was not for the employer collecting income tax from the employee during the year under the Australian ‘Pay-as-you-go Withholding’ system as well as the goods and services tax, fringe benefits tax and a variety of other taxes. In this way, the administrative costs of collecting taxes have been transferred to the private sector and these administrative costs are no longer being borne by the government. However, the government would argue that the administration – ATO – is now focusing on tax avoidance and tax evasion, the review and audit functions and education of the public.

Agnar Sandmo is of the view that these administrative costs have an impact on the choices made by people and businesses. His following comments are important because they once again highlight the ‘deadweight costs’ of taxes:

In the case of firms, a major cost to them is doing a significant part of the work of actually collecting the taxes for the government … If the private costs of tax compliance vary among branches of industry, modes of business organisation and personal occupation, there is every reason to believe that people’s choices will be affected by these differences in cost. Someone who is about to decide whether to set up his own business or accept a salaried position in a big company, may let his choice be influenced by the consideration that in the former case his costs of tax compliance – as well as the opportunities for tax evasion and avoidance – are likely to be much higher. So the costs of tax compliance on the part of the taxpayer, which form part of the economy-wide costs of the tax system, are likely to have effects on the structure of industry and occupations in a country, and in the next round on returns to investment and gross wages.149

In the US, ‘78 percent of total personal income tax’ that is collected from labour is via the employer, and the Internal Revenue Service (IRS) ‘correctly believes that it is much more efficient to collect and monitor taxes remitted by a smaller group of employers compared with taxes remitted by a hundred million or so employees’.150

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149 Sandmo, above n 143, 643 and 644.
This might be an efficient situation for the tax administrators in the US and Australia but what of the compliance costs for business?

Economists in the US, the United Kingdom, Canada and Australia have attempted to quantify the actual compliance cost to the individual and corporate taxpayer in those countries. For individuals in the US, compliance costs are ‘about seven percent of revenue’ raised.\(^{151}\) On the corporate side, compliance costs are over three percent of the total federal and state corporate income tax collections.\(^{152}\) The UK, Canadian and Australian research ‘suggests that compliance costs can range from two to twenty four percent’.\(^{153}\) These findings are also supported by Alex Robson who states that ‘recent US studies indicate that the average cost of funds (ACF)\(^{154}\) for all forms of taxation lies somewhere between 18 per cent and 24 per cent of total government revenue’.\(^{155}\) He further states that ‘this means that on average each dollar that the US government collects in revenue from all forms of taxation costs the private sector between $1.18 and $1.24’.\(^{156}\) Australian studies have confirmed that the ‘Australian tax system imposes higher compliance costs on taxpayers than virtually any other income tax system in the world’.\(^{157}\) This may not be the type of statistic that any country should be proud of. The current review of the Australian tax system highlights some of the government’s concerns about complexity in the tax and transfer system and the government may ultimately address some of the obvious problems. However, the report still emphasises the necessity to take into account the need to balance equity and efficiency concerns with the complexity issues.\(^{158}\)

### 2.7.2 Does complexity lead to an erosion of the ‘rule of law’?

The ‘Rule of Law’ is a principle contained in the English legal system and, as enunciated by Professor Dicey, holds that all men are equal under the law except the

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151 Alm, above n 42, 117 and 120.
152 Ibid.
153 Ibid, 121.
154 The average cost of funds computes the total deadweight loss created by tax, and then divides it by the total amount of revenue collected by that tax - Robson, n 45.
155 Robson, above n 45, 7.
156 Ibid.
158 Commonwealth of Australia, above n 5, 312.
Crown.\textsuperscript{159} It can also be expressed as the notion ‘that the people and the government should obey the law and be ruled by it’ but the legal concept of the ‘rule of law’ is not readily definable.\textsuperscript{160} What is important in this context is the fact that there is a ‘strong correlation between economic growth and a strong rule of law’.\textsuperscript{161} In other words; a country that ensures that all of its citizens and the government obey the law will have a strong and vibrant economy. If that is the case then the law must be easy to understand and administered fairly, and the doctrine of separation of powers should also operate effectively. Parliament, consisting of the elected representatives, makes the law; the Executive administers the law; and, the Judiciary resolves any disputes arising from interpreting the law. In the context of an overly complex taxation system, the rule of law has relevance because of how the existing law is to be made and interpreted by Parliament, the Executive and administrators, and the Judiciary. Professor Walker is of the opinion that the rule of law is under threat due to the complexity of the legislation and provides the following statement to that effect:

\begin{quote}
[T]he rule of law has all but collapsed under pressure of the sheer volume of often unintelligible legislation and the grant of wide discretions to the Australian Taxation Office (ATO) and the courts. The ATO, with its power to vary the incidence of tax and issue binding rulings, is increasingly becoming the final deciding authority. Legal advice leaves the taxpayer unmoved as ATO rulings become the only source of certainty for those seeking to plan their future activities. The separation of powers has also virtually broken down: the executive government exercises legislative and quasi-legislative powers, the judiciary exercises policy-making powers, rights effectively turn on opinions about a citizen’s purposes and in a variety of ways the law is changed at the point of application.\textsuperscript{162}
\end{quote}

Some of the key issues that Professor Walker has identified as being conducive to an erosion of the rule of law are found in the ATO’s ruling system where in ‘perhaps 90

\textsuperscript{159} Mick Woodley, (ed), \textit{Osborn’s Concise Law Dictionary} (10\textsuperscript{th} ed, 2005) 359.


\textsuperscript{161} Ibid, 425. Ross Buckley has taken this quote from Douglas North, the Nobel Prize winner in Economics in 1993 who researched the correlation between the rule of law and economic growth and development.

percent of cases these materials are consistent with enacted law, but in the remainder the ATO is effectively making its own rules. In 1992, when the ruling system was being introduced into Parliament by the Minister assisting the Treasurer, it was stated that ‘the ruling system was touted as promoting certainty for taxpayers and thereby reduce their risk and opportunity cost’. However, a recent example of where an ATO ruling, TR 1999/5, was in conflict with the case law is found in the Federal Court decision in Essenbourne Pty Ltd v FCT (2002) 51 ATR 629. The ruling was subsequently withdrawn on 27 June 2007 after the Commissioner of Taxation had publicly disagreed with the decision of Kiefel J through an ATO media release and the Commissioner had brought three more cases before the Federal Court in an attempt to obtain a Federal Court decision in line with its public ruling, TR 1999/5. In the end, all of the Federal Court decisions held that there was no fringe benefit in the situation involving employee benefit trusts and non-complying superannuation funds. The major issue threatening the ‘rule of law’ in this situation was that the Commissioner of Taxation was adopting the position of the Parliament and the Judiciary in making new taxation law in relation to the fringe benefits tax. The stance taken by the ATO went far beyond what is required to administer the taxation law and would have added to the confusion facing tax professionals, business and individual taxpayers. Professor Walker provides other examples of situations where the discretion provided to the Commissioner of Taxation has led to the ATO adopting the role of law maker and, as such, threatening the rule of law. One example that has serious implications for tax administration is the bonus arrangement that ATO auditors are being paid for every extra dollar of revenue collected. As Professor Walker states, ‘the practice of remunerating tax officers according to the amount of revenue they collect recalls the 18th century tax-farming abuses that helped trigger the French Revolution’. 

163 Ibid, 2.
164 Wallis, above n 157, 283.
166 The cases before the Federal Court that held that there was no fringe benefit in terms of the ruling TR 1999/5 were Walstern Pty Ltd v FCT (2003) 138 FCR 1, Caelli Constructions (Vic) Pty Ltd v FCT (2005) 147 FCR 449, and Indoorsopilly Children Services (Qld) Pty Ltd v FCT [2007] FCAFC 16.
167 Walker, above n 162, 3-5. In particular the uncertainty with the tax avoidance provisions, Part IVA, and its application as well as the ATO’s power to settle cases.
168 Ibid, 5.
2.7.3 Does complexity lead to tax avoidance and evasion?

It could be argued that the tax accountants and lawyers are responsible for the complexity in the tax law because of the need by the government to close loopholes used to minimise tax developed by them. On the other hand, it can just as equally be argued that, as a result of complexity, loopholes are available to be taken advantage of for the purpose of tax minimisation.

Professor Krever places the blame for tax advisers being able to exploit loopholes for their clients squarely on the complex legislation that exists in Australia. The following passage from Krever sums up the situation very well:

There is no basis for blaming the tax adviser for their role in minimisation if the legislature decides to erect a tax system built upon the fragile façade of legal forms and taxpayers engage tax advisers to minimise their taxes by manipulating legal forms. It would be naïve at best to think a tax law based on legal distinctions with little or no underlying substance would not invite taxpayers to recast the form of transactions, and it is fanciful to think tax advisers assisting taxpayers to cross such artificial thresholds are the persons ultimately responsible for tax avoidance. The culprit is the legislature that introduced the thresholds, not the taxpayers who seek to cross them or the tax advisers whose job it is to assist taxpayers to achieve economic benefits.\(^{169}\)

Margaret McKercher conducted research on the effects of the complex tax laws on the compliance behaviour of taxpayers in Australia and concluded that complexity impacted on compliance and this, in turn, impacted on the perception of fairness of the tax system. Based on her research, McKercher was able to arrive at the following statement on the theory of the relationship of complexity to compliance:

It was theorised that complexity and high levels of commitment caused taxpayers to experience high levels of compliance costs, which in turn reduced the perception of fairness of the income tax system. As the perception of fairness decreased, there was a decrease in commitment to compliance. If commitment to compliance was to not fall, then the most direct means to ensure that this did not occur was to reduce the

\(^{169}\) Krever, above n 7, 33.
cost of compliance. This could be achieved by reducing complexity, which would have the added positive effect of increasing the perception of fairness.\(^{170}\)

Research conducted by Ken Devos\(^ {171}\) on the effect of penalties and sanctions on non-compliance of the tax law found that the ‘level of taxpayer non-compliance with taxation law in Australia is not directly or solely affected by either the introduction of new tax offences or the imposition of heavier sanctions’.\(^ {172}\) Devos goes on to explain that research in the US, conducted by Schwartz and Orleans, has shown that ‘the threat of legal sanctions has an impact on compliance but not as great as an impact as appealing to the taxpayer’s consciences’.\(^ {173}\) Unfortunately, this research was not directed at why taxpayers do not comply with the law but what effect sanctions and penalties have on compliance behaviour.

A vast amount of research on taxpayer behaviour in relation to compliance with the tax law has been conducted over the past 20 years and the results of this research have been summarised by James Alm as follows:

(1) An increase in tax complexity leads to greater use of a tax practitioner and the average level of non-compliance is higher for returns prepared with paid assistance (Erard, 1993)

(2) A higher audit rate leads to more compliance, at least to a point, with an estimated reported income-audit rate elasticity ranging from 0.1 to 0.2 (Dubin and Wilde, 1988)

(3) A higher fine rate leads to marginally more compliance, with an estimated reported income-fine rate elasticity less than 0.1 (Alm, Bahl and Murray, 1993)

(4) A higher tax rate leads to less compliance, with an estimated reported income-tax rate elasticity ranging from -0.5 to -3.0 (Clotfelter, 1983)

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172 Ibid, 286.

(5) Audit rates are endogenous, in that they depend in part on the choices of taxpayers (Feinstein, 1991).174

From the above analysis, it can be seen that complexity in the tax system leads to greater non-compliance and even greater tax avoidance and evasion. It is interesting to note that the use of tax professionals also leads to greater non-compliance and the use of tax schemes to minimise tax. This research is also important in the final question of whether or not tax havens will survive as the impact of tax accountants and lawyers, especially those located in tax havens, have had on generating non-compliance with tax laws throughout the world. As well as tax professionals, international banks and financial institutions have been facilitating the flow of capital into tax havens and offshore financial centres.

2.8 Conclusion

The three basic tenets of a good tax system require equity, efficiency and simplicity. These principles have been part of the philosophy of any tax system for hundreds of years. The comprehensive tax system, as developed by Haig-Simons and refined over the years, is now an established part of the tax systems in most OECD member countries as well as non-member states. The optimal tax theory proponents place more emphasis on the efficiency side of a tax system than the equity aspect of redistribution of wealth because of the dead-weight loss of certain taxes. The third principle of a good tax system, namely the need to have simplicity in its design and administration, has been found to be the cause of many of the problems facing both taxpayers and the tax collectors alike.

In terms of the requirement for vertical equity in a tax system, studies have found that ‘participants increased the amount of taxes evaded when they perceived themselves to be victims of vertical inequity’ and this was particularly so in the case of tax scheme investors in Australia during the latter part of the 1990s where those participants viewed the tax system as an ‘unfair system’ compared with the highly educated and higher earning proportion of the population.175 Research has also

174 Alm, above n 42, 124.
shown that higher rates of income tax in a highly progressive tax system will also lead to tax minimisation and the distortion of rational economic behaviour on the part of taxpayers and businesses. The finding of the research that has been conducted on the effect of complexity in a tax system also suggests that the existence of complex tax laws encourages tax minimisation.

The ATO booklet on the ‘High Wealth’ taxpayers, published on 3 April 2008, shows that the ATO collects a large amount of tax from this group of Australian residents that control more than $30 million or more in net wealth. During the period from May 1996 until June 2007, the ATO collected an extra $1.766 billion in revenue and, from the 1997-1998 financial year until the 2006-2007 financial year, the ATO disallowed $934 million in revenue losses and $777 million in capital losses.\(^{176}\)

Does this mean that the Australian tax system does not encourage compliance and, instead, encourages the wealthy in Australia to engage in tax avoidance and tax evasion? The Commissioner’s rationale for the need to comply with the tax law for the 1,200 individuals that were identified as falling within this category was that failure to do so breached the concept of ‘fairness’.

The Australian tax system is currently being reviewed because the government has acknowledged that the level of complexity in the existing tax law is beyond what is reasonable in a fair and efficient tax system. If history can teach anything, then the early approaches by such renowned economists and philosophers as Adam Smith and John Stuart Mill should be revisited and much of what they advocated should now be adopted.

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CHAPTER 3  THE HISTORY AND STRUCTURE OF TAXATION IN AUSTRALIA

3.1 Introduction

The purpose of this chapter is to provide a brief overview of the current Australian taxation system. This will include a discussion of the evolution of income tax and indirect taxation from the early colonies leading up to their eventual Statehood. This will be followed with a brief overview of the taxation system that has been adopted by the Commonwealth of Australia. Many of the specific taxation issues relevant to Australian taxpayers and their use of tax havens and OFCs are examined in detail in Chapters 5, 6, 7 and 8 of this thesis. Therefore, it is not intended to examine those areas of taxation law in this chapter but, rather, to provide an overview of the evolution of taxation in Australia starting with the early colonies through to the present day with the Commonwealth government having sole responsibility for the collection of income tax.

Australia has a similar taxation system and similar taxation laws to about 60 countries that are based on the income tax law of the United Kingdom.\(^1\) The United Kingdom has had a significant influence on the first the colonies and later the Commonwealth of Australia.\(^2\) Moreover, as Professor Walpole states, both countries have a common Head of State.\(^3\) It is against this background that the Australian tax system is discussed in this chapter. Australia only became a nation in Commonwealth of Australia Constitution Act 1900, an Act of the United Kingdom Parliament which took effect from 1 January 1901. This required each of the six States and the Northern Territory to relinquish certain powers to the national government. A federal system was introduced with each State Government having specific powers with

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\(^2\) Ibid.

\(^3\) Ibid. Queen Elizabeth II is the head of state for both the United Kingdom and Australia.
other powers reserved for the Commonwealth or Federal Parliament. However, the true sense of nationhood was not developed until the 1914-18 European war.\(^4\) The Commonwealth of Australia first introduced an income tax in 1915 to fund the war effort for the First World War. However, between the years of 1915 to 1942 the States and the Commonwealth levied income tax, which led to complexity and inequitable taxation across states.\(^5\)

### 3.2 Early History of Taxation in the Colonies

The colonies operated as separate economies until Federation in 1901. The early colonies of Australia raised most of their revenue from indirect taxes such as customs and excise duties. Early customs and excise duties on tobacco and alcohol were intended not only to raise revenue but also to control the consumption of alcohol in the colonies.\(^6\) By 1840, these taxes were extended to not only luxury items but also to basic household goods such as sugar, flour, meal, rice, grain and pulses. This meant that the tax was being shouldered disproportionately by poorer households relative to their income.\(^7\) The colonies also introduced a range of indirect taxes in the form of fees and licenses; stamp duty, liquor retailing licence fees, auction licence fees, probate fees and stock taxes.\(^8\) The ‘gold rush’ of the 1850s in Victoria and New South Wales provided governments with an opportunity to impose gold licence fees but, when this led to a rebellion, namely the ‘Eureka Stockade’ in Victoria, the licence fee was replaced with an export tax on gold.\(^9\)

When this was not sufficient, the states generally imposed excise duty and sold land to raise sufficient funds to meet their requirements.\(^10\) Huge tracts of government land were sold at ridiculously low prices to private owners, even where Aboriginal

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\(^{6}\) Ibid, 4.

\(^{7}\) Ibid.

\(^{8}\) Ibid, 5.

\(^{9}\) Ibid. It is of interest to note that the license fee was imposed on the miner irrespective of whether they found gold. At the same time wealthy land owners were only lightly taxed. This led to the resentment by the miners and the rebellion against this form of tax.

\(^{10}\) Driesen and Fayle, above n 4, 27.
communities were located. Moreover, leasehold was converted to freehold by the legislatures that were dominated by the landowners. The first direct taxes, which were introduced in New South Wales in 1851 and Tasmania in 1865, were in the form of death duties on personal property and not real property. Victoria introduced a succession duty on real property in 1870, South Australia in 1876, Queensland in 1886 and Western Australia in 1895. New South Wales extended its death duty to real property in 1870. According to Steve Gibson, the landowners ‘wailed and bleated’ about the introduction of the death duty but it ‘was increasingly clear that many had virtually stolen the land in the first place’.

Income tax was introduced into New South Wales in 1894. However, the New South Wales Labor government was indifferent to taxation as a source of revenue because they shared the view of European socialists that, in a socialist society, revenue was generated by the surplus from nationalised industries. The receipts from state owned enterprises fell in most states during the 1920s and, as Labor governments faced the prospect of imposing income tax, they adopted the rhetoric of equity. Governments imposed progressive rates of income tax based on the concept of ‘ability-to-pay’. By the 1930s and the period of the great depression, all states increased income taxes and most wage earners were required to pay tax for the first time. Queensland imposed the most severe progressive rates of tax with the highest income tax earners paying a rate of 117% on the highest marginal rate.

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12 Ibid.
13 Ibid, 33
14 Ibid.
15 Ibid.
16 Ibid.
18 Ibid, 68.
19 Ibid.
20 Ibid.
21 Ibid.
22 Ibid, 69.
The United Kingdom had a strong influence on the states through the adoption of the 1842 *Income Tax Act* (UK).\(^{23}\) This act was to last for 75 years until replaced in 1918.\(^{24}\) The United Kingdom income tax system is based on schedules; a different rate of tax for different types of income. The scheduler system was not generally adopted in Australia although the Tasmanian government introduced an Income Tax Bill in 1866, which contained various schedules, but, the Bill was defeated by the government of the day.\(^{25}\) When the government re-introduced an income tax bill in 1873, it contained only one schedule which was intended to make the law simpler.\(^{26}\) South Australia was the first state to introduce a proper broad based direct tax and it achieved this in 1884 with its *Taxation Act*.\(^{27}\) The colony was granted self-government in 1856 and became a State with a bicameral system of Parliament. South Australia, unlike other states, did not allow convict labour to be used.\(^{28}\) It was settled entirely by free persons from two groups; the first group were principally wealthy landowners and the second group ‘poor persons’ from Great Britain and Ireland. This Act contained a definition of ‘income from personal exertion’ and ‘income from property’ and different rates applied to each type of income with income from property taxed at a higher rate.\(^{29}\) This particular feature was adopted by the Commonwealth government in its own income tax legislation.

Neither Queensland nor Western Australia adopted a broad based income tax until after federation as they obtained sufficient revenue from land sales and mineral exploration.\(^{30}\)

### 3.3 Commonwealth Taxation

The first imposition of direct taxation by the Commonwealth government was in 1910 when a land tax was levied for both fiscal and social purposes.\(^{31}\) The

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\(^{23}\) Walpole and Evans, above n 1, 207.

\(^{24}\) Ibid.

\(^{25}\) Ibid, 209.

\(^{26}\) Ibid.

\(^{27}\) Ibid, 210.


\(^{29}\) Ibid.

\(^{30}\) Ibid, 673.
Commonwealth of Australia introduced income tax in 1915 as a result of an external crisis. The statute was the *Income Tax Assessment Act 1915* (Cth) and it followed very closely the income tax legislation in force in the States. It comprised seven parts, sixty-five sections, and was only twenty-two pages in length.\(^{32}\) The first time income tax was introduced by the Commonwealth government was in 1915, during the First World War, and then in 1942, when the Commonwealth took over as being solely responsible for income tax during the Second World War.\(^{33}\) According to Simon Blount, the introduction of a federal income tax in 1915 and the maintenance of the sole taxing authority in Australia by the Commonwealth government were well received by the people. The following statement reinforces this point:

In 1946 the government signalled its intention to retain the war-time income tax arrangements in the post-war era. During both wars, there was general support for the Commonwealth’s actions. In the First World War, government revenues from customs and excise had collapsed due to the disruption of trade, and the income tax measures were considered to be a ‘sensible move’. The Commonwealth’s actions in 1942 were also politically well received, particularly since the changes to income tax arrangements were accompanied by a national scheme for widows’ pensions.\(^{34}\)

The 1915 Act was replaced by the *Income Tax Assessment Act 1922* (Cth) and that statute was only forty-three pages in length.\(^{35}\) This Act was simply a taxing statute with social policy only evidenced by the graduating rates of tax payable and a higher rate on income from property than on income from personal exertion.\(^{36}\) In other words, it retained the scheduler approach to taxing different sources of income at different rates that existed in similar State legislation. Income from property and income from personal exertion continued to be taxed at different\(^{37}\) progressive rates.

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31 Ibid, 675.
32 Driesen and Fayle, above n 4, 32.
34 Ibid.
36 Ibid, 682.
that peaked at 60 pence in the pound.\textsuperscript{38} The dual rate structure continued to be imposed by the Commonwealth government until 1953 and then again, briefly, in 1974-75. The United Kingdom still retains its scheduler approach to taxing income whereas Australia has adopted a more global approach to taxing income.\textsuperscript{39} According to Professor Krever, the reason for the distinction was as follows:

\begin{quote}
The framers of the first Act believed that ability-to-pay corresponded not only to amount, but also to the sacrifice and effort of the taxpayer to earn that income. Income from labour or business was seen to involve a greater sacrifice while income from property was perceived as a passive gain.\textsuperscript{40}
\end{quote}

The 1915 Act only imposed income tax on Australian-sourced income and not on the taxpayers’ world-wide income.\textsuperscript{41} In 1930, Australia moved to a residence based tax system but exempted income derived and taxed in the United Kingdom.\textsuperscript{42} However, in 1947, Australia exempted all foreign income from further tax in Australia if it had been subject to a comparable rate of tax in the foreign country.\textsuperscript{43}

By 1936, the \textit{Income Tax Assessment Act} had grown to eighty-two pages and two-hundred and sixty-six sections and provided an exemption for the income from savings banks and from gold mining.\textsuperscript{44} Surprisingly, the gold mining exemption, s 23(o) of the \textit{Income Tax Assessment Act 1936} (Cth), remained in force until 1 January 1991.

Income tax on capital gains was not part of the United Kingdom legislation until 1965 and Australia in 1985. Professor Walpole points out the fact that, in the US, capital profits had been part of its tax base since 1913 as well as many other western-

\begin{footnotes}
\item[38] Michael Walpole, and Chris Evans, above n 1, 213.
\item[39] Ibid, 207.
\item[40] Krever, Richard, above n 37, 12.
\item[41] Reinhardt and Steel, above n 5, 13.
\item[42] Ibid.
\item[43] Ibid.
\item[44] Slater, above n 35, 682.
\end{footnotes}
developed economies.\textsuperscript{45} Yet surprisingly, the United Kingdom left it until the second half of the twentieth century before introducing a capital gains tax.\textsuperscript{46}

\subsection*{3.4 Tax Minimisation in Australia}

Australians have always had a propensity to try to minimise income tax. There are two main periods in recent times when tax avoidance schemes have become a major problem for the Australian Taxation Office (ATO). The first period was in the 1970s with the ‘bottom of the harbour’ schemes in which company profits were stripped and paid to investors as tax free capital gains as part of a dividend stripping operation.\textsuperscript{47} The company records were then destroyed by being sent to the ‘bottom of the harbour’.\textsuperscript{48} The fact that the Australian taxation law was, at that time, very complex was, in part, suggested as one of the main reasons for the development of the ‘bottom of the harbour’ scheme.\textsuperscript{49}

The second period was in the late 1990s with mass marketed tax schemes involving employee benefit trusts, offshore superannuation schemes and arrangements such as the ‘budplan’ investment.\textsuperscript{50} The first of the arrangements involved employers and self-employed trying to reduce their tax liability by engaging in tax effective remuneration schemes and the budplan scheme involved the investment by individual taxpayers in an agricultural tax effective scheme. The ATO conducted at least twenty court challenges to the schemes and invoked its laws under the general anti-avoidance rules, namely Part IVA of the \textit{Income Tax Assessment Act 1936} (Cth). In all cases, the ATO was successful.\textsuperscript{51}

As discussed in Chapter 2 of this thesis, there are many reasons why taxpayers engage in tax avoidance and tax evasion schemes; the complexity of the tax law, the

\begin{itemize}
\item \textsuperscript{45} Walpole, Michael and Evans, Chris, above n 1, 220.
\item \textsuperscript{46} Ibid.
\item \textsuperscript{48} Graeme Cooper, Richard Krever, Richard Vann, et al, \textit{Cooper, Krever & Vann’s Income Taxation, Commentary and Materials}, (5\textsuperscript{th} Ed. 2005), 914.
\item \textsuperscript{49} Ibid.
\item \textsuperscript{50} Ibid.
\item \textsuperscript{51} Ibid.
\end{itemize}
rates of income tax that are applied to the top income earners, lack of efficiency in the tax law, and a number of other reasons associated with taxpayer attitude to paying tax. Whatever the reason, it appears that Australian taxpayers are similar to taxpayers the world over; they engage in tax minimisation whenever schemes are available.

Australia is regarded as having a very adversarial tax culture; high tax planning costs on the side of the taxpayer and their adviser and significant auditing costs by the tax administrator, the ATO.\(^{52}\) Professor Binh et al., suggest that both the Government and the ATO should take more responsibility for improving the culture by making the tax system fairer and more transparent.\(^{53}\) What is apparent in Australia is that the rich pay more than their fair share of tax. According to Professor Sinclair, the top 25 per cent of income earners in Australia ‘voluntarily’ pay 64.1 per cent of the net tax.\(^{54}\) This may be one of the reasons why wealthy Australian taxpayers may engage in tax minimisation activities, including holding assets in bank accounts and investments in tax havens and OFCs.

### 3.5 Tax Reform Proposals

Successive Australian governments have conducted a number of enquiries and reviews of the Commonwealth taxation system. The most current review being undertaken is formally known as *Australia’s Future Tax System*; informally referred to as the ‘Henry Review’. It is named after the Chairman, Ken Henry, the present Secretary of the Commonwealth Department of Treasury.\(^{55}\) The review was commenced in 2008 and the report is due to be released in May 2010. The purpose of the review was to examine the current tax system in the context of future challenges presented by the 21\(^{st}\) century as well as the tax transfer arrangements which involve providing welfare funding to eligible citizens.

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\(^{53}\) Ibid, 459.

\(^{54}\) Sinclair Davidson, ‘Who Pays the Lion’s Share of Personal Income Tax? Perspectives on Tax Reform’, (4), *The Centre for Independent Studies*, 9

\(^{55}\) Evans and Krever, above n 47.
One of the most successful reviews of the tax system was conducted by the ‘Asprey Committee’ which was commenced in 1972 and completed in 1975. Aspects of this report were examined in detail in the previous chapter, Chapter 2. None of the recommendations of the committee were adopted in the decade following the report but many of the recommendations have ultimately been implemented by successive governments. In particular, the introduction of a tax on ‘fringe benefits’ that are provided to an employee in substitution for a cash salary, a tax on capital gains, and a goods and services tax were first recommended by the Asprey Committee. Professor Evans and Professor Krever contend that both the fringe benefit tax measures and the capital gains tax enhanced both the equity and efficiency of the income tax system.

The 1998-1999 Review of Business Taxation, known as the Ralph Review after its Chairman, provided a number of recommendations to the government of the day. However, the review has not been seen by business as having achieved its outcomes. The fact that the amount of income tax payable on capital gains has been halved for individuals in certain cases, the introduction of small business concessions, capital gains roll-over relief, and a reduced company tax rate to 30 per cent have been viewed as bringing about change but not reform. The Business Council of Australia have continued to voice their concerns over the substantial costs to business in complying with the business tax environment and detract from Australia being capable of providing a world-class environment for the business sector.

It is interesting to note the observations of Professor Evans and Professor Krever that, based on past experience, tax reviews rarely lead to successful tax reform. However, they contend that tax reform in Australia is overdue and that the Henry Review has the opportunity and the capability to establish the foundation for long term tax reform.

56 Ibid, 4.
57 Ibid, 7.
58 Ibid, 9.
59 Ibid.
60 Ibid.
61 Ibid.
CHAPTER 4  THE HISTORY AND THEORY OF INTERNATIONAL TAXATION

4.1 Introduction

This chapter will focus on the history and development of international cooperation in the field of international taxation and the way in which each nation shares the tax revenue from income generated by mobile labour, mobile capital and multi-national enterprises (MNEs) involved in investment and business in more than one country.

The basic approach to the taxation of foreign income is to impose income tax on the basis of the ‘residence’ of the taxpayer or on the basis of the ‘source’ of the income, or both. If the taxpayers’ country of residence imposes income tax on a ‘worldwide basis’ then all income derived by the taxpayer, including both domestic and foreign income, will be taxed in the home country of the taxpayer. The country of the source of the income may also impose income tax; however, that is not the case with most tax havens and OFCs. The rationale for taxing resident taxpayers on their worldwide income is discussed below. The issue of whether a ‘worldwide system’ is better than a ‘territorial system’ for the taxation of foreign income is examined in detail in Chapter 5 of this thesis. A territorial system requires resident taxpayers to only pay income tax on income derived within the territory. This system endorses a ‘source’ basis for the imposition of income tax.

According to Professor Avi-Yonah, ‘the current international tax regime is a flawed miracle’.\(^1\) He makes the following statement, which provides an excellent summary of the situation facing all nations in the taxation of international income:

It is a miracle because taxes are the last topic on which one would expect sovereign nations to reach a consensus. International taxation is, to some extent, a zero-sum game: one country’s gain is another’s loss. If income is derived by a resident of one

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country from sources in another, and if both countries have a legitimate claim to tax that income and the ability to enforce that claim, then either country will lose revenue by agreeing to grant the other the primary right to tax that income.²

A principle norm of international taxation law is that the double taxation of international income is harmful and should be avoided.³ The norm is that residence countries should allow the country of the source of the income to impose tax in relation to certain types of income.⁴ This is achieved by the residence country granting the taxpayer a credit for tax paid in the country of source or an exemption from any tax whatsoever in the country of residence.⁵ It is not necessary to have a double taxation agreement to achieve this outcome if the country of residence has domestic tax law that enshrines those provisions.

In the classic international tax system, the country of source imposes income tax on income derived in their state and the country of residence will provide an exemption from tax on that income in the country of residence or a tax credit for tax paid in the country of source or, in some cases, a deduction for income tax paid in the country of source. Basically, the country of residence will provide an exemption from tax in the home country for income that has been taxed at source; a tax credit for tax paid in the source country; or a deduction for tax paid in the source country in order to relieve the taxpayer from double taxation of the same income. This is the situation that exists in Australia and is discussed later in this chapter.

The law relating to the imposition of taxation on international transactions is part of the broad body of law known as ‘International Law’ or the ‘Law of Nations’ or ‘Public International Law’. The theory and philosophy of international law is discussed in detail in Chapter 6 in the context of whether the OECD makes international law when it provides guidelines or policy. It is not intended to examine international taxation law as being part of international law in this chapter. The

² Ibid.
⁴ Ibid.
⁵ Ibid.
international tax regime is generally regarded as constituting ‘customary international law’, which is defined as ‘a general and consistent practice of states followed by them from a sense of legal obligation’.\(^6\)

In a global world, people and capital are constantly moving between countries, including tax havens and OFCs, in order to take advantage of better economic and financial returns that may be offered in a particular foreign country. When individuals sell their labour globally or the capital that is invested globally returns interest income or business income, that receipt of money is potentially subject to tax, either in the country of source or the country of residence of the individual or corporation or in both countries, thereby causing the same income to be subject to double taxation. The issue of how to best share any tax on the income between two or more states has been the major concern of international tax law. If double taxation is to be avoided then one state must give up its right to collect tax in favour of the other state. This is achieved by agreement between the two states in the form of a ‘Double Taxation Agreement’ (DTA).

Most OECD member countries, including Australia, impose income tax on their ‘residents’ on a worldwide basis whereas the US imposes income tax on a worldwide basis on its own US citizens. The US system is unique in that all US citizens must lodge an income tax return on their worldwide income, irrespective of where they live, as long as they wish to maintain their US citizenship.\(^7\)

Other countries simply impose income tax on income sourced within their territory irrespective of residence or citizenship, such as Hong Kong, and this system of taxation is known as a ‘territorial basis’ of taxation. Australia and France have a tax system that allows foreign source income derived by corporations to be exempt from further income tax in their country of residence, which is in effect a ‘territorial basis’ of taxation. No country uses a pure worldwide or territorial system but all systems currently in use share at least some features of both worldwide and territorial

\(^6\) Avi-Yonah, above n 1, 1304.

\(^7\) Michael Graetz, ‘Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies’. (2000-2001) 26 Brooklyn Journal of International Law 1357, 1438. This requirement does not apply to individual US citizens that earn less than a prescribed amount of foreign income from salary or wages and as at 2000, the amount was USD 78,000.
The theory and benefits of imposing income tax on a worldwide or territorial basis is examined in detail in Chapter 5. The rationale for a government to choose a worldwide tax system, as opposed to a territorial system, is discussed in this chapter.

4.2 Regulation of International Taxation – Double Taxation Agreements (DTAs)

The current international law regulating the taxation of income in a foreign country was originally developed by the International Chamber of Commerce (ICC) and the League of Nations, now the United Nations. The result of this early development is the OECD model tax treaty.\(^9\) The League of Nations and the International Chamber of Commerce (ICC) were concerned with preventing the double taxation of income by foreign individuals and corporations as well as finding an ‘equitable solution to the conflict between debtor and creditor countries’.\(^{10}\) Professor Wang uses the terms ‘debtor country’ to describe the source country and ‘creditor country’ to describe the investor and country of residence. Each country, namely the country of source or the country of residence, wants the jurisdiction to impose income tax on the income generated. Wang states that, at the time the League of Nations and the ICC were examining the double taxation problem, the following four methods to solve this issue were suggested:

1. **Deduction allowed by state of residence.** The state of residence deducts from the tax payable by its citizens the amount of income tax imposed by foreign governments.

2. **Exemption allowed by state of source.** The state of source exempts all income wherever earned from taxation, leaving the taxing power to the state of residence.

3. **Adjustment of tax rates by both states.** The state of source levies taxes on income earned there, while the state of residence levies on all income wherever earned.

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However, by convention, specific rates are varied so that the total effective rate on that portion of income subject to double taxation does not exceed the higher rate.

4. *Apportionment of taxable items between both states.* The whole of the taxpayer’s income is divided into two parts, of which one part is taxed by the state of domicile, and the other, by the state of origin, each applying its own rates of tax.\(^\text{11}\)

While all of these solutions were contemplated, none was ultimately accepted and a great deal of discussion was entered into by various countries. The US Government recognised the potential problem with double taxation by introducing legislation before the League of Nations attempted to formally provide a solution. Prior to 1918, US corporations operating in foreign countries were only allowed a deduction for the foreign taxes paid against their worldwide income subject to income tax in the US.\(^\text{12}\) In the US, the taxation of international income was developed during the period 1918 to 1928 with the introduction of the *Revenue Act* of 1918. It is useful to note that income tax had only just been introduced in the US, in 1913, after the Sixteenth Amendment took effect to allow for the *Revenue Act* to impose income tax on incomes for the first time in the US.\(^\text{13}\) In 1921, the *Revenue Act* was amended to allow for a foreign tax credit to be given to a US citizen against their foreign income. The person regarded as being responsible for this approach was Thomas Sewall Adams, an economics professor at Yale University and adviser to the US government on taxation law. He advised the US Chapter of the International Chamber of Commerce on a solution to the double taxation problem and was credited with providing the concept of the ‘foreign tax credit’ to overcome this problem.\(^\text{14}\) While the US was one of the first countries to provide relief from double taxation by incorporating a tax credit mechanism into its domestic tax law, it was one of the last to provide relief from the ‘classical system’ of taxing corporations.\(^\text{15}\) The classical system imposes income tax on the corporation and income tax on the shareholder when a dividend is paid, thus taxing the same profit twice. Australia has had a system of ‘dividend imputation’ since 1986 whereby the shareholder is given a credit for tax

\(^{11}\) Ibid.


\(^{13}\) Graetz and O’Hear, above n 9, 1021 and 1022.

\(^{14}\) Ibid, 1045.

\(^{15}\) Ibid, 1025.
paid by the company and that credit attaches to the dividend, thus eliminating double taxation. The US finally introduced similar measures in 2006.

The first attempt to regulate international taxation in order to prevent double taxation was in 1921 when the International Chamber of Commerce held a conference in London to discuss this issue.\(^\text{16}\) The Chamber exercised primary leadership in the movement against double taxation up until 1925, when the League of Nations appointed a panel of technical experts to study the problem.\(^\text{17}\) The Chamber remained active in this area primarily through their representative to the League’s Committee of Technical Experts.\(^\text{18}\) This led to the League of Nations holding a conference in 1923 and asking four economists to develop policy that could be used as a basis of taxation grounded on the concepts of source of income and residence of the taxpayer. The four economists consisted of Professor Seligman from the US, Sir Josiah Stamp from Great Britain, Professor Bruins from the Netherlands, and Professor Einaudi from Italy. Seligman was the primary architect of the report which developed the following principles for the taxation of international income:

1. The classification and assignment of specific categories of income to source or residence should be determined by an objective test, ‘economic allegiance’, whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income,

2. Existing tax practices across the globe tended to underestimate the contribution of residence and to reflect a misguided belief in the naturalness and rightness of source-based taxation, and

3. Progressive taxes on global income were fundamentally different than other taxes and ought to be the unique province of residence-based taxation.\(^\text{19}\)

The report has been criticised for a number of things. It did not provide for a tax credit for foreign tax paid; it allocated taxes on interest and dividend income to the country of residence, the recipient, and it was not in the form of a treaty that could be


\(^{17}\) Graetz and O’Hear, above n 9, 1073.

\(^{18}\) Ibid, 1074.

\(^{19}\) Ibid, 1076.
used by nations. The problem of double taxation was not finally settled until the OECD model treaty was first issued in 1963, which limited the source country’s ability to collect tax on investment income. Developing countries, dissatisfied with the pro-residence focus of the OECD model, prompted the United Nations to develop a model treaty to promote investment in developing countries. This model treaty was first released in 1969. Both the OECD and the UN have revised their treaties over the years. The OECD and UN model double taxation treaties allow for a foreign tax credit or full exemption of foreign active business income; the taxation at source of interest income, dividend income and royalties in the form of withholding tax; and the concept of a permanent establishment to justify the taxation of business income at source. The distinction between active business income and passive investment income is fundamental to the taxation of international income and is discussed next.

4.3 Permanent Establishment – Active and Passive Income Distinction

Professor Avi-Yonah contends that in 1923 when the League of Nations was trying to resolve the problem of double taxation, it came to the conclusion that the following principle applied:

the ultimate goal underlying the international tax regime is that active business income is taxed in the country in which it originates (the source country) and passive income should be taxed in the country in which the recipient resides (the residence country).

This can be extended to reflect that income from investments should be subject to some limited form of taxation in the source country but greater tax in the home country, namely the country of residence. The distinction between passive and active business income is reflected in the double tax treaties by use of the permanent establishment concept. The basis on which income tax is imposed on non-resident business taxpayers is the concept of having a ‘permanent establishment’ (PE) in that

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20 Ibid, 1077.
21 Ring, Diane, above n 3, 122.
22 Ibid.
23 Ibid.
24 Avi-Yonah, above n 1, 1301 and 1306.
country. The distinction between passive and active income by the use of a PE is a compromise, according to Avi-Yonah, because the threshold of what constitutes a PE is quite low, a single office or even a single agent with authority to conclude sales is generally sufficient.\textsuperscript{25} Taxation of passive income in the country of source still exists but at very low rates of tax. The OECD Model Income Tax Treaty recommends that dividends be subject to withholding rates of tax of between 5 percent and 15 percent, interest at 10 percent and royalties 0 percent.\textsuperscript{26} Professor Avi-Yonah holds that the low tax rates imposed by the source country are a compromise between the source countries levying some tax but at the same time acknowledging that the country of residence should be the primary taxing authority.\textsuperscript{27}

However, according to Professor Graetz, the PE concept is ‘facing new pressure from electronic commerce, new financial techniques, and new forms of business arrangements and combinations’.\textsuperscript{28} He strongly advocates a modernisation of the permanent concept possibly based on a threshold amount of sales, assets, labour or research and development within a nation.\textsuperscript{29}

### 4.3.1 Active v. passive income – exemption or credit

Australia already provides relief from double taxation in the form of exemptions of certain active income; s 23AG of the \textit{Income Tax Assessment Act 1936} (Cth) (ITAA 36) for certain personal services income derived in a foreign country, s 23AH, ITAA 36 for branch income in a foreign country, and s 23AJ, ITAA 36 exempts non-portfolio dividend income from foreign countries. A portfolio investment differs from a non-portfolio investment in that a non-portfolio investment in a company is regarded as a being a direct and active investment in a foreign company where the investor holds more than 10 percent of the voting interest in that company. By way

\textsuperscript{25} Ibid, 1307.

\textsuperscript{26} Ibid, 1308. It is important to note that in Australia withholding tax based on income derived at source, is subject to rates of 10\% on interest to be paid to a foreign lender unless from the US or United Kingdom in which case the tax rate is zero; dividend withholding tax of 15\% or 30\% if no DTA or no tax to the extent that the dividend carries imputation credits; and royalty withholding tax at the rate of 30\% or where there is a DTA at the rate specified.

\textsuperscript{27} Ibid, 1308.

\textsuperscript{28} Graetz, above n 7, 261 and 319.

\textsuperscript{29} Ibid, 319.
of contrast, a portfolio investment is simply the holding of a range of shares in a number of foreign companies purely for the purpose of passive investment.

It is important to note that the US does not provide an exemption for active business income for its resident companies and this issue has become an important consideration for the US government, especially as US corporations are claiming that they are not as competitive as other MNEs. Australia also provides a credit for foreign tax paid on foreign sourced income so again, in many instances, no more income tax is paid in Australia.

A credit given by the home country for income tax paid in a foreign country is not as effective as the exemption method. Division 770 of the ITAA 97 applies from 1 July 2008 and now refers to the foreign tax credit as a ‘foreign income tax offset’. Philip Bender has highlighted one of the potential defects of the new foreign tax credit arrangements; when active business income is repatriated to Australia that is exempt, it carries no imputation credits from the foreign tax that has been paid. So, while the income is not subject to double taxation, it is subsequently taxed in the hands of the Australian resident shareholders when they receive a dividend.

A company or individual should be able to operate their business or an individual invest their money in any foreign country and be in the same position from a taxation perspective as if they had conducted the business or made the investment at home. If they were worse off then no business would be located in a foreign country and no investments would be made in that country as well. This highlights the need for the following three factors; taxpayer equity, locational neutrality and inter-nation equity. These issues are examined in detail in Chapter 5.

4.4 Rationale for a Worldwide Tax System

As a starting point, in a worldwide tax system a taxpayer pays income tax on income derived in their home country and anywhere else in the world. The general view of

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30 For a detailed discussion see US, Joint Committee on Taxation, above n 8 and Graetz, Michael, above n 7.
countries that have adopted a worldwide system of taxation is that it ‘preserves the
residence-country tax base more effectively than a pure territorial system’. The
contention is that if ‘foreign-source income is entirely exempt from taxation, resident
taxpayers will shift investment and income into lower-tax jurisdictions, thus eroding
the residency-country tax base’. It is also considered that a worldwide system
promotes equity more than a territorial system. In Chapter 2 of this thesis, the basis
of a comprehensive tax system was examined in detail and the two main concepts of
equity were discussed; first, the concept of horizontal equity, and second, the concept
of vertical equity. Proponents of a worldwide system believe that it promotes both
horizontal and vertical equity. With horizontal equity, all taxpayers irrespective of
where they derive their income, either at home or abroad, will be subject to income
tax in their country of residence. A tax credit for tax paid in a foreign country will
ensure that a higher rate of tax is not paid by that particular taxpayer. In terms of
vertical equity, by requiring a taxpayer to include their worldwide income it acts as a
disincentive for that particular taxpayer to shift their income producing activities
away from their country of residence and ensures that they pay their fair share of tax
based on the progressive rates of tax in their country of residence.

Professor Peggy Musgrave discusses the sovereign right of the nation state to tax its
residents on their worldwide income and contends that the right is recognised in
international law. Musgrave states that the right to tax the income of residents and
non-residents is based on the following criteria:

Residents are held to owe tax allegiance in return for the rights and privileges which
they receive as residents, giving rise to what is commonly referred to as the
‘residence principle’. Exercise of this tax sovereignty over foreign source income is
also is necessary to achieve equitable tax treatment of resident taxpayers by making
all income, wherever earned, subject to tax, consistent with the accretion principle.
… What is important is that the country of residence is the residual taxing authority

32 Joint Committee on Taxation, US, above n 8, 4.
33 Ibid.
34 Ibid, 3.
35 Ibid.
Brooklyn Journal of International Law 1335, 1336.
and thus has sovereignty over the total tax burden on the foreign-source income of its resident taxpayers.  

Professor Kaufman does not ‘agree that a taxpayer’s entire income necessarily needs to be taxed by a single country, the residence country, in order to satisfy the equity criteria. Horizontal equity is achieved by both the country of source and the country of residence imposing tax on income.

4.5 Other International Taxation Issues

There are two other issues that should be raised in this chapter because they are relevant to the way in which international taxation impacts on nations; first, the formula approach to the sharing of tax revenue between nations; and second, the concept of ‘tax sparing’ and its implications for the home country’s tax revenue.

4.5.1 Formula apportionment

The formula apportionment system tries to apportion the income of a taxpayer between different countries when the taxpayer is engaged in foreign transactions. For example, if a company is a resident of one country, exports components to another country to be assembled, and then sells those finished products in a third country, how is the income to be apportioned between states so that income tax can be paid on the basis of income being sourced from the various activities? Formula apportionment is used in the US to apportion the income of corporations that do business in more than one state where state taxes apply. It is also used in apportioning shipping income on an international basis. Professor Kaufman notes that the Clinton Administration opposed adopting a formula apportionment system on the grounds that there would be difficulties in find agreement between nations as to a definition of income and an agreed formula for sharing revenue. A formula apportionment system would overcome some of the problems of inter-nation equity, but create the need for international agreement between nations and add further

37 Ibid, 1337.
40 Ibid.
complexity to an already complex taxation system. It would do nothing to solve the problems of trying to detect foreign income being generated in tax havens and OFCs.

4.5.2 Tax sparing

Tax sparing involves a country not imposing the full amount of income tax on a foreign investor and yet the country of residence accepting that the full amount of foreign tax has been paid. In effect ‘the “spared” taxes are treated as actually paid and credited against the taxes imposed by the capital exporting countries on that foreign source income’. 41 The basis for the concept of tax sparing is that as the country of source is foregoing revenue in the form of uncollected income tax, the country of residence of the capital provider should not benefit by collecting more income tax that it would under normal circumstances.

Tax sparing is the term given to a situation where one country, the host country, provides tax incentives for businesses to be established in their country and the home country gives a tax credit or exemption for income that would have been taxed at the normal rate in the host country, if it had not been for the existence of the tax incentives. For example, Country A wants to attract insurance business so instead of the company from Country B paying the normal rate of company tax, say 20 percent, it pays only 10 percent for the first 5 years. The company pays the lower rate of company tax but the home country provides a full exemption from further income tax or a tax credit at the rate of 20 percent, even though only a 10 percent rate of tax has been paid. In effect the ‘spared taxes’ are treated by the home country as having been paid. The reason why home countries agree to tax sparing arrangements are at odds with the inter-nation equity principles is because the home country is foregoing a greater share of tax revenue than it would normally be required to lose. Professor Kaufman argues that the existence of tax sparing arrangements reinforces the notion that the entitlement theory is not applicable in terms of inter-nation equity. 42 Furthermore, Professor Kaufman sees tax sparing agreements with developing countries as ‘indicating an acceptance of a certain degree of redistribution within the


42 Kaufman, above n 38, 203.
international tax system’. It definitely contradicts the ability to pay and the benefit theorists as well as the economic allegiance approach. It is evidence of developed countries wanting to assist developing countries by encouraging businesses to expand while at the same time being prepared to accept less revenue. Peggy Musgrave made the following statement in relation to the attractiveness of tax sparing for developing countries and the investor involved in the development:

Without tax sparing, it is argued, the revenue given up by the capital importing country is merely picked up by the treasury of the capital exporter. It is doubtful whether this is a well-founded argument when the fact of deferral is taken into consideration. … it is not wise for the capital exporting country to provide an across-the-board tax sparing agreement. Yet foreign policy considerations are likely to cause it to become widely applied when once introduced in a specific case.43

The main beneficiaries from tax sparing agreements are the MNEs that establish business operations in developing countries that provide tax incentives. From an equity perspective, tax sparing contradicts notions of horizontal equity and international equity.

4.6 Conclusion

The movement of capital out of high taxing jurisdictions to low taxing countries is a major concern for OECD member states, the G20 and the EU. As Professor Avi-Yonah states, the current system of international taxation ‘suffers from significant weaknesses, especially in two areas in which the development of the world economy has made the principles that were agreed upon in the 1920’s and 1930’s obsolete: the growth of internationally mobile capital markets for portfolio investment and the rise of integrated multi-national enterprises (MNE’s)’.44 These two issues are part of the main focus of this thesis. As capital becomes more mobile and MNEs engage in global enterprises, tax authorities throughout the world have a great deal of difficulty in detecting taxpayers utilising the financial and banking services offered in tax havens and OFCs. This situation is reinforced by many commentators on international taxation law.

43 Musgrave, above n 41, 279 and 288.
44 Avi-Yonah, above n 1, 1304.
Professor Avi-Yonah contends that there are two principle weaknesses of the current international tax regime: first, the difficulty in enforcing residence based taxation and second, the difficulty of allocating the income of MNEs among source jurisdictions. The first difficulty is examined in detail in Chapter 5 and also throughout this thesis as it is one of the reasons discussed in Chapter 10 for the likely survival of tax havens and OFCs. Similarly, the business operations of MNEs through the use of tax havens and OFCs present a major challenge to tax administrators throughout the world and there may be no solution to this problem. The work by the OECD with its harmful tax competition project and the subsequent cooperation shown by tax havens to enter into taxation information exchange agreements may result in MNEs paying more income tax in their country of residence. This issue is also discussed throughout this thesis.

\[\text{Ibid, 1305.}\]
CHAPTER 5  THE OECD’S ‘HARMFUL TAX COMPETITION’ PROJECT: IS IT INTERNATIONAL TAX LAW?

5.1 Introduction

On 13 March 2009 the Organisation for Economic Cooperation and Development (OECD) announced that Austria, Luxembourg and Switzerland had agreed to introduce laws to allow for the exchange of information on tax evaders.¹ The OECD has been actively trying to protect the national tax bases of its member states and this has now become an imperative with the global financial crisis and government deficits. The OECD’s harmful tax competition project has been actively pursued for the past twelve years and appears to be receiving worldwide acceptance.² On this basis it can be strongly argued that it now has the status of ‘soft’ international law and appears to have all of the hallmarks of being part of the range of OECD initiatives that have been accepted as constituting international taxation law, such as the transfer pricing rules, Controlled Foreign Corporation (CFC) rules and the model double tax agreement, to name just a few. This chapter will contend that the harmful tax project has not only become part of international taxation law but, as a result, the major tax havens and offshore financial centres (OFCs) have now agreed to comply with the OECD’s harmful tax competition project and to provide details of non-resident taxpayers using their financial system for tax avoidance and tax evasion purposes.


There are three main questions that are raised in this chapter. First, it explores what international taxation law is and whether the OECD makes international law with its guidelines and reports, in particular, the project to eliminate harmful tax competition. Second, it analyses whether this is the reason why Switzerland and other tax havens are now prepared to comply with the OECD initiative on harmful tax competition and to enter into agreements to exchange information on the banking practices of non-resident individuals and multi-national enterprises (MNEs). If this is the case, the paper examines the implications for the sovereignty of those nations and the economic impact of not being able to attract mobile capital and provide financial and banking services to non-residents. The third question examined in this chapter is whether it is desirable for the OECD to make soft law in the first place or for soft law to be part of international taxation law. In order to answer these issues, the chapter is divided into six parts. Part one discusses the current problem facing the OECD member countries as a result of the global financial crisis and the need to ensure that their tax base is not eroded by tax havens. In part two, the chapter provides a detailed analysis of the OECD’s harmful tax competition project, in particular, the practices that are considered to be harmful to the OECD member countries by tax havens and offshore financial centres (OFCs). The analysis will also discuss the progress to date of the OECD’s project and the push by the G20 nations to stem the loss of tax revenue as a result of tax havens providing bank secrecy to non-residents. This will be followed in part three with an examination of what constitutes international law, in particular, international taxation law. The concepts of ‘hard’ and ‘soft’ international law will be discussed in detail in this context as well as the way in which international law becomes part of a country’s domestic law. The fourth part of the chapter will discuss the desirability of having soft international law as opposed to hard international law. The fifth part of the chapter critically reviews the current progress made by the OECD in convincing tax havens to follow their initiatives in changing their bank secrecy laws and exchanging information on taxation matters. This review should assist in drawing a conclusion as to whether or not the OECD’s harmful tax project is now part of international taxation law and the basis on which other countries have felt compelled to comply with that aspect of international taxation law, such as Austria, Switzerland and Luxembourg. Part six, the conclusion, seeks to provide answers to the original three questions raised by this research, namely, whether the OECD makes international tax law; second, is soft international
law desirable; and third, if this is the case then is this the reason why many tax havens and OFCs are now complying with the OECD’s initiative.

Since the late 1990s, the OECD has been very active in trying to identify and eliminate harmful tax competition. The harmful tax practices project was aimed at tax havens and OFCs and involved the ‘naming and shaming’ of some 36 tax havens. Since then a large number of tax havens have agreed with the OECD to reform their bank secrecy laws and to become more transparent in their dealings with other countries. To some extent, there have been threats of sanctions against tax havens if they did not agree to cooperate but, generally, most tax havens have accepted the views of the OECD. The question raised by this is whether the OECD makes ‘law’ in the area of taxation policy? If it does, is this ‘soft law’ and what is meant by the term ‘soft law’? The chapter will commence with an analysis of what is ‘international law’ and how is it made, followed by a discussion of the distinction between soft and hard international law. The question of what constitutes ‘soft law’ will then be assessed within the framework, developed by Professor Baxter, of international norms being considered soft international law. Having then assessed the OECD guidelines and norms within the ‘Baxter’ framework, it will be possible to determine whether or not the OECD makes international law. Some of the OECD member countries initially rejected many of the norms contained in the guidelines, campaigning against harmful tax competition, and some commentators have gone so far as to contend that the campaign has failed to achieve its objectives. However, for the reasons which will be articulated in the paper, this does not appear to be the case today.

Tax havens and harmful tax competition has become the concern of many nations, including Australia. The methods being used to combat tax havens extend beyond Australian domestic law and into the international legal arena. The OECD and the European Union (EU) have been very active in trying to find ways to limit the use of tax havens by their own national taxpayers. Also, the Financial Action Task Force (FATF), set up by the Group of Seven Countries (G7) and located within the OECD,

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is concentrating on the elimination of money laundering by requiring international cooperation from countries that maintain domestic bank secrecy laws. The methods used to try to obtain international cooperation and agreement between countries are considered to be ‘soft’ international law.\(^5\) The concept of international law taking two forms, ‘soft or hard’, are very important issues for the study of tax havens and the question of their survival. Soft international law consists of such instruments as OECD guidelines, agreements and resolutions. Hard international law consists of agreements and treaties that are subsequently transformed into national laws, such as the agreement between Australia and Bermuda on the sharing of information on taxpayers and their bank account details as well as other matters relating to tax avoidance and tax evasion.

### 5.2 The OECD’s Project to Eliminate Harmful Tax Competition

#### 5.2.1 Introduction

The starting point for answering the two questions raised in this chapter is to examine the OECD’s project to eliminate harmful tax competition. Professors Eden and Kudrle contend that the origins of the OECD’s harmful tax competition project can be ‘traced to two key actors within the OECD – the United States and the European Union … for different reasons.’\(^6\) First, the existence of cross-border financial transactions through electronic commerce via the Internet and the existence of tax havens and OFCs were perceived by the US Government to have the capacity to erode the tax base unless international cooperation could be obtained.\(^7\) Second, as a result of the ‘1992 single common market initiative’ and the removal of barriers the European Union became concerned about the effect of different tax rates between members, especially Ireland. Cooperation between member states became crucial to prevent the erosion of their tax bases.\(^8\)

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\(^7\) Ibid, 118.

\(^8\) Ibid, 117. In particular the March 1996, ‘Verona Paper’ developed guidelines to limit harmful tax competition among member States.
The 1998 OECD report on ‘Harmful Tax Competition: An Emerging Global Issue’ was the result of the OECD being asked by the OECD Ministers in May 1996 to ‘develop measures to counter the distorting effect of harmful tax competition on investment and financing decisions and the consequences for national tax bases…’. The report examines the effect of mobile capital, the location of financial services and the distortion of trade between OECD member countries and tax havens. The report also focuses on non-sovereign dependencies that were predominantly controlled by the United Kingdom.

The first report, in 1998, was followed by a progress report in 2000, a further progress report in 2001 and a final report in 2004. Since then, the OECD has reported on ‘Tax Co-operation: Towards a Level Playing Field’ in 2006 and a final progress report in 2008. The long gestation period from the first report until significant progress in 2009 is reflective of the problem in achieving international consensus in this area when there was a lack of an immediate perceived problem for the OECD member states. However, the reality of the global financial crisis has resulted in the OECD member states recognising that the time for action had come and that pressure needed to be put on the recalcitrant tax havens and OFCs to enter into exchange of information agreements. The immediate emphasis is now on promoting a level playing field by all countries eliminating domestic bank secrecy laws and entering into agreements with other countries, especially OECD member states, for the exchange of information on non-residents using their financial services.

5.2.2 Identification of tax havens

The 1998 OECD report identifies two distinct jurisdictions that are considered to be a threat to the tax bases of the OECD member states. They are tax havens and countries that have harmful preferential tax regimes but are not tax havens. These states may or may not be a member of the OECD. However, it is of note that some members of the OECD contained preferential tax treatments in order to attract

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9 OECD, above n 2, 3.
10 Michael Littlewood, ‘Tax Competition: Harmful to Whom?’ (2004-2005) 26 Michigan Journal of International Law 411, 420. The UK dependencies have dominated the tax haven debate due to their dominance in this area. The Channel Islands and Caribbean States have been very active as tax havens. However, the Netherlands have dependencies that are tax havens. For a full list see the 2000 OECD report at paragraph 17.
investment capital and other financial services activities, such as Switzerland. The distinction between the two types of regimes noted above is discussed in paragraphs 42 and 43 of the report. According to the OECD, a ‘tax haven’ is a country that does not need income taxes to finance their public services and offer themselves as a place for non-residents to escape tax in their own country of residence but the report acknowledges that the concept does not have a precise meaning. There are four factors used to identify tax havens contained in the report. These factors are; first, no or nominal taxes; second, a lack of effective exchange of information as a result of having strict bank secrecy rules that prevent high taxing jurisdictions identifying their own resident taxpayers; third, legislation, a legal system and administrative practices that ensure a lack of transparency, such as favourable treatment for particular taxpayers or entities on tax rates or special concessions; fourth, the absence of any investment or business activity within the country that would counter any suggestion that the activity was purely tax driven.

The OECD has tried to define a ‘tax haven’ for the purposes of this report as a jurisdiction that imposes no or only nominal taxes. The OECD report does qualify this statement by adding that ‘the concept of tax haven does not have a precise technical meaning’. However, the definition contained in the report is considered to be unsatisfactory because some states may impose income tax at higher than normal rates on some income but no tax on other forms of income. Professor Littlewood contends that the attempt by the OECD to define tax havens in a narrow way may allow some states to escape the imposition of sanctions because they exempt some income from tax but not other forms of income. He uses Hong Kong as an example of a state that could be considered to be both a tax haven and having a preferential tax regime but he downplays the fact that Hong Kong taxes its residents on a territorial basis and not on a worldwide basis, thus excluding from taxation income derived outside the territory.

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11 OECD, above n 2, 20.
12 Ibid.
13 Ibid, 22.
15 Littlewood, above n 10, 460. This paper provides a comprehensive discussion of the evolution of the OECD’s harmful tax competition project.
The progress report issued by the OECD in June 2000 listed 35 countries that were considered to be tax havens and identified 47 potentially harmful preferential tax regimes in OECD member countries. By 2008, only three countries that were on the original list of 35 countries had not made a commitment to the OECD to provide an effective exchange of information. Those three countries comprised Liechtenstein, Monaco and Andorra. However, as at 17 April 2009, all three countries, namely Liechtenstein, Monaco and Andorra had pledged to enter into exchange of information agreements which would result in the OECD having achieved cooperation from all of the original countries named on the ‘black list’ in the 2000 progress report.

5.2.3 What are the features of harmful preferential tax regimes?

The report outlines four key factors which assist in identifying harmful preferential tax regimes. These are; first, the country imposes a low or zero effective tax rate on the relevant income, similar to a tax haven; second, the tax regime is ‘ring fenced’ in that residents of that state do not have access to tax concessions which are only offered to foreign investors or businesses; third, there is a lack of transparency; and fourth, there is a lack of effective exchange of information on investments and bank accounts operated by non-residents. The report goes on to discuss other factors which may also assist in identifying a harmful preferential tax regime. Those factors can be summarised as follows; first, an artificial definition of the tax base which may allow some non-resident investors or businesses to obtain certain exemptions from tax or tax concessions that are not offered to similar residents and non-residents; second, a failure to adhere to international transfer pricing principles; third, foreign source income exempt from residence country tax as is the case with a territorial system; fourth, negotiable tax rate or tax base; fifth, secrecy provisions relating to bank account details or the allowing bearer shares; and sixth, the existence of a wide


18 OECD, above n 16.
network of taxation treaties between countries which may allow for abuse through treaty shopping.\textsuperscript{19}

The OECD claims that preferential tax regimes harmed ‘global welfare’ but this claim is not justified by the OECD in their report.\textsuperscript{20} This issue was analysed by Littlewood and he concluded that the theory was not supported by evidence, particularly in the area of preferential tax regimes. He contends that the only beneficiaries will be the G7 countries’ treasuries and that some developing countries will lose investment capital if they comply with the OECD.\textsuperscript{21}

5.2.4  Recommended measures to counteract harmful tax practices

There are a range of measures that are discussed in the report to try to counter harmful tax practices. These measures are directed at both tax havens and OECD member countries and non-member countries that have harmful preferential tax regimes. The recommendations are divided into three categories; the first focusing on domestic legislation to make it more effective; second, to review tax treaties that may facilitate tax avoidance or evasion through treaty shopping and to make the exchange of information provisions in the treaties more effective; and third, to push non-OECD member nations to accept the recommendations and guidelines of the harmful tax practices project. In effect, this third category involves promoting the OECD’s project so that it eventually becomes a part of the ‘soft’ international tax law.

The first category of measures relates to the need for a country to have specific domestic legislation and practices that will counter harmful tax practices. There are seven specific areas which have been selected; first, the need to have tax laws embodying the Controlled Foreign Corporations (CFC) rules; and second, the Foreign Investment Fund (FIF) rules. Most OECD members have these rules and they are discussed in detail later in this paper. The third recommendation concerns the need to restrict the ‘exemption of foreign income’ laws to only ‘active business income’ in situations where the foreign sourced income has not been advantaged by


\textsuperscript{20} Ibid, paragraph 4.

\textsuperscript{21} Littlewood, above n 10, 486.
harmful tax competition in that particular country. The fourth recommendation relates to the need to have laws that permit the exchange of information with other countries on non-residents engaged in financial transactions similar to Article 26 of the OECD Model Double Tax Agreement.\textsuperscript{22} The need to have in place the administrative practice of issuing tax rulings to taxpayers so that the tax authority is given advanced notice is the fifth recommendation. The need for all countries to adopt the OECD’s transfer pricing guidelines that are based on an ‘arm’s length principle’, published in 1995, is the six recommendation. The last main recommendation is that countries ensure that access to banking information is available to other countries so that foreign tax authorities have the ability to collect information on their own residents engaged in financial activities. This recommendation ties in with the OECD’s project to ‘ improve access to bank information for tax purposes’, which was subsequently published two years later.\textsuperscript{23}

The remaining two categories of recommendations, namely those concerning tax treaties and those relating to the need to intensify international cooperation, also contain a number of specific recommendations. In particular, the recommendations relating to tax treaties concern the need to ensure that the treaty provisions are not being used to benefit harmful tax practices, such as treaty shopping by MNEs. The OECD was also concerned that domestic anti-abuse measures did not conflict with provisions of the OECD Model Double Tax Agreement (DTA) and that work would be undertaken to review the model DTA. Of concern was the existence of DTAs with tax havens and the OECD recommended that those existing agreements be terminated and no new agreements be entered into with tax havens. Recommendation 13 focuses on the need to have adequately trained tax administrators to undertake international audits on taxpayers involved in CFCs, FIFs and transfer pricing activities. Recommendation 14 focuses on extra-territorial enforcement of tax claims by other countries and the need to provide assistance in collecting the taxes. This particular recommendation could be misinterpreted as the OECD wanting other countries, such as tax havens or OFCs, to help collect taxes for OECD member states. The third category of recommendations only contains one specific recommendation.

\textsuperscript{22} Article 26 – Exchange of Information - is discussed later in this paper.

recommendation, recommendation 15, which recommends the establishment of a ‘forum’ on harmful tax practices to monitor the implementation of the major recommendations and prepare a list of jurisdictions that constitute tax havens. That list was subsequently published in the 2000 report.

5.2.5 Review of progress

The 2000 report, entitled ‘Towards Global Tax Co-Operation: Progress in Identifying and Eliminating Harmful Tax Practices’, was notable for publishing a list of 35 jurisdiction satisfying the criteria of being a ‘tax haven’ and a list of 47 potentially harmful tax regimes found in OECD member countries.\(^{24}\) The report emphasised the need for collective action against tax havens and suggested new measures, such as the imposition of withholding taxes on payments to tax havens and withholding ‘non-essential economic assistance’.\(^{25}\) This may have been a concern for many of the small Pacific tax havens but not necessarily a concern for Monaco, a wealthy tax haven.\(^{26}\)

Subsequently, two more reports followed; the 2001 progress report entitled ‘The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report’ and the 2004 progress report entitled ‘The OECD’s Project on Harmful Tax Practices: The 2004 Progress Report’. The 2001 progress report emphasised the need for tax havens to ensure that their tax systems were transparent and that they provided an effective exchange of information system.\(^{27}\) This would appear to be the start of the approach taken by the OECD in the following years; the need for an effective arrangement to exchange information on non-residents using the banking and financial systems in the tax havens. This need for information on non-residents using tax havens is a major requirement for any country using a worldwide system of taxation and is at the heart of the Australian ‘Operation Wickenby’ in trying to detect Australians using tax havens. It is also at the core of the OECD’s project.\(^{28}\) The 2004 report was more optimistic than the earlier report in that all OECD member states had either

\(^{24}\) OECD, above n 16.

\(^{25}\) Ibid, para 36.

\(^{26}\) Littlewood, above n 10, 433.

\(^{27}\) Ibid, 435.

eliminated any harmful tax regimes or they had been found not to have been harmful in the first place. Similarly, the OECD reported progress in securing exchange of information agreements with a number of tax havens or commitments to enter into agreements to exchange information.  

The OECD has been successful in convincing Vanuatu, Samoa and Niue to enter into an agreement to exchange information on foreign investors using their offshore financial services. The countries entered into the agreements to exchange information on civil tax matters by 31 December 2005. On the 24 July 2007, the OECD announced that Liberia was removed from the list of ‘Unco-operative Tax Havens’ following its ‘commitment to improve transparency and establish effective exchange of information in tax matters’. Since then, there have been many agreements between OECD member countries and non-member countries that have improved access to bank information, including four entered into by Australia with Finland, France, New Zealand and Norway. On 13 March 2009, the OECD announced that Austria, Luxembourg and Switzerland had agreed to introduce laws to allow for the exchange of information on tax evaders prior to the G20 meeting. At the G20 meeting in the United Kingdom, tax havens and OFCs were the prime focus of attention and the Finance Ministers agreed to ‘take action against non-cooperative jurisdictions, including tax havens that failed to implement international standards of transparency and exchange of banking information for tax purposes’.  

The United States of America has also been very active in trying to prevent money flowing to tax havens and to recoup lost tax revenue on foreign bank accounts. According to Senator Carl Levin, the loss in revenue is estimated at USD 100 billion every year and this has been the impetus for the Senator to try to stop this activity. He introduced the ‘Stop Tax Haven Abuse Act’ Bill to Congress as a means to

29 OECD, above n 2, paras. 11 – 37.  
33 OECD, above n 1.  
combat tax evasion through tax havens. The US government has taken action against the Union Bank of Switzerland (UBS) to disclose the names of 52,000 US citizens with bank accounts suspected of hiding USD 15 billion and at the same time UBS has paid USD 780 million as a penalty for promoting tax evasion. The US Internal Revenue Service (IRS) is encouraging US citizens with more than USD 10,000 in offshore bank accounts to voluntarily disclose any income that has not been declared. They had until 23 September 2009 to make the voluntary disclosure or face civil or criminal penalties. Prior to the global financial crisis, the US and the UK were reluctant to see tax haven activities diminished as they believed they played a valuable role in the liberalisation of international capital flows and this capital eventually found its way to London or New York. The Bush Administration was critical of the OECDs project to eliminate tax competition due to a combination of being ideologically opposed to the European welfare states and their high rates of taxation and critical of the threat posed by the OECD’s project to the sovereignty of tax havens. However, this is not the current situation in the US today.

The question that is raised by the success of the OECD is whether or not the ‘harmful tax competition project’ has now become part of international law and this is the reason for tax havens and OFCs to comply with the OECD and to exchange information on non-residents. This then leads to the next main question to be answered in this chapter; what is international law?

5.3 What is International Law?

International ‘law’ is not made by an international parliament; the International Court of Justice has no compulsory jurisdiction over all countries; and, there is no body able to sanction any breach of international law, such as an international police force.

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38 Ibid.

39 Webb, above n 4, 797.

40 Ibid, 814.
Clearly, in the absence of these characteristics, international law does not fit within the ‘Positivist theory’ of law.

Professor Hart, in his book the ‘Concept of Law’, questions whether or not international law was really ‘law’. He makes the following comment on the concept of international law:

For, though it is consistent with the usage of the last 150 years to use the expression ‘law’ here, the absence of an international legislature, courts with compulsory jurisdiction, and centrally organised sanctions have inspired misgivings, at any rate in the breasts of legal theorists. The absence of these institutions means that the rules for states resemble that simple form of social structure, consisting only of primary rules of obligation, which, when we find it among societies of individuals, we are accustomed to contrast with a developed legal system. It is indeed arguable, as we shall show, that international law not only lacks the secondary rules of change and adjudication which provide for legislature and courts, but also a unifying rule of recognition specifying ‘sources’ of law and providing general criteria for the identification of its rules. These differences are indeed striking and the question ‘Is international law really law?’ can hardly be put aside.\textsuperscript{41}

However, Hart does accept the fact that international law did exist, even in the absence of the ‘rule of recognition’, because sovereign states did observe rules that were binding on each other and this was enough to constitute a valid legal system.\textsuperscript{42}

\subsection*{5.3.1 Legal positivism}

There are a number of theories of law but the legal positivist theory, developed by Professor HLA Hart and Professor Hans Kelsen, is arguably the most appropriate for examining the creation of international law in the international tax arena. In brief, legal positivism holds that laws were ‘posited’, that is, created by people and sovereign states; not a supreme being or nature as is the case with the ‘natural theory’ of law. Law is created by people based on actions, not morality, and law is described

\begin{flushleft}
\textsuperscript{41} HLA Hart, \textit{The Concept of Law}, (1961) 209.
\textsuperscript{42} Ibid, 235.
\end{flushleft}
‘as it is and not as it should be’ similar to pure science.\textsuperscript{43} In other words, a legal positivist view of what is ‘law’ is the ‘black letter’ law or law as is made by parliament and the courts as, arguably, is the situation in Australia.

Kelsen developed the concept of a ‘legal norm’ and the ‘hierarchy of norms’ to illustrate how his theory of law was developed.\textsuperscript{44} The ‘legal norm’ is similar to a rule that somebody ought to act or behave in a prescribed way or to behave in a certain way without any moral or ethical connotations.\textsuperscript{45} The concept of what is a ‘norm’ according to Kelsen is discussed in detail in Part four of this paper. What, then, was Kelsen’s view of international law? In the words of Hughes, Kelsen argued that ‘national and international law are not only of the same essential nature but must, indeed, be viewed as one, unified system, not as a collection of coexisting systems.’\textsuperscript{46}

In light of the above legal positivist views of Hart and Kelsen and their theory of law, and, in particular, that international law is ‘law’, the next step is to examine the sources of international law in order to assess if such things as the OECD guidelines and norms are to be considered as a source of international law.

5.3.2 The ‘soft and hard law’ distinction

In order to properly assess international law, it is necessary to examine the distinction between ‘hard’ international law and ‘soft’ international law. According to August,\textsuperscript{47} the sources or evidences of international law are what international tribunals rely on in determining the content of international law. The best example of this is found in the Statute of the International Court of Justice, Article 38(1), which states that:

\[
\text{the Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:}
\]

\textsuperscript{43} Margaret Davies, \textit{Asking the Law Question} (1994) 75.

\textsuperscript{44} Hans Kelsen, \textit{General Theory of Law and State} (1946) 343.


(a) international conventions, whether general or particular, expressly recognised by the contesting states;
(b) international custom, as evidence of a general practice accepted as law;
(c) the general principles of law recognised by civilised nations;
(d) subject to the provisions of Article 59, treaties and conventions and Customary law.’

The Statute would appear to be setting out a hierarchy of the sources of international law. According to August, in practice, the International Court of Justice and other tribunals turn first to treaties. This is appropriate because treaties are clear-cut statements of the rules the court should apply. 48

In the preamble to the ‘Vienna Convention on the Law of Treaties 1969’ it is stated that the States party to the convention:

recognises the ever-increasing importance of treaties as a source of international law… Affirming that disputes concerning treaties, like other international disputes, should be settled by peaceful means and in conformity with the principles of justice and international law’. 49

As a result of this convention there is now a tendency to view all treaties as ‘hard law’, especially if they are covered by this Convention. Article 26 of the Convention provides that the maxim, ‘pacta sunt servanda’ must be observed by States that are a party to the convention, namely that ‘Every treaty in force is binding upon the parties to it and must be performed by them in good faith’.

If treaties are regarded as being a primary source of international law then general principles that are recognised by States should be considered a secondary source of international law. As Eric Lauterpacht contends, the source of international law is forever changing:

48 Ibid, 3.
We know that international law consists of, on the one hand, treaties and, on the other, custom. Treaties represent the express agreement of States. We know that treaties are not unchangeable and that in many cases they have been revised by subsequent agreement … Apart from treaties we have customary international law – law that binds all States, old and new alike … This customary international law is an expression of the practice of States which have generally been accepted as law. This dependence on State practise is both the source and the reflection of the legal relevance of divergence from the normal … Where there is a repeated divergence – a divergence is either widely accepted or, at any rate, is not widely disapproved of, then that deviation itself tends to become the norm and, therefore, the law.50

Where, then, does ‘soft law’ fit into this hierarchy of the sources of law? It has been suggested by many writers on international law, with the advent of international organisations such as the OECD, the International Chamber of Commerce and the World Trade Organisation issuing policies and guidelines on international commercial matters, that, at best, these statements can only be considered to be ‘soft’ law. According to Professor Alston ‘soft’ law can be defined as follows:

Soft law standards are those contained in non-binding statements such as declarations, guidelines, and codes of conduct or recommendations. They include a wide range of OECD, World Health Organisation, and International Telecommunications Union instruments as well as better known standards such as the UN’s Standard Minimum Rules for the Treatment of Prisoners, which are widely considered to have become part of customary law.51

Hartmut Hillgenberg, when discussing the question of whether or not the UN General Assembly can create law beyond their contributory role in the formation of customary international law, according to Article 38(1)(b) of the Statute of the International Court of Justice, comes to the following conclusion:

If, therefore we extend the notion of soft law to such resolution [of the General Assembly] we would come to the same conclusions as for soft law in general, i.e. 52

that international law in its present state does not attribute soft law to the status of a source of law.’  

If the OECD makes soft law only, what then is the status of their guidelines, norms and recommendations? Should tax havens and offshore financial centres take any notice of what the OECD is trying to achieve by encouraging member countries and non-member countries to reform their bank secrecy laws and become more transparent in their dealings with other countries? After all, these instruments of soft law are, by definition, non-binding on the parties. Therefore, why should tax havens have any concern about the OECD’s project to eliminate harmful tax competition?

One way in which these questions may be answered is to critically analyse the approach taken by Professor Baxter in his contention that ‘legal norms occupy a place in international law, even though they do not create rights or duties’. This theory of what constitutes ‘soft’ international law is discussed below.

5.3.3 The ‘Professor Baxter’ theory of ‘norms’ as soft international law

In order to fully comprehend the ‘Baxter Theory of Norms’, it is necessary to start with a brief discussion of what is meant by the concept of a ‘norm’ in the context of international law. Professor Hans Kelsen developed a ‘Pure Theory of Law’ predicated on the concept of the hierarchy of norms, that is, rules or principles created by the Parliament or Judiciary, which, in turn, creates lesser norms involved in the enforcement and sanctions imposed on a person for not complying with the law or the higher norms. Kelsen’s ‘pure theory of law’ excludes the ‘practices and mores of the society whose political organisation has duly constituted that law’. In other words, Kelsen rejected a natural law approach, instead choosing to look at law from a scientific perspective, which views things from an objective point of view. In this case, religious and moral views are not taken into account in determining what law is and how it should affect behaviour, instead, adopting a legal positivist view of law. As stated by William Ebenstein, Kelsen believed that ‘a revival of metaphysics

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and natural law doctrines [were] obstacles to an ideology-free science of the law. Stressing the outspoken anti-ideological tendency of the Pure Theory of Law, Kelsen calls the theory a radical realistic theory of law, that is, a theory of legal positivism’. If legal norms consist of rules and legal principles that are concerned about the way in which people or nations should be dealt with if the norm has not been complied with, then how does this fit with the theory of norms as soft law?

Taking this theory and applying it to the international arena, it can be seen that norms play an important part in providing soft law and that the OECD is arguably a major provider of this type of soft law. In the words of Michael Webb:

A distinctive feature of the OECD is that its primary impact comes through efforts to develop and promote international norms. It rarely develops binding agreements and has very few powers of enforcement. Instead, it works largely by defining standards of appropriate behaviour for states which seek to identify themselves as modern, liberal, market-friendly and efficient and uses monitoring procedures and peer review processes to socialize member states into accepting and institutionalizing OECD-recommended practices. The status of OECD agreements as norms does not mean they are weak; even powerful states generally try to behave in accordance with these norms…

Professor R. R. Baxter contends that ‘rules of international law exists and create obligations even though they may not be enforceable by sanctions’. He goes on to assert that ‘legal norms occupy a place in international law’. Professor Baxter makes the following assertions about ‘soft’ norms contained in a written form as having a legal impact:

1. If some form of written norm has been consented to by States involved, the future course of discussion, negotiation, and even agreement will not be the same in the absence of the norm.
2. Once a matter has become the subject of such a norm, the matter can no longer be asserted to be one within the reserved domain or domestic jurisdiction of the State.

55 Ebenstein, above n 45, 617 and 624.
56 Webb, above n 4, 792.
3. The norm will establish new standards of relevance for the negotiations between the parties. Certain arguments will be ruled out.

4. The norm will establish the legal framework within which the dispute about its application may be resolved. It will establish presumptions, indicate the prevailing trend of opinion, provide a guiding principle which may have a certain inherent appeal for the parties, and channel negotiation and settlement into legal and orderly paths.\(^{57}\)

How then can these principles be applied to guidelines, norms and policies developed by the OECD? If the project to eliminate harmful tax competition is used as the example and applied to the above four principles, then it can be seen that Professor Baxter is arguably correct in his assertion about legal norms becoming soft international law.

In relation to point one of Baxter’s assertions, all OECD member countries, including Austria, Luxembourg and Switzerland, have adopted the policies to try to eliminate harmful tax competition and to encourage tax havens to reform their bank secrecy laws and become more transparent in their financial dealings. As a result of adopting these norms, future developments in this area have been continuing and developing in new directions, such as the new anti-money laundering laws developed by the Financial Action Task Force (FATF) that also have been adopted by most of the OECD member countries. Moreover, the OECD has been actively trying to encourage non-member countries to work towards a ‘level playing field’ and agree to exchange information on non-residents using their banking and financial systems.\(^{58}\)

In relation to point two, the OECD campaign has been extended to non-OECD member countries, such as the Caribbean Community and Common Market (CARICOM) countries, including Bermuda, and a number of offshore financial centres, such as Guernsey, Jersey and the Isle of Man, where exchange of information agreements are now in place.\(^{59}\)

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\(^{57}\) Baxter, above n 53, 565.


\(^{59}\) See note 4 for a discussion on the CARICOM countries and the role of the OECD.
In relation to point three, a number of member and non-member countries, including Switzerland, have agreed to exchange information on taxation matters that involve criminal conduct, such as tax evasion or tax fraud. This development has taken the OECD’s project against harmful tax competition into a specific area of trying to eliminate criminal activity involving taxation offences and not just ‘fishing for information’ exercises on non-resident investors.

In relation to point four, it can be seen that, from its beginnings in the 1990s until today, the OECD’s campaign has definitely focused the attention of the member and non-member countries and has involved a number of tax havens and offshore financial centres in trying to eliminate criminal conduct involving taxation, whether it be tax fraud, tax evasion or money laundering, and progress has definitely been made by the OECD in this respect.

The approach taken by Professor Baxter is supported by Professor Alison Christians in her recent publication where she argues that the OECD’s initiative on harmful tax competition ‘creates a strong degree of obligation among member and non-member states alike’ and that it should be considered to be ‘soft law’. Professor Christians examined the OECD’s project to eliminate harmful tax competition in terms of its impact as international taxation law and uses the OECD’s initiative as an example of how ‘soft’ law evolves. Professor Christians argues that the OECD guidelines developed into ‘international tax norms defining appropriate international tax practices.’ As evidence of this, the guidelines have been adopted not only by the majority of the OECD member states but also by many tax havens in the Caribbean and Pacific and, by 2002, 28 of the original 35 countries listed by the OECD as having harmful tax practices had agreed to exchange information on tax evasion by non-resident bank account holders.

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61 Ibid 325.
62 Ibid, 327.
63 Avi-Yonah, above n 17, 4.
Professor Christians contends that the OECD’s project on harmful tax competition could not be considered to be customary international tax law due to the fact that it had not obtained widespread acceptance among non-member countries and, in particular, that Switzerland and Luxembourg had objected to the project from the start. However, given the recent compliance by Switzerland, Austria and Luxembourg, and the general level of compliance by tax havens and OFC prior to the G20 meeting in London, it could be argued that this particular OECD project has now become more than ‘soft law’ and has the status of customary law.

Professor Reuven Avi-Yonah examines the status of international tax law as being part of international law and argues that the CFC rules are part of customary international law due to their wide-spread acceptance by 23 countries, including Australia. Similarly, Professor Avi-Yonah contends that the transfer pricing rules based on the ‘arm’s length standard’ are also part of customary international law. From a review of the above two highly respected commentators in the field of international taxation law, it is possible to argue that the OECD makes soft law and customary law in the international taxation environment.

5.3.4 A Monist or dualist approach to international law

Is an international agreement part of the national law once it is signed on behalf of the state and then incorporated into the domestic law or does it only become part of the national law once it has been ‘transformed’ into the domestic law? The ‘Monist’ approach holds that international law is part of the municipal law of a nation and not a separate source of law. The theory also holds that international law is superior to the municipal law. The theory was championed by Professor Hans Kelsen who contended that both legal systems developed from the same universal norm. The ‘Dualist’ approach holds that international law and municipal law are two separate legal orders existing independently of each other. As such, nations are not obligated to follow international law until that law has become part of the nation’s domestic

65 Ibid, 499 and 500.
67 Triggs, above n 5, 105.
law. This fundamental concept is based on the notion of state ‘sovereignty’ in that the nation must consent to the international law becoming part of the municipal law before it takes effect within the state.\textsuperscript{68}

5.3.5 International law as part of the national law

There are two ways in which international law can become part of a state’s national law; either due to the ‘operation of incorporation’, a monist approach, or by ‘transformation’, a dualist approach. In Australia, international agreements only become part of the Australian domestic law once the Australian Parliament has ‘transformed’ the international law into Australian law. There is no automatic incorporation of international law into Australian domestic law.\textsuperscript{69} This means that Australia has a ‘dualist’ approach to international law. This principle was reinforced by the High Court in the case of \textit{Minister for Immigration and Ethnic Affairs v Ah Hin Teoh}\textsuperscript{70} where Mason CJ and Deane J made the following statement in their joint judgment:

\begin{quote}
It is well established that the provisions of an international treaty to which Australia is a party do not form part of Australian law unless those provisions have been validly incorporated into our municipal law by statute. This principle has its foundation in the proposition that in our constitutional system the making and ratification of treaties fall within the province of the Executive in the exercise of its prerogative power whereas the making and alteration of the law fall within the province of Parliament, not the Executive. So, a treaty which has not been incorporated into our municipal law cannot operate as a direct source of individual rights and obligations under that law.\textsuperscript{71}
\end{quote}

If tax havens have adopted a dualist approach and require international law to be incorporated into their national law then many of the international guidelines and agreements on the exchange of information will not become binding on the tax haven until the law becomes part of the national law. Switzerland recently entered into an

\textsuperscript{68} William Slomanson, \textit{Fundamental Perspectives on International Law} (5\textsuperscript{th} ed, 2007). Hans Kelsen and his philosophy of law is discussed in detail in an earlier part of the thesis under the heading of ‘legal positivism’.

\textsuperscript{69} Triggs, above n 5, 128.

\textsuperscript{70} (1994-1995) 183 CLR 273.

\textsuperscript{71} Ibid, 286.
agreement with the OECD to exchange information on non-resident bank account holders and to legislate to allow their banks to disclose account information.\textsuperscript{72} However, according to Peter Wilson, ‘Switzerland will take perhaps six years to negotiate and legislate for the agreements and the banks will use that time to find new structures and perhaps new bases.’\textsuperscript{73} This comment illustrates that Switzerland adopts a dualist approach to international law and will need to transform the ‘exchange of information agreements’ into national statutory law before the international tax law will take effect in their country.

On the opposite side of the equation, the ‘theory of incorporation’ follows the monist approach and holds that international law is part of a nation’s law and that international law has priority. This approach is based on a ‘natural theory’ of law and is found in the role of human rights law based on morality. Some tax havens may adopt the theory of incorporation. Two European Union (EU) member countries, France and The Netherlands, adopt a monist approach to the incorporation of international with EU laws as they are automatically part of their domestic law.\textsuperscript{74} The United Kingdom must recognise the supremacy of EU law over national law due to the UK Parliament passing an implementing act, namely the \textit{European Communities Act 1972}.\textsuperscript{75} All other EU member countries have a dualist approach and EU law is not automatically incorporated into their own domestic law.\textsuperscript{76} It is of interest to note that the European Community Treaty specifically prohibits the European Community (EC) from introducing measures relating to taxation provisions, Article 157.3.\textsuperscript{77}

\section*{5.3.6 The OECD and its role in the international environment}

In order to appreciate the role and purpose of the OECD, it is necessary to briefly discuss the history and rationale for the existence of the organisation. The OECD was established in 1961 and is located in Paris France. The forerunner of the OECD was the Organisation for European Economic Co-operation (OEEC), which was

\textsuperscript{72} OECD, above n 23.
\textsuperscript{73} Peter Wilson, ‘Pirates of the Caribbean’, \textit{The Australian} (Sydney), 14 April 2009.
\textsuperscript{75} Triggs, above n 5, 131.
\textsuperscript{76} Ibid, 79.
\textsuperscript{77} Ibid, 92.
formed to administer American and Canadian aid under the Marshall Plan for reconstruction of Europe after World War II. Since it took over from the OEEC in 1961, the OECD’s vocation has been to build strong economies in its member countries, improve efficiency, hone market systems, expand free trade and contribute to development in industrialised, as well as developing, countries. \(^\text{78}\)

It was subsequently transformed in 1961 into the Organisation for Economic Cooperation and Development with trans-Atlantic, and then global, reach. Today, the OECD has 30 member countries with plans to ‘invite Chile, Estonia, Israel, Russia and Slovenia to open discussions for membership of the Organisation and offered enhanced engagement, with a view to possible membership, to Brazil, China, India, Indonesia and South Africa’. \(^\text{79}\) There are now more than 70 developing and transition economies that are engaged in a working relationships with the OECD.

The official website of the OECD\(^\text{80}\) lists the following objectives of its policies as:

- to achieve sustainable economic growth and employment and rising standards of living in member countries while maintaining financial stability, so contributing to the development of the world economy,
- to assist sound economic expansion in member countries and other countries in the process of economic development,
- to contribute to growth in world trade on a multilateral, non-discriminatory basis.

In terms of corporate governance, the OECD believes that it has been instrumental in:

promoting good governance at all levels of government and corporate activity; ensuring transparency and fairness in tax systems and competition rules; fighting


\(^\text{80}\) Ibid.
corruption and money-laundering and promoting high ethical standards; and supporting accountability and encouraging citizen-participation in policy-making.\textsuperscript{81}

The OECD lists a number of initiatives as evidence of its achievements over the past 40 years. Some of those are the OECD Model Tax Convention; the OECD Anti-Bribery Convention; the OECD Principles of Corporate Governance; and the OECD Transfer Pricing Guidelines for Multinational Enterprises, to name just a few. These initiatives have been adopted to a large extent by the Australian Government and transformed into Australian domestic law.

5.3.7 Examples of OECD guidelines becoming tax law in Australia

The best way to illustrate the process by which OECD norms become part of the Australian domestic law is to examine some of the OECD policies and norms that have found their way into the Australian domestic tax law. The following examples clearly illustrate the fact that the OECD has had a major impact on taxation law in Australia through its influence as a maker of soft international law. These initiatives have become part of the domestic law through the doctrine of ‘transformation’. This means that in order to give effect to the OECD guidelines, the Australian domestic law has to be amended in order to transform those policies into the existing taxation law. In the case of Australia, the \textit{Income Tax Assessment Act 1997} (Cth) or the \textit{Income Tax Assessment Act 1936} (Cth) or other Commonwealth or State legislation is amended to incorporate the OECD initiatives.

\textbf{The OECD Model Double Taxation Agreement (DTA)}

With the development of global business activities there was a need to prevent a profit made in a foreign country, the source of the income, being subsequently taxed again in the home country, being the country of residence of the taxpayer. From as early as 1921, the League of Nations started to develop an international agreement to eliminate double taxation and the first model agreement was drawn up in 1928. The OEEC, the forerunner to the OECD, then continued to refine the model agreement

\textsuperscript{81} Ibid.
until 1963 when the first OECD model agreement was widely accepted by 69 member countries.\textsuperscript{82}

The OECD model double taxation agreement (DTA) for the elimination of double taxation has been used by member and non-member countries for many years in their international taxation dealings. In Australia, double tax agreements are based on the OECD model and are given the force of law as part of the Australian domestic law by being passed by the Commonwealth of Australia Parliament and then being included as a schedule to the \textit{International Tax Agreements Act} 1953 (Cth). This is the way in which double tax agreements become part of the Australian domestic law. The model agreement is clearly part of the ‘soft’ international law developed by the OECD as it has been widely accepted in the international community.

The double tax agreements have two main objectives; first, they are designed to prevent double taxation of the same profit; and second, they are also designed to prevent fiscal evasion by requiring the treaty countries to share information on taxpayers. This also amounts to assistance in the collection of taxes for the other contracting state. Article 26 of the Model DTA contains the ‘Exchange of Information’ obligation between the two states. It is this provision that is being examined by the OECD for revision with a view to strengthening the goals of the harmful tax competition project.\textsuperscript{83}

However, not all countries have accepted the model agreement without some reservations. The situation in Switzerland and the UK in relation to the exchange of information article provides an example of how the ‘soft’ law has not been unreservedly accepted by that country, which is in essence the form that ‘soft’ law takes. According to Professor Christians, ‘soft law is sometimes praised for its flexible, bottom-up, which may allow states to adapt to their diverse circumstances and lower the cost of contracting between states’.\textsuperscript{84} For example, Switzerland has an express reservation on the exchange of information contained in their DTAs with other countries but the more startling example comes from the United Kingdom

\textsuperscript{82} Thomson/ATP, Commentary on the OECD Model Convention, [21 002] and [21 003].  
\textsuperscript{84} Christians, above n 60, 332.
According to Hartman, the Commentary to the Model Tax Convention, Article 26, explains that:

The United Kingdom takes the view that the Article imposes no obligation on it to carry out enquiries on behalf of a contracting state in cases where no liability to United Kingdom tax is at issue, since to carry out such enquiries would be contrary to its laws and administrative practice.  

**Taxpayer Charter**

In 1990 when the OECD’s Committee of Fiscal Affairs conducted a survey of the member countries to determine whether or not they had a charter on taxpayers’ rights, they found that most countries had no explicit document but most had rights and obligations contained in their existing tax system. Since then most member countries have introduced a charter on taxpayers’ rights. The original justification for the introduction of a charter of rights can be summed up in the following statement from the OECD report:

Many countries are seeking to improve the service provided to the taxpayer, in part because modern tax systems require increased co-operation from the taxpayer if they are to operate efficiently and also as a result of changing attitudes towards the role of tax administration vis-à-vis the taxpayer. This co-operation is more likely to be forthcoming if there is mutual trust between the taxpayer and the administration and if the taxpayers’ rights are clearly set out and protected.  

As a result of this policy from the OECD most member countries have introduced a ‘charter of taxpayer rights’ in one form or another. According to Professor Duncan Bentley, Australia was able to examine the existing taxpayer charters from Canada, New Zealand and the United Kingdom before formulating its own charter. While

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86 Ibid, 287.


88 Ibid, 7.

the Australian Taxpayers’ Charter is not part of the black letter law, its introduction is a further example of how the OECD has been able to develop norms which are subsequently adopted by member countries.90

Transfer pricing rules
In 1979, the OECD provided a report on ‘Transfer Pricing and Multinational Enterprises’ and a subsequent report in 1984 suggesting a range of methods that could be used to control the pricing of goods and services between multi-national enterprises that are not dealing at ‘arm’s length’. In the early 1980s, Australia adopted many of these suggestions by introducing provisions in the Income Tax Assessment Act 1936 (Cth), namely Division 13 of Part III. Basically, the provisions were designed to prevent multi-national enterprises from dealing in goods and services between their own businesses by manipulating the price at which the goods or services are sold or purchased by subsidiaries in other countries. Without some form of control, this would mean that a greater profit could be derived in a low tax jurisdiction and a small profit in a high tax jurisdiction. The key issue was to ensure that the parties acted as if they were dealing at arm’s length and not as related parties. In order to prevent any manipulation of prices, a number of methods were introduced to try to safeguard against any possible abuse. The Australian Taxation Office takes into account prices charged for goods or services between independent parties operating in similar markets in order to determine what the arm’s length price should be.

The OECD is very active in the area of transfer pricing and is a major developer of norms to be used by member countries to price goods and services not sold at arm’s length. The 1995 OECD Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators was a high-water-mark in providing a comprehensive guide as to the principles that should be applied in the area of transfer pricing. This report has been widely accepted by member countries and is an example of soft law. As stated earlier in this paper, Professor Avi-Yonah argues that the transfer pricing guidelines may have the status of being part of customary

90 The Charter is an administrative document produced by the Australian Taxation Office. However, most of the rights discussed in the Charter are specifically provided for in the statutory law in Australia.
international law. Very clearly, the OECD has been actively involved in developing soft law in the area of transfer pricing and has a major impact on Australian taxation law as a result. However, it is interesting to note that the US was the first country to introduce measures to prevent corporate tax avoidance in the 1960s by introducing regulations on transfer pricing, thin capitalisation and Controlled Foreign Corporation rules. The OECD and other countries replicated the US initiatives at a later time.

**CFC, FIF and Transferor Trust Rules**

Once again the OECD has been very active in providing guidelines and norms for member countries for the taxing of income derived by resident taxpayers in low tax countries and offshore financial centres where the investment activity is held in a company, investment fund or foreign trust. The Controlled Foreign Corporation (CFC) and Foreign Investment Fund (FIF) rules were introduced in Australia from 1 July 1990 with the introduction of the *Taxation Law Amendment (Foreign Income) Act 1990* (Cth). The CFC rules originated in the US in 1937 and, according to Professor Avi-Yonah, have arguably become part of customary international law. Basically, the rules are designed to impose income tax on passive and highly mobile income derived from foreign corporations or foreign investments in low taxing countries that is not repatriated to the Australian taxpayer. The rules then attribute income to the Australian taxpayer. The transferor trust rules operate in a similar way to attribute income derived by a non-resident trust to Australian taxpayers. The difficulty with applying these provisions to Australian resident taxpayers is being able to locate the foreign company, foreign investments or non-resident trust. The rules are being reviewed and new legislation may be forthcoming within the next year in an attempt to simplify the existing rules. The OECD recommends the use of

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91 Avi-Yonah, above n 64, 500.

92 ‘Thin Capitalisation’ refers to the process whereby multinational companies establish a subsidiary company in another country and provide 100% financing which results in the interest expense for the subsidiary being a tax deduction and used to reduce taxable income in the foreign country. The thin capitalisation rules limit the amount of financing the parent company can provide, usually 75%, in order for the subsidiary to claim a deduction for the interest expense. It is not proposed to examine thin capitalisation in this thesis although the OECD has been active in developing norms in this area of tax law.

93 Webb, above n 4, 796.

94 Avi-Yonah, above n 64, 486 and 488.
these rules to remedy the harmful effects of tax competition from tax havens and to prevent the erosion of the tax base in member countries.⁹⁵

**Non-deduction for bribes of foreign officials**
The OECD has been very active in its campaign to deny taxpayers in member countries the ability to claim a tax deduction for bribes paid to foreign officials. From 1 July 2000, s 26-52, *Income Tax Assessment Act 1997* (Cth) denies the deductibility of bribes paid to foreign officials unless it is regarded as a ‘facilitation’ payment. A facilitation payment is defined as a ‘routine government action of a minor nature’.⁹⁶

In the Explanatory Memorandum to the Taxation Laws Amendment Bill 1990, it is stated that the main reason for the amendment to the *Income Tax Assessment Act 1997* is that the OECD has strongly recommended that member countries deny the deduction. The OECD Council made the recommendation on 27 May 1994 that all member countries implement measures to deter and prevent the bribery of foreign public officials as it creates economic and trade distortions. On 15 February 1999, the criminal law was amended in Australia to make the payment of bribes to foreign officials a criminal offence in certain circumstances. This is a clear example of where policies and norms were developed by the OECD and then implemented by member countries. The soft law made by the OECD eventually became hard domestic law in Australia through the transformation of the soft law into domestic law.

The ‘Financial Action Task Force’ (FATF) is concentrating on the elimination of money laundering by requiring international co-operation from countries that maintain bank secrecy laws. As a result of the FATF report on non-cooperative countries and the twenty five criteria promulgated in its report, Australia implemented its own anti-money laundering legislation, known as the *Anti-Money Laundering and Counter Terrorism Financing Act 2006* (Cth). The FATF ‘twenty five criteria’ were used to determine what countries were being non-cooperative in

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⁹⁵ OECD, above n 1.
⁹⁶ Explanatory Memorandum to the Taxation Laws Amendment Bill 1990, Chapter 4, 5.
its fight against money laundering and these were based on the original ‘forty recommendations’ developed by FATF in 1990 and subsequently revised and reduced in number in 1996. According to Hartman, ‘these recommendations are said to “have been established as the International standard for effective money-laundering measures”’.

The AML/CTF Act was implemented in two tranches; the first tranche was enacted by Parliament in 2007 and the second tranche was intended to apply two years later, namely 2009. The law was designed to be implemented over a 24 months period to allow businesses to meet their obligations. The first tranche ‘covers the financial and gambling sectors, bullion dealers and lawyers/accountants, but only to the extent that they provide financial services in direct competition with the financial sector’. The Replacement Explanatory Memorandum to the AML/CTF Bill states that the ‘reforms are a major step in bringing Australia into line with international best practice to deter money laundering and terrorism financing that includes standards set by the Financial Action Task Force (FATF)’ and hence the reason for its proposed enactment.

The existing law was not considered by the Australian Government to be adequate, especially with the increase in non-face to face transactions through electronic transfers. Instead, the AML/CTF Act adopts a ‘risk based approach’ to identifying customers that may be engaged in money laundering or terrorism financing and will apply to a very wide range of businesses, not just cash dealers. The use of tax havens and schemes devised by lawyers and accountants is now part of the focus of the new law and will be comprehensively dealt with in the second tranche of law.

What then is the status of the FATF recommendations and why were they of such influence as to cause the Australian Government to implement new statutory law? Could it be said that the twenty five criteria or the original forty recommendations

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97 Hartman, above n 85, 262.
98 Replacement Explanatory Memorandum to the AML/CTF Bill, 1.
99 The new law was released to the public for comment as an ‘exposure draft’ and the Anti-Money Laundering and Counter Terrorism Financing Bill was eventually introduced to the Commonwealth Parliament on 1 November 2006 after taking into account submissions by interested parties.
100 Replacement Explanatory Memorandum, n 98, 1.
have the status of soft international law and, as such, require compliance by member
and non-member countries? Hartman contends that the twenty five criteria may
‘constitute a new norm of customary law’.  

Hartman does accept the view that the
original forty recommendations have become soft law and, as such, should be
binding on all countries. He makes the following observation:

[A] more viable argument is that the Forty Recommendations have become binding
customary law and that the 25 Criteria are enforceable indirectly, insofar as they
reflect the obligations of the Forty. Without going into an exhaustive analysis of the
customary value of the Forty Recommendations, several strong foundations upon
which such a claim might rest can be identified. Although in 1993 Bruce Zagaris
described the Forty Recommendations as soft law, he went on to say that “although
soft laws are not immediately binding, they are usually precursors to hard law”.
Since then, the International acceptance that the Forty Recommendations enjoy has
broadened substantially. … over one hundred countries have committed to the
implementation of the Forty Recommendations. Some have even agreed to mutual
evaluation to assess their progress in the implementation. All of these factors are
evidence that there is an obligation to comply with the Forty Recommendations.

One of the main reasons why the FATF campaign against money laundering has
been widely accepted is that it involves criminal conduct and most countries do not
wish to be seen as making it easy for criminals to conduct business within their
jurisdiction. The FATF campaign is an excellent example of soft international law
developing into a binding form of hard international law.

It would appear that Australia, like many other OECD member countries, is happy to
adopt in full many of the policies and norms developed by the OECD, especially
where these soft international laws directly assist in the member country being able
to collect more revenue or safeguard existing revenue. In fact, in many of the above

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101 Hartman, above n 85, 276. At the time of publication many of the CARICOM states had not accepted the
principles. However, since then all CARICOM nations have agreed to enact laws to prevent money laundering
and to exchange information.

102 Ibid, 276.

103 Ibid, 277.
situations, the norms, which start their life as ‘soft’ international law, become part of the domestic law through the doctrine of transformation.

5.4 Is Soft Law Desirable?

The preceding discussion of the role of the OECD and its influence in international taxation law raises the question as to whether or not soft law, as a source of international tax law, is desirable. There are two schools of thought; one that soft law is redundant and fulfils no useful purpose; and, the second school of thought that soft law is not only desirable but it can also lead to hard law due to its flexibility. Before answering the question it is necessary to examine both sides of the argument.

5.4.1 The undesirability of soft law

One of the main opponents of soft law as a concept is Jan Klabbers who contends that soft law fulfils no useful function and, in practice, is hard to distinguish from hard law. The distinction he draws is between hard law and no law at all. He goes so far as to argue that not only does soft law serve no identifiable purpose but that it is actually a bad thing. Klabbers holds that soft law allows for political and moral values and administrative power to become part of the law and this is the very reason to abandon the concept in the first place. The following statement by Klabbers illustrates this point:

Law, in other words, must have a simplifying rigor over it: the simplicity of the law, knowing only categories of legal or illegal, in force or not in force, binding or not binding, makes it possible to survive in this complex world. It is the simplifying rigor of the law, the way in which it can translate complexity into something we can handle, which makes law such a useful tool. … the term ‘soft law’, the very notion itself, undermines this blissful simplicity … .

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105 Christians, Alison, above n 60.
107 Ibid, 383.
Soft law is perceived by Klabbers to be a threat to the Rule of Law\textsuperscript{109} by allowing political and moral concerns to become part of the law, whereas the law should be autonomous from those concerns.\textsuperscript{110} However, while he may arguably be correct in his view of the concept of law from a legal positivist perspective, in reality, soft law is found in both the international taxation law and the domestic taxation law of Australia and other countries, as discussed below.

5.4.2 The benefits of soft law

One of the benefits of the existence of soft law in the European Union context is that it is credited with promoting tax harmonisation in the area of reducing harmful tax competition and transfer pricing regimes.\textsuperscript{111} The Code of Conduct on Business Taxation is the best known example of EC soft law in the tax field.\textsuperscript{112} This is particularly important as pursuant to Article 94 of the European Community Treaty, a unanimous vote of all members is required before the adoption of a community-wide tax provision is permitted due to the fact that all states retain competence in the tax field.\textsuperscript{113} Soft law measures have achieved what hard law could not and, although not legally binding, must be seen as being desirable in the absence of a treaty or legislation. A proponent of the use of soft law in the area of domestic taxation is Professor Duncan Bentley. While he does not directly state that soft law is desirable, he does illustrate the benefits of soft law in the administration of taxation by the tax authorities.\textsuperscript{114} He contends that the existence of soft law, in the form of tax rulings and the Taxpayers’ Charter, provide benefits to taxpayers in the form of certainty and trust that can only be achieved through soft law and it is in this area of tax

\textsuperscript{109} ‘The concept of the ‘Rule of Law’ is best enunciated by Professor Dicey in his Law of the Constitution where he explains that the doctrine denotes three things: first, the regular law of the land predominates over, and excludes, the arbitrary exercise of governmental powers. Second, all classes of people are equally subjected to the ordinary law of the land, administered by the ordinary courts. Third, that the law of the constitution itself is not to be found in a code, but is derived from the rights of individuals, as declared by the courts.’ James, Philip, Introduction to English Law (12ed, 1989) 146. Arguably in modern times the Rule of Law faces its biggest threat from exercise of power given to the administration (Executive) and tribunals.

\textsuperscript{110} Ibid, 391.


\textsuperscript{112} Ibid, 413.

\textsuperscript{113} Ibid, 381.

administration where the strength in soft law lies.\textsuperscript{115} This is particularly the case where taxpayers self-assess and the legal system is based on the common law as opposed to a civil law system.\textsuperscript{116}

Professor Christians reiterates the fact that soft law is ‘praised for its flexible, bottom-up approach which may allow states to adapt to their diverse circumstances and lower the cost of contracting between states’.\textsuperscript{117} It is the precursor to something more definitive in international tax law. This appears to be a common attribute of soft law, particularly if it subsequently leads to hard law in the form of a treaty or agreement.

\textbf{5.4.3 Conclusion}

Is soft law desirable? The answer is yes but with reservations. It is desirable from an international perspective because organisations such as the OECD, the EU and the UN play an important role in convincing nations to adopt tax practices that, arguably, are for the benefit of many other nations. The example discussed in this paper, the OECD’s harmful tax competition project, is evidence of soft law becoming widely accepted and being transformed into hard law through the introduction of exchange of information agreements between tax havens and OECD member states and other non-member states. If it was not for the existence of the OECD in its policy role in formulating guidelines and recommendations in the taxation law area, many nations would not have the benefit of the OECD initiatives, such as the Model DTA, the transfer pricing regime, the CFC and FIF rules and the Taxpayers’ Charter, as discussed earlier in this paper. From a domestic perspective, Australian taxpayers have the benefit of the Rulings system and the Taxpayers’ Charter, which, arguably, assist taxpayers in their dealings with the ATO, especially as the ruling is binding on the ATO.

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\textsuperscript{115} Ibid, 39.
\textsuperscript{116} Ibid. Professor Bentley examines this aspect of soft law in the context of the taxpayer and foreign investor being subject to self-assessment in the preparation of their tax return, as is the case in Australia, Malaysia and South Africa, and the legal system is based on the common law system. He contends that in a civil law system more reliance is placed on a specific rule of law being contained in the codes whereas in a common law system the administration exerts more power and influence and therefore is able to make rules of a soft law nature.
\textsuperscript{117} Christians, Alison, above n 60, 332.
\end{flushright}
The only reservation that must be placed on the desirability of soft law in the taxation environment is that, while the law is not being made by elected representatives sitting in a parliament, the primacy of the Rule of Law must be maintained. Provided the OECD and the domestic tax administrators in various countries are subject to sufficient international and domestic controls over their development and implementation of soft law that is imposed on taxpayers, then the existence of soft law is not only desirable but, arguably, should be encouraged.

5.5 The OECD’s Project against Harmful Tax Competition: Are Tax Havens Complying because it is Law?

Professor Reuven Avi-Yonah has highlighted the fact that there are at least two opposing views on the success of the OECD’s harmful tax competition project. On the one hand, J.C. Sharman contended that the OECD project had failed, as at 2006, at the time when his book was published. On the other hand, Professor James contended that the OECD project had been so successful that the Caribbean tax havens had consented to exchange information and to reform their bank secrecy laws. In fact, with Switzerland, Luxembourg and Austria now agreeing to exchange information, the OECD’s project could be viewed as having achieved an outstanding result.

J.C. Sharman was convinced that the OECD’s harmful tax competition project had not succeeded and made the following statement to that effect:

By 2002, not only had the OECD failed to convince tax havens of the error of their ways, but it had also failed to convince key sectors of the international audience of the wisdom and justice of its arguments relative to those of its opponents.

118 Avi-Yonah, above n 17, 1.
121 Sharman, above n 119, 71.
Professor James concluded that within four years from the launch of the OECD’s harmful tax competition project, fourteen of the fifteen Caribbean Community and Common Market (CARICOM) countries had agreed to cooperate with the OECD. Barbados, the fifteenth CARICOM country, had already agreed to cooperate with the OECD on an earlier occasion.\(^{122}\)

Professor Avi-Yonah contends that the OECD project has been a success but that more work still needs to be done.\(^{123}\) Professor Avi-Yonah recommends that if all OECD member countries and non-OECD countries strengthened their CFC rules and eliminated the opportunity for MNEs to defer taxation, then tax havens would not be attractive to corporations. In terms of individuals, he recommends imposing a refundable withholding tax of up to 35% on payments made to non-cooperating tax havens or non-treaty countries and insisting on exchange of information agreements.\(^{124}\) Investment capital is rarely invested in a tax haven and it flows from the tax haven to the main economies, such as the US and the United Kingdom. In fact there is a strong view that the United Kingdom, in particular, encouraged the British overseas territories, such as Guernsey, Jersey, the Isle of Man and the certain Caribbean countries, to attract mobile capital because it eventually flowed to London to be invested and to increase growth in the financial services sector.\(^{125}\) If the OECD has been successful with its project and it has now become law, what then of the tax intermediaries and the people engaged in providing financial and banking services in tax havens and OFCs?

There are two consequences of the OECD’s initiative in eliminating tax competition that need to be discussed; first, all nations should have the right to determine their own tax law and should not be subject to pressure from other states; and second, if foreign capital ceases to flow to these tax havens then who is going to be responsible for the social cost flowing from unemployment and a lowering of the standard of living for the people currently employed in providing financial and banking services in those countries? The following discussion of those two issues highlights the fact

\(^{122}\) James, above n 120, 50.
\(^{123}\) Avi-Yonah, above n 17, 2.
\(^{124}\) Ibid, 15.
\(^{125}\) Wilson, above n 73, 24.
that countries now complying with the OECD must have an overwhelming sense of obligation to the current international taxation law that they are prepared to sacrifice the notion of national sovereignty and face economic hardship as a result of reducing financial and banking activity within their state.

5.5.1 Threat to the sovereignty of the tax haven

The United Nations recognises the importance of the equality of the sovereignty of its members, irrespective of their size and importance.\(^\text{126}\) Professor Ring contends that the meaning of ‘sovereignty’ has changed ‘over the centuries and across contexts’.\(^\text{127}\) At a minimum, a sovereign state is expected to have three elements; ‘territory, people and a government’.\(^\text{128}\) Tax havens have these three elements and exert control over their territory and people as well as exhibiting external independence from other states.\(^\text{129}\) Professor Ring discusses the fact that very few states can assert that they are truly sovereign. It is suggested that the US may possess the attributes of a sovereign nation and that all others are semi-sovereign due to their dependence on larger economic and political systems in the international environment for their maintenance.\(^\text{130}\) On this basis, Australia could be considered to be a semi-sovereign nation due to the dependence on the larger economic and political states providing markets for its commodities as well as military protection. Clearly, the governments of tax havens need mobile capital to be deposited into their banks and financial institutions and MNEs to establish a presence in their country in order to provide for the welfare of their own people within their own territory.

The role of the OECD seeking to force tax havens to collect income tax on behalf of the developed countries is of concern for the sovereignty of those nations. According to Peter-Szerenyi, the sovereignty of tax havens is being severely impaired by the actions of the OECD. As the author contends:

\(^\text{126}\) Article 2(1) of the United Nations Charter, ‘The organisation is based on the principle of the sovereign equality of all its Members,’


\(^\text{128}\) Ibid, 160.

\(^\text{129}\) Ibid.

\(^\text{130}\) Ibid, 161 and footnote 15.
Many of the tax havens are small, poor countries that rely heavily on their financial service. They lack natural resources, capital, and labour, and are significantly disadvantaged compared to industrialized nations in their ability to contribute to the global economy. … Most listed tax havens do not have the choice of ignoring the OECD’s demands. This shows again that the harmful tax competition project is, in fact, interfering with the sovereignty of small or developing jurisdictions.\footnote{131}

By way of contrast, national sovereignty is an important issue for member countries of the European Union in relation to taxation law. Cerioni contends that the ‘principle of subsidiarity’ supports the argument that taxation policy is a matter for the sovereign state, and that states can compete with each other in setting rates of income tax within the European Community.\footnote{132} In the European Council, in accordance with ‘Article 95(2) of the European Commission Treaty, no decision in tax matters can be taken unless all Member States agree to a specific measure. It is always the Member States that go it alone or act in concert … not Brussels.’ \footnote{133}

The importance of fiscal sovereignty to every nation is reinforced by the following observation by Michael Webb:

Another important norm that helped to shape the OECD project was that of fiscal sovereignty. Taxation is viewed as closer to the core of sovereignty than almost any other kind of economic policy, and this made states reluctant to consider international measures similar to those that are commonplace in sectors like trade. Sovereignty also mattered in the debate with the tax havens, who were able to argue that the plan to tell them what kinds of tax systems were inappropriate … was a violation of their sovereignty. The fact that the OECD appeared unwilling to override the fiscal sovereignty of its own tax havens – Switzerland and Luxembourg – opened the OECD up to the additional charge of applying a double standard.\footnote{134}

\footnote{131}Peter-Szeryni, above n 30, 10 and 13. 
\footnote{134}Webb, above n 4, 820.
Given that Switzerland, Luxembourg and Austria, the three remaining OECD member states that originally refused to comply with the harmful tax competition project, have now agreed to exchange information on non-residents using their financial and banking system, would add further weight to the fact that national sovereignty can be surrendered in these circumstances. This situation is consistent with the concept referred to as the ‘Hobbes paradox’, in that Thomas Hobbes argued that giving up state rights in exchange for mutual benefits may even strengthen a state rather than weaken its sovereignty. It further illustrates the fact that the OECD’s initiative on harmful tax competition has arguably become part of the international law.

It would appear that many tax havens and OFCs are prepared to enter into exchange of information agreements which will ultimately make it very difficult for non-resident individuals and MNEs to be able to hide their capital in offshore bank accounts in the future. While tax havens have not agreed to impose income tax in situations where they have not imposed tax in the past, the fact that they are prepared to surrender their one main competitive advantage, that of maintaining bank secrecy laws, is evidence of the success of the OECD project to eliminate harmful tax competition and a lessening of those nation’s claim to sovereignty. It will be interesting to follow the progress of tax havens and OFCs in complying with the OECD’s initiatives and their impact on the future of those nations.

5.5.2 Economic consequences

It is important to recognise that tax havens and OFCs rely on revenue from their financial services and banking activities to create employment and wealth for their nation. According to Greg Brabec, banking revenue in Switzerland makes up nearly 11 percent of the country’s gross domestic product. If, as a result of agreeing to exchange information on the names of bank account holders, this level of revenue is

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threatened or declines, then the Swiss Government may have second thoughts on the economic merits of complying with the OECD’s ‘soft law’. As an illustration of how tax havens have been used by MNEs, tax havens account for more than 50 percent of world trade, although they only account for three percent of the world’s gross domestic product.\textsuperscript{137}

The OECD, in its eagerness to eliminate harmful tax competition and to target tax havens, even suggested imposing trade sanctions against the sovereign states or terminating existing treaties in order to promote compliance with its recommendations.\textsuperscript{138} It is difficult to see how the OECD could in fact impose economic sanctions on tax havens and this illustrates the fact that the OECD had difficulty in enforcing its recommendations contained in its harmful tax competition project. However, such action would possibly constitute a breach of international law on at least two fronts. As Hartman states, ‘a unilateral termination of a treaty would breach Article 54 of the Vienna Convention on the Law of Treaties and trade obstacles would violate obligations to the World Trade Organisation.’\textsuperscript{139}

One of the dangers of driving small tax havens to give up their role in attracting mobile capital is that they end up becoming failed states. This means that they need to rely on foreign aid in order to survive and are susceptible to other international influences. If aid is not forthcoming then the social upheaval becomes exacerbated. This was the conclusion drawn by J. C. Sharman when discussing the consequences for Pacific tax havens being required to introduce regulations to overcome bank secrecy laws and to make their tax system more transparent.\textsuperscript{140} Those tax havens which could not meet the standards of regulation required by the OECD were ‘excluded from global markets’ and subsequently became reliant on foreign aid.\textsuperscript{141} A similar situation has emerged with the tax havens of the Caribbean region. According to Vaughan James, the ‘Barbadian offshore sector employed approximately two

\begin{itemize}
\item \textsuperscript{137} Ibid, 251.
\item \textsuperscript{139} Hartman, above n 85, 264.
\item \textsuperscript{140} JC Sharman, ‘South Pacific tax havens: From leaders in the race to the bottom to laggards in the race to the top?’ (2005) 29 Accounting Forum 311, 321.
\item \textsuperscript{141} Ibid, 321.
\end{itemize}
thousand people and provided about one third of government revenue’ and without
the financial services industry the country could find itself facing increased criminal
activity and corruption.\footnote{James, above n 120, 34.} James concluded with the strong statement that the OECD
had ‘robbed the CARICOM states of their gold – their sovereign right to determine
tax and economic policies.’ \footnote{Ibid, 50.}

5.6 Conclusion

In relation to the first main question raised in this chapter, whether the OECD makes
soft law, it is contended that the OECD does make soft international law and the
norms made by the OECD are, in the main, accepted by the member countries and
even non-member countries as being part of the international tax law. The OECD’s
harmful tax competition project is an example of recommendations and norms
becoming soft international law. This view is supported by Professors Avi-Yonah
and Christians. There are other examples of where the OECD norms have had an
influential impact on tax law in Australia, such as the Model DTA, CFC rules, FIF
rules, transfer pricing policies and anti-money laundering laws, which are evidence
of the OECD’s role as a maker of soft and even hard international tax law.

In relation to the second main question raised in this chapter, that if the OECD makes
soft law is this the reason why tax havens have agreed to comply with the
recommendations, it is contended that because OECD’s initiative is soft law, many
countries are now complying with the requirements of entering into exchange of
information agreements and repealing their bank secrecy laws. The fact that virtually
all tax havens and OFCs have agreed to share information with other countries,
especially the OECD member states and in consideration are willing to give up part
of their national sovereignty and their economic wellbeing, must suggest that the
OECD’s harmful tax competition project has taken effect as soft international law.

The Swiss government has entered into an agreement with the US to share
information on potential tax evaders that are US citizens. In exchange for this
agreement, the US will drop the civil case against the UBS in which they were being
asked to provide information on 52,000 clients. Instead, UBS will pay the US government USD 780 million and provide the names of 250 clients. However, because Switzerland requires international law to be incorporated into its domestic law, the Swiss Parliament must agree with the reform of its banking laws, otherwise a referendum of the nation if 50,000 signatures are collected. The Swiss Government will not permit other countries to undermine the confidentiality of its financial institutions by allowing unspecified ‘trawling’ for names by foreign tax administrations. The historical basis for the Swiss bank secrecy laws are based on saving lives rather than facilitating tax evasion. The Swiss Federal Banking Act was enacted in 1934 to protect foreign customers by ensuring that their bank details were kept confidential. The law was established to counter the Nazi Government in Germany, which at that time imposed a death penalty on German citizens who did not report assets held in a foreign bank. In order to protect the German customers, no information could be provided to a foreign agency by the Swiss bank.

In relation to the third question raised in this chapter, whether soft law is desirable, it is contended that it is desirable as an innovative and flexible source of law, particularly in the international environment. The OECD, the EU and the UN all play a vital role in generating policies, guidelines and recommendations for the benefit of nations. At the domestic level, soft law has now become part of the way in which tax laws are administered, provided there is trust and fairness between the taxpayer and the administrator. The only reservation is that soft law should not become so dominant in any legal system that it threatens the Rule of Law.

It will be interesting to see if, in the future, all countries that have committed to enter into agreements to exchange information do in fact pass the requisite domestic laws to put this aspect of international law into effect. In terms of this paper, it can be argued that the OECD has been successful in making soft international law and for that law to be complied with by tax havens and OFCs. There are some commentators

145 Ibid, 22.
146 Ibid.
147 Brabec, above n 136, 233.
that believe that this commitment by tax havens will ultimately fail to translate into hard law. For example, the following statement from the Australian newspaper may be correct, only time will tell:

The fact that Switzerland ‘led a rush of offers to exchange information with other governments’ before the G 20 meeting March 2009, does not mean that Switzerland will not be a major repository of finance from tax avoidance. According to Murphy, the ‘agreements to exchange information are useless; the secrecy will be completely intact’. 148

148 Wilson, above n 73. The ‘Murphy’ referred to in the article is Richard Murphy, a British accountant who runs the ‘Tax Justice Network’ dedicated to eliminating tax evasion through tax havens. More information is available at <www.taxjustice.net>.
CHAPTER 6 SHOULDN'T INTERNATIONAL INCOME OF AN AUSTRALIAN RESIDENT BE TAXED ON A WORLDWIDE OR TERRITORIAL BASIS?

6.1 Introduction

Many countries impose income tax on the worldwide income of their residents or citizens. This is the case in Australia where ‘Australian residents for tax purposes’ must pay income tax on their worldwide income including statutory income such as capital gains and dividends. If the government of a country adopts a ‘worldwide’ basis for imposing income tax on its residents then the existence of tax havens and offshore financial centres becomes an important issue because income from passive investments may not be disclosed and, subsequently, taxed in Australia. The Australian Government has recently funded ‘Operation Wickenby’ in an attempt to detect Australians using tax havens and reinforcing the integrity of a worldwide taxation system. On the other hand, in 2007, the Australian Government introduced an important change to the existing income tax law that was very favourable for ‘temporary residents’ working in Australia. This new law adopts a ‘territorial basis’ for the imposition of income tax on temporary residents. From 1 April 2006, New Zealand has exempted from taxation certain types of foreign income for new migrants and returning New Zealanders for a period of 49 months. This chapter will start with a discussion of the philosophical basis for Australia having adopted a ‘worldwide’ system of taxation as opposed to a ‘territorial system’ and then critically examine the problems with collecting income tax on foreign sourced income generated by Australian residents. The chapter will then draw a conclusion as to the merits of Australia adopting a territorial system for taxing foreign income and whether or not the worldwide system should be abandoned altogether.

As capital and labour become more mobile in a globalised world, the ability of a government to tax income generated in a foreign country becomes one of the most
important challenges of the twenty-first century.\(^1\) Similarly, with the growth in technology and electronic commerce as well as the general effects of globalisation, it will be difficult for countries to collect taxes.\(^2\) It is not intended in this chapter to examine in detail the methods being used by international organisations, such as the OECD, and various countries to try to control the loss to revenue as a result of individuals and multi-national enterprises (MNEs) using tax havens and offshore financial centres (OFCs). That is examined in detail in Chapter 9 of the thesis. Instead, this chapter will discuss the effectiveness of the Australian government in trying to impose income tax on the foreign sourced income of Australian residents. The main question to be answered in this paper is whether or not it would be more equitable, efficient and with fewer complexities to simply impose income tax on income derived within Australia by Australian residents. In other words, should Australia adopt a pure territorial system for taxing foreign income or continue with the current arrangements? It should also be noted that no country uses a pure system of either worldwide or territorial taxation.\(^3\) Indeed, some commentators in this area of law have advocated the need to describe a worldwide system with deferral for foreign sourced active business income as a ‘hybrid worldwide’ system and a territorial system that taxes some worldwide income as a ‘hybrid exemption system’.\(^4\) On this basis of classification, Australia has a hybrid worldwide system. Moreover, the taxation treatment of ‘temporary residents’, as discussed in detail later in this paper, adopts a territorial system for that particular group of Australian taxpayers.

The chapter has been divided into five parts. The first part will look at the philosophical framework for taxing international income and, in particular, the sharing of tax revenue between nations. The second part of the chapter will examine the advantages and disadvantages of a worldwide tax system using the criteria of


equity, efficiency and simplicity to assess the current performance of the Australian taxation arrangements. This examination will include the problems of tax arbitrage and its impact on horizontal equity, capital export neutrality (CEN) and the need for anti-deferral measures, such as the CFC and FIF rules, which add layers of complexity to the tax law. One of the main problems with having a worldwide taxation system is that unless one country gives up its right to tax the income derived in the source country or the country of residence, the taxpayer will face double taxation of the same profit; first, in the country of source and second, in the country of residence. In order to overcome this problem, countries have entered into double taxation agreements (DTAs) whereby foreign income is either exempt from further taxation in the country of residence or a tax credit is given for tax paid in the country of source by the country of residence. Either way, these measures and the DTAs have further added to the level of complexity that exists in the tax law for the country of residence. This is particularly important when reviewing the concept of ‘efficiency’ in the taxation system and the need to balance equity considerations with the need for efficiency.

The third part of the chapter will examine the rationale for adopting a territorial system and the advantages and disadvantages will be assessed within the framework of equity, efficiency and simplicity. Issues that will be examined will include horizontal equity concerns, the concept of capital import neutrality (CIN) and the ability to have simpler tax laws as a result of not taxing foreign sourced income. However, if Australia changed to a territorial system, the revenue base may be further eroded as high-net-worth investors and multi-national enterprises (MNEs) move their capital and businesses to low taxing jurisdictions. There would still need to be a distinction between active or passive income in the same way as it is currently dealt with in Australia. This area of tax law could not be simplified and would need to be enforced even under a territorial tax system. This distinction between passive and active income will be examined in detail in this part of the paper.

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5 The distinction between passive and active income is extremely important because active income is generally exempt from further income tax in the country of residence after income tax has been paid in the country of source under the exemption provisions, s 23AH and s 23 AJ, *Income Tax Assessment Act 1936 (Cth)* (ITAA 36) in Australia. Passive income, on the other hand, is taxed at source under the withholding system and a credit is given in the country of residence for the tax paid. In Australia the income tax withholding provisions, Division 11A, ITAA 36 relate to the payment of interest, dividends and royalties to a non-resident. Division 770, ITAA 97 allows for the foreign tax credit to be claimed.
The fourth part of the chapter will examine measures that have been adopted in Australia and New Zealand to try to attract capital and labour. In Australia, the government provides tax concessions for temporary residents and in New Zealand new migrants and returning New Zealanders have been provided with similar tax concessions on foreign income. In 2007, the Australian Government introduced an important change to the existing income tax law that was very favourable for temporary residents working and living in Australia. The statutory law is contained in Division 768 of the ITAA 97 and adopts a ‘territorial basis’ for the imposition of income tax on temporary residents. This means that the temporary resident only pays income tax on income sourced in Australia and their foreign income is not subject to tax in Australia when it is remitted. In New Zealand, new migrants and returning New Zealanders are provided with a temporary exemption from New Zealand income tax on some of their foreign income. The New Zealand concession lasts for 49 months from the date that the exemption is first claimed by the new migrant or returning New Zealander. Some commentators have gone so far as to suggest that Australia is now a confirmed ‘tax haven’ as a result of these changes.

The United Kingdom, Singapore and Japan have already introduced taxation laws to provide tax concessions for ‘temporary residents’, so Australia and New Zealand are now trying to catch up with other countries that are competing for foreign investment and foreign labour. Under the new law, a temporary resident will only be liable to income tax on their Australian sourced employment or services income and not their worldwide income even though they live and work in Australia and may not be a resident of any other country for income tax purposes. This means that income generated from non-Australian sources, including capital gains, may not be subject to income tax anywhere, especially if they take advantage of a tax haven in which to hold their investments. There are no tax implications in Australia if the temporary resident remits all of their foreign source income to Australia for their use while living in Australia. This is a classic ‘territorial’ system of taxation of international

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The introduction of these statutory measures would indicate that the Australian and New Zealand governments are prepared to adopt a territorial basis of not taxing foreign sourced income, as part of that taxpayer’s worldwide income, in those circumstances. Can it be inferred from these examples that a territorial system could be introduced in Australia?

The fifth part of the chapter will provide a conclusion based on the analysis of worldwide and territorial systems of taxation as to what changes, if any, should be made to Australian tax law. From this examination, it may be possible to conclude that a territorial system for taxing foreign income provides the most efficient form of taxation and that the worldwide system should be abandoned. However, equity considerations may be threatened by changing to a territorial system and this may prove to be a good reason to keep the tax law as it is.

### 6.1.1 Philosophical framework for taxing international income

Prior to examining the specific attributes of a worldwide or territorial system for the taxation of international income, it is important to review the theory behind why countries have chosen one method of taxing international income over the other. The three recognised criteria, to be used as a framework for assessing the effects of the tax system on taxpayers, are the need for equity, efficiency and simplicity. These principles are based on the Adam Smith model of taxation but are now regarded as the ‘recognised cannons’ of taxation. These principles of taxation were also recognised as being fundamental to the review of the Australian Tax System by the Asprey Committee and have since been used as a framework for the review of the Australian ‘tax and transfer system’ currently being conducted by the Australian

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11 Commonwealth of Australia, ‘The Taxation Review Committee’, Australia 1975. University of Sydney Library. <http://purl.library.usyd.edu.au/setis/id/p00087> 17 November 2008. The Committee was asked to consider the effects of the taxation system upon the economic and efficient use of resources in 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.’ Chapter 3, 40. The three criteria were also used to evaluate the exemption and credit methods to provide relief against double taxation of international income, Chapter 17, 336.
Government.\textsuperscript{12} This framework will be used to assess the merits of taxing foreign income on a worldwide basis or a territorial basis. Fundamental to this analysis are the concepts of taxing international income at the ‘source’ of the income in the host country or in the country of the ‘residence’ of the taxpayer, the home country. It should be remembered that all countries tax income that has been derived ‘within the geographic borders of the country levying the tax’, namely the source of the income.\textsuperscript{13} In other words, income generated within any country will be subject to income tax even if derived by non-residents. However, in terms of describing an international tax system, the levying of income tax is based on taxation at the source of the income or on the basis of the residence of the taxpayer. Taxation at source is at the foundation of a territorial system of international taxation, whereas taxation of international income based on the residence of the taxpayer is at the foundation of a worldwide system of taxation. However, in reality ‘no country uses a pure worldwide or territorial system’.\textsuperscript{14} The existence of the exemption of foreign active income from further taxation in Australia or the foreign tax credit for tax paid in the source country are aspects of a ‘territorial’ tax system.\textsuperscript{15} These aspects of international taxation are explained in detail later in the paper.

Professor Peggy Musgrave discusses the sovereign right of the nation state to tax its residents on their worldwide income and contends that the right is recognised in international law.\textsuperscript{16} Musgrave states that the right to tax the income of residents and non-residents is based on the following criteria:

\begin{itemize}
  \item \textsuperscript{13} Nancy Kaufman, ‘Fairness and the Taxation of International Income’, (1998) 29 \textit{Law and Policy in International Business} 145, 146.
  \item \textsuperscript{15} The exemptions for active income, as opposed to passive income are found in sections 23AG, 23AH and 23AJ, \textit{Income Tax Assessment Act 1936} (Cth), (ITAA 36) or the foreign tax credit, Division 770, \textit{Income Tax Assessment Act 1997} (Cth), (ITAA 97). Division 770 applies from 1 July 2008 and now refers to the foreign tax credit as a ‘foreign income tax offset’.
\end{itemize}
Residents are held to owe tax allegiance in return for the rights and privileges which they receive as residents, giving rise to what is commonly referred to as the ‘residence principle’. Exercise of this tax sovereignty over foreign source income is also necessary to achieve equitable tax treatment of resident taxpayers by making all income, wherever earned, subject to tax, consistent with the accretion principle. … What is important is that the country of residence is the residual taxing authority and thus has sovereignty over the total tax burden on the foreign-source income of its resident taxpayers.17

Professor Kaufman does not ‘agree that a taxpayer’s entire income necessarily needs to be taxed by a single country – the residence country’.18 According to Professor Kaufman, traditional international tax theory holds that a worldwide tax system based on residency and citizenship is grounded on the ‘ability-to-pay theory’ and source taxation, a territorial system, is based on a ‘benefit theory’.19 Therefore, individual taxpayers with equal incomes should pay the same amount of tax no matter where the income is derived.20 The benefit theory holds that a non-resident should contribute to the host country’s cost of government by being subject to tax at the source of the income.21 However, Kaufman rejects this view and contends that the ‘ability to pay’ and ‘benefit theory’ cannot explain the structure of the present international income tax system.22 Horizontal and vertical equity is a national tax matter concerning taxpayers of the home country. The equitable sharing of taxes either based on source or residence is an international matter. As Kaufman states, ‘equity in international taxation is an international matter’.23 Kaufman rejects the view that ‘fairness in the international tax system necessitates the adoption of a worldwide tax base and that benefit theory underlies source taxation’.24

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17 Ibid, 1337.
19 Kaufman, above n 13, 153.
20 Ibid, 153.
21 Ibid, 153.
23 Ibid.
24 Ibid, 203.
Inter-nation equity in international taxation is concerned about the sharing of tax revenue. If the host country imposes tax on income generated within its borders then the country of residence, by providing a credit for tax paid or an exemption from further tax on the income, is foregoing revenue that it could have collected. Similarly, the host country may impose higher or lower taxes than those imposed in the home country on the resident taxpayer.\(^{25}\) It is this sharing of revenue on an equitable basis that is the foundation of international tax law. The justification for the imposition of taxes based on the ability to pay principle grounded in a worldwide system or the benefit theory grounded in a territorial system is what Professor Kaufman argues is not correct, and that economic allegiance theory should be considered as a basis for inter-nation equity. In 1923, when the economic experts appointed by the League of Nations attempted to resolve the problem of sharing international taxation between two or more countries in order to eliminate double taxation, they considered the ‘economic allegiance’ theory for the sharing of taxes.\(^{26}\)

According to Professor Kaufman, the League’s economic experts considered economic allegiance to be the foundation of a nation’s competence in taxation and provides the following quotation to illustrate the point:

A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each.\(^{27}\)

Professor Kaufman concludes that there are three instances where the current international tax system provides evidence that the economic allegiance theory is at the foundation of the way in which nations share the tax revenue from international transactions. The following statement illustrates this point:

\(^{25}\) In Australia non-resident individuals are subject to higher marginal rates of personal income tax than are residents. This would appear to be at odds with a benefit theory for the imposition of tax at source because even though the non-resident receives little benefit from the host country, the host country imposes higher rates of tax.

\(^{26}\) The four economic experts appointed by the League of Nations were Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp. The document produced was the ‘Report on Double Taxation by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp’, League of Nations (1923).

\(^{27}\) Kaufman, above n 13, 196.
The first is the present international consensus on residence as the criterion for determining which country is the home country; the essence of residence is economic contacts between the country and the individual. The second is the universality of source taxation despite the condemnation of income taxes based on benefit theory. Today’s systems of source taxation are not founded on benefit theory, if indeed they ever were. Source taxation finds its justification in the economic connection between the source country and the income arising within its borders. Finally, although quite far from the original understanding of economic allegiance, the foreign tax credit and exemption from tax for foreign source income are consistent with a view that the economic connection between the host country and the income arising there gives the host country its own interest in international income.28

It would appear that any discussion on inter-nation equity in international taxation is quite distinct from equity considerations at the national level. Commentators are divided over what is the correct philosophical basis for the sharing of tax revenue between the competing states. Philosophically, worldwide taxation was grounded on a theory of ability to pay and territorial taxation was grounded on a benefit theory. Professor Kaufman argues that an economic allegiance theory should be considered as the basis for inter-nation equity and the justification for the sharing of revenue based on a worldwide system and a territorial or source based system.

There are two other issues that should be raised in this part of the paper because they are relevant to the way in which international taxation impacts on nations; first, the formula approach to the sharing of tax revenue between nations; and second, the concept of ‘tax sparing’ and its implications for the home country’s tax revenue.

6.1.2 Formula apportionment

The formula apportionment system tries to apportion the income of a taxpayer between different countries when the taxpayer is engaged in foreign transactions. For example, if a company is a resident of one country, exports components to another country to be assembled, and then sells those finished products in a third country, how is the income to be apportioned between states so that income tax can be paid on

the basis of income being sourced from the various activities? Formula apportionment is used in the US to apportion the income of corporations that do business in more than one state where state taxes apply. It is also used in apportioning shipping income on an international basis.\textsuperscript{29} Professor Kaufman notes that the Clinton Administration opposed adopting a formula apportionment system on the grounds that there would be difficulties in finding agreement between nations as to a definition of income and an agreed formula for sharing revenue.\textsuperscript{30} A formula apportionment system would overcome some of the problems of inter-nation equity but create the need for international agreement between nations and add further complexity to an already complex taxation system. It would do nothing to solve the problems of trying to detect foreign income being generated in tax havens and OFCs.

\subsection*{6.1.3 Tax sparing}

Tax sparing is the term given to a situation where one country, the host country, provides tax incentives for businesses to be established in their country and the home country gives a tax credit or exemption for income that would have been taxed at the normal rate in the host country, if it had not been for the existence of the tax incentives. For example, Country A wants to attract insurance business so instead of the company from Country B paying the normal rate of company tax, say 20 percent, it pays only 10 percent for the first 5 years. The company pays the lower rate of company tax but the home country provides a full exemption from further income tax or a tax credit at the rate of 20 percent, even though only a 10 percent rate of tax has been paid. In effect the ‘spared taxes’ are treated by the home country as having been paid. The reason why home countries agree to tax sparing arrangements are at odds with the inter-nation equity principles because the home country is foregoing a greater share of tax revenue than it would normally be required to lose. Professor Kaufman argues that the existence of tax sparing arrangements reinforces the notion that the entitlement theory is not applicable in terms of inter-nation equity.\textsuperscript{31} Kaufman sees tax sparing agreements with developing countries as ‘indicating an acceptance of a certain degree of redistribution within the international tax system’.

\begin{flushright}
\textsuperscript{29} Ibid, 200. \\
\textsuperscript{30} Ibid. \\
\textsuperscript{31} Ibid, 203.
\end{flushright}
It definitely contradicts the ability to pay, and the benefit theorists, as well as the economic allegiance approach. It is evidence of developed countries wanting to assist developing countries by encouraging businesses to expand while at the same time being prepared to accept less revenue. Peggy Musgrave made the following statement in relation to the attractiveness of tax sparing for developing countries and the investor involved in the development:

> Without tax sparing, it is argued, the revenue given up by the capital importing country is merely picked up by the treasury of the capital exporter. It is doubtful whether this is a well-founded argument when the fact of deferral is taken into consideration. … it is not wise for the capital exporting country to provide an across-the-board tax sparing agreement. Yet foreign policy considerations are likely to cause it to become widely applied when once introduced in a specific case.\(^{32}\)

The main beneficiaries from tax sparing agreements are the MNEs that establish business operations in developing countries that provide tax incentives. From an equity perspective, tax sparing contradicts notions of horizontal equity and international equity.

### 6.2 Worldwide System - Residence Taxation

Australia has adopted a worldwide system for the taxation of foreign income but provides an exemption from income tax in Australia, for some active income that has been subject to income tax at source, and a credit against income tax to be paid in Australia, for income tax paid in the source country for passive income. In effect, this is a mixture of a worldwide and territorial system of taxation which prevents the double taxation of the income, first in the source country and then again in the country of residence of the taxpayer. The use of DTAs to prevent this problem is discussed in detail below. Australian residents pay income tax on their foreign ordinary income as well as their statutory income, which includes capital gains. The taxing sections of the *Income Tax Assessment Act 1997 (Cth)*, (ITAA 97) are s 6-5

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and s 6-10. The provisions relating to statutory income derived by residents and non-residents are very similar to the sections relating to ordinary income.

6.2.1 Equity – vertical, horizontal and inter-nation

Put simply, the concept of equity holds that the rich pay more in tax than the poor, vertical equity, and, those on the same income pay the same amount in tax, horizontal equity. Over the past centuries, different forms of taxation have been imposed on different sources of income and wealth, at different rates and, in some cases, at higher rates for the wealthy than for the poor. One of the main aims of a tax system is to redistribute wealth from the rich to the poor, hence the concept of vertical equity. If tax is imposed at the same rate on the rich and poor alike, then it is considered to be contrary to vertical equity because it impacts on the poor to a greater extent than the rich. Therefore, it can be seen that a progressive rate system is crucial in achieving vertical equity, namely, that different rates of tax are imposed on different amounts of income. The Australian tax system adopts a progressive rate system for income tax and views vertical equity as being important for redistributive purposes. The concept of equity in taxation is based on the perceived need to have taxpayers contributing to revenue based on their ‘ability to pay’, as enunciated by Adam Smith or, as expanded by J.S. Mill, the ‘equal sacrifice principle’. Those with more income should pay more and those with less should pay less. The best advocate of vertical and horizontal equity is Professor Richard Musgrave. Musgrave states that Adam Smith ‘can be seen as an ability-to-pay theorist’ and with a mix of benefit components. In other words, Smith viewed the payment of taxes as being in proportion to the benefits being obtained from the state. According to Musgrave, J.S. Mill then:

33 Sub-section 6-5(2) - If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year. Sub-section 6-5(3) - If you are not an Australian resident, your assessable income includes: the ordinary income you derived directly or indirectly from all Australian sources during the income year.

34 Sub-section 6-10(1) - Your assessable income also includes some amounts that are not ordinary income. Sub-section 6-10(2) - Amounts that are not ordinary income, but are included in your assessable income by provisions about assessable income, are called statutory income. Sub-section 6-10(4) - If you are an Australian resident, your assessable income includes your statutory income from all sources, whether in or out of Australia. Sub-section 6-10(5) - If you are not an Australian resident, your assessable income includes your statutory income from all Australian sources.

35 Commonwealth of Australia, above n 12, 180.

separated the analysis of tax equity from the expenditure side of the budget … Mill then translated equal ability into equal sacrifice terms. Fairness, according to Mill, required tax differentials which impose equal absolute sacrifice across unequal incomes.37

In terms of a worldwide tax system, vertical equity requires all taxpayers in Australia to pay income tax at different rates based on their total income and their ‘ability to pay’ in a progressive rate system. Unless foreign sourced income is included in assessable income, at least two inequitable consequences would follow; first, the burden of tax would fall on those taxpayers unable to move capital offshore; and second, there would be an even greater incentive to earn foreign sourced income. This is one of the main reasons why a worldwide system is seen as being better than a territorial system because, with a territorial system, foreign sourced income is not subject to income tax in the home state. What then is the situation with horizontal equity under a worldwide system? Horizontal equity requires all taxpayers earning the same level of income to pay the same amount of income tax. Richard and Peggy Musgrave contend that horizontal equity is linked to vertical equity. The following statement by Richard Musgrave sums up the position perfectly:

The call for equity in taxation is generally taken to include a rule of horizontal equity (HE), requiring equal treatment of equals, and one of vertical equity (VE), calling for an appropriate differentiation among unequals. HE appears non-controversial. Not only does it offer protection against arbitrary discrimination but it also reflects the basic principle of equal worth. The United States Constitution provides for ‘equal protection under the law’.38

Richard Musgrave acknowledges that ‘vertical equity … is inherently controversial. An appropriate pattern of differentiation must be chosen but people will disagree on its shape’.39 He goes on to hold that ‘horizontal equity appears non-controversial’. This view is endorsed by Henry Simons, of the Haig-Simons definition of income, who states that ‘it is generally agreed that taxes should bear similarly upon all people

37 Ibid, 115.
38 Ibid, 113.
39 Ibid.
in similar circumstances’. Proponents of a worldwide tax system contend that horizontal equity is safeguarded under that system because all taxpayers must include foreign income in their taxable income, based on their residency, and pay the same rate of tax on that income. As well, horizontal equity is further enhanced because a system of foreign tax credits or exemptions ensures that the taxpayer does not pay more tax in their country of residence just because they include foreign sourced income.

The issue of the source country imposing taxes on income generated by non-residents raises the concept of inter-nation equity. The country of source and the country of residence must agree on the share of taxes each country will claim. The source country is entitled to tax the income of the non-resident ‘in line with the benefits provided by government services in generating that income’. On this basis, the source country imposes a withholding tax on interest, dividends or royalties paid to a non-resident on their income from passive activities. An interesting example of differences with withholding tax rates is found in the exemption provided by the US, UK and Australia with interest withholding tax for payments from Australia to banks in the UK and the US. Income from business activity is taxed at source on the basis of the non-resident having a ‘permanent establishment’ in that country and the income is subject to the higher rates of tax than the withholding tax rates. The standard of inter-nation equity is a responsibility of the source country whereas taxpayer equity is a responsibility of the residence country.

6.2.2 Efficiency

The concept of capital neutrality is fundamental to having an international tax system that is efficient. The concept of ‘neutrality’ holds that the tax law should have no effect on behaviour and, in this situation, in relation to the choice of location where capital is to be invested. In order to achieve efficiency in international taxation, two

40 Ibid, 113
41 Joint Committee on Taxation, above n 14, 3.
42 Musgrave, above n 32, 279 and 282.
43 As a result of the Australia-US free trade agreement, Australia exempted interest withholding tax of 10% needing to be paid to banks in the US and UK.
44 Musgrave, above n 32, 281.
types of neutrality are regarded as being crucial to that goal, capital export neutrality (CEN) and capital import neutrality (CIN).\textsuperscript{45} Under an efficient international tax system, CEN requires the taxpayer to be neutral about domestic or foreign investment because both should provide the same pre-tax rate of return. As Professor Graetz states, ‘economists regard CEN as essential for worldwide economic efficiency, because the location of investments will be unaffected by capital income taxes’.\textsuperscript{46} For CEN to work, the country of source should not impose any source-based taxes, only the country of residence. The CEN concept has been adjusted in practice to allow for source based taxes but with a credit for those taxes being given in the country of residence.\textsuperscript{47}

This is similar to the current situation in Australia and many other OECD member countries that allow a credit for tax paid by their residents in the source country. It is usually passive income that is subject to a form of withholding tax at source and a credit given for those taxes that have been paid.\textsuperscript{48}

The other kind of neutrality is CIN, which ‘requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor’.\textsuperscript{49} According to Professor Graetz, ‘if CIN holds, all savers, regardless of their residence, receive the same after-tax returns’.\textsuperscript{50} CIN is said to support taxation only by the source country, with the country of residence exempting foreign source income from further taxation.\textsuperscript{51} This is the situation with active or business income being generated by an Australian resident in a foreign country with a full exemption being given for the income that has been subject to income tax at a comparable rate in the foreign country.\textsuperscript{52} However, it should be remembered that the US does not provide an exemption for active income generated by its own residents in a foreign

\begin{thebibliography}{9}
\bibitem{46} Ibid, 270.
\bibitem{47} Ibid, 271.
\bibitem{48} Division 770, ITAA 97.
\bibitem{49} Graetz, Michael, above n 45, 270
\bibitem{50} Ibid, 271.
\bibitem{51} Ibid.
\bibitem{52} Sections 23AH and 23 AJ, ITAA 36.
\end{thebibliography}
country that has been subject to income tax at source. The current situation is aptly summarised by the following passage by Professor Graetz:

Thus, policy discussion of international income tax policy is now dominated by a simple matrix, where capital export neutrality and capital import neutrality generally constitute the normative universe. Implementing these policies requires respectively, worldwide taxation with a foreign tax credit or ‘territorial’ taxation with foreign earnings exempt from tax. In theory, CEN gives the prime claim to tax international income to the country of residence and CIN awards that right to the country of source.\(^5\)

Professor Graetz then states that it is ‘impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations’.\(^5\) This means that governments must either choose a worldwide or territorial system for the taxation of foreign income in order to achieve efficiency in the tax system. Professor Graetz uses the following three principles to illustrate the ‘irreconcilable conflict’ between residence and sourced based taxation of income:

**Principle 1:** People should pay equal taxes on their income regardless of the country that is the source of that income. In particular U.S. taxpayers should be treated equally regardless of the source of their income.

**Principle 2:** All investments in the United States should face the same burden regardless of whether a U.S. person or foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.

**Principle 3:** Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.

The essential difficulty is that the first two principles can hold simultaneously only when capital income is taxed at the same rate in all countries. This requires identical tax systems, including identical tax rates, tax bases and choices between source-and

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\(^5\) Graetz, Michael, above n 45, 271.

\(^5\) Ibid, 272.
residence-based taxation. That has never happened, and it never will. Moreover, there would be no way to keep such a system in place without violating Principle 3.\(^{55}\)

These principles outline the problem facing any government in trying to achieve equity in an international taxation system and, at the same time, trying to achieve efficiency. Both a residence and sourced based system have difficulty in achieving efficiency when most countries have different rates of income tax. The simple answer in deciding on the most efficient system to use is to adopt the system used in Australia; a hybrid system with a mixture of a worldwide and territorial system that allows for a credit for foreign taxes paid and an exemption from further income tax on the resident taxpayer for active income. In recent years many countries have adopted a hybrid exemption system and more than half of the OECD member countries have adopted such a system.\(^{56}\)

### 6.2.3 Permanent establishment – active v. passive income

Professor Avi-Yonah contends that in 1923 when the League of Nations was trying to resolve the problem of double taxation, it came to the conclusion that the ultimate goal underlying the international tax regime is that active business income is taxed in the source country in which it originates and that passive income should be taxed in the country in which the recipient resides.\(^{57}\)

This can be extended to reflect that income from investments should be subject to some limited form of taxation in the source country but greater tax in the home country, namely the country of residence. The distinction between passive and active business income is reflected in the double tax treaties by use of the permanent establishment concept. The basis on which income tax is imposed on non-resident business taxpayers is the concept of having a ‘permanent establishment’ (PE) in that country. The distinction between passive and active income by the use of a PE is a compromise, according to Professor Avi-Yonah, because the threshold of what

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\(^{55}\) Ibid, and footnote 12.  
\(^{56}\) Fleming, above n 4, 37.  
constitutes a PE is quite low; a single office, or even a single agent with authority to conclude sales, is generally sufficient.\(^{58}\) Taxation of passive income in the country of source still exists but at very low rates of tax. The OECD Model Income Tax Treaty recommends that dividends be subject to withholding rates of tax of between 5 percent and 15 percent, interest at 10 percent and royalties 0 percent.\(^ {59}\) Professor Avi-Yonah holds that the low tax rates imposed by the source country are a compromise between the source country’s levying some tax but at the same time acknowledging that the country of residence should be the primary taxing authority.\(^ {60}\)

However, according to Professor Graetz, the PE concept is ‘facing new pressure from electronic commerce, new financial techniques, and new forms of business arrangements and combinations’.\(^ {61}\) He strongly advocates a modernisation of the permanent concept, possibly based on a threshold amount of sales, assets, labour or research and development within a nation.\(^ {62}\) The threat of reduced tax revenue from e-commerce was discussed by Professor Cheung when examining the challenges facing Hong Kong with its territorial tax system.\(^ {63}\) Because Hong Kong only taxes income based on its geography, e-commerce threatens future tax revenue to a far greater extent than a tax system based on the residence of the taxpayer.\(^ {64}\)

### 6.2.4 Active v. passive income – exemption or credit

Australia already provides relief from double taxation in the form of exemptions of certain active income; s 23AG\(^{65}\) for limited situations where personal services

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\(^{58}\) Ibid, 1307.

\(^{59}\) Ibid, 1308. In Australia the withholding rates are different depending on whether or not the dividends are carrying imputation credits, and if so, then the non-resident shareholder is subject to withholding tax to the extent the dividend is unfranked up to a maximum rate of tax of 15%. Interest is subject to 10% withholding tax unless paid to a ‘bank’ in the UK or US and then 0% applies. Royalties are subject to 5% in the case of a US resident owner of the IP or 15% for any other non-resident.

\(^{60}\) Ibid, 1308.

\(^{61}\) Graetz, Michael, above n 45, 261 and 319.

\(^{62}\) Ibid, 319.


\(^{64}\) Ibid.

\(^{65}\) Section 23AG was amended effective from 1 July 2009, Tax Laws Amendment (2009 Budget Measures No 1) Bill 2009, and only provides an exemption for relief workers and defence force personnel.
income is derived in a foreign country; s 23AH for branch income derived in certain foreign countries; and, s 23AJ exempts non-portfolio dividend income paid by a foreign company. It is important to note that the US does not provide an exemption for active business income for its resident companies and this issue has become an important consideration for the US government, especially as US corporations are claiming that they are not as competitive as other MNEs.\textsuperscript{66} If these exemptions already apply, why try to impose income tax on worldwide income and be concerned with tax havens? Australia also provides a credit for foreign tax paid on passive foreign sourced income so, again in many instances, no more income tax is paid in Australia.

A credit given by the home country for income tax paid in a foreign country is not as effective as the exemption method. Division 770 of the ITAA 97 applies from 1 July 2008 and now refers to the foreign tax credit as a ‘foreign income tax offset’. Philip Bender has highlighted one of the potential defects of the new foreign tax credit arrangements. When active business income is repatriated to Australia that is exempt, it carries no imputation credits from the foreign tax that has been paid. So, while the income is not subject to double taxation, it is subsequently taxed in the hands of the Australian resident shareholders when they receive a dividend.\textsuperscript{67} The solution may be to only impose income tax on a territorial basis and not be concerned with income derived in foreign countries. Or, the Australian government could adopt a derived and remitted system where only income remitted back to Australia is subject to income tax but this may act as a disincentive to repatriate profits to the home country.

\textbf{6.2.5 Anti-deferral measures - the Accruals System – the CFC, FIF and Transferor-Trust Provisions}

In 1991, Australia introduced anti-tax deferral legislation to impose income tax on Controlled Foreign Corporations (CFCs) and Foreign Investment Funds (FIFs) by

\textsuperscript{66} For more detail see Joint Committee on Taxation (US), above n 14 and Graetz, above n 45.

\textsuperscript{67} Philip Bender, ‘Foreign Tax Credits and Overseas Investment: More Reform Necessary?’, (2008) 37 \textit{Australian Tax Review}, 38.
'attributing' to Australian taxpayers income perceived to have been generated in a tax haven or low taxing country. At the same time, the government introduced measures to prevent foreign trusts and foreign beneficiaries being used to avoid income tax in Australia. Those anti-avoidance and anti-deferral rules of taxation law have not worked well. As Professor Burns states, the 'legislation enacting these regimes is among the most detailed and complex tax legislation in Australia. … It is argued that the design does not adequately take account of the nature of the global economy today.' If Australia adopted a territorial basis of taxation then these anti-avoidance provisions would not be required, resulting in a reduction of complexity in the existing taxation law. The issue of the severe complexity of the Australian taxation law and the urgent need for reform has been discussed above and the fact that one way in which complexity can be resolved is to adopt a territorial basis of taxation. Under a territorial system, there is no need to have CFC, FIF and transferor-trust provisions, as foreign sourced income would not be subject to income tax in the home country.

The third criterion for determining an appropriate tax system is whether or not the laws and rules are simple to apply and administer and to be understood by taxpayers, both resident and non-resident.

6.2.6 Simplicity

According to Fleming et al, territorial systems are not simple but are simpler than a worldwide system. Other commentators have also expressed the view that a territorial system is less complex that a worldwide system, due largely to the anti-avoidance and anti-deferral measures contained in such a system. One simple way in which the existing taxation system in Australia could be made less complex would be to introduce a territorial basis of taxation.

70 Fleming, above n 4, 39.
71 Joint Committee on Taxation, above n 14, 5.
A complex system is perceived to lead to tax evasion and tax avoidance because of the wealthy being able to obtain advice on how to take advantage of the complexities in the law. The current review of the Australian tax system has noted that the income tax law contained in the various statutes is now 5,743 pages, up from 526 pages in 1975 when the ‘Asprey’ report on the review of the tax system was produced. The Business Council of Australia and the Corporate Tax Association released a report in 2007 on measures to reduce compliance costs on business and found that those businesses had to deal with 21 Australian Government taxes, 33 State taxes and 2 Local Government taxes. It was noted that this was more than twice the number of taxes effecting businesses in the United Kingdom. There are two issues that require examination under this heading; first, the actual cost of collecting taxes and the resources from both the public and private sectors that are involved in this process; and second, the implications for society when the law becomes extremely complex to understand and be applied by taxpayers which may lead to an erosion of the ‘rule of law’.

6.2.7 The practical problems of detecting income in a tax haven

The Australian Government has recently funded ‘Operation Wickenby’, a multi-agency task force investigating tax avoidance and tax evasion involving the use of offshore entities. The task force comprises the Australian Taxation Office (ATO), the Australian Crime Commission (ACC) and the Australian Federal Police (AFP). The budget for a five year period is around $300 million and the Commissioner of Taxation estimates that the revenue recovered will be over $300 million. According to the ATO, Project ‘Wickenby’ investigations have so far also resulted in:

- 23 criminal investigations
- 28 people charged on indictable offences
- 249 completed tax audits (and a further 352 underway)

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73 The Report on ‘Commonwealth Taxation Review Committee (Asprey Committee) (1975) looked at the Australian tax system in terms of equity, efficiency and simplicity as well as the need to broaden the tax base that existed in Australia at that time.

74 Commonwealth of Australia, above n 11, 305.


76 Thomson ATP Weekly Tax bulletin, 23 February 2007, [para 285].
$207.16 million in tax liabilities raised

$79.06 million in tax collected (as well as $70.7 million in improved compliance by people reviewed under Project Wickenby)

$75.7 million worth of assets restrained.

A further two individuals have pleaded guilty to tax fraud and money laundering charges in relation to Vanuatu based schemes.\textsuperscript{77}

If the ATO has not recovered in excess of $420 million within the eight year period then the question will be asked, why go to this trouble and expense when the cost of recovery of income tax exceeds the amount of income tax actually recovered? The simple solution is to only impose income tax on income derived from sources in Australia by Australian residents and impose income tax on foreign income remitted to Australia by Australian residents. In addition, many countries, including Australia, are facing the problem of ‘international tax arbitrage’. International tax arbitrage has been described by Professor Rosenzweig as arising when:

\begin{quote}
[a] taxpayer can structure a transaction so as to technically comply with the laws of two or more jurisdictions while at the same time reducing their total worldwide tax liability as compared with what the taxpayer would have paid if only one jurisdiction had exercised its taxing authority.\textsuperscript{78}
\end{quote}

This is similar to situations that arise with countries that impose income tax on a territorial basis where a structure is used to derive income in another jurisdiction by artificial means so that it is not construed to have been derived in the home country. As a result of the fact that it is very difficult for the ATO to ascertain the existence of income being generated by Australian taxpayers in a tax haven or OFC, should the Australian Government therefore consider the merits of adopting the ‘territorial approach’ to the imposition of income tax on the foreign sourced income of Australian residents?\textsuperscript{79}


\textsuperscript{78} Adam Rosenzweig, ‘Harnessing the costs of international arbitrage’, (2007) 26 Virginia Tax Review 555.

\textsuperscript{79} The territorial basis of imposing income tax is to only tax income sourced within the country or territory. This means that income generated by a resident taxpayer out of the territory is not subject to income tax in the home country. This is the situation in Hong Kong, Malaysia, Philippines and Singapore, Australia’s nearest neighbours.
6.3 Territorial System - Source Taxation

Under a ‘territorial system’ of taxation, income tax is only imposed on income derived within the territory and this system is known as a pure ‘territorial system’ of taxation. Hong Kong is one of the few remaining countries with a territorial system and is the best example so will be used throughout this section of the paper to illustrate the advantages and disadvantages of a territorial system of taxation. Up until 1 January 2001, South Africa also used a source based system of income tax but changed to a worldwide system.\footnote{Trevor Manuel, Minister of Finance, Budget Speech, Republic of South Africa, 23 February 2000, <www.finance.gov.za/> at 20 August 2009.} The Minister of Finance, Trevor Manuel stated that a sourced based system was out of line with international practices and permitted tax avoidance by allowing income to be structured as ‘foreign sourced’ and that this was one of the main reasons for changing to a worldwide system.\footnote{Ibid, 19.} Other countries, including Singapore\footnote{From 1 January 2003 Singapore has adopted a ‘one tier system’ for resident companies whereby all dividends paid to shareholders are exempt from tax and a partial exemption for foreign ‘active’ business income. See Kah Chuan Ho, ‘The Exemption Regime for Foreign-Source Business Income – An International Comparison’, (2008) Asia-Pacific Tax Bulletin 118, 120. See also Andrew Halkyard and Stephen Phua, ‘Common Law Heritage and Statutory Diversion – Taxation of Income in Singapore and Hong Kong’, (2007) Singapore Journal of Legal Studies 1, 15.} and Malaysia, have a hybrid territorial system which only imposes income tax on income that is sourced in their country and some categories of remitted foreign source income. This is commonly referred to as a ‘derived and remittance’ basis of a territorial system. Moreover, Australia, New Zealand and Canada had a territorial system of taxation up until the first few decades of the twentieth century due to the fact that the tax law was based on statutory law developed in the UK and applied in the colonies.\footnote{Michael Littlewood, ‘How Simple can Tax Law be?: The Instructive Case of Hong Kong’, (2005) 1( 2) Journal of the Australasian Tax Teachers Association 259, 280.}

One of the major criticisms of those advocating a territorial system is that if a country that was currently using a worldwide system changed to a territorial system, then businesses and investment would move to a low or no tax country. There would be a flight of capital and business activity and, with it, employment and technology. A worldwide system is seen as protecting the residence country’s tax base more effectively than a territorial system.\footnote{Joint Committee on Taxation, above n 14, 4.} On the other hand, a territorial system would
make MNEs, currently a resident of say Australia, more competitive in a global environment because they would not need to worry about paying income tax on their foreign sourced income in situations where there is no exemption, either because it is passive income or the source country is not a listed country with comparable tax rates. This is more important for companies resident in the US where there is no exemption system, only a tax credit for foreign paid taxes. Professor Green claims that ‘sourced based taxation is difficult to justify on theoretical grounds’. Green makes this statement on the basis that it is hard to reconcile with an ‘ability to pay theory’ and the cost to government. Presumably he means that ability to pay and the benefits theory cannot be reconciled. There is no argument with that finding but the Professor Kaufman approach, as discussed above, based on the economic allegiance theory, may provide a solution. Professor Green then suggests that in order to prevent income shifting by MNEs and tax competition, an international acceptance of a worldwide system would be the best solution. Fleming et al do not advocate the adoption of a territorial system in the US but suggest ways to remedy the defects in the US worldwide system.

6.3.1 Equity – vertical and horizontal

The major impact on equity within a territorial system is that taxpayers only pay income tax on their income generated within their own country of residence and their foreign income is not subject to income tax, other than taxes imposed by the source country such as withholding tax on passive income or normal taxes on active business income on the basis of having a permanent establishment (PE). This means that the concept of horizontal equity has no meaning because not all taxpayers deriving the same income pay the same amount of income tax. Similarly, the imposition of progressive rates of tax does not achieve a distributional effect because some taxpayers are only paying tax on a portion of their total income, namely, income derived in their home country. From an equity perspective, a territorial system fails to achieve either horizontal or vertical equity. The same reasoning

85 Fleming et al, above n 4, 39.
87 Ibid, 70 and 86.
88 Fleming, above n 4, 40.
applies when applying a fairness test of ‘ability to pay’ because income derived out of the territory is not taken into account. This is why a territorial system is based on a ‘benefits rule’, in that the non-resident of the source country is levied on their source income on the basis that they have derived benefits from the host country. Kaufman contends that source taxation, a territorial system, is out of favour with commentators because the ‘ability-to-pay’ theory has supplanted the ‘benefit’ theory. This statement is reinforced by Michael Littlewood when commenting on the Hong Kong taxation system. He contends that the tax system is inherently inequitable due to the rampant tax avoidance and evasion but with the poorest two-thirds of the workforce exempt from tax altogether, it is not necessary to try to ‘achieve equity among this part of the workforce’. In terms of the remaining third of taxpayers, Littlewood is of the view that the inequality is considerable given the fact that, under the Hong Kong tax system, no income tax is paid on interest, offshore income and employee perquisites, such as employer provided housing and motor vehicles. However, according to Littlewood, people do not complain about the inequality due to the very low rates of tax, namely 16 per cent. However, given the extent of the poverty and deplorable living conditions for a substantial part of the population in Hong Kong, the tax system is, arguably, failing to achieve vertical and horizontal equity by not collecting sufficient revenue from those with the ability to pay and providing the requisite level of welfare.

In conclusion, a territorial system, as illustrated by the example of Hong Kong, clearly proves that a worldwide system satisfies vertical and horizontal equity better than a territorial system.

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89 Kaufman, Nancy, above n 13, 183.
90 Ibid.
92 Ibid, 287.
93 Ibid.
94 Ibid, 288.
6.3.2 Efficiency

It is in the area of efficiency that a territorial system has substantial advantages over a worldwide system. A territorial system ‘treats all investment within a particular country, the source country, the same, regardless of the residence of the investor’.\(^{96}\) This efficiency norm is referred to capital import neutrality (CIN), which is seen as favouring competitiveness between MNEs. In other words, source countries with a territorial system are indifferent as to the tax rates that apply in the capital importing country because that income will not be taxed in the source country. The investment decision is neutral from the perspective of the taxpayer in a territorial system and the government of that state. If the tax rates in the capital importing nation are lower than the home country, then the taxpayer obtains the benefit. However, if the capital is imported to a low taxing country and the taxpayer is a resident of a country with a worldwide system, then the taxpayer obtains no advantage in taxation with their own home country. In the case of US MNEs, they claim that they are at a competitive disadvantage because they are not able to claim an exemption from tax from their home country, merely a credit for tax paid at source. However, Australian MNEs do obtain the benefit of an exemption for active business income and non-portfolio dividends in some cases so they are not disadvantaged. In the situation with Australian MNEs exporting capital, they would hold that CIN is a measure of efficiency when investing in foreign countries because the home country provides an exemption or credit for tax paid. The Australian MNE is able to obtain the efficiency advantages because of the exemption from tax on active income that has the result of placing the MNE in the same position as that of an MNE in a territorial system home country.

Professor McDaniel disagrees with the contention that, from an efficiency perspective, tax planning by lawyers and accountants is wasteful and that, under a worldwide system, the tax planning is more complex and, hence, more wasteful. His view is that sophisticated and complex tax planning to reduce the burden of tax would not change if the MNEs operated in a territorial system. He contends that the

\(^{96}\) Joint Committee on Taxation, above n 14, 5.
US tax culture is such that just as much effort would be exerted in reducing the tax burden in the US.\(^7\)

### 6.3.3 Simplicity

A territorial system is seen as being less complex than a worldwide system because it does not need the anti-deferral regimes or the tax credit provisions which are ‘two of the most complex features of a worldwide system’.\(^8\) This contention has been totally rejected by Professor Paul McDaniel and he argues that the complexity in a worldwide system should also be present in a territorial system.\(^9\) He contends that source of income rules, transfer pricing rules and the use of tax havens all impact on the complexity of taxation laws in a territorial tax system to the same extent as they do in a worldwide system.\(^10\) It could be claimed that, from an administrative perspective, a territorial system would not require vast amounts or money to be spent on trying to detect foreign income being derived by its residents and trying to obtain the cooperation of many nations in exchanging information about foreign investors. The perfect example of the resources required in tracking foreign investments by high-net-worth individuals or the activities of MNEs engaging in transfer pricing or profit shifting through interposed entities can be found in Australia with ‘Operation Wickenby’. However, tax avoidance and tax evasion is a problem for tax administrators in a territorial system in the same way it is in a worldwide system.

### 6.3.4 Tax avoidance and tax evasion

Using Hong Kong as the example of a pure territorial system, it is evident that tax avoidance and tax evasion occurs because income can be structured as being derived from a ‘foreign source’ and not from within the territory. In Hong Kong, the Inland Revenue Ordinance contains an anti-avoidance rule which is based on the Australian and New Zealand rules.\(^11\) However, according to Michael Littlewood, the Hong Kong approach is unique as the law has also adopted the ‘Ramsay Principle’ as


\(^8\) Joint Committee on Taxation, n 14, 5.

\(^9\) Paul McDaniel, above n 97, 291.

\(^10\) Ibid, 292-296.

\(^11\) Michael Littlewood, above n 95, 267.
enunciated by the House of Lords in that case.\footnote{102} The Ramsay Principle is an approach to statutory interpretation based on the concept of ‘fiscal nullity’.\footnote{103} In other words, transactions are entered into between parties where there is no commercial business effect other than to achieve an avoidance of tax. However, Hong Kong appears to have rarely used its few anti-avoidance rules in the same way as Australia and New Zealand have done and, as Littlewood states, the lack of the number of specific and general anti-avoidance rules has reduced the complexity of the tax law in that country.\footnote{104} The tax authorities in Singapore are facing the prospect of greater tax avoidance and tax evasion as a result of increasing their Goods and Services Tax to a rate of 7 percent, up from 3 percent. Halkyard and Phua contend that this increase will see a greater rise in the use of cash within the black economy.\footnote{105}

### 6.3.5 Examples of territorial systems - Singapore, Malaysia and Hong Kong

In Singapore, the basis of levying income tax on the residents of Singapore is only on income derived in Singapore or income remitted to Singapore. The *Income Tax Act* (*Cap 134*) section 10(1) states that ‘[i] income tax shall … be payable at the rate or rates specified … for each year of assessment upon the income of any person accruing in or derived from Singapore or received in Singapore from outside Singapore in respect of - (a) gains or profits from business … (b) gains or profits from employment; (c) dividends, interest or discounts …’.

In Malaysia, the imposition of income tax on residents of Malaysia is similar to Singapore. The *Income Tax Act 1967 (Act 53)*, section 3 states that ‘… a tax to be known as income tax shall be charged each year of assessment upon the income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia’. The Malaysian statute, Schedule 6, Part 1 contains a list of

\footnote{102} Ibid. *WT Ramsay v IRC* [1982] AC 300.
\footnote{103} For a detailed discussion on this case and the concept of fiscal nullity see, Philip Burgess, Graeme Cooper, Richard Krever, et al, *Cooper, Krever & Vann’s Income Taxation Commentary and Materials* (6th ed, 2009), 1079.
\footnote{104} Littlewood, above n 95, 268.
income which is exempt from income tax. The list specifically exempts the ‘income of any person … derived from sources outside Malaysia and received in Malaysia’.

In Hong Kong, the Inland Revenue Ordinance (Chapter 112) imposes tax, under a scheduler system,\(^{106}\) on rental income from property, section 5; on salaries from employment, section 8; and on business profits, section 14. In all of the three separate taxes, the key wording in the sections is that tax shall only be charged on property, salaries and profits ‘situated in; arising in or derived from Hong Kong’. This means that there is no general tax on income but, rather, a tax on three different kinds of income from specific activities.\(^{107}\) The definition of ‘profits arising in or derived from Hong Kong’ is defined, pursuant to section 2, as ‘for the purposes of Part IV shall, … include all profits from business transacted in Hong Kong, whether directly or through an agent’. The issue of determining the extent to which a profit ‘has arisen or is derived from Hong Kong’ has created a unique situation under the Hong Kong territorial tax system. Littlewood discusses this issue in detail and the fact that the current judicial interpretation of the statutory law is that a Hong Kong business must show that they have a branch, similar to a PE, in another jurisdiction or they fall within a ‘rare case’ principle before the income can be said to have originated outside Hong Kong.\(^{108}\)

These three states do not need to have elaborate bureaucracies in place to try to ascertain the income of their residents that are derived in other countries, such as tax havens. Moreover, the statutory law is contained in legislation that is a fraction of the size of the Australian Income Tax Assessment Acts, 1936 and 1997. However, these countries do have anti-avoidance rules but they do not have complex anti-deferral provisions similar to the CFC and FIF provisions used by Australia and other OECD member countries that tax on a worldwide basis.

\(^{106}\) A scheduler system of taxation imposes a different rate of tax, in some cases at progressive rates, on salaries, property and profits. In Australia the scheduler system was abolished in 1953 and was reintroduced for one year only in 1974.

\(^{107}\) Littlewood, above n 95, 258. If an individual elects to be assessed on their total income from all three schedules then in effect a general income tax operates.

\(^{108}\) Ibid, 266.
6.4  Developments in Attracting Capital and Labour in Australia and New Zealand

This part of the paper discusses two examples of relatively new changes to the taxation law in both Australia and New Zealand, which adopt a ‘territorial basis’ of taxation for certain taxpayers living in either country. These two examples are included in this paper because they do support the overall contention that Australia could adopt a territorial system of taxation, as is the case with temporary residents in Australia or new migrants or returning New Zealand citizens to New Zealand.

6.4.1 Taxation of temporary residents in Australia

Two very important changes to the existing income tax law, that have very favourable implications for non-residents working in Australia or investing in Australia, have been introduced by the government. Some commentators have gone so far as to suggest that Australia is now a confirmed ‘tax haven’ as a result of these changes.\(^\text{109}\) The UK, Singapore and Japan have already introduced taxation laws to provide tax concessions for ‘temporary residents’, so Australia is now trying to catch up with other countries that are competing for foreign investment and foreign labour.\(^\text{110}\)

The first change relates to ‘temporary residents’ that have temporary visas for work purposes and how that impacts on their non-Australian sourced income. Under the law, a temporary resident will only be liable to income tax on their Australian sourced employment or services income and not their worldwide income, even though they live and work in Australia and may not be a resident of any other country for income tax purposes. This means that income generated from non-Australian sources, including capital gains, may not be subject to income tax anywhere, especially if they take advantage of a tax haven to hold their foreign capital and investments. There are no tax implications in Australia if the temporary resident remits all of the foreign source income to Australia for their use while living in Australia.


The second change in the tax law relates to non-residents and the narrowing of the range of assets that will be subject to income tax under the capital gains tax regime. The new law only imposes income tax on capital gains made from real property or other assets being used in a business being conducted through a permanent establishment in Australia. The term ‘permanent establishment’\(^{111}\) takes its meaning from s 23AH, ITAA 36 where a Double Tax Agreement applies or, if no DTA, then the definition under s 6(1), ITAA 36.\(^{112}\) The definition of a permanent establishment referred to in s 23AH is the definition contained in the DTA which is based on the OECD Model. The definition in s 6(1), ITAA 36 is broader and more descriptive than the definition contained in the DTA.

### 6.4.2 Temporary residents – no income tax on foreign source income

The law took effect from 1 July 2006 and is contained in Division 768, ITAA 97. Section 768-900 provides that ‘this Subdivision modifies the general tax rules for people in Australia who are temporary residents, whether Australian residents or foreign residents’. Generally, foreign income derived by temporary residents is non-assessable non-exempt income and capital gains and losses they make are also disregarded for CGT purposes. There are some exceptions for employment-related income and capital gains on shares and rights acquired under employee share schemes. Temporary residents are also partly relieved of record-keeping obligations in relation to the controlled foreign company and foreign investment fund rules. Interest paid by temporary residents is not subject to withholding tax and may be non-assessable non-exempt income for a foreign resident.

Section 768-910 prescribes the way in which income derived by a non-resident is treated for income tax purposes. The following income is non-assessable non-exempt income (NANE):

(a) the ordinary income you derive directly or indirectly from a source other than an Australian source if you are a temporary resident when you derive it;

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\(^{111}\) ‘Permanent establishment’ is defined in the OECD Model Convention on Double Tax Agreements as ‘a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, quarry or any other place of extraction of natural resources’.

\(^{112}\) Explanatory Memorandum, Tax Laws Amendment (2006 Measures No. 4) Bill 2006, 55.
(b) your statutory income (other than a net capital gain) from a source other than an Australian source if you are a temporary resident when you derive it.

This subsection has effect subject to subsections (3) and (5).

Section 768-915 provides that certain capital gains and capital losses of temporary resident are to be disregarded. Section 768-915 states that ‘a capital gain or capital loss you make from a CGT event is disregarded if:

(a) you are a temporary resident when, or immediately before, the CGT event happens; and

(b) you would not make a capital gain or loss from the CGT event if you were a foreign resident when, or immediately before, the CGT event happens.’

### 6.4.3 Who is a temporary resident?

The major question is who is a ‘temporary resident’ for the purposes of obtaining this tax concession? Section 995-1, ITAA 97 provides the definition of a ‘temporary resident’. ‘A person is a temporary resident if:

(a) They hold a temporary visa granted under the Migration Act 1958; and

(b) They are not an Australian resident within the meaning of the Social Security Act 1991; and

(c) Their spouse is not an Australian resident within the meaning of the Social Security Act 1991.

However, they are not a temporary resident if they have been an Australian resident (within the meaning of this Act), and any of paragraphs (a), (b) and (c) are not satisfied, at any time after the commencement of this definition. The tests in paragraphs (b) and (c) are applied to ensure that holders of temporary visas who nonetheless have a significant connection with Australia are not treated as temporary residents for the purposes of this Act.

This definition would therefore exclude any Australian citizen returning to Australia after having worked in a foreign country for a considerable length of time. This tax concession differs from the New Zealand tax concession in that New Zealand provides an incentive for New Zealand citizens to return to New Zealand if they have been away for more than 15 years. It is a missed opportunity for the government of
Australia to provide an incentive for Australian citizens to return to Australia and to be able to bring their wealth and experience without paying income tax on their foreign earnings. If the former Australian resident had considerable wealth from foreign investments, then they would not be able to take advantage of these provisions to avoid income tax on those investments, namely their worldwide income. However, ‘temporary residents’ are treated more like non-residents and the new tax concessions impose no income tax on foreign sourced income. This applies even if they have a controlled foreign corporation (CFC) or a foreign investment fund (FIF). The country that misses out on tax revenue is the home country of the temporary resident because all of their investments can be located in a tax haven where no income tax is paid.

6.4.4 Non-resident investors - no income tax on capital gains

The Taxation Laws Amendment (2006 Measures No.4) Act 2006 introduced new measures to overcome disincentives for foreign investors to invest in a range of non-real-property investments. The old law, as contained in s 136-25, ITAA 97, states that non-resident owners of assets that have the ‘necessary connection’ with Australia will be subject to income tax on their capital gain, statutory income pursuant to s 6-10, ITAA 97. Under the old law, s 136-25 provided that ‘an asset has the necessary connection with Australia’ in the nine categories of CGT assets. The

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1. Land, or a building or structure, in Australia; an interest in land in Australia, or a right, power or privilege to do with land in Australia; a stratum unit in Australia, or an interest in a stratum unit in Australia; a share in a company that owns a building on land in Australia that gives you a right to occupy a flat or home unit in the building,

2. A CGT asset that was used at any time in carrying on a business through a permanent establishment in Australia,

3. A share, or an interest in a share, in a company that is an Australian resident, and a private company, for the income year in which the CGT event happens,

4. An interest in a trust that is a resident trust for CGT purposes for the income year in which the CGT event happens,

5. A share, or an interest in a share, in a company:
   (a) that is an Australian resident, and a public company, for the income year in which the CGT event happens; and
   (b) in which you and your associates beneficially owned at least 10%, by value of the shares of the company (except shares that carried a right only to participate in a distribution of profits or capital to a limited extent) at any time during the 5 years before the CGT event happens,

6. A unit in a unit trust that is a resident trust for CGT purposes for the income year in which the CGT event happens; and in which you and your associates beneficially owned at least 10% of the issued units in the unit trust at any time during the 5 years before the CGT event happens,

7. An option or right to acquire a CGT asset of the kind referred to above,
new provisions provide a definition of assets having the ‘necessary connection with Australia’ and, instead of nine categories, the law simply uses the concept of ‘taxable Australian property’. The Explanatory Memorandum states that the new law will narrow the range of assets that a foreign resident will be subject to income tax on their capital gain.\textsuperscript{114} Basically, only an interest in Australian real property, namely land and fixtures such as buildings and mining and quarrying interests that are not considered to be real property, and business assets of a ‘permanent establishment’, will be considered to have the necessary connection with Australia, s 885-15, ITAA 97. The law also provides elaborate tests to be used to prevent a non-resident investor using an interposed entity to hold real property and avoid income tax on any capital gain.

6.4.5 Australia as a ‘tax haven’

A temporary resident living in Australia, and being regarded as a non-resident in their home country, can generate income from their foreign investments in any country, including a tax haven, and pay no income tax on that income. Similarly, any capital gain generated through investment in Australian shares will not be included in the temporary resident’s assessable income in Australia and effectively not taxed anywhere in the world. This situation fits within the classic definition of a ‘tax haven’ in that there are no or low effective tax rates being imposed on the temporary resident and, in the case of capital gains on non-real property investments, the non-resident.

8. A share or security in a company that you received as consideration for your disposal of another CGT asset to the company and:
   (a) you chose to obtain a roll-over under Division 122 (roll-over of assets by an individual or partnership to a company) or Subdivision 126-B (roll-over of assets within certain company groups) because of the disposal; and
   (b) either you were a foreign resident just before the disposal, or you were a trustee of a trust that was not a resident trust for CGT purposes for the income year in which the disposal happened,

9. A share, option, right or similar interest in a company or a unit, option, right or similar interest in a trust you acquire where:
   (a) you choose a scrip for scrip roll-over under Subdivision 124-M for your acquisition of the interest; and
   (b) your original interest had the necessary connection with Australia; and
   (c) you are a foreign resident at the time you acquire it; and

\textsuperscript{114} Explanatory Memorandum, Taxation Laws Amendment (2006 Measures No.4) Bill 2006, 34.
The OECD\textsuperscript{115} has expressed concerns with its member countries having harmful preferential tax practices in order to attract investment and other ‘financial and geographically mobile activities’\textsuperscript{116}. One specific area that the OECD is concerned about is when a country ‘ring fences’ its own residents from taking advantage of taxation benefits that are only offered to foreign investors that are non-residents. The law in Australia which provides tax concessions for temporary residents and non-residents is not available to ordinary residents of Australia. They are being excluded from these benefits by a ‘ring fence’ and so, by definition, Australia is a tax haven according to the OECD guidelines.\textsuperscript{117}

The OECD contends that regimes that engage in ‘ring fencing’\textsuperscript{118} have a harmful effect on foreign tax bases. If the temporary resident of Australia is a non-resident of, say, the United Kingdom, then any capital gain generated from an investment in a third country, such as Vanuatu, will not be subject to income tax anywhere in the world. It is expressly excluded in Australia, not subject to income tax in the United Kingdom and not subject to income tax in the source country. For example, a temporary resident can generate income on investments in, say, Vanuatu and pay no income tax on their world-wide income in Vanuatu, the United Kingdom or Australia.

Australia is now an attractive place to live as a temporary resident. According to Szekely, ‘the tax law changes will not only attract the super rich but should assist in attracting the super talented’.\textsuperscript{119} Large investment funds can be left in a tax haven and the income or capital gains generated will not be taxed in Australia and not in the temporary resident’s home country. The temporary resident can even invest in, say, shares or units in a unit trust in Australia and not pay income tax on the capital gain generated from those assets in Australia, as the new CGT rules for non-residents would apply as well. It would appear that the Australian Government is keen to

\begin{itemize}
  \item[116] Ibid, 7.
  \item[117] Ibid, 26.
  \item[118] The term ‘ring fencing’ is used by the OECD to describe situations where the resident taxpayers are prevented from accessing tax benefits that are being provided to non-resident taxpayers. In effect the resident taxpayers are ‘fenced in’ and not allowed to enjoy the tax benefits being offered to foreign investors or businesses.
  \item[119] Szekely, above n 109, 3.
\end{itemize}
attract very wealthy individuals from around the world to live in Australia as ‘temporary residents’ and bring their wealth with them. It will be interesting to see if the OECD has any comment to make about these very attractive tax concessions and whether or not it generates a tax war between other countries all trying to compete for wealthy individuals.

6.4.6 New Zealand and the exemption for transitional residents

The government of New Zealand was concerned about alleviating the extra tax costs for skilled labour working for the first time in New Zealand or New Zealanders who were returning after being away for more than ten years. As an incentive for new migrants to settle in New Zealand, or for New Zealanders to return to New Zealand, certain foreign income is exempt from taxation in New Zealand. Returning New Zealanders must have not been a tax resident at any time during the past ten years prior to their arrival in New Zealand. The exemption from New Zealand tax on foreign income is for a period of four years or up to 49 months. The type of income that is exempt includes CFC and FIF income that would have been attributed under the New Zealand rules, income from foreign trusts, foreign dividends, foreign interest or royalties derived offshore, foreign rental income, income from employment performed overseas before coming to New Zealand, such as bonus payments, gains on the sale of real property derived offshore and, offshore business income that is not related to the performance of services.

6.5 Threats to the Tax Base

It may not matter whether a country has a worldwide or territorial system for taxing the income of its residents, as MNEs are able to take advantage of lower taxes in other countries by locating operations in different jurisdictions. Portfolio or passive capital and foreign direct investment by MNEs are increasing in their mobility. MNEs will continue to become larger and more powerful and their revenue sources

120 The statutory law provisions providing the exemption from income tax for ‘transitional residents’ are contained in sections FC 22, FC 23 and FC 24, Income Tax Act 2004 (NZ).
121 Inland Revenue Department, ‘Reducing tax barriers to international recruitment to New Zealand – a government discussion document’, (2003), 3.
and operations will lack any ‘true residence’.  

Professor Avi-Yonah discusses the US trend towards a territorial system as the result of MNEs moving their head offices to low tax jurisdictions and the way in which those jurisdictions are lessening the impact of their CFC rules. Professor Avi-Yonah illustrates this point by showing that a third of the foreign profits of US-based multi-nationals are in countries with an effective tax rate of less than 10 percent. In 2003, when the data was gathered, those countries were the Netherlands, Ireland and Bermuda. Avi-Yonah contends that the CFC rules and similar anti-deferral regimes need to be adopted and enforced by all OECD member states. However, he accepts that if MNEs are prepared to reincorporate in non-OECD countries, then the OECD will need to do more to protect the corporate tax base. This may be harder to do in practice as the current project to eliminate harmful tax competition has demonstrated.

The current situation with the flows of capital from one country to another is illustrated by the following example given by Professor Graetz:

Luxemburg, for example, supplies almost as much direct investment to the United States as France and Canada, and the size of direct investment from the United States to Bermuda and Panama surely is not justified by economic considerations alone.

Many commentators in this area of international taxation have pointed out the fact that the traditional tax base will continue to be eroded as capital, in the form of portfolio investment or direct investment, is moved to low taxing countries. The global economic crisis may add to this problem as investors chase better after-tax returns on their investments.

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125 Graetz, above n 45, 261 and 267.
6.6 Conclusion

In answer to the main question raised in this paper, whether Australia should adopt a territorial basis for taxing international income and abandon the worldwide system, it is contended that, based on the available research in this area of taxation law, the current system that exists in Australia is perfectly adequate from the perspective of the three main criteria for assessing a tax system, namely equity, efficiency and simplicity. From the various views examined above, a territorial system of taxation is inherently inequitable from both a vertical and horizontal perspective. Based on the example of Hong Kong, Michael Littlewood provides an excellent overview of the existence of inequity in the current system. However, Hong Kong is unique and the fact that the taxpayers do not complain may just be indicative of the beneficial effects of having very low tax rates.

There is no evidence from the above analysis that a territorial system is more efficient than a worldwide system. Many of the commentators in this area are examining efficiency from the perspective of the US system where the only benefit for US MNEs is with a credit for foreign taxes that have been paid. This encourages the deferral of profit from being repatriated to the US whereas, a credit and exemption system, similar to that used in Australia and elsewhere, would arguably be better for US companies competing internationally.

In terms of simplicity, the argument that a territorial system is simpler than a worldwide system is not conclusive. A territorial system still needs to have robust anti-avoidance rules, transfer pricing rules and laws that clearly distinguish between income sourced within the state and sourced in a foreign jurisdiction. The example of Hong Kong used in this paper also illustrates the government’s need to rely on anti-avoidance rules to safeguard revenue.

Australia does adopt both a worldwide and territorial system for the taxation of international income. Active business income, non-portfolio dividends and certain foreign employment income is exempt from taxation in Australia under the exemption mechanism. In other words, this type of income is not taxed on a worldwide basis. Passive income from investments is not subject to double taxation
due to the existence of the credit mechanism that operates in Australia. Given this current situation, the only reason why the Australian Government would consider changing from a worldwide system to a pure territorial system is that, in the global environment, it is becoming very difficult to tax the income from mobile capital unless all nations cooperate on the disclosure of information on investments by non-residents in the host country. This raises questions about the effectiveness of the OECD measures in relation to ‘harmful tax competition’ and exchange of information agreements. It also raises questions about the effectiveness of ‘Operation Wickenby’ in Australia and the estimated income tax to be recovered. However, on balance there are strong arguments to leave the current hybrid worldwide system in place because it already incorporates many aspects of a territorial system, as discussed above.

The fact that the Australian and New Zealand governments introduced measures to put temporary residents and new migrants in a position where their foreign sourced income was not taxed in their home country can be explained as the two countries merely trying to compete globally for mobile capital and labour. It is contended that these measures should not be seen as a sign that a territorial system should replace the existing worldwide systems in, at least, Australia.
CHAPTER 7  THE DISTINCTION BETWEEN TAX AVOIDANCE AND TAX EVASION HAS BECOME BLURRED IN AUSTRALIA: WHY HAS IT HAPPENED?

7.1 Introduction

The Australian statutory law, as well as the common law, recognises the important distinction between taxpayers engaging in conduct that constitutes tax avoidance and conduct that constitutes tax evasion. However, for some time, the Australian Government has ignored the difference between the two concepts when it comes to Australians using tax havens and being investigated as part of ‘Project Wickenby’. For example, the law to deter the promotion of tax schemes, Division 290, of the Taxation Administration Act 1953 (Cth) ignores the distinction between tax avoidance and tax evasion and deals with ‘tax exploitation schemes’ instead. The Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth) (AML/CTF Act) is another example of the blurring of the distinction between tax avoidance and tax evasion because it allows government agencies to detect Australian taxpayers using tax havens by requiring their accountants, lawyers and financial advisers to report ‘suspicious transactions’ that involve the transfer of money between tax havens and Australia. These two examples of statutory law are clear examples of the Australian Government deliberately labelling all attempts to minimise income tax through the use of tax havens and offshore financial centres (OFCs) as tax evasion and, therefore, a criminal act. There have been examples quoted in the press where the Australian Crime Commission, conducting investigations as part of ‘Project Wickenby’, have gained access to Swiss bank...

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1 ‘Operation or Project Wickenby’ is the name given to a joint operation involving the Australian Crime Commission (ACC), the Australian Taxation Office (ATO) and the Australian Securities and Investment Commission (ASIC) investigating the use of tax havens by Australian taxpayers in what is alleged as criminal activity.
records on the basis that the Australian taxpayer has been involved in suspected tax fraud when this was not the case.² If tax minimisation can be held to constitute a criminal act, then tax havens and OFCs can be encouraged to disclose bank account details of Australian taxpayers in that country. Is this one of the main reasons why the Australian Government is ignoring the distinction between tax avoidance and tax evasion in order to detect money held in tax havens? This chapter will examine the distinction between the two concepts and try to provide an answer for the approach being taken by the government.

Professor Justin Dabner contended that the OECD’s campaign against ‘harmful tax competition’ was trying to ‘criminalise tax avoidance’ by attempting to group tax evasion and tax fraud with legitimate tax avoidance in order to achieve their outcome of deterring tax competition between countries, especially tax havens.³ For example, the law to deter the promotion of tax schemes, Division 290, Taxation Administration Act 1953 (Cth), ignores the distinction between tax avoidance and tax evasion and deals instead with ‘tax exploitation schemes’. The Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth) (AML/CTF Act) is another example of the blurring of the distinction between tax avoidance and tax evasion and this will be examined in detail later in the paper. It is contended that the Australian Government, the OECD⁴ and the Financial Action Task Force (FATF)⁵ are deliberately labelling all attempts to legally minimise income tax through the use of tax havens and offshore financial centres (OFCs) as tax evasion and, therefore, a criminal act.

If all tax minimisation activity amounts to a criminal act then tax havens and the OFCs can be encouraged to disclose information on foreign investments in their country and justify breaching their own bank secrecy laws. All banks have strict laws

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⁵ The Financial Action Task Force (FATF) is located within the OECD in Paris but was established to actively prevent money laundering.
that govern their ability to disclose information about their customers. However, in the case of criminal activity, information can be provided to foreign government agencies. Tax evasion constitutes the crime of fraud which, in turn, amounts to the act of ‘defrauding of the Commonwealth’. Hence, utilising the services of an OFC or a tax haven may also constitute the crime of money laundering. This would appear to be the reason why the Australian Government needs to blur the distinction between tax avoidance and tax evasion and, therefore, to be able to obtain banking details from other countries on the basis that all tax minimisation activity amounts to criminal conduct, irrespective of whether it is ‘tax avoidance’ or ‘tax evasion’.

The research commences with a discussion on the distinction between tax avoidance and tax evasion in Australia and then critically examines the current approach of the Australian Government to ignore the difference between the two concepts. It is argued in this chapter that there has been a deliberate move by the Australian Government to treat tax avoidance as amounting to tax evasion and to ignore the legal distinction between the two activities.

7.2 The Australian Approach to ‘Tax Avoidance and Tax Evasion’

It is generally acknowledged that tax evasion constitutes an act outside the law whereas tax avoidance is considered an act within the law. This basic principle of taxation law is supported by the definitions of tax avoidance and tax evasion contained in ‘The Taxation Review Committee’ Report, Australia 1975, which is commonly referred to as the ‘Asprey Committee Report’. According to I. G. Wallschutzky, the following definitions are based on those used in the ‘Carter

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6 It is not intended to discuss the law relating to the relationship between a bank and its customer other than to emphasise that both statutory law and common law provides strict codes of conduct in relation to the confidentiality of bank details. An excellent discussion of the importance of bank secrecy and the laws that try to ensure that customer information is kept confidential can be found in the OECD document, ‘Improving Access to Bank Information for Tax Purposes’, (2000) OECD, 19.


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. …‘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 had been distributed and the whole been taxed as the income of that taxpayer.

The definitions of ‘tax evasion’ and ‘tax avoidance’, as quoted above, are no different from the definitions used in both Canada and the UK. According to I.G. Wallschutzky, ‘the [two types] of tax avoidance are within the law and are therefore different from instances of evasion which are outside the law’. Not all commentators believe that the distinction is always clear. Professor Logue contends that the distinction is ‘notoriously fuzzy’, but reinforces the fact that tax evasion usually involves an ‘element of intentionality on the part of the taxpayer’. An example of this is provided by Professor Logue with a wealthy individual hiding income in a foreign bank account in a manner that is clearly not allowed by US tax law. In that case, the taxpayer is clearly a tax evader. Logue then suggests that tax evasion

10 The Royal Commission on Taxation, Canada 1966, commonly referred to as the ‘Carter Commission’.
11 The Royal Commission on Taxation of Profits and Income, 1955, commonly referred to as the ‘Radcliffe Commission’.
13 Wallschutzky, n 9, 55. The reference to the two types of avoidance contained in the Asprey Committee’s Report are referring to types of tax avoidance intended to be covered by the legislature and those types of avoidance which are not covered by the legislature.
15 Ibid, 354.
avoidance could be simply defined as ‘arranging your affairs to minimise your taxes in a manner that is consistent with the law’.  

If the law relating to the distinction between tax evasion and tax avoidance was that simple, and it is contended in this paper that it should be that simple, then the government has no basis for treating tax minimisation and tax avoidance as constituting tax evasion, and, thus, a criminal activity. The next step in this examination of the area of taxation law is to review the current statutory law in Australia.

### 7.2.1 Statutory law approach

In Australia, the anti-avoidance measures are contained in a number of ‘General Anti-avoidance Rules’ (GAARs). According to Professor Evans, these GAARs are found in Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36), Section 67 of the *Fringe Benefits Tax Assessment Act 1986* (Cth) and Division 165 of the *New Tax System (Goods and Services Tax) Act 1999* (Cth). Professor Evans discusses the ‘shotgun and sniper’ approach to the specific statutory anti-avoidance provisions (SAARs) aimed at tax avoidance, such as section 26-54 of the ITAA 97 relating to tax deductions incurred in criminal activities and section 86-10 of the ITAA 97 relating to preventing the alienation of personal services income through companies, partnerships or trusts. Evans contends that, in Australia, there is a ‘reliance on GAARs, SAARs and the promoter penalty regime, all bounded together in a carefully crafted risk management strategy’. The tax scheme promoter penalty regime will be critically examined later in this paper as an example of the blurring of the distinction between tax evasion and tax avoidance. However, it is important to note that the promoter penalty regime is seen as a major weapon being used by the government to combat tax avoidance in Australia. Similarly, the concept of a ‘risk based’ approach to managing tax avoidance will be discussed later in the paper under

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16 Ibid, 355.
18 Ibid, 42.
19 Ibid, 46.
the heading of ‘other approaches to tax avoidance’, as many countries are using this system to try to overcome tax minimisation through abusive tax avoidance and tax mitigation schemes.

The statutory law does not provide a definition of what constitutes ‘tax evasion’ or ‘tax avoidance’. A definition of tax avoidance is found in s 82KH(1) of the ITAA 36 but, as Ian Wallschutzky states, it is only relevant for the sub-division in which it appears. In fact, the GAAR provisions contained in Part IVA, of the ITAA 36, do not provide a definition of what constitutes tax avoidance. At best, the provisions exhaustively define what a ‘tax benefit’ is pursuant to s 177C(1). There is no mention of what might be considered to be acceptable tax avoidance or what is regarded as abusive tax avoidance. The GAAR provisions do not make any distinction at all. In the context of the Commissioner of Taxation being empowered to amend a taxpayer’s assessment of taxation, s 170(1) of the ITAA 36 provides that, in the case of avoidance of tax due to fraud or evasion, there is no limit on the time in which the assessment can be amended. In the case of tax avoidance, the time limit is now four years from the date of the original assessment for the Commissioner to amend the assessment. The section does not attempt to provide any type of definition of tax avoidance or tax evasion. In order to obtain an explanation of the type of activity that constitutes tax evasion or tax avoidance, it is necessary to look to the common law in order to see how the courts in Australia have interpreted this area of the statutory law.

### 7.2.2 The common law approach

The common law in Australia is regarded as being settled on the distinction between ‘tax avoidance and tax evasion’. In the case of *R v Mears*,  the NSW Court of Criminal Appeal, when considering an appeal against the severity of a sentence for an action pursuant to s 86A, *Crimes Act 1914* (Cth), conspiracy to defraud the Commonwealth, Gleeson CJ made the following statement on the distinction between tax avoidance and tax evasion:

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20 Wallschutzky, above n 9, 49.

21 Section 170(1) Item 5 for tax evasion and Item 4 for tax avoidance.

Although on occasion it suits people for argumentative purposes to blur the difference, or pretend that there is no difference, between tax avoidance and tax evasion, the difference between the two is simple and clear. Tax avoidance involves using or attempting to use lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful. Although some people may feel entitled to disregard the difference, no lawyer can treat it as unimportant or irrelevant. It is sometimes said that the difference is difficult to recognise in practice. I would suggest that in most cases there is a simple test that can be applied. If the parties to a scheme believe that its possibility of success is entirely dependent upon the authorities never finding out the true facts, it is likely to be a scheme of tax evasion, not tax avoidance.23

If the former Chief Justice of the High Court, Gleason CJ, believes that the distinction is so important for lawyers and the courts, then why has the government been prepared to overlook this important distinction? A further example of the court considering the distinction between tax avoidance and tax evasion is found in Denver Chemical Manufacturing Co v DCT (NSW). The judgment of Dixon J provides an excellent description of the conduct required to constitute tax evasion by a taxpayer.

I think it is unwise to attempt to define the word ‘evasion’. The context of s 210(2) [now s 170(1), ITAA 36] shows that it means more than avoid and also more than a mere withholding of information or the furnishing of misleading information. It is probably safe to say that some blameworthy act or omission on the part of the taxpayer or those for whom he is responsible is contemplated. An intention to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion.

In the present case the Board concluded that the appellant intentionally omitted the income from the return and that there was no credible explanation before them why he did so. They thought that the conduct of the taxpayer answered the description of an avoidance of tax by evasion.24

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23 Ibid, 323.
24 (1949) 79 CLR 296, per Dixon J, 313.
Dixon J agreed with the earlier finding of the NSW Court of Appeal in that the actions of the Appellant amounted to tax evasion. However, it should also be noted that the actions which might be regarded as constituting tax evasion and tax avoidance can arise in more situations than those involving the withholding of information or the provision of misleading information. Dealing in cash, as part of the ‘black economy’, to avoid paying tax on income is more than withholding information but still constitutes tax evasion.

In the recent case of Kajewski v Federal Commissioner of Taxation, the Commissioner of Taxation alleged tax avoidance through fraud and evasion. The taxpayer argued that the alleged fraud and evasion resulted from actions taken by their tax agent and that they were not aware of the situation that gave rise to the allegation. Section 170(2)(a), ITAA 36 [now s 170(1)] provides the Commissioner with the power to issue an amended assessment at any time if the avoidance of tax is due to fraud or evasion. The taxpayer also contended that ‘even if their original assessments were affected by fraud or evasion within s 170(2)(a), it was not fraud or evasion in which they personally engaged and that s 170(2)(a) did not therefore empower the Commissioner to issue the amended assessments in October 1999’. Drummond J made the following comment on the distinction between tax avoidance and tax evasion:

> There will be "an avoidance of tax" within this provision where, without any active or passive fault on the part of the taxpayer, less tax has been paid than ought to have been paid. See, eg, Australasian Jam Company Proprietary Limited v FCT (1953) 88 CLR 23 at 34; 10 ATD 217 at 222. Fraud within s 170(2)(a) involves something in the nature of fraud at common law, i.e., the making of a statement to the Commissioner relevant to the taxpayer's liability to tax which the maker believes to be false or is recklessly careless whether it be true or false.

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25 The term ‘black economy’ is commonly used in Australia to denote business conducted in cash in order to avoid any evidence of the receipt of income so as to avoid the payment of income tax or the Goods and Services Tax (GST) constitutes tax evasion.


27 Ibid, 483.

28 Ibid, 484.
Drummond J also quoted from the judgment by Dixon J in *Denver Chemical Manufacturing Company v Commissioner of Taxation (New South Wales)* and confirmed that His Honour’s analysis was the most appropriate in determining the type of conduct that amounted to fraud or evasion on the part of a taxpayer. From the above limited examination of the common law, it can be seen that tax evasion can be clearly distinguished from tax avoidance and that tax evasion involves the taxpayer being engaged in conduct outside the law with an intention to not pay the required amount of tax by fraud or reckless behaviour. If the courts in Australia have no difficulty in distinguishing between tax evasion and tax avoidance, what then is the approach of other countries to this issue?

### 7.2.3 Other approaches to tax avoidance

One of the main criticisms of having a GAAR is that the legislature has a particular view of the type of conduct that may constitute tax avoidance on the part of the taxpayer. However, the judiciary does not always interpret and apply the law in the same way as was intended by Parliament.  

29 Tim Edgar explores this dilemma in his paper and strongly contends that it ‘is hopeless to leave it to the judiciary to articulate a behavioural prohibition that is neither under-inclusive nor over-inclusive in its identification of prohibited transactions’.  

30 He advocates the design of a GAAR by reference to a ‘business-purpose test’ with emphasis on the different concepts of the economic substance associated with the categories of tax avoidance behaviour, such as tax evasion, acceptable tax avoidance and abusive tax avoidance.  

31 By way of illustration, Edgar states that the Canadian GAAR has, at its core, a distinction between ‘acceptable’ and ‘abusive’ tax avoidance and this is seen by some commentators as providing an ‘overly-broad category of acceptable tax avoidance and … an under-inclusive category of abusive tax avoidance’.  

32 Acceptable tax avoidance is sometimes referred to in the literature as ‘tax mitigation’ or ‘tax minimisation’ whereas abusive tax avoidance is seen as involving schemes that are

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30 Ibid, 837.

31 Ibid.

‘contrived’ or ‘artificial’. The Australian GAAR does not provide that level of
distinction and it is then left to the judiciary to determine those differences.

It could be argued that, with the deliberate blurring of the distinction between tax
evasion and tax avoidance in Australia, the Canadian approach may be seen as a
desirable way of maintaining a distinction between acceptable tax avoidance and
abusive tax avoidance. Acceptable tax avoidance is clearly seen to be within the law,
whereas abusive tax avoidance, which may be outside the law, is properly treated as
being similar to tax evasion.

Furthermore, the OECD in its ‘Study into the Role of Tax Intermediaries’, has
introduced the ‘notion of aggressive tax planning into the international tax lexicon’ and draws a distinction between acceptable tax avoidance, such as tax mitigation and
minimisation, and aggressive tax planning involving sham transactions. The OECD
study looks at the supply side of aggressive tax planning solutions, being provided by
tax intermediaries such as accounting and law firms, and the taxpayers, representing
the demand side of the tax minimisation products. Aggressive tax planning is
defined as:

planning involving a tax position that is tenable but has unintended and unexpected
tax revenue consequences, and taking a tax position that is favourable to the
taxpayer without openly disclosing that there is uncertainty whether significant
matters in the tax return accord with the law.

It is contended that ‘the test of whether tax planning is “acceptable” should be what
the legislation says as interpreted by the courts, and not what the tax authorities
suppose it was intended to say’. This issue is highlighted in Part V under the
heading of ‘Implications for the Rule of Law’. The approach taken by the OECD in

33 Ibid, 878 and JB McCombs, ‘An Historical Review and Analysis of Early United States Tax Policy
34 Judith Freedman, Geoffrey Loomer and John Vella, ‘Alternative Approaches to Tax Risk and Tax Avoidance:
Analysis of a Face-to-Face Corporate Survey’, (2008) Working Paper 08/14, Oxford University Centre for
Business Taxation, 2.
36 Ibid, 10.
37 Freedman et al, above n 34, 3.
their study into ‘tax intermediaries’ adds further weight to the argument that the
current approach to tax mitigation and tax evasion in Australia, and internationally, is
threatening the fundamental principle of the importance of the ‘rule of law’ in all
legal systems throughout the world.

It is obvious that tax intermediaries have always created a problem for organisations,
such as the OECD, and many countries with the promotion of tax havens and OFCs
as a means of reducing the effect of taxation on multi-national corporations and high
net worth individuals. As discussed below in this paper, the OECD has been
deliberately blurring tax evasion and tax avoidance but this current study
by the
OECD would appear to put all activities used to mitigate tax within the category of
‘abusive tax avoidance’ and unlawful conduct and, therefore, amount to criminal tax
activity. The OECD approach can be seen as another attempt to criminalise tax
avoidance by creating an artificial distinction between tax mitigation, on the one
hand, and aggressive tax planning, on the other hand, while, all the time, ignoring the
clear cut distinction between tax evasion and tax avoidance that has existed in the
law of many of the OECD member countries based on the Anglo-US legal system.

One of the features of the OECD study into tax intermediaries is the discussion of the
need for effective risk management by the tax authorities and the OECD sees that as
an important method to prevent tax avoidance by intermediaries. In fact, Australia
and the UK\textsuperscript{38} have already adopted a risk-based approach to try to combat tax
avoidance. As Anita Paddock and Chris Oates state, ‘[o]ne of the main drivers in the
ATOs risk-profiling process is the perceived willingness of the corporate to use
marketed tax mitigation in its tax planning programme’.\textsuperscript{39} If tax authorities engaged
in cooperative discussions with corporations and high net worth individuals as part of
a risk management program to encourage disclosure of tax mitigation arrangements,
then there may not be a need to rely on the legislature, and the courts, to prevent tax
avoidance after the event. In turn, this may alleviate the need to engage in the tactic
of declaring all forms of tax minimisation as constituting criminal activity.

\textsuperscript{38} The ‘Varney Review’ in the UK had advocated a risk-based approach to managing the tax risk associated with
tax avoidance and large corporations. See the paper by Freeman, Judith et al, above n 34 for a discussion on
this issue.

\textsuperscript{39} Anita Paddock and Chris Oates, ‘Corporate tax self-assessment lessons from down under’, (2003) 14
7.3 The International Approach to the Distinction between ‘Tax Avoidance and Tax Evasion’

International bodies such as the OECD, the Financial Action Task Force (FATF), and the Economic Union (EU) have been actively involved in trying to limit harmful tax competition by tax havens and OFCs. By grouping tax avoidance and tax evasion as constituting one and the same activity, the international bodies, such as the OECD, the FATF and the EU, are able to make the presumption that any financial activity using an OFC or a tax haven must be tax evasion and, therefore, of a criminal nature. Branson QC \(^{40}\) makes the observation that the OECD, in its crusade against ‘harmful tax competition’, has ‘not sought to draw any clear or marked difference between evasion and avoidance and in every relevant respect they have been treated as one homogenous subject’.

The OECD report on harmful tax competition, paragraphs 53 and 54, \(^{41}\) do not attempt to clearly distinguish between tax avoidance and tax evasion when discussing the need for tax havens to become more transparent and to exchange information. In paragraph 53, the OECD makes the following comment:

[B]ecause non-transparent administrative practices as well as an inability or unwillingness to provide information not only allow investors to avoid their taxes but also facilitate illegal activities, such as tax evasion and money laundering, these factors are particularly troublesome. \(^{42}\)

In paragraph 54, the OECD then states that progress has been made in accessing information from tax havens through the entering of ‘mutual legal assistance treaties’ in criminal matters, such as criminal tax fraud. According to Peter-Szerenyi, the issue of the exchange of information and transparency should only relate to criminal tax matters:


\(^{41}\) OECD, n 4.

\(^{42}\) Ibid, 23.
The lack of exchange of information and transparency facilitates only illegal activity, not tax avoidance. Tax avoidance is legal, whether the home country knows about it or not. Thus, the tax authorities of the home country do not need any information for the correct and timely application of its own tax law. The lack of the two criteria (exchange of information and transparency) in connection with tax avoidance is a problem merely because it makes it difficult for the home country to detect and prevent the use of foreign tax regimes – in other words, to enact laws aimed at combating offshore investments (e.g. CFC rules), Paragraphs 70 and 114.43

In the OECD report44 on improving access to bank information, it was stated that where ‘some countries rely heavily on a self-assessment system to administer their taxation laws … wilful failure of a taxpayer accurately to report income will generally be considered a criminal action.’45 In terms of requiring other countries to cooperate in providing access to information, the OECD Report goes on to make the following observation:

With respect to assistance provided to other countries in criminal investigations (including criminal tax investigations), some countries generally apply the principle of ‘double incrimination’. That is, before assistance can be provided to a requesting country, it must be established that the conduct being investigated would constitute a crime under the laws of the requested country if it occurred in the requested country. In the tax area, application of this principle will not generally be an impediment to exchange of information for criminal purposes where the definitions of tax crimes are similar. However, where the definitions of tax crimes in the requesting and requested countries are markedly different, it may be impossible in many cases for the requesting country to obtain information that is vital to a criminal investigation.46

In most tax havens, tax avoidance is not a crime because, as a result of those countries not imposing any form of income tax, there is no tax to avoid. However, the non-payment of income tax by an Australian resident taxpayer on income derived in an offshore bank account can be construed as constituting the act of ‘money

45 Ibid.
46 Ibid.
laundering’ in Australia because the proceeds are from a criminal act, namely tax evasion. In the tax havens that have introduced anti-money laundering legislation, tax related criminal activities would constitute a crime under their domestic law, particularly if the requesting country was able to argue that tax avoidance, in any form, was a crime and the subsequent laundering of the money through a tax haven constituting the crime of money laundering. For example, the Cook Islands introduced the *Money Laundering Prevention Act* in 2000 and amended its *Crimes Act* in order to introduce law based on the FATF forty recommendations which are similar to the anti-money laundering law in Australia.47 In that situation, the appropriate banking information about the Australian taxpayer may be supplied by the requested country. This is one of the main reasons why the new AML/CTF Act has been introduced by the Australian Government.

The OECD has been successful in convincing Vanuatu, Samoa and Niue to enter into an agreement to exchange information on foreign investors using their offshore financial services. The countries entered into the agreements to exchange information on civil tax matters by 31 December 2005.48 Since that time, the OECD has been able to convince a further 83 OECD and non-OECD countries to enter into ‘Double Tax Conventions’ for the exchange of banking information.49 In the same OECD announcement, it is noted that Belgium has agreed to exchange banking information with the US in relation to civil and criminal tax matters. This raises the issue of the need for countries such as Australia to not only develop relationships with other countries in order to enter into an agreement for the exchange of banking information, but also the need to classify tax matters as constituting a civil or criminal offence under the domestic law. It is not sufficient to merely classify all types of tax minimisation as constituting abusive tax avoidance and tax evasion on the basis that the investments are held in a tax haven.

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48 Peter-Szerenyi, above n 43, 18.

49 OECD, above n 7.
When the then Minister for Foreign Affairs, the Honourable Alexander Downer was asked about his attitude to Vanuatu being a ‘tax haven’ and Australians using Vanuatu to avoid income tax, his answer was as follows:

Well, I’m in favour of low tax and countries have got to make themselves as competitive as they possibly can in a competitive world, but what has worried us in the past has been on the issue particularly of money laundering. And the Vanuatu Government and Vanuatu Parliament has now legislated against money laundering and introduced this anti-money laundering legislation. We see that as a very good step forward but obviously it’s going to be a challenge to implement the provisions of the legislation and we’re happy to help the Government of Vanuatu in that respect.  

This comment from the former Australian Minister for Foreign Affairs would appear to condone Vanuatu as engaging in tax competition but, at the same time, taking measures to combat money laundering. It would be assumed that the Vanuatu law is designed to combat illegal tax evasion and not legitimate tax avoidance or minimisation. For the OECD or the Australian Government to impose sanctions as a result of tax avoidance in, say, Australia, while it is not contrary to the law in Vanuatu, would, in fact, be a breach of international law.  

To threaten another sovereign nation with sanctions or to terminate existing treaties just because they will not exchange banking information, that may or may not be of a criminal nature, is potentially a breach of obligations to the World Trade Organisation (WTO) or a breach of Article 54 of the Vienna Convention on the Law of Treaties. According to Benjamin Hartman, there is ‘no necessary connection between low taxes and tax evasion … therefore, no basis to claims that offering low taxes facilitates crimes’. He makes this claim on the basis that the tax havens are under no obligation to

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51 Peter-Szerenyi, above n 43, 23.


53 Ibid, 265.
comply with the directives issued by the OECD or FATF and non-compliance is not sufficient grounds to impose sanctions under international law.\(^\text{54}\)

The introduction of the, so-called, USA Patriot Act\(^\text{55}\) has not dramatically reduced the use of Caribbean tax havens by citizens of the US.\(^\text{56}\) OECD and EU member countries still compete in trying to attract capital by reducing income tax rates. There is no ‘level playing field’\(^\text{57}\) in the world today and Australia has joined in the tax competition to attract wealthy individuals while ‘ring fencing’\(^\text{58}\) its own residents through the recently introduced tax law that applies to ‘temporary residents’.\(^\text{59}\) It will be interesting to see if the AML/CTF Act introduced into Australia will have a dramatic effect on tax havens. As Eden and Kudrle put it, ‘the jury is still out on whether the OECD’s attempt to name and shame tax havens as renegade states will be successful’.\(^\text{60}\) The same situation can be said of the following legislative attempts being introduced in Australia to prevent tax minimisation through OFCs and tax havens.

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\(^{54}\) Ibid.

\(^{55}\) The term ‘USA Patriot Act’ is an anachronism for the Act called the ‘Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act’.


\(^{57}\) The term ‘level playing field’ is taken from the OECD, ‘Tax Co-operation: Towards a level playing field’ (2006) OECD, 7. The OECD is determined to achieve a ‘level playing field’ in the areas of transparency and effective exchange of information for tax purposes, especially with civil and criminal tax matters.

\(^{58}\) ‘Ring Fencing’ is the term used by the OECD, ‘A progress report on the jurisdictions surveyed by the OECD Global Forum in implementing the internationally agreed tax standard’, (2010) OECD www.oecd.org at 12 April 2010 to denote the existence of tax concessions for foreign investors that are not available to resident taxpayers. For example, temporary residents are not taxed on their foreign sourced income and are taxed as if on a ‘territorial’ basis. In this case the Australian resident taxpayer is ‘fenced in’ and not able to take advantage of the same tax concession.

\(^{59}\) The new law takes effect from 1 July 2006 and is now contained in Division 768, ITAA 97. The law started out as the Taxation Laws Amendment (2006 Measures No.1) Bill 2006 (Cth) and was enacted as Act No.32 of 2006. Section 768-900 provides that ‘this Subdivision modifies the general tax rules for people in Australia who are temporary residents, whether Australian residents or foreign residents. The term ‘ring fencing’ is used to denote tax law that favours non-residents over a country’s own residents. In this case temporary residents do not pay income tax in Australia on income derived outside Australia.

\(^{60}\) Eden and Kudrle, above n 56, 124.
7.4 An Example of Blurring: The Law to ‘Deter the Promotion of Tax Schemes’

The Australian Government introduced the law to deter the promotion of tax schemes, with effect from 6 April 2006. The provisions are designed to complement the GAAR.\(^\text{61}\) This law has the potential to deter the promotion of tax schemes, such as those that involve the use of tax havens and OFCs, but it appears that it has deliberately ignored the difference between tax evasion, a criminal offence, and tax avoidance or tax mitigation, legal activity.

7.4.1 The law used to deter the promotion of tax schemes

The statutory provisions\(^\text{62}\) consist of three main parts; first, the imposition of ‘civil penalties’ on ‘promoters’ of ‘tax exploitation schemes’; second, ‘injunctions granted by the Federal Court’ to restrain an entity from engaging in promoting schemes; and third, ‘voluntary undertakings’ given by an entity not to continue promoting schemes.

Section 290-5 states that the objects of this Division are:

(a) to deter the promotion of tax avoidance schemes and tax evasion schemes; and
(b) to deter the implementation of schemes that have been promoted on the basis of conformity with a product ruling in a way that is materially different from that described in the product ruling.

In the Explanatory Memorandum, the government advises that the measures are designed to deter the promotion of tax avoidance and evasion schemes, collectively referred to as ‘tax exploitation schemes’, and to deter the implementation of schemes that have been promoted on the basis of a product ruling being provided by the ATO but the actual scheme is materially different from what was disclosed in the ruling.\(^\text{63}\) The government justifies the new law from an economic and social perspective on the basis that, by making the promoter of tax schemes at risk of financial loss in the same way that the investor is at risk, then this will deter the marketing of schemes

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\(^{61}\) Evans, above n 17, 46.

\(^{62}\) The new statutory law is found as Schedule 3, starting with Division 290, of TAA 53.

and provide investors with protection from bad investments and, therefore, encourage more legitimate and productive investments. The promoter would be required to pay an amount of money, equivalent to the amount of tax, interest and penalties that is required to be paid by the taxpayer, as a result of having entered into the scheme in the first place, if the scheme is found to have constituted tax avoidance or tax evasion. The money to be paid by the promoter is in the form of a civil penalty that can be imposed by the Federal Court up to a maximum of $550,000 for individuals or $2.75 million for a body corporate, and twice the consideration received as payment for selling the scheme.

The objective of providing investor protection is a very positive move on the part of the government but it is also designed to support Part IVA, the tax avoidance measures, because of a perceived weakness in the current provisions. This issue was discussed by McCormack and Anderson on the basis that Part IVA may not extend to promoters of tax schemes in order for them to be penalised under those provisions. It would be usual for a promoter to obtain a fee or profit from the underlying scheme rather than a tax benefit. The only way to penalise the promoter was to introduce the ‘promoter penalty’ regime. The ATO have recently released their practice statement, PS LA 2008/8, to provide guidance to their staff as to the application of the law to situations involving the promotion of tax schemes and, in particular, the role of the ‘promoter penalty review panel’ that is responsible for administering the law.

7.4.2 Civil penalties, promoter and tax exploitation schemes

This area of the law gives rise to most of the perceived problems that may confront accountants, tax lawyers and financial advisers providing taxation advice to their clients. The concept of imposing a ‘civil penalty’ is similar to the range of remedies available to the Australian Securities and Investment Commission in situations where it may be difficult to obtain sufficient evidence to satisfy a burden of proof ‘beyond reasonable doubt’ (as is the case in criminal proceedings) but it may be possible to

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64 Ibid, 59.
65 J McCormack and D Anderson, Tax Schemes: “Unscrupulous promoters stand warned” (2004) 38 Taxation in Australia, 27. The contention in the paper was that in the case of Vincent v FCT (2002) 51 ATR 18, the Full Bench of the Federal Court was not prepared to hold that the promoter engaged in the scheme in order to generate a tax benefit but rather to make a profit out of the companies associated with him.
satisfy a burden of proof of ‘balance of probabilities’ under civil proceedings. While it may be good law to impose civil penalties on those involved in insider trading or breaching director’s duties, it may not be the case with taxation law where there is a reasonable argument that the conduct is within the law and does not amount to tax avoidance. This area of taxation law is still very vague and penalties may be imposed before a court has had an opportunity to rule on the legitimacy of the tax scheme. This situation could arise as it can take many years before a dispute as to whether or not a tax arrangement constitutes tax avoidance or tax evasion is determined by the High Court but, in the meantime, the promoter has been required to pay civil penalties.

What is meant by the term ‘promoter’? Section 290-60 provides the meaning of promoter as:

1. An entity is a promoter of a tax exploitation scheme if:
   a. the entity markets the scheme or otherwise encourages the growth of the scheme or interest in it; and
   b. the entity or an associate of the entity receives (directly or indirectly) consideration in respect of that marketing or encouragement; and
   c. having regard to all relevant matters, it is reasonable to conclude that the entity has had a substantial role in respect of that marketing or encouragement.

2. However, an entity is not a promoter of a tax exploitation scheme merely because the entity provides advice about the scheme.

3. An employee is not to be taken to have had a substantial role in respect of that marketing or encouragement merely because the employee distributes information or material prepared by another entity.

What would be the situation for accountants, tax lawyers and financial advisers in a situation where their clients would like to utilise the services of an OFC in, say, Singapore, in order to invest their savings more effectively? Simply locating investments in an OFC such as Singapore\(^{66}\) does not amount to tax avoidance or tax evasion. Singapore is regarded by both Australia and the OECD as an offshore financial centre and has demonstrated a reluctance to cooperate on the disclosure of banking information unless it concerns their own tax law. The

\(^{66}\) Singapore is regarded by both Australia and the OECD as an offshore financial centre and has demonstrated a reluctance to cooperate on the disclosure of banking information unless it concerns their own tax law. The
evasion and most accountants and taxation advisers would still believe that such an arrangement was legal. If the accountant or tax adviser in Australia provided advice or received a payment from the offshore finance centre, does this make them a promoter? Clearly it can be seen that merely giving advice does not make that person or entity a promoter but what is the situation if they received a commission related to the amount of money invested with the financial institution in Singapore or encouraged their clients to enter into the arrangement; would they be caught by section 290-60 and possibly face civil penalties?

One major criticism of the promoter penalty provisions contained in Division 290 is that while the Explanatory Memorandum does try to clarify what is a ‘promoter’, section 290-60 fails in its attempt to provide any detailed clarification as to the extent of the conduct required to be held to be a ‘promoter’. For example, in the Explanatory Memorandum, the promoter needs to have a ‘substantial role’ in the promotion of the tax exploitation scheme and not merely provide advice. The concept of what is a ‘substantial role’ is, to some extent, discussed in the Explanatory Memorandum but only mentioned once in s 290-60(1)(c), as seen above. The subsection 290-60(3) merely states that having a ‘substantial role’ requires more than the ‘marketing or encouragement through the distribution of information or material prepared by another entity’. It would have been very helpful if the section had provided greater guidance on this point so that accountants and advisers would be able to gain a greater understanding of their legal position when a client asks them for advice on investing money in, say, Singapore. The Acts Interpretation Act 1901 (Cth), sections 15AA and 15AB, does provide for the judiciary to interpret provisions of the act by taking into account the objectives and the purpose of the government in enacting the ‘promoter penalty regime’, and section 15AB also allows the court to take into account extraneous materials, such as the Explanatory Memorandum.


67 Explanatory Memorandum, above n 63, 49.
The adviser may not be liable to the civil penalties if it can be shown that the arrangement was not a ‘tax exploitation scheme’, Section 290-65. In summary, the section provides the following meaning of tax exploitation scheme:

A scheme is a tax exploitation scheme if:

1. the scheme was implemented with the sole or dominant purpose of that entity or another entity obtaining a scheme benefit from the scheme;
2. if the scheme has been implemented and it is not reasonably arguable that the scheme benefit is available at law or would be available at law;

This then leads to the question, what is meant by the term ‘reasonably arguable’? The statutory provision covering this area of law is found in Schedule 1, s 284-15, of the TAA 53 in relation to the imposition of penalties for a shortfall in the payment of tax. The concept of what constitutes a ‘reasonably arguable’ position was considered judicially by the Federal Court in *Prebble v Federal Commissioner of Taxation*.

### 7.4.3 When is a matter ‘reasonably arguable’, Section 284-15

Section 284-15 (1) states that ‘a matter is ‘reasonably arguable’ if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect’.

Section 284-15 (2) states that to the extent that a matter involves an assumption about the way in which the Commissioner will exercise a discretion, the matter is only ‘reasonably arguable’ if, had the Commissioner exercised the discretion in the way assumed, a court would be about as likely as not to decide that the exercise of the discretion was in accordance with law.

In *Prebble v Federal Commissioner of Taxation*, the taxpayer, Dr Prebble was denied a deduction for a contribution made to a non-complying superannuation fund. However, even though the deduction had been denied, Cooper J held that, as a result of advance opinions and rulings having being issued by the ATO to other taxpayers in earlier years, it was ‘reasonably arguable’ for him to take that position in preparing

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his tax return and, therefore, no understatement penalties should be imposed. It would be very difficult to predict whether this case and the existence of s 284-15 will provide comfort for advisers engaged in encouraging clients to implement a marketed tax mitigation arrangement. It would be comforting for advisers to think that the Federal Court would find that they have not contravened Division 290, of the TAA 53, on the basis of a reasonably arguable position but, with all litigation, it is not possible to predict the outcome and they could be facing civil penalties as a promoter of a tax exploitation scheme.

### 7.4.4 No distinction between tax evasion and tax avoidance: overseas experience

It is very disappointing that the new law does not differentiate between tax evasion and tax avoidance. The new law simply lumps the two distinct activities into one, namely a ‘tax exploitation scheme’, and ignores the fact that tax evasion is an illegal activity and prosecuted under the criminal law, whereas tax avoidance is legal but may be struck down by the courts under Part IVA. The law does not even consider making a distinction between acceptable tax avoidance and abusive tax avoidance, which appears to be the trend in other countries, as discussed above. The two activities, tax avoidance and tax evasion are clearly different and it illustrates the fact that the government is content to blur the distinction. In the US, New Zealand and Canada, with their equivalent promoter penalty regimes, the distinction has been considered and given appropriate weight and the penalties imposed on promoters of tax shelter schemes are significantly less than those being considered in Australia.

According to McCormack and Anderson, Australia is not the first country to introduce a civil penalty regime to deter promoters of tax exploitation schemes. McCormack and Anderson discuss the situation in three countries, Canada, New Zealand, and the US and the measures that have been introduced to deter the promotion of tax schemes. In New Zealand, the government introduced measures designed to encourage the use of tax rulings issued by the Inland Revenue Department so that the government can be alerted to new arrangements, in case the

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69 Ibid, 470.
70 J McCormack and D Anderson, above n 65, 423.
law has to be changed to prevent a loss of revenue. The term ‘arrangement’ is very broadly defined to include ‘any contract, agreement, plan or understanding’. The Australian equivalent, a ‘tax exploitation scheme’, has at its core the requirement that the entity has the ‘sole or dominant purpose of obtaining a scheme benefit’. In New Zealand, the law requires the tax arrangement to be offered, sold or promoted to at least ten or more people in New Zealand before it is considered a scheme that is caught under the statutory provisions. The penalty that can be imposed is the amount of income tax shortfall from all participants in the arrangement. The New Zealand experience is similar to the Australian situation in that both governments are keen to see tax rulings obtained before tax planning arrangements are widely marketed to taxpayers. However, trying to obtain a private ruling in Australia requires time and money, which runs counter to the whole concept of having a tax system based on self-assessment.

In Canada, the law to deter tax schemes was introduced on 29 June 2000 and was designed to catch schemes that ‘do not work and result in unwarranted claims for deductions’. According to McCormack and Anderson, the Canadian approach takes a narrow interpretation of the law so that the principles of ‘self-assessment’ are not undermined, in that all taxpayers are entitled to prepare their tax returns on the basis that they are correct in assessing their income and deductions, and that their position has merit, in the absence of any misleading or criminal conduct. The penalties in Canada are significantly less than those in Australia, namely the greater of $1,000 and 100 per cent of the gross revenue gained from selling the tax shelter arrangement.

In the US, tax shelter promoters are required to register their scheme with the Inland Revenue Service. The penalties are the greater of $1,000 and 20 per cent of the gross income derived from the arrangement. However, the IRS Internal Revenue Manual, Part 20, states that ‘a tax adviser would not be subject to the penalty for suggesting

71 Ibid, 425.
72 The new measures were made law on 26 March 2003 and are contained in the Tax Administration Act 1994 (NZ).
73 McCormack, above n 65, 425.
74 Ibid, 426.
an aggressive but supportable filing position to a client even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. 75

There is genuine concern that some taxation advisers may be caught by the law even when providing advice to their clients on marketed tax mitigation arrangements. There is a fine line between tax planning and tax avoidance but, in both cases, there is no criminal conduct on the part of the adviser or taxpayer. It does not appear that the government considered the experience in Canada and the US and, in particular, the penalty provisions before enacting the new law.

One of the main concerns with the law is that many innovative lending and financial arrangements may not be promoted simply because the originators of the plans are hesitant to release the products for fear of being subject to very onerous civil penalties. Also of major concern is that the self-assessment system may be severely undermined as a result of taxation advisers being too frightened to be seen as ‘promoters of tax exploitation schemes’ when preparing their clients’ tax returns and offering taxation advice. The government may well have taken a ‘sledge hammer’ approach to a perceived problem, dressed it up as investor protection, but may have caused many taxpayers and accounting and law firms to be too frightened to take a position that may be considered to be well within the law but, may subsequently, be regarded as tax avoidance and then be branded as unscrupulous tax scheme ‘promoters’. In a situation where an accountant or lawyer is asked by their client to provide advice and to use their professional network to establish an investment fund with an offshore bank in, say, Singapore, what should they do? They will not be held to be engaging in the conduct of being a tax scheme promoter if the structure is not marketed to other clients of the firm or other professional practices. However, if that client fails to include any foreign income in their tax return each year, is the tax adviser then held to be a tax scheme promoter and guilty of a criminal offence? The tax adviser would be very wise to have extensive evidence that their client was made aware of their obligations to declare all foreign income and that criminal sanctions

75 Ibid.
could be imposed, similar to those imposed on Glenn Wheatley,\textsuperscript{76} and potentially other taxpayers targeted by ‘Operation Wickenby’.

### 7.5 A Further Example of Blurring: The AML/CTF Act

The *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act)\textsuperscript{77} was introduced to overcome the inadequacies of the existing law relating to the reporting of cash transactions and to require professional accounting, legal and financial advisory firms to report suspect transactions. The law has been implemented over a 24 months period to allow businesses to meet their obligations.\textsuperscript{78} The first tranche has ‘covered the financial and gambling sectors, bullion dealers and lawyers/accountants, but only to the extent that they provide financial services in direct competition with the financial sector’.\textsuperscript{79} The second tranche then applied to real estate agents as well as accountants/lawyers carrying out certain transactions, such as setting up a company in a foreign country. This means that accountants and lawyers will, from 12 December 2008, be required to report their clients if engaged in suspicious transactions, such as transmitting money to a tax haven or OFC. On the face of it, such conduct would appear to constitute the act of money-laundering because the proceeds of that conduct would constitute the proceeds of a crime; in this case, the crime being tax related. Even if the client was engaged in legitimate tax planning activity, the transfer of funds to a tax haven would need to be reported to the Australian Transaction Reports and Analysis Centre (AUSTRAC).

The Replacement Explanatory Memorandum\textsuperscript{80} to the AML/CTF Bill states that the ‘reforms are a major step in bringing Australia into line with international best

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\textsuperscript{76} Glenn Wheatley, a high profile Australian, was sentenced to gaol on 19 July 2007 for tax evasion as a result of using a tax haven to hide his investments. His actions were detected as part of the ‘Project Wickenby’ investigations. ATO, ‘Banking on you, our open door policy’, Speech by the Commissioner of Taxation, Australian Bankers’ Association Tax Workshop, Sydney, 22 August 2008.

\textsuperscript{77} The *AML/CTF Act 2006* received Royal Assent on 12 December 2006.

\textsuperscript{78} The obligations under the Act require (1) customer identification and verification within 12 months from 12 December 2006; (2) record keeping – in various stages within the 12 months; (3) establishing and maintaining an AML/CTF program – within 12 months; (4) ongoing customer due diligence and reporting suspicious matters, international funds transfers – 24 months after 12 December 2006.

\textsuperscript{79} Replacement Explanatory Memorandum to the AML/CTF Bill at page 1.

\textsuperscript{80} The new law was released to the public for comment as an ‘exposure draft’ and the Anti-Money Laundering and Counter Terrorist Financing Bill was eventually introduced to the Commonwealth Parliament on 1 November 2006 after taking into account submissions by interested parties.
practice to deter money laundering and terrorism financing that includes standards set by the Financial Action Task Force (FATF)\textsuperscript{81} and, hence, the reason for its proposed enactment. Prior to the AML/CTF Act, under the \textit{Financial Transactions Reports Act 1988} (Cth) cash dealers were required to report suspect transactions involving $10,000 or more in cash or international funds transfers and the opening of bank accounts in Australia. The statutory law in existence prior to 2006 was not considered by the government to be adequate, especially with the increase in non-face to face transactions through electronic transfers. Instead, the AML/CTF Act adopts a ‘risk based approach’ to identifying customers that may be engaged in money laundering or terrorism financing and applies to a very wide range of businesses, not just cash dealers. The use of tax havens and schemes devised by lawyers and accountants is now part of the focus of the new law and will be comprehensively dealt with in the second tranche of law.

\subsection*{7.5.1 What is ‘money laundering’?}

Much is made of the conduct known as ‘money laundering’ but very little attention is paid to defining exactly what are the essential ingredients in the act of engaging in ‘money laundering’. In the ‘Issues Paper 1, Financial Services Sector’, released as part of the Commonwealth Attorney-General’s Department paper on the Anti-Money Laundering Reform, an attempt was made to describe ‘What is money laundering?’\textsuperscript{82} ‘The goal of most criminals is to generate a profit. To enjoy their ill-gotten gains, criminals commonly seek to disguise the illegal source of those profits. Money laundering is the processing of criminal profits to disguise their illegal origin.’

In the Australian Law Reform Commission Report 87\textsuperscript{83} on the Proceeds of Crime and, in particular, Part 7, Laundering of Property and Money, the report attempts to define money laundering as follows:

\begin{quote}
The definitions of money laundering most frequently used in domestic legislative provisions is derived from that used in the 1988 United Nations Convention against
\end{quote}

\textsuperscript{81} Replacement Explanatory Memorandum, Anti-Money Laundering and Counter Terrorism Financing Bill 2006, 1.
\textsuperscript{82} Attorney-General’s Department, Issues Paper 1, Financial Services Sector, 1.
Illicit Traffic in Narcotic Drugs and Psychotropic Substances \(^{84}\) which provides that money laundering is:

- the conversion or transfer of property, knowing that such property is derived from any indictable offence or offences, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person, who is involved in the commission of such an offence or offences to evade the legal consequences of his or her actions or

- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from an indictable offence or offences or from an act of participation in such an offence or offences. \(^{85}\)

Similarly, in the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, money laundering is defined as follows:

- the conversion or transfer of property, knowing that such property is proceeds, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of the predicate offence to evade the legal consequences of his actions;

- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is proceeds. \(^{86}\)

This means that tax evasion, which constitutes the criminal offence of ‘defrauding the Commonwealth’ which is in the Commonwealth Criminal Code, \(^{87}\) could amount to money laundering if an OFC or a tax haven was used to disguise or conceal income from investments that were not subsequently declared in the Australian taxpayers’ tax return. The offence of money laundering is contained in Part 10.2, Division 400 of the Criminal Code. The Replacement Explanatory Memorandum to the AML/CTF Bill provides the following estimate of the extent of the financial

\(^{84}\) Although that was restricted to narcotics related offences.

\(^{85}\) Australian Treaty Series 1993 No 4 UNTS art 3(1)(b).

\(^{86}\) ETS No 141 art 6.

\(^{87}\) The offence of defrauding the Commonwealth was until 2005 contained in the *Crimes Act 1914* (Cth), s 29D.
The size of the money laundering problem cannot be accurately quantified but, in a research project funded by AUSTRAC and drawing on a wide range of financial and other data relating to 1994, it was estimated that in that year a range of between $1,000 million and $4,500 million would appear to be a sensible interpretation of the information provided in these sets of estimates, with perhaps some confidence that the most likely figure is around $3,500 million, since this figure lies within all three estimate ranges.

7.5.2 Designated services – lawyers, accountants and financial advisers

The concept of requiring businesses engaged in providing ‘designated services’ to report suspect customers and obtaining proof of identification are the key measures being used by the law to detect suspicious matters. The definition of ‘designated services’ is so broad that it will cover all businesses which provide trade credit, including all consumer credit transactions. There is also no limit on the money being paid for a designated service, except a $1000 limit for stored value cards.

The Act generally requires a business to ‘identify’ new customers before providing a service. Circumstances in which a customer can be identified after the service has been provided are if the prior identification would disrupt the ordinary course of business, the service is specified in the AML/CFT Rules, and:

- It is not provided face-to-face; or
- It consists of acquiring or disposing of a security or derivative on behalf of a customer; or
- It consists of issuing or undertaking liability as the insurer under a life policy or a sinking fund policy.
- In some circumstances, the provision of certain low-risk services will not require client identification.

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88 J Walker, *Estimates Of The Extent of Money Laundering In And Through Australia*, AUSTRAC September 1995, 39. This report is also referred to in the Replacement Explanatory Memorandum to the AML/CTF Bill at page 12 to justify the introduction of the law.
The AML/CTF Rules are made by AUSTRAC pursuant to powers provided by s 229 of the AML/CTF Act and, to date, a number of rules have been made.89

Lawyers, accountants and financial advisers are only under an obligation to report suspicious matters when providing ‘designated services’. Section 6 of the Act contains two tables; the first lists 63 designated services of a financial services nature with specific reference to Australian Financial Services License holders (Items 62 and 63 refer to buying and selling bullion). The second table refers to gambling services. Therefore, lawyers, accountants and financial advisers are a reporting entity to the extent that they provide designated services.

For example, lawyers acquiring or disposing of securities on behalf of clients, creating and dealing with promissory notes, bills of exchange and arranging safe deposit box facilities are providing a designated service. Preparing a will is not a designated service. However, the purchase of real property and the provision of mortgage finance or international transfer of funds is a designated service because the transfer of real property and mortgage arrangements can be used to launder money.90 Similarly, the creation of a trust or company structure to be used to move funds offshore or on shore will be a designated service. The following services are not regarded as being ‘designated services’:

- Preparation of a tax return is not a designated service.
- Providing advice on what are securities and derivatives.
- Establishing a superannuation fund and then advising on the investment of the funds.
- Advising on life insurance or a sinking fund insurance policy.

The main thrust of the AML/CTF Act is to require businesses which provide designated financial services to have a process to identify their customers. Professional advisers are referred to as ‘gatekeepers’ in the Explanatory Memorandum because of those people involved in money laundering using the services of professionals to launder the money. The government has recognised that

90 Attorney-General’s Department, AML/CTF Bill, Issues Paper 5 – Legal Practitioners – Accountants – Company and Trust Service Providers, 5.
criminals use sophisticated structures, such as trusts, companies and managed investment schemes, to launder money. However, what happens when an existing client seeks advice from their lawyer or accountant about establishing an investment fund in, say, Singapore, because they want to diversify their investments? Would their accountant or lawyer have to report this activity or be in breach of their obligations under the AML/CTF compliance requirements, or do they make the judgment that the activity is legal and does not amount to money laundering? The simple answer is that they must report those transactions to AUSTRAC or face serious consequences.

The AML/CTF Act requires professional practices, whether they are engaged in accounting, legal or financial planning services, to not only formally identify their clients but also to report their activities, that may be suspicious in terms of money laundering or terrorist financing, to AUSTRAC. As was mentioned above, the government is aware that these types of professional practices provide services to those people engaged in money laundering and they want to identify those involved so that they can be prosecuted. Unfortunately, taxpayers engaged in tax planning activities may be caught by this new law as it makes no distinction between tax evasion, tax avoidance or tax planning. Clearly, the government would like to see all tax minimisation activity categorised as constituting a criminal offence and then the taxpayer can be prosecuted under the Commonwealth Criminal Code for money laundering.

7.5.3 International implications of the law

Designated services are not subject to the new law unless the service is provided in Australia through a ‘permanent establishment’ of a Foreign Service provider or the service is provided by an Australian resident or a resident subsidiary company through a permanent establishment in a foreign country. Will this law result in Australians obtaining financial and taxation advice from a non-Australian provider in a location outside Australia? This may well be the case and the government will be in an even more difficult situation in trying to detect Australian taxpayers engaged in tax planning activities in tax havens and OFCs. Similarly, will Australians be reluctant to obtain tax planning advice in Australia, even if not engaged in money
laundering but legal tax mitigation using a tax haven or OFC? In particular, what effect will this law have on Australians using tax havens for legal purposes? Given that Australian banks, Australian accounting firms and Australian law firms have offices in tax havens in the Asia-Pacific region, their services are subject to the AML/CTF Act where they are operating through a permanent establishment in that country. These questions will not be answered for a number of years and should provide a fertile area for future research. Indeed, as Eden and Kudrle have noted in their research as to the future of tax havens in light of initiatives by the OECD and now Australia, with the proposed anti-money laundering legislation, at this stage, no research has been undertaken into the role of the multi-national enterprises and international tax and accounting firms located in tax havens.91

7.6 Implications for the ‘Rule of Law’

One of the major implications of the government treating all activity to minimise taxation, either by tax avoidance or tax evasion, as constituting criminal activity, is that it threatens the ‘rule of law’ by ignoring clear distinctions within the established taxation law of Australia on this point and provides the ATO with powers that potentially infringe the rights of taxpayers. More importantly, by confusing the issue of what constitutes acceptable tax mitigation activity with unacceptable tax avoidance, the rule of law is put at risk by the inherent complexity of the current law.

The ‘Rule of Law’ is a principle contained in the English legal system and, as enunciated by Professor Dicey, holds that all men are equal under the law except the Crown.92 It can also be expressed as the notion ‘that the people and the government should obey the law and be ruled by it’ but the legal concept of the ‘rule of law’ is not readily definable.93 What is important, in this context, is the fact that there is a ‘strong correlation between economic growth and a strong rule of law…’.94 In other words, a country that ensures that all of its citizens and the government obey the law

91 Eden and Kudrle, above n 56, 124.
94 Ibid, 425. Ross Buckley has taken this quote from Douglas North, the Nobel Prize winner in Economics in 1993 who researched the correlation between the rule of law and economic growth and development.
will have a strong and vibrant economy. If that is the case, then the law must be easy to understand and administered fairly, and the doctrine of separation of powers should also operate effectively. Parliament, consisting of the elected representatives, makes the law, the Executive administers the law and, the Judiciary resolves any disputes arising from interpreting the law. In the context of a deliberate blurring of the distinction between tax avoidance and tax evasion, the rule of law has relevance because of how the existing law is to be made and interpreted by Parliament, the Executive and administrators, and the Judiciary. Professor Walker is of the opinion that the rule of law is being eroded due to the number of wide discretions, especially in relation to tax avoidance, Part IVA, and provides the following statement to that effect:

The ultimate grant of discretionary power is, of course, Part IVA, enacted in 1981 and to which the rest of the Act is subject. Australia has placed more reliance on the GAAR than any other Western democracy, and Part IVA’s supporters argue that it may strengthen the rule of law by increasing compliance with tax legislation. The problem, however, is that it seeks to encourage compliance by means that compromise the rule of law, for example by depending on discretion and opinion.95

Professor Walker contends that there is far too much discretion given to both the ATO and the courts in determining what constitutes tax avoidance. He quotes extensively from Professor Jeffrey Waincymer in that ‘this approach offends against the separation of powers doctrine and the requirement that the laws be made by parliament not bureaucrats’.96

One of the key issues that Professor Walker has identified as being conducive to an erosion of the rule of law is found in the ATO’s ruling system where, in ‘perhaps 90 percent of cases these materials are consistent with enacted law, but in the remainder the ATO is effectively making its own rules’.97 In 1992, when the ruling system was

97 Ibid, 2.
being introduced into Parliament by the Minister assisting the Treasurer, it was stated that ‘the ruling system was touted as promoting certainty for taxpayers and thereby reduce their risk and opportunity cost’.98 However, a recent example of where an ATO ruling, TR 1999/5 was in conflict with the case law is found in the Federal Court decision in *Essenbourne Pty Ltd v FCT*.99 The ruling was subsequently withdrawn on 27 June 2007 after the Commissioner of Taxation had publicly disagreed with the decision of Kiefel J through an ATO Media release100 and the Commissioner had brought three more cases before the Federal Court in an attempt to obtain a Federal Court decision in line with its public ruling, TR 1999/5. In the end, all of the Federal Court decisions101 held that there was no fringe benefit in the situation involving employee benefit trusts and non-complying superannuation funds. The major issue threatening the ‘rule of law’ in this situation was that the Commissioner of Taxation was adopting the position of the Parliament and the Judiciary in making new taxation law in relation to the fringe benefits tax. The stance taken by the ATO went far beyond what is required to administer the taxation law and would have added to the confusion facing tax professionals, business and individual taxpayers.

Professor Walker provides a number of examples of situations where the discretion provided to the Commissioner of Taxation has led to the ATO adopting the role of law maker and, as such, threatening the rule of law.102 One example that has serious implications for tax administration is the bonus arrangement that auditors are being paid for every extra dollar of revenue collected. As Professor Walker states, ‘the practice of remunerating tax officers according to the amount of revenue they collect recalls the 18th century tax-farming abuses that helped trigger the French Revolution’.103

101 The cases before the Federal Court that held that there was no fringe benefit in terms of the ruling TR 1999/5 were *Walstern Pty Ltd v FCT* (2003) 138 FCR 1, *Caelli Constructions (Vic) Pty Ltd v FCT* (2005) 147 FCR 449, and *Indooroopilly Children Services (Qld) Pty Ltd v FCT* [2007] FCAFC 16.
102 Walker, above n 95, 3-5.
103 Ibid, 5.
7.7 Conclusion

The distinction between tax avoidance and tax evasion, that has been firmly established in the Australian common law, is still of great importance when dealing with taxation issues domestically. However, it would appear that the Australian Government is determined to ignore the distinction between tax avoidance, a legal activity, and tax evasion, a criminal activity, when it comes to Australian taxpayers engaging in tax planning in a tax haven or through the use of an OFC. The government has recognised that many tax schemes involved the use of tax havens and appear to have designed a set of laws to deter the promotion of tax schemes that make no distinction between tax avoidance and tax evasion. Similarly, in relation to the law to detect and eliminate money laundering, once again, the government appears to have deliberately blurred the difference between tax avoidance and tax evasion. The AML/CTF Act would appear to designate that all measures to reduce and minimise income tax through the use of tax havens constitutes criminal activity and, therefore, justifies the tax haven in breaching its bank secrecy laws. The fact that the rights of the taxpayer may be adversely affected and the taxpayer wrongly being accused of criminal activity is of no concern for the government when trying to maximise government revenue.
Chapter 8  Exchange of Information

Agreements with Tax Havens: How Will This Affect the Rights of Non-Resident Taxpayers and Investors?

8.1 Introduction

The Organisation for Economic Cooperation and Development (OECD) appears to have been successful in convincing tax havens and countries with strict bank secrecy laws to exchange information on non-resident taxpayers, investors and businesses using their financial services. The OECD announced that representatives of over 100 governments met in Mexico on 1 September 2009 to discuss the next steps in improving transparency and exchange of banking information. While this situation may be good for tax administrators in the pursuit of their goal of maximising the collection of tax revenue, the main question that is examined in this chapter is where does it leave the non-resident taxpayer and foreign investor in terms of their right to privacy and the right to maintain the confidentiality of their financial and banking details? The Australian Taxation Office (ATO) has statutory powers that provide an extensive right to access information about a taxpayer’s dealings, both within Australia and overseas. ‘Operation Wickenby’, a joint operation between the ATO, the Australian Crime Commission, the Australian Federal Police and a number of government agencies are trying to detect Australian taxpayer’s operating foreign bank accounts and evading income tax through the use of tax havens.¹ Some of the methods being used by the taskforce to obtain information about taxpayers is examined in this Chapter. Currently the Australian taxpayer has some rights to protect their privacy or to keep confidential their financial affairs, in certain

¹ Operation Wickenby is examined in detail in Chapter 9 of the thesis. For information on ‘Operation Wickenby’ connect to the following ATO internet address: http://www.ato.gov.au/corporate/content.asp?doc=/content/00220075.htm&page=3&H3.
situations. One of the major concerns about the tax information exchange agreements is that tax authorities may be able to access information about their resident taxpayers without restriction and without the taxpayer or investor being given the right to intervene or be consulted. This chapter will commence with an examination of the existing rights of the taxpayer, both domestically and internationally, as well as the powers of the ATO. The chapter will then assess whether the OECD’s ‘model tax information exchange agreements’ will reduce the rights that the taxpayer currently possesses.

The OECD and the European Union (EU) are anxious to end the movement of capital to low or no tax jurisdictions that have strong bank secrecy laws. The OECD’s harmful tax competition project has been successful in convincing tax havens and OFCs to exchange bank details with OECD member states by way of bi-lateral agreements. The OECD’s harmful tax competition project as well as the recent actions by the G20 is examined in detail in Chapter 5 of this thesis. The OECD can claim to have had success with the Caribbean Community and Common Market (CARICOM) states of the Caribbean and, more recently with the assistance of the G20 nations, success with the European countries with strong bank secrecy laws. It would appear that with the agreement by Switzerland, Austria and Luxembourg, the days of tax havens not being prepared to exchange information on non-resident taxpayers are coming to an end. The G20 Ministers at the London conference announced that ‘the era of banking secrecy is over’. The harmful tax competition initiative generated by the OECD has been viewed as the destruction of privacy by requiring these sovereign states to breach confidentiality by disclosing bank account information.

The second and third parts of the chapter will discuss the rights to privacy that existing taxpayers have, both from a domestic perspective and an international perspective. The fourth part of the chapter will examine the likely impact the OECD initiated tax information exchange agreements will have on the rights of privacy and

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confidentiality of non-resident taxpayers and investors operating in the international arena.

The Australian Commissioner of Taxation has appealed to tax agents in Australia to ‘dob’ in tax scheme promoters and clients with undeclared overseas income. This statement was made as part of the offensive by the ATO against tax havens which receive up to $5.3 billion a year from Australia. The ATO encourages the public to report suspected tax cheats either by telephone or through the Internet. However, tax agents now have a separate line to report suspect action of other tax agents or even their own clients. If this approach was to be accepted by tax agents in Australia, what are the implications for both the taxpayers and the tax adviser and accountants? It is contended in this chapter that tax advisers and accountants owe a fiduciary duty to their clients who require them to maintain the confidentiality of their financial information. However, should they place their clients first or do they have a higher duty to the community and, in turn, the ATO, which requires them to report the conduct of their client if their client’s activities will result in not paying the correct amount of tax.

By way of contrast, the Internal Revenue Service in the US pays a reward to tax informers and has been doing this since 1867. More recently, the Bush Administration introduced the Tax Relief and Health Care Act 2006 which amended the previous informant reward program and introduced a ‘whistleblower’ program with rewards up to 30 percent of the tax, penalties and interest collected. As a countervailing measure, US State parliaments have specifically enacted laws making it a crime for accountants and lawyers to disclose confidential information about their clients in relation to taxation matters. Accountants and lawyers in Australia

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4 The term ‘dob’ is Australian slang for to report or to inform someone in authority about a persons’ behaviour.
6 However, according to Justin Dabner this may have been put on hold as a result of opposition from the accounting profession. See Justin Dabner, ‘An update on the OECD’s harmful tax practices project’, (2004) 40 CCH Tax Week, 76.
9 Ibid, 274.
have a similar duty to maintain the privacy and confidentiality of their clients’
details. It is contended that, in most cases, these duties are based on the fiduciary
relationship they have with their client.

There are established mechanisms that enable tax administrators in one country to
obtain financial information about the business and investment activities of their own
taxpayers in another country. This is achieved through a Double Taxation Agreement
(DTA). One of the main purposes of a DTA is to provide the contracting states with
the right of the home state to obtain financial and banking information about their
residents engaged in business or investment activities within the territory of the other
contracting state. Therefore, within countries with DTAs, the taxpayer has always
been liable to have their foreign financial information disclosed to the tax
administration in their home state. However, one of the main features of tax havens
is that they have not actively entered into DTAs with other countries for this very
reason. DTAs are discussed in detail below.

It should also be noted that tax havens and OFCs generate substantial income from
the provision of banking, financial, legal and accounting services. In effect, the tax
avoidance and tax evasion industry provides the income for tax havens and OFCs to
survive and prosper and, in many cases this is the main generator of the country’s
revenue. It is understandable that tax havens have strong bank secrecy laws and an
incentive to maintain the privacy of their non-resident taxpayers.

8.2 The Rights of the Taxpayer - The Australian Position

Australia has a ‘self-assessment’ system of taxation in that all income tax returns, as
well as Fringe Benefit Tax returns and Business Activity Statements, are accepted at
face value and are not subject to immediate scrutiny. This means that the
Commissioner of Taxation has certain powers to check the veracity of claims by
taxpayers.  

Every year, the ATO collects financial information about its citizens, including interest earned on bank deposits, the receipt of dividends, employment information, including income tax paid under the ‘pay-as-you-go withholding system

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(PAYGW), the sale of shares and real property, the purchase of motor vehicles and boats over a certain monetary limit and, a whole range of transactions that involve money derived in Australia or overseas. The main method used by the ATO to track these transactions is through the need for all taxpayers to have a Tax File Number (TFN). The penalty for not having a TFN is that tax is withheld at source at the rate of 46.5 percent.\(^1\) For business taxpayers, the requirement is to have an Australian Business Number (ABN), a TFN, registration for Goods and Services Tax (GST), if sales are over a defined amount,\(^2\) the lodgement of a Business Activity Statement (BAS) monthly, quarterly or yearly,\(^3\) with the result that the ATO has a very good indication of the financial position of each business deriving income in Australia before a tax return is lodged each year. There is very little that the ATO does not know about the finances of the individual and, with developments in exchanging information between Australia and other countries, even foreign finances will be part of the vast amount of information gathered by the ATO each year. Even when visiting accountants or lawyers stay in Australia, their client lists, which may be contained on a data file within the laptop computer, can be seized by the police and used in the prosecution of Australian taxpayers.\(^4\)

The crucial issue with the collection of taxes and administering the tax law is to balance the rights of the taxpayer with maximising the collection of revenue. From the perspective of the tax administrator, the ATO, the Australian taxpayer has a number of basic rights that are encapsulated in the ‘Taxpayers’ Charter’. The charter was first introduced in Australia on 4 July 1997 and was the result of a parliamentary inquiry into the administration of the tax system.\(^5\)

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\(^1\) The rate of tax deducted under the withholding system for not providing a TFN is the top marginal rate of income tax, namely 45% plus 1.5% Medicare levy. Once the taxpayer lodges a tax return the amount withheld is credited against tax payable by the taxpayer.

\(^2\) An entity must be registered for GST if their turnover is greater than $75,000 or $150,000 if a non-profit entity or a business may choose to be registered if their turnover is less.

\(^3\) A business must lodge a BAS monthly, quarterly or yearly depending on their turnover and level of PAYG withholding.


8.2.1 The Taxpayers’ Charter

The Charter outlines the relationship the ATO seeks with the community and is stated to be one of mutual trust and respect. To this end, the Charter sets out the following:

- taxpayers’ rights under the law;
- the service and other standards taxpayers’ can expect from the ATO;
- what taxpayers can do if they are dissatisfied with the ATO’s decisions, actions or service, or if they wish to complain; and
- taxpayers’ important tax obligations.

The Charter contains two specific rights relating to privacy and confidentiality. At point 5, the ATO assures taxpayers that they respect their privacy and assure taxpayers that they are collecting the information in a fair and lawful way that is not unreasonably intrusive and, furthermore, will advise the taxpayer of the reason why the information is being collected, especially from third parties, and the purpose to which the information will be used. The information will only be shared with another person or organisation if it is authorised by the law. The ATO is also bound by the Privacy Act 1988 (Cth) and the Privacy Commissioner can investigate a complaint by the taxpayer.

At point 6, the ATO assures taxpayers that all information collected will be kept confidential unless the disclosure is authorised by the law. However, the Charter has not been given legislative force and, as such, does not provide taxpayers with any legal basis in which to bring an action against the ATO based on a breach of their obligations. At best, it provides some comfort and a legitimate expectation that the ATO will act with some level of professionalism in their dealings with the taxpayer. The concept of what is meant by the taxpayer having a ‘legitimate expectation’ that the ATO will adhere to the Charter is discussed by Margaret McLennan16 and clarified in the judgment of Deane J in Haoucher v Minister for Immigration and Ethnic Affairs (Haoucher) (1990) 169 CLR 648. The opinion expressed by Deane J

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can be summarised as where statutory power is being exercised, a person has a legitimate expectation that they will be treated with procedural fairness.

The notion of a ‘legitimate expectation’ which gives rise to a prima facie entitlement to procedural fairness or natural justice in the exercise of statutory power or authority is well established in the law of this country.  

Margaret McLennan discusses the impact the Charter has on the ATO and their duty to treat taxpayers in a fair and reasonable manner. McLennan acknowledges the extension of administrative law into the revenue area by virtue of the introduction of a Charter and the expectations of taxpayers in their dealings with the ATO.

The Charter sets out five main obligations of the taxpayer and they are described as follows:

- **Honesty** - taxpayers are required to provide complete and accurate information in preparing returns and ruling requests.
- **Record keeping** - taxpayers are required to keep the records required by law to support the positions taken in relation to their taxation affairs. Generally, records must be kept in English for a period of 5 years.
- **Reasonable care** - the Charter states that taxpayers are required to take reasonable care to fulfil their taxation obligations. Assistance may be obtained from the ATO.
- **Timely lodgement** - documents required to be lodged by the taxation legislation are required to be lodged by the dates specified in the legislation. Where an extension is required, taxpayers should contact the ATO.
- **Prompt payment** - taxpayers are obliged to ensure that taxes and other amounts due are paid by the due date. Taxpayers experiencing payment difficulties should contact the ATO to discuss the possibility of obtaining an extension of time to pay.

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17 *Haoucher v Minister for Immigration and Ethnic Affairs (Haoucher)* (1990) 169 CLR 648, 651.

18 McLennan, Margaret, above n 16, 31.

19 Ibid, 49.
The ‘right to privacy’ and ‘breach of confidentiality’ are used in this Chapter in a general sense to explain that taxpayers have an expectation that their private affairs will not be unlawfully disclosed to the public. The Charter, as discussed above, provides taxpayers with an expectation that the ATO will not unlawfully disclose their financial details.

One main issue that is at odds with the right of the taxpayer to privacy and is contrary to the concept of mutual trust and respect, as contained in the Taxpayer’s Charter, is the ease by which information about a taxpayer can be obtained from third parties.\textsuperscript{20} Taxpayers are not given notice of the ATO’s intention to obtain information from third parties and third parties are placed in a position where they could potentially infringe their legal obligations under the \textit{Privacy Act 1988} (Cth) by not informing the taxpayer of the situation and not obtaining their consent. However, in relation to criminal matters the Australian Crime Commission (ACC) has powers under the \textit{Anti-Money Laundering and Counter Terrorism Financing Act 2006} (Cth) and the \textit{Australian Crime Commission Act 2002} (Cth) to obtain information about suspected criminals from third parties subject to the \textit{Privacy Act 1988}. Tang argues that taxpayers should have the right to contest the release of information in what has been described as a ‘reverse-FOI procedure’.\textsuperscript{21} This approach is in line with the Australian Law Reform Commission report on privacy in advocating that all personal information should be kept confidential and that a person affected by disclosure of that information by a third party should be subject to objection by the person so affected.\textsuperscript{22} However, the ATO would contend that, in order to effectively collect revenue in some cases, the taxpayer should not receive advance notice. This is the situation when documents are obtained from a third party pursuant to a notice under s 263, \textit{Income Tax Assessment Act 1936} (Cth) (ITAA 36) or a warrant to seize documents from a third party. These mechanisms for obtaining information by the ATO are discussed in detail later in this chapter.

\textsuperscript{20} Tang, above n 10, 27.

\textsuperscript{21} Ibid, 26.

8.2.2 Duty of confidentiality

It is not proposed to discuss the equitable breach of confidence action in detail or to examine the concept of information as ‘property’ in the context of an analysis of the rights of taxpayers. It is well established in the common law that trade secrets and commercial intellectual property are protected by equity. Similarly, certain private and public organisations are governed by the Privacy Act 1988 (Cth) in order to protect confidential information. This issue was discussed in some detail by Tang and the fact that organisations breach their legal obligation to maintain the privacy of information of individuals when served with notices under s 263 or s 264, ITAA 36. The protection of the public revenue is paramount and rights provided by the Privacy legislation are secondary. The coercive powers under s 263 and s 264 provide access powers beyond those provided to the police. The police require a search warrant to access information for criminal proceedings but they are not required by the ATO when the revenue is being threatened. However, the focus of this section is to examine what protection the law provides to a taxpayer in their confidential dealings with their tax adviser. In particular, how comfortable can a taxpayer be in maintaining the confidential nature of their financial details, including arrangements that may involve investments in tax havens and OFCs with their tax adviser, given that the Commissioner of Taxation would like that same tax adviser to report their client’s activities to the ATO? The legal action for breach of confidence has, according to P.D. Finn, only matured in recent decades into a rule that ‘those who receive information in confidence shall not take unfair advantage of it’.

It is established law that certain people or institutions have a duty to keep information confidential. This duty is based on trade secrets, the existence of a special relationship, such as lawyer and their client, accountant and their client or a director and the company. If a tax adviser or accountant were to take notice of the Commissioner of Taxation’s advice and report their clients that have foreign

24 Tang, above n 10, 22.
25 Ibid, 23.
28 Ibid.
undeclared income, then they would breach their duty of confidentiality. If the adviser and client are in a fiduciary relationship, then the taxpayer can take legal action on the basis of the special relationship. However, if that special relationship does not exist, the taxpayer must then rely on the common law to provide the basis for legal action for breach of confidence. The concept of fiduciary duties is based on a duty of ‘loyalty’. According to Dal Pont and Chalmers, the duties are ‘proscriptive’ in that the person owing their client a fiduciary duty must ensure that they comply with the ‘no conflict’ duty and the ‘no profit’ duty.

8.2.3 Fiduciary relationship

It is contended in this chapter that accountants, tax agents and tax advisers are in a fiduciary relationship with their clients, the taxpayer and as such owe their client certain fiduciary duties. Moreover, it is equally contended that bookkeepers engaged in preparing Business Activity Statements (BAS) are also in a fiduciary relationship with their clients and owe them particular fiduciary duties.

In the High Court case of Hospital Products Limited v United States Surgical Corporation (1984) 156 CLR 41, Mason J made the following observation about the existence of a fiduciary relationship:

The accepted fiduciary relationships are sometimes referred to as relationships of trust and confidence or confidential relations (cf. Phipps v. Boardman [1966] UKHL 2; (1967) 2 AC 46, at p 127), viz., trustee and beneficiary, agent and principal, solicitor and client, employee and employer, director and company, and partners. The critical feature of these relationships is that the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense. The relationship between the parties is therefore one which gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that other person who is accordingly vulnerable to abuse by the fiduciary of his position. The expressions ‘for’, ‘on behalf of’ and ‘in the interests of’ signify that the

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29 Dal Pont, G, and Chalmers, D, above n 23, 91.
30 Ibid, 92.
31 Ibid, 91.
fiduciary acts in a "representative" character in the exercise of his responsibility, to adopt an expression used by the Court of Appeal.

It is partly because the fiduciary's exercise of the power or discretion can adversely affect the interests of the person to whom the duty is owed, and because the latter is at the mercy of the former, that the fiduciary comes under a duty to exercise his power or discretion in the interests of the person to whom it is owed. See generally, Weinrib, ‘The Fiduciary Obligation’ (1975) 25 University of Toronto Law Journal 1, at pp.4-8.  

In the case of Pilmer v Duke Group Ltd (In Liq) (2001) 207 CLR 165, Kirby J examined in detail the tests to be used in determining the existence of a fiduciary relationship. Applying the tests as enunciated by Kirby J, it can be strenuously argued that an accountant, registered tax agent, tax adviser and registered bookkeeper stand in a fiduciary relationship with their client. As such, the duty to maintain the privacy and confidentiality of their clients’ personal financial details is of paramount importance. If they fail to uphold this duty, then they should face the prospect of being sued for damages and, if the code of conduct for the professional body requires a duty of confidentiality, be investigated and sanctioned by the appropriate professional body for misconduct.

8.2.4 Right to privacy

A right to privacy is not as well established in the law as is the duty of confidentiality. Traditionally, privacy has been protected through the equitable doctrine of ‘breach of confidence’. However, as a result of the High Court decision in the case of ABC v Lenah Game Meats Pty Ltd (2001) 208 CLR 199, the door has been left open to introduce a common law action at some time in the future. Since

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34 At paragraph [107] per Gummow and Hayne JJ, with whom Gaudron J agreed. See also the article by Robert Dean, ‘A right to privacy?’ (2004) 78 Australian Law Journal 114, 114.
36 Ibid, 119.
this decision there have been two lower court decisions that have held that a cause of action for breach of privacy exists in the Australian common law.\(^{37}\)

In the UK, the Court of Appeal in the case of *Douglas v Hello! Ltd* [2002] WLR 992 recognised that a right of privacy had developed in the law.\(^{38}\) The Court also recognised the influence that Article 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms had on the equitable doctrine of breach of confidence.\(^{39}\)

The main problem with relying on using the breach of confidence action to either prevent a tax adviser disclosing information or suing for damages is that it requires the existence of a special relationship. This does not exist if the disclosure of information is made by a third party, as was the case in the *ABC v Lenah Game Meats* case. For example, what if an employee of the tax adviser disclosed information about the taxpayer to the ATO and then left the employment? The taxpayer has no special relationship to the former employee, only to the tax adviser. It is contended in this chapter that, in order for the Australian law to provide protection for taxpayers, there needs to be in existence a strong legal safeguard against unauthorised disclosure. Much has been written on this area of law especially in relation to non-disclosure restrictions contained in employment contracts and their effectiveness in protecting confidential information.\(^{40}\) However, it is not intended to examine this aspect in this Chapter.

### 8.2.5 Information gathering powers of the ATO

Sections 263 and 264 of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36) provide the ATO with coercive power to obtain information from the taxpayer and third parties. Section 263 allows the Commissioner or his delegate to enter buildings and take copies of documents, records and data stored on computers, provided it is

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\(^{38}\) Ibid, 117.

\(^{39}\) Ibid.

undertaken for the purpose of administering the *Income Tax Assessment Act* 1936 or 1997. Section 264 requires the recipient of the notice, being either the taxpayer or a third party, to provide information to the Commissioner. Both sections are reproduced below together with s 8C of the *Taxation Administration Act 1953* (Cth) (TAA) which makes it an offence to refuse to comply with the notices. A taxpayer served with a notice pursuant to s 263 or s 264 has the right to claim legal professional privilege to maintain the confidentiality of certain documents.\(^{41}\) The privilege against self-incrimination is abrogated by virtue of s 8C,\(^ {42}\) as discussed below. In fact, failure to comply with either a s 263 or s 264 notice is a strict liability offence, s 8C, TAA. The implications for claiming legal professional privilege or the privilege against self-incrimination, and the way in which taxation law takes precedence over the rights of the taxpayer, are discussed below.

**Section 263 - Access to books, etc**

(1) The Commissioner, or any officer authorized by him in that behalf, shall at all times have full and free access to all buildings, places, books, documents and other papers for any of the purposes of this Act, and for that purpose may make extracts from or copies of any such books, documents or papers.

(2) An officer is not entitled to enter or remain on or in any building or place under this section if, on being requested by the occupier of the building or place for proof of authority, the officer does not produce an authority in writing signed by the Commissioner stating that the officer is authorised to exercise powers under this section.

(3) The occupier of a building or place entered or proposed to be entered by the Commissioner, or by an officer, under subsection (1) shall provide the Commissioner or the officer with all reasonable facilities and assistance for the effective exercise of powers under this section.

Penalty: 30 penalty units.

**Section 264 - Commissioner to obtain information and evidence**

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\(^{42}\) Ibid.
(1) The Commissioner may by notice in writing require any person, whether a taxpayer or not, including any officer employed in or in connexion with any department of a Government or by any public authority:
   (a) to furnish him with such information as he may require; and
   (b) to attend and give evidence before him or before any officer authorized by him in that behalf concerning his or any other person's income or assessment, and may require him to produce all books, documents and other papers whatever in his custody or under his control relating thereto.
(2) The Commissioner may require the information or evidence to be given on oath or affirmation and either verbally or in writing, and for that purpose he or the officer so authorized by him may administer an oath or affirmation.
(3) The regulations may prescribe scales of expenses to be allowed to persons required under this section to attend.

Under these coercive powers, a taxpayer does not have the ability to remain silent or the ability to claim the privilege against self-incrimination. If a taxpayer fails to comply with either a s 263 or s 264 notice, they face prosecution under s 8C of the TAA. Section 8C is reproduced below as follows:

Section 8C - Failure to comply with requirements under taxation law
(1) A person who refuses or fails, when and as required under or pursuant to a taxation law to do so -
   (a) to furnish an approved form or any information to the Commissioner or another person; or
   (aa) to give information to the Commissioner in the manner in which it is required under a taxation law to be given; or
   (b) to lodge an instrument with the Commissioner or another person for assessment; or
   (c) (Repealed by Act 101 of 2006)
   (d) to notify the Commissioner or another person of a matter or thing; or
   (e) to produce a book, paper, record or other document to the Commissioner or another person; or
   (f) to attend before the Commissioner or another person; or
   (g) to apply for registration or cancellation of registration under the A New Tax System (Goods and Services Tax) Act 1999; or
   (h) to comply with a requirement under subsection 45A(2) of the Product Grants and Benefits Administration Act 2000; or
(i) to comply with subsection 82-10F(4) of the Income Tax (Transitional Provisions) Act 1997;
- is guilty of an offence.

(1A) An offence under subsection (1) is an offence of absolute liability. For "absolute liability", see section 6.2 of the Criminal Code.

(1B) Subsection (1) does not apply to the extent that the person is not capable of complying with the relevant paragraph. A defendant bears an evidential burden in relation to the matters in subsection (1B), see subsection 13.3(3) of the Criminal Code.

As a result of the ATO’s coercive powers pursuant to s 263 and s 264, together with s 8C of the TAA, where does that leave the Australian taxpayer in respect of the privilege against self-incrimination and the right to claim legal professional privilege to protect certain documents and communications from disclosure? Both of these rights will be examined in detail below.

8.2.6 Privilege against self-incrimination

The privilege against self-incrimination is different from the common law right to remain silent. The right to remain silent simply means that a person, in the absence of some legal compulsion to answer questions from persons in a position of authority, is free to remain silent and do nothing without fear of having an adverse inference drawn at any subsequent proceeding. The privilege against self-incrimination only arises where a person is compelled to answer questions or provide documents, as is the situation with s 263 and s 264, ITAA 36 and s 8C, TAA. The privilege is also contained in s 128 of the Evidence Act 1977 (Cth).

The case of Deputy Commissioner of Taxation v De Vonk (1995) 31 ATR 481, concerned the issue of a s 264 notice while the taxpayer, De Vonk, had been indicted for a criminal offence relating to a dishonest representation to the ATO and conspiracy to defraud the Commonwealth. The taxpayer was prepared to comply with the notice once the criminal proceeding had been completed but, in the meantime, argued that he had the right not to answer questions on the grounds that answers to those questions would tend to incriminate him. He further argued that the

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issue of the s 264 notice was an abuse of power by the ATO. In the joint judgment of Hill and Lindgren JJ, the following passage provides an excellent summary of the privilege against self-incrimination and its limited use in taxation matters:

It is the genius of the common law that it gave rise to judge-made rules protecting the citizen in response to perceived abuses of fundamental rights and freedoms. One such rule was the right of the individual to remain silent in circumstances where his or her testimony might tend to incriminate. As McHugh J points out in *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993) 178 CLR 477, the so-called privilege against self-incrimination arose in the 17th century as a result of dissatisfaction with the practices of the Council of Star Chamber and the Court of High Commission (see at CLR 543-4). Certainly by the end of the reign of Charles II it was accepted that an accused person might refuse to answer a question which might tend to incriminate him.

Those critical of the modern ability of the common law to protect the rights of individuals who seek now to espouse the entrenchment of a Bill of Rights into the Constitution, point to the concomitant and alleged weakness of the common law, namely, that it is subject to any rights which may be found expressly or by implication in a written constitution, subject to the overriding supremacy of Parliament. Thus, it remains open at any time for Parliament to legislate common law rights out of existence. While it is accepted that fundamental common law rights may be abrogated by Parliament, the courts will not lightly presume that Parliament intended so to do.

The principles to be applied have been enunciated in a series of decisions in the High Court commencing with *Mortimer v Brown* (1971) 122 CLR 493 and concluding with *Hamilton v Oades* (1989) 166 CLR 486. In the last of those cases, Mason CJ (at CLR 495) said:

The privilege against self-incrimination can only be abrogated by the manifestation of a clear legislative intention. The intention may nonetheless be demonstrated by reference to express words or necessary implication ... But the privilege is not lightly abrogated, and the phrase "necessary implication" imports a high degree of certainty as to legislative intention.
… It may be noted at this point that it has now been established as the law in Australia that the privilege against self-incrimination is not confined to judicial proceedings. Rather, it has been held to apply to administrative proceedings so as to afford a defence to the failure to answer questions, unless otherwise statutorily abrogated: Pyneboard at CLR 341 and Sorby at CLR 309.\footnote{44}

In terms of whether a taxpayer has the right to refuse to comply with the s 264 notice on the grounds of self-incrimination, Hill and Lindgren JJ concluded that, as a result of s 8C being inserted into the TAA in 1984, the privilege against self-incrimination had been abrogated. The following passage sets out their reasoning:

\begin{quote}
In these circumstances we are of the view expressed in Stergis v FCT (9189) 20 ATR 591; 89 ATC 4442 that the context of the legislation combined with the terms of ss 8C and 8D lead to the conclusion that the privilege has been abrogated. Clearly it is of the utmost importance that a taxpayer disclose to the Commissioner all sources of income. Failure so to do would constitute an offence. If the argument were to prevail that the privilege against self-incrimination was intended to be retained in tax matters, it would be impossible for the Commissioner to interrogate a taxpayer about sources of income since any question put on that subject might tend to incriminate the taxpayer by showing that the taxpayer had not complied with the initial obligation to return all sources of income. Such an argument would totally stultify the collection of income tax.\footnote{45}
\end{quote}

In view of the finding of the majority of the Full Bench of the Federal Court in the De Vonk case, the privilege against self-incrimination provides no safeguard for a taxpayer facing a s 264 notice due to the effect of s 8C of the TAA. However, Hill and Lindgren JJ did find that an examination under a s 264 notice could amount to a contempt of court and an interference in the administration of criminal justice. The following passage from the judgment highlights the risk that a s 264 notice may be invalidated where criminal or civil proceedings are underway, or a real possibility, in the future:

\footnote{44} (1995) 31 ATR 481, 494.
\footnote{45} Ibid, 498.
Even if s 264 of the Act required questions to be answered, notwithstanding that so
to do would otherwise constitute a contempt of court, it would not follow that the
fact that questions so asked might tend to interfere with the administration of justice
would be an irrelevant consideration in the Commissioner's deciding whether to
interrogate or to put particular questions. Even were contempt not to excuse the
failure to answer questions put under s 264 of the Act, failure to take into account
the possibility that a compulsory interrogation might interfere with the course of
justice could invalidate the giving of a notice under s 264 or the exercise of power
under it. In such circumstances, there is much to be said for the approach adopted by
Wilcox J of requiring the conduct of the interrogation to be deferred pending the
conclusion of the criminal proceedings.46

The only benefit a taxpayer has in relation to the privilege against self-incrimination
is that a s 264 notice should not be used to obtain information in any pending or
subsequent criminal prosecution; otherwise, the conduct by the ATO may be
construed as interfering with the administration of justice. However, Lisa West
contends that any evidence gathered under a s 264 notice for audit purposes could be
used as evidence if a prosecution is launched but it may be excluded by a court on
grounds of unfairness.47 West does concede that s 263 and s 264 notices should not
be used for the dominant purpose of gathering information for criminal purposes.
This view is supported by the decision of Hill and Lindgren JJ in the De Vonk case as
stated above.48

8.2.7 Legal professional privilege

If the Commissioner of Taxation serves a notice pursuant to s 263 or s 264, ITAA 36
the only means available to an Australian taxpayer to prevent access by the ATO to
certain documents and advice is to claim legal professional privilege. That privilege
will prevent the disclosure of written communication between the taxpayer and their
lawyer relating to certain legal advice and legal services in some instances. There are
exceptions to this privilege and they are discussed below.

47 West, above n 41, 204.
48 Ibid, 203.
The concept underlying the justification for upholding legal professional privilege is explained by Professor Ligertwood as the right of all citizens to obtain legal advice, which is at the core of the rule of law and protection of human rights. It is especially important as a bulwark against tyranny and oppression. If citizens are to fully understand their rights, they must be encouraged to communicate with lawyers through open and frank discussions and this can only be achieved if the communications are protected from disclosure. Legal professional privilege is described as a ‘substantive right which applies to prevent any compulsory access to client-lawyer communications’.

The concept of legal professional privilege has been recognised by the Evidence Act 1995 (Cth) as providing two privileges; an advice privilege (s 118) and a litigation privilege (s 119). The sections provide for the written communications between a legal adviser and their client to be kept confidential provided the communication was made or the written advice was prepared for the ‘dominant purpose’ of the lawyer in providing that advice. The sections are reproduced as follows:

**Section 118 - Legal advice:**
Evidence is not to be adduced if, on objection by a client, the court finds that adducing the evidence would result in disclosure of:

(a) a confidential communication made between the client and a lawyer; or
(b) a confidential communication made between 2 or more lawyers acting for the client; or
(c) the contents of a confidential document (whether delivered or not) prepared by the client, lawyer or another person;

- for the dominant purpose of the lawyer, or one or more of the lawyers, providing legal advice to the client.

**Section 119 – Litigation:**
Evidence is not to be adduced if, on objection by a client, the court finds that adducing the evidence would result in disclosure of:

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51 Ibid, 274.
52 Ibid.
The specific provisions of the *Commonwealth Evidence Act* have been reproduced above, but all states have similar provisions in their own Evidence Acts, commonly known as the ‘uniform Evidence Act’.

The common law approach to legal professional privilege had adopted a ‘sole purpose’ test as being the test to be used to determine whether the communication between the lawyer and client should be protected from disclosure, but this view was changed by the High Court decision in the case of *Esso Australia Resources Limited v Commissioner of Taxation* (1999) 201 CLR 49. The High Court finally resolved this issue and the majority found in favour of a ‘dominant purpose’ test similar to the statutory requirements. The main concern of the High Court was that, in a large company with in-house lawyers, many documents were capable of having the privilege attached to them when that may not have been the original intent of the legal advice in the first place. The sole purpose test was seen as being too rigid and absolute and that a more practical application was required.\(^{53}\)

The judgment of Gleeson CJ, Gaudron and Gummow JJ provides an excellent summary of the basis of the existence of legal professional privilege and the practical issues to be considered in its application:

Legal professional privilege (or client legal privilege) protects the confidentiality of certain communications made in connection with giving or obtaining legal advice or the provision of legal services, including representation in proceedings in a court. In

\(^{53}\) *Esso Australia Resources Limited v Commissioner of Taxation* (1999) 201 CLR 49, 73.
the ordinary course of events, citizens engage in many confidential communications, including communications with professional advisers, which are not protected from compulsory disclosure. The rationale of the privilege has been explained in a number of cases, including Baker v Campbell, and Grant v Downs itself. The privilege exists to serve the public interest in the administration of justice by encouraging full and frank disclosure by clients to their lawyers.54

The majority of the High Court, Gleeson CJ, Gaudron, Gummow and Callinan JJ, held that the correct test is the dominant purpose test, which is the common law test for claiming legal professional privilege.55

8.2.8 Tax advisers and professional privilege

In June 2005, the New Zealand Government introduced statutory law to extend the professional privilege to tax advisers.56 The US had extended the privilege to tax advisers from as early as 1998.57 Keith Kendall contends that there is a logical argument to extend the privilege to tax advisers in Australia on the basis that registered tax agents are given a statutory right to provide advice on tax law and that many tax agents are not lawyers.58 Section 251L(1), ITAA 36 provides a penalty for the provision of advice on taxation law unless a registered tax agent or a barrister or solicitor. This view, namely that the privilege should be extended to registered tax agents and their clients, is supported by the ATO in their ‘Access and Information Gathering Manual, Chapter 7 – Guidelines to Accessing Professional Accounting Advisors’ Papers’. The manual is used by ATO staff but it is available to the public through the ATO website. While the ATO acknowledges the practical effect of providing a privilege from disclosure of certain source documents, there is no legislative or common law justification for this approach. According to Kendall, the existence of these guidelines has created a legitimate expectation of the confidentiality of certain documents between a tax adviser and their client and this

54 Ibid, 64.
55 Ibid, 73.
57 Ibid.
58 Ibid, 52.
has been supported in two Federal Court decisions. Kendall is in favour of extending the privilege to non-lawyer tax advisers on the basis of their need to be registered tax agents before they can provide advice. The fact that both the US and New Zealand have extended the privilege, coupled with the fact that the ATO recognises the role played by accountants in the taxation process, should be reason enough for the privilege to be extended in Australia. This view is also supported by the Australian Law Reform Commission as discussed in their report titled ‘Privilege in Perspective: Client Legal Privilege in Federal Investigations’. It would appear that it is only a matter of time before the privilege will be extended to tax advisers in Australia.

8.2.9 Exceptions to the privilege – crime and fraud

The legal professional privilege to protect written communication between a lawyer and their client is lost when the documents relate to an activity involving a crime or fraud. The privilege is also lost if the client of the lawyer waives their right to claim protection under the privilege. Both of these exceptions will be examined as they relate to the rights of taxpayers and the ATO.

In the case of *Clements, Dunne & Bell Pty Ltd v Commissioner of Australian Federal Police* (2001) 48 ATR 650, North J held that the crime and fraud exception prevented the legal professional privilege being used to protect certain documents between the lawyer and client from being disclosed to the Australian Federal Police even though the alleged fraud was committed by a third party.

While this exception to the application of legal professional privilege may be sound law, what then is the situation where the third party, as in this case, is eventually found not to be guilty of the serious crime of defrauding the Commonwealth, but the claim for protecting the confidentiality of the documents had not been granted some years earlier on the basis of the fraud exception? From the perspective of the

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59 Ibid, 54.
taxpayer and their right to maintain the confidentiality of certain written communications, the basis on which this exception has been applied would tend to suggest that the tax administrator has been granted an unfair advantage. This view is supported by Vincent Morfuni when he contends that the extension of the exemption of the privilege to third parties contradicts the widely held view that legal professional privilege is a fundamental right and he hopes that an appellate court will restore the exception to its traditional boundary. Morfuni advocates the restoration of the view taken by Deane J in *Attorney-General (NT) v Maurice* (1986) 161 CLR 475 where he stated that:

> Its efficacy as a bulwark against tyranny and oppression depends upon the confidence of the community that it will in fact be enforced. That being so, it is not to be sacrificed, even to promote the search for justice or truth in the individual case or matter and extends to protect a citizen from compulsory disclosure of protected communications or materials to any court or to any tribunal or person with authority to require the giving of information or the production of documents or other materials.

### 8.2.10 Exception to the privilege - waiver

The privilege belongs to the client and not to the lawyer providing the advice. Therefore, unless the client expressly claims the privilege, there is a presumption that it has been waived. However, if the documents are already in the possession of the lawyer, it is assumed that the privilege exists unless waived by the client. In this situation, the lawyer needs to be in a position where they can contact their client for specific instructions on claiming the privilege. Section 122 of the *Evidence Act 1995* (Cth), the uniform evidence legislation, provides for the waiver of the privilege along the lines of the common law waiver.

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63 Ibid.
64 (1986) 161 CLR 475, 491.
65 Ligertwood, above n 49, 294.
66 Ibid, 295.
67 Ibid.
In the case of *Federal Commissioner of Taxation v Pratt Holdings Pty Ltd* (2003) 51 ATR 593, the issue of whether the privilege was waived in a situation where written legal advice prepared by ABL was provided to a firm of accountants, PW for further analysis. In the Federal Court of Australia, Kenny J held that the client had not waived privilege in a situation where documents were provided to a firm of accountants. He made the following finding:

The Commissioner also submits that the privilege which attached or may have attached to some documents (including written advices given by ABL to Pratt Holdings …) was waived by Pratt Holdings when it disclosed the communications to PW. …

Mr O'Halloran also gave evidence that, from time to time after PW's retainer by Pratt Holdings, Pratt Holdings obtained advice from ABL concerning drafts of documents prepared by PW. It follows from this that a question of waiver may arise in relation to legal advice from ABL communicated by Pratt Holdings to PW in the course of instructing PW and discussing the work being done by PW for Pratt Holdings. The Commissioner apparently submits that, whilst this advice was initially privileged, privilege over these communications was also waived when Pratt Holdings disclosed their contents to PW.

In response to the Commissioner's submissions on waiver, Pratt Holdings conceded that Mr O'Halloran's disclosures to PW were voluntary. Counsel for Pratt Holdings submitted, however, that this voluntary disclosure did not constitute waiver.

As Gleeson CJ, Gaudron, Gummow and Callinan JJ observed in *Mann v Carnell* (1999) 201 CLR 1 (*Mann v Carnell*) at 13:

At common law, a person who would otherwise be entitled to the benefit of legal professional privilege may waive the privilege. ... Legal professional privilege exists to protect the confidentiality of communications between lawyer and client. It is the client who is entitled to the benefit of such confidentiality, and who may relinquish that entitlement. It is inconsistency between the conduct of the client and maintenance of the confidentiality which effects a waiver of the privilege. ...
Waiver may be express or implied. Disputes as to implied waiver usually arise from the need to decide whether particular conduct is inconsistent with the maintenance of the confidentiality which the privilege is intended to protect. When an affirmative answer is given to such a question, it is sometimes said that waiver is "imputed by operation of law". This means that the law recognises the inconsistency and determines its consequences, even though such consequences may not reflect the subjective intention of the party who has lost the privilege. ... What brings about the waiver is the inconsistency, which the courts, where necessary informed by considerations of fairness, perceive, between the conduct of the client and maintenance of the confidentiality; not some overriding principle of fairness operating at large.

In the first place, the legal advice given by ABL to Pratt Holdings attracted advice privilege. Pratt Holdings did not necessarily waive the privilege when it disclosed that advice voluntarily to PW (see Mann v Carnell at 14). Whether Pratt Holdings has, in fact, waived the privilege by such disclosure depends upon whether the disclosure to PW was inconsistent with the maintenance of confidentiality. In the circumstances of the case, I do not think it was. First, the purpose of the privilege is to protect the confidentiality of the legal advice received by Pratt Holdings from its solicitors. There is nothing inconsistent with that purpose in Pratt Holdings conveying the contents of the advice to PW, in order that PW provide an accounting analysis that would enable Pratt Holdings' solicitors to advise Pratt Holdings further on the matters of concern, upon the basis that PW would maintain the confidentiality of the legal advice: cf Mann v Carnell at 35 per McHugh J dissenting. It follows that I would uphold Pratt Holdings' claim of advice privilege in respect of document 35.68

This decision is important because many taxpayers provide their accountants with copies of legal advice so that tax returns can be prepared on the basis of the legal advice provided. In such situations, that legal advice retains the protection of the privilege and it would therefore not be available to the ATO. This would also apply to foreign legal advice provided to an Australian accountant for similar purposes.

8.2.11 Spousal privilege

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According to Professor Ligertwood, the common law sought to protect the institution of marriage by forbidding spouses from testifying for or against each other in civil or criminal cases.\footnote{Ligertwood, above n 49, 371.} Unfortunately, the common law has been overruled by specific statutory provisions at the state and federal level which makes the spouse a competent and compellable witness. The statutory law generally makes the spouse a compellable witness for the defence but the spouse can be exempted from being compelled to give evidence for the prosecution by the judge if the relationship may be harmed.\footnote{Ibid, 372.} The case of \textit{Stoddart v Boulton} [2009] FCA 1108 provides an excellent example of where the statutory law has overruled the common law in relation to the marital privilege. Mrs Stoddard did not wish to give evidence against her husband but, in order for her to succeed in claiming the privilege, she had to prove that the common law privilege or immunity against spousal incrimination has not been abrogated by the \textit{Australian Crime Commission Act 2002} (Cth), s 30.

Section 30 of the Act provides that:

1. **A person served, as prescribed, with a summons to appear as a witness at an examination before an examiner shall not:**
   - fail to attend as required by the summons; or
   - fail to attend from day to day unless excused, or released from further attendance, by the examiner.

2. **A person appearing as a witness at an examination before an examiner shall not:**
   - when required pursuant to section 28 either to take an oath or make an affirmation—refuse or fail to comply with the requirement;
   - refuse or fail to answer a question that he or she is required to answer by the examiner; or
   - refuse or fail to produce a document or thing that he or she was required to produce by a summons under this Act served on him or her as prescribed.

The following statement from Reeves J provides an excellent summary of the position on spousal privilege in Australia and the supremacy of the \textit{Australian Crime Commission Act 2002} (Cth):

\footnote{69 Ligertwood, above n 49, 371.}
\footnote{70 Ibid, 372.}
... whether spousal privilege is derived from self-incrimination privilege, or is a separate and distinct type of privilege based, as Ms Martin submits, on the unity of the family, the ultimate purpose of both is to prevent the husband (in this case) being incriminated. If this is so, it would be perverse, in my view, for the legislature to abrogate the husband’s privilege against self-incrimination in s 30 of the Act, such that he must answer and thereby incriminate himself directly by his own words, and yet, to keep in place his wife’s privilege not to incriminate him (not herself) indirectly by her words. Furthermore, as Mr Cooke QC pointed out, it would be somewhat surprising if the ends of marital and family harmony were to be given a higher level of protection under the Act, than the perseveration of personal liberty.

For these reasons, I conclude that s 30 of the Act has abrogated spousal privilege by necessary implication.71

The consequences of this decision are that in taxation matters that constitute a crime such as tax evasion, a spouse is compellable as a witness against their husband or wife even if it affects the marital relationship. The statutory provision overrules the privilege given to a spouse not to be compelled to testify against their wife or husband.

8.2.12 Banker – customer relationship

A resident taxpayer and foreign taxpayer should be confident that their financial details will not be disclosed by their bank. However, is this still the situation today? The common law duty of confidence or secrecy72 that a bank owes to its customers was established in the case of Tournier v National Provincial and Union Bank of England Ltd [1924] 1 KB 461.73 The following summary of the duty of secrecy is provided by Professor Weerasooria:

The bank’s duty of confidentiality extends to all information and transactions that go through the account including securities and guarantees, if any. It extends beyond

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72 WS Weerasooria, Banking Law and the Financial System in Australia (5th ed, 2000) 474. It is important to note that the text refers to the fact that the duty of confidence is also referred to as a duty of secrecy.
73 The law report is also available at: [1923] ALL ER Rep 550
the state of the customer’s account; that is, whether there is a debit or credit balance and the amount of the balance. It extends to information obtained from sources other than the customer’s actual account, if the occasion upon which the information was obtained arose out of the banking relations of the bank and its customer. For example, information obtained with a view to assisting the bank in conducting the customer’s business or in coming to decisions as to the bank’s treatment of its customer, would be covered by this duty of secrecy.\textsuperscript{74}

The English Court of Appeal established a number of principles qualifying the Bank’s duty of confidence in relation to a customer’s banking details.\textsuperscript{75} In the following circumstances the bank is justified in disclosing the customer’s details:

- Disclosure under compulsion of law. A bank is not above the law and if required under a specific statutory provision to disclose information about a customer then this must be done. This covers ATO action pursuant to a s 263 or s 264 notice. These sections have been examined in detail above in the context of legal professional privilege. The role of the bank, when faced with a s 263 or s 264 notice, is discussed in detail below.
- Disclosure that is in the public interest. There are no cases on this issue but it would cover the right of the banker to disclose secrets in a time of war or terrorist activity. It may extend to the bank voluntarily disclosing information of serious fraud or crime.\textsuperscript{76}
- Disclosure that is in the interest of the bank. In the case of Sunderland v Barclays Bank Ltd (1938) 5 Legal Decisions Affecting Bankers 163, the bank manager advised the husband of the plaintiff that cheques had been drawn by the plaintiff in favour of bookmakers when the plaintiff requested the manager to speak to her husband. The disclosure by the bank was required, even though the plaintiff’s confidentiality was breached, due to the husband requiring an explanation.\textsuperscript{77}
- Disclosure that is made with the express or implied consent of the customer. Customers may require the bank to disclose account

\textsuperscript{74} Weerasoria, above n 72, 476.
\textsuperscript{75} Ibid, 472.
\textsuperscript{76} Ibid, 492.
\textsuperscript{77} Ibid, 494.
information to third parties where a bank reference is required or a guarantee is being given.\textsuperscript{78}

There are two situations where s 263 and s 264 notices were served on banks seeking information about certain customers, and the role of the bank in providing that information to the ATO created a concern for the bank in performing their duty to their customer. The first case highlighted the fact that the banker-customer duty of secrecy is overridden by statutory requirements to disclose customer information. In the case of \textit{Smorgon v Federal Commissioner of Taxation} (1979) 9 ATR 483, the High Court of Australia held that the ANZ Bank must allow the ATO access to documents contained in a safe deposit box belonging to their customer and it did not matter that the ATO was on a ‘fishing’ expedition because they had no idea of what information or documents might be found in the safe deposit boxes. The following extract from Gibbs ACJ provides an excellent statement of the law in this respect:

\begin{quote}
It is true that a bank to whom a notice is given in circumstances such as the present may be placed in a position of considerable difficulty. In many cases the bank will have no knowledge as to what is contained in a safe deposit locker; it may not know whether it contains any documents or whether any documents that it does contain relate to the income or assessment of the person concerned. If the bank causes the locker to be opened, and finds inside it a locked box or sealed envelope, it has no right to open the box or the envelope to see what it contains. If a bank which is required to produce the documents contained in a safe deposit locker does produce the contents of the locker, and it is found that they are not documents which relate to the income or assessment of the person named in the notice, the bank may be liable to the depositor for breach of contract. On the other hand, if the bank fails to produce the contents of the locker, and they are found to be documents which do relate to the income or assessment of the person named, it may be liable for a breach of s 224 [now s 8C TAA].
\end{quote}

The apparent intention of the Parliament is that the Commissioner is entitled to have produced any books and documents that relate to the taxpayer’s income or assessment, even if he does not know what those books and documents may reveal. A document may be required to be produced only if it in fact relates to the income or

\textsuperscript{78} Ibid, 495.
assessment of the person in question but, if it is of that description, that is enough. In other words the Commissioner is entitled to make what was described as a "roving enquiry" into the income or assessment of a particular taxpayer and for that purpose to have produced such documents as relate to that income or assessment.\textsuperscript{79}

It would appear from the above decision that, possibly, the pendulum has swung too far in favour of the Commissioner in terms of obtaining information pursuant to s 264, ITAA 36. As is discussed later in part 4 of this Chapter under the heading of ‘exchange of information agreements’, tax administrators are not permitted to engage in ‘fishing expeditions’ when seeking information about their own residents’ financial dealings from a contracting country but, in terms of obtaining information from a bank in Australia, a ‘fishing expedition’ is permitted.

In the case of \textit{Citibank v Federal Commissioner of Taxation} (1989) 20 ATR 292, a bank was placed in a difficult situation of not being in a position to claim legal professional privilege over documents being seized by the ATO pursuant to a s 263 notice. The ATO entered Citibank’s premises looking for documents relating to a preference share arrangement but copied other documents relating to tax minimisation. The bank’s employees were not given an opportunity to claim legal professional privilege before the copies were taken by the ATO. The Full Bench of the Federal Court, per Bowen CJ, Fisher and French JJ, held that Citibank should have had an opportunity to claim privilege on behalf of their customers before copies of documents were taken and that the ATO needed to adopt guidelines in order to prevent this from happening in a similar situation in the future.\textsuperscript{80} One of the major issues that a non-resident taxpayer must face is that documents could be seized from a bank in, say, a tax haven and the bank does not have an opportunity to claim the privilege on behalf of their customer before copies are taken by the tax authority, similar to the issue raised in the \textit{Citibank} case.

One of the arguments in favour of using s 263 or s 264 notices is that they are quicker to obtain because they do not require the consent of a judicial officer, as is the case with obtaining a search warrant. However, in some situations, a search

\textsuperscript{79} (1979) 9 ATR 483, 490.

\textsuperscript{80} French J, (1989) 20 ATR 292, 320.
warrant is used particularly when criminal activity is suspected and evidence needs to be collected for a prosecution. In that case a s 263 or s 264 notice is not appropriate.

8.2.13 Search warrants

The use of a search warrant clearly violates the privacy of the individual and, therefore, there must be checks on the powers of the police. The justification for the warrant system is that it represents a control device by requiring a judicial officer, the person who issues the warrant, being convinced of the reasonableness of both the suspicion of the police and the proposed investigative action in order to provide some protection for the individual.81

The case of Egglishaw v Australian Crime Commission [2006] FCA 819 concerned a challenge to a search warrant pursuant to the Judiciary Act 1903 (Cth) on the basis that the warrant was unlawful, and of no effect, and that the seizure of the laptop computer and other material was unlawful. The applicant was Philip Egglishaw, a banker from Switzerland, who, while staying in a hotel in Australia, had his laptop computer seized under a search warrant. The laptop computer contained a list of Australian clients using the services of Strachans bank, a bank controlled by Egglishaw and situated in Switzerland. As a result of the personal records of the Australian clients using the tax haven bank being disclosed to the Australian authorities, Egglishaw, the applicant, challenged the validity of the search warrant in an attempt to protect his clients from the pending disclosure.

Sundberg J held that the Australian Crime Commission had discharged their burden of proof that their actions were lawful by obtaining a search warrant and that the applicant had the burden of showing that the warrant and actions of the officers executing the warrant was unlawful. Egglishaw was unable to convince the court that the obtaining of information that was contained in the laptop computer was unlawful.


Philip Egglishaw was compelled to provide evidence to the Australian Crime Commission (ACC) pursuant to s 28 of the *Australian Crime Commission Act 2002* (Cth) (ACC Act). From this, the ACC learnt that Egglishaw’s bank, Strachans, administers various companies, trusts and bank accounts based in foreign countries on behalf of, and for the benefit of, a number of Australian residents and their families. The ACC believed that the services provided by Strachans enabled Australian residents to accumulate substantial assets overseas in companies and trusts hidden behind an impenetrable veil of incorporation; create misleading documents which assist in defrauding the Commonwealth of Australia; and access their funds administered by Strachans from anywhere in the world by the use of debit or credit cards linked to bank accounts opened and operated for them by Strachans outside Australia, including at Corner Banca, SA in Lugarno, Switzerland. Based on the information obtained from Egglishaw, the ACC commenced criminal investigations into suspected fraud and money laundering by a number of Australian residents who have utilised the services provided by Strachans and Corner Banca.

Philip Egglishaw challenged the validity of the summons to appear, s 28, and the notice to produce documents, s 29. The matter came before Besanko J of the Federal Court and is reported in *Egglishaw v Australian Crime Commission* [2009] FCA 1027, (2009) 71 ATR 570. Egglishaw failed on all grounds to have the proceedings by the ACC declared invalid.

The ATO have the ability to obtain information from any taxpayer or tax adviser that is suspected of being involved in a criminal activity by way of a search warrant or compelling that person to attend and give evidence or produce documents pursuant to the *ACC* Act. The fact that the tax adviser is from another country makes no difference to the exercise of these powers. It was, arguably, unfortunate for the Australian clients that their details were contained in a laptop computer and the information was subsequently used by the ATO. However, from the perspective of the ATO, it was fortunate because many details about Australian resident taxpayers
were uncovered that has resulted in numerous prosecutions and the recovery of tax by the ‘Wickenby taskforce’.

8.2.15 Freedom of information

Taxpayers have a legal right to access information held by the ATO pursuant to the *Freedom of Information Act 1982* (Cth). However, there are a number of exemptions contained in ss 36, 37, 38, 40 and 42 that may prevent the taxpayer from being able to access all relevant information. Obviously, if the ATO has obtained legal advice from the Australian Government Solicitor (AGS) then legal professional privilege would apply. Similarly, if the Director of Public Prosecutions (DPP) provides legal advice to the ATO then the documents are privileged. This was the finding of the Administrative Appeals Tribunal (AAT) in the case of *Re Collie and Deputy Commissioner of Taxation* (1997) 35 ATR 1204. However, not only can the ATO claim an exemption from disclosing information but it can frustrate the process by charging for the retrieval of documents and, in some cases, can amount to tens of thousands of dollars.  

As Reynah Tang states, the taxpayer is precluded from being able to recoup the costs of complying with any ATO demands to provide information.

8.2.16 Human rights to protect taxpayers

The United Kingdom (UK) adopted the European Convention on Human Rights in 1953 but it was not until 1998 that the UK Parliament brought into existence statutory law to incorporate the Charter with the enactment of the *Human Rights Act 1998* (UK). The effect of the European convention was to guarantee a number of basic human rights by allowing the individual to complain about the behaviour of their own government. Lee contends that there are three main principles for the operation of the UK *Human Rights Act 1998*; first, any statutory interpretation must find a meaning that will prevent the legislation from being incompatible with the Convention rights; second, no court is able to strike down or disregard legislation.

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83 Ibid.
that conflicts with the Convention rights otherwise the primary or secondary legislation must be corrected; and third, the act requires all public authorities, including the Inland Revenue Service, to act in accordance with Convention rights.\textsuperscript{86} However, Lee is of the opinion that taxpayers in the UK will have a bleak future in trying to use the Convention rights as a weapon against statutory provisions.\textsuperscript{87} The impact of human rights legislation in Australia in relation to taxation law was considered by Farrell as potentially providing a fertile ground for tax practitioners\textsuperscript{88} and it has been raised by the Federal Court in the case of \textit{Federal Commissioner of Taxation v Citibank Ltd} (1989) 20 ATR 292. In the judgment by French J, the following passage illustrates the importance of the Convention on Human Rights in relation to the administration of tax law by the ATO:

\begin{quote}
Australia is a liberal democracy with a broad tradition of at least nominal resistance to encroachment upon established rights and freedoms. That view is reinforced by its adherence to the International Covenant on Civil and Political Rights, which relevantly provides in Art 17, inter alia, that: ‘No-one shall be subject to arbitrary or unlawful interference with his privacy, family, home or correspondence. ...’ The nature of this society and its tradition of respect for individual freedoms, will support an approach to construction which requires close scrutiny and a strict reading of statutes which would otherwise remove or encroach upon those freedoms. But where the natural meaning of the words is clear, the will of the Parliament must be respected.

Section 263 will plainly operate, in some if not all cases, to interfere with privacy and, in particular, that kind of privacy recognised by the rights to quiet possession of land and personal property which are protected by the common law relating to trespass.

In my respectful opinion, the approach taken by his Honour did not involve the choice of a narrow, over a broad, construction, although it might have been seen in practical effect as the choice of a lesser, over a greater, encroachment on private rights. For, there is nothing to suggest that a specific authorisation may not reach as
\end{quote}

\textsuperscript{86} Ibid, 159-160.
\textsuperscript{87} Ibid, 181.
\textsuperscript{88} James Farrell, ‘Strange Bedfellows? Tax Administration and Human Rights Brought Together’ (2009) 44(3) \textit{Taxation in Australia} 147, 150.
far into the territory of private rights as the process of general authorisation. A judicial requirement for such authorisation involves the imposition of a procedural safeguard on the exercise of the Commissioner's power. The concept of curially imposed procedural safeguards is not entirely novel. The rules of natural justice are an obvious example. In my opinion, however, it is not open to the court in the present case to create a new category of rules which would impose a procedural fetter on the exercise of this ‘wide’ statutory power in order to ensure that its repository gives due regard to common law rights.\textsuperscript{89}

In light of the above statement, it is clear that the coercive powers contained in s 263 will not be overridden by the protections contained in the Convention on Human Rights.

At present the State of Victoria and the Australian Capital Territory are the only jurisdictions in Australia that have introduced legislation to incorporate the Convention on Human Rights. The legislation is similar to the Convention and is found in the *Charter of Human Rights and Responsibilities Act 2006* (Vic) and the *Human Rights Act 2004* (ACT) respectively. The most relevant section for the purposes of this chapter is section 13 of the Victorian Act, Privacy and reputation:

A person has the right-

(a) not to have his or her privacy, family, home or correspondence unlawfully or arbitrarily interfered with; and

(b) not to have his or her reputation unlawfully attacked.

The Charter of Fundamental Rights of the European Union contains a similar provision with Article 7, Respect for private and family life:

Everyone has the right to respect for his or her private and family life, home and communications.

The United Nations Universal Declaration of Human Rights, Article 12:

\textsuperscript{89} (1989) 20 ATR 292, 316.
No one shall be subjected to arbitrary interference with his privacy, family, home or
correspondence, nor to attacks upon his honour and reputation. Everyone has the right
to the protection of the law against such interference or attacks.

Only time will tell if taxpayers in Australia are able to utilise the benefit of human
dropights legislation or conventions in an action against the ATO to prevent the
disclosure of financial information. What happens in Europe may be a guide as to the
future situation in Australia.

8.2.17 Australian tax agents and tax advisers – duty to society

A tax adviser can never, without the authority of his or her client, voluntarily give
information to the Commissioner no matter how inclined he or she may be to
cooperate. The confidentiality implied in the relationship of lawyer and client or
accountant and client ensures this. This confidentiality is, however, overborne by s
264.90 However, in the absence of any lawful obligation to disclose confidential and
private information, it is submitted that a tax agent or tax adviser must not disclose
any information belonging to their client to the ATO. The following statement by A.
J. Myers QC on the duty owed by a tax adviser to their client provides the most
appropriate answer to the conflict between a duty to society and a duty to the
taxpayer:

A legal adviser in the field of taxation or anything else has two main duties: to
advise his client to the best of his knowledge and ability, and to uphold the law.
There is no conflict between those roles, properly understood. The adviser upholds
the law by advising his client to the best of his knowledge and ability.91

If a tax adviser is uncomfortable with the activities of their client then they should
refrain from providing professional services to their client. If they decide to disclose
any information to the ATO then they should expect to be sued for damages for
breaching their duty of confidentiality, their duty to maintain the privacy of their
clients’ information and, in most cases, breach their fiduciary duty to act in the best
interests of their client.

8.3  The Rights of the Taxpayer – The International Position

With the OECD being successful in having all OECD member states accepting the revised Article 26 of the Model Double Taxation Agreement on the exchange of information and more than 320 tax information exchange agreements, what, then, are the chances of a non-resident taxpayer being able to maintain the confidentiality of their banking details? This is one of the main issues to be examined in this part of the chapter. The international situation is further complicated by the fact that some countries are willing to disclose information on banking details if the request involves a criminal tax matter but refuse to cooperate if it is merely a civil tax matter. However, the emphasis of the Australian government on categorising all forms of tax minimising, tax avoidance and tax evasion as constituting a criminal act is designed to overcome this particular reservation and to succeed in obtaining information from other countries. This particular issue will not be discussed in this chapter as it has been discussed in detail elsewhere.92

8.3.1 The OECD and a level playing field

In their recent report, ‘Tax Co-operation 2009: Towards a Level Playing Field’, the OECD highlighted the reason why transparency and exchange of information agreements were so important for the collection of revenue and the following statement illustrates this point:

International banking has become commonplace and it is no longer extraordinary for taxpayers to reside in one country, hold assets in another and have them managed from a third location. … But regardless of why taxpayers situate their assets beyond the boundaries of their own residence country, the result is that tax administrations around the world face more and greater challenges to the proper enforcement of their tax laws than ever before. To meet these challenges, tax authorities must increasingly rely on international co-operation based on the implementation of international standards of transparency and effective exchange of information.93


The OECD’s standards for transparency and information exchange are contained in the progress report. The standards are supported by the European Union, the G8, the G20 and the UN. They require countries to have a mechanism for exchanging information on request; the information will relate to domestic tax matters of a civil and criminal nature; there will be no restriction caused by the application of the dual criminality principle or domestic tax interest requirement; there will be respect given to safeguards and limitation; strict confidentiality rules; and the availability of reliable information, such as ownership, identity and accounting information, and powers to obtain and provide such information in response to a specific request.94

8.3.2 Double taxation agreements – Article 26

Double taxation agreements (DTAs) are entered into between two nations for the avoidance of double taxation and the prevention of fiscal evasion. The following article, relating to the exchange of information, is only relevant where there is in existence a DTA. Australia does not have a DTA with tax havens, although there is a DTA between Australia and Switzerland. However, in the case of tax havens, other ‘exchange of information agreements’ are used to try to achieve a similar outcome.

The new Article 26 for the exchange of information provides as follows:

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the

94 Ibid.
above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:
   a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
   b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
   c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

A non-resident taxpayer or foreign investor will not be involved in the exchange of information process and therefore not be in a position to claim legal professional privilege over documents or to be in a position to argue that the documents have no relevance to a taxation matter. According to Branson, some countries provided the taxpayer with notification that their financial details were being requested by another state except in the case of fraud.95 The following countries provided some type of prescribed notification to taxpayers when a request for information had been made:

Germany; Luxembourg; Portugal; The Netherlands; Sweden; Switzerland; and the United States. Branson discusses the possibility of providing the taxpayer with a right to notification, a right of consultation or a right of intervention and concludes with the finding that, at present, Australian taxpayers have no right to participate in the process whereby information is made available under the DTA. Branson discusses the fact that, in Germany, The Netherlands, Portugal and Switzerland, the government has introduced regulations giving rights of participation, and The Netherlands and Switzerland have provided laws to govern obtaining court orders to prevent or control the transfer of information. An Australian taxpayer or foreign investor would have no knowledge of the fact that their financial information was being requested from a foreign country under the DTA nor would they have the ability to contest the validity of such a request. Branson examines the possible remedies available to a taxpayer, including resorting to the various conventions on human rights as one possible way in which a taxpayer’s privacy may be maintained in the absence of rules providing a taxpayer with the right to participate in the information exchange process.

8.3.3 Offshore information notice - Section 264A(1)

Section 264A took effect on 8 January 1991 and was part of the general anti-avoidance regime. This notice is designed to obtain information about the affairs of the taxpayer that is located outside Australia. The notice can be served either on the taxpayer or a third party. The taxpayer has 90 days in which to comply. The documents or information may not be in the control or custody of the taxpayer, but a third party, but they still must be produced. The information or materials required to be produced must relate to the assessment of the taxpayer. If the notice has been served on a trustee and the trustee is not in a position to pay income tax because there are beneficiaries presently entitled and not under a legal disability, then the notice

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96 Ibid.
97 Ibid, 86.
98 Ibid, 87.
99 Taxation Laws Amendment (Foreign Income) Act 1990 (Cth)
100 For a detailed examination of this issue see Commissioner of Taxation v ANZ Banking Group Ltd (1979) 143 CLR 499, 535.
will be invalid.\textsuperscript{101} The taxpayer liable to tax must be identified in the notice.\textsuperscript{102} This means that if the Commissioner is not sure about the actual taxpayer because of trusts being used, then a s 264A notice may not be appropriate. The taxpayer can refuse to provide documents and information if covered by legal professional privilege.

As stated above, subsection 264A(22) does not have the same effect as s 263 and s 264 in that it is not an offence if the taxpayer fails to comply with the offshore notice. The only sanction is that the taxpayer is unable to rely on offshore information or documentary evidence in contesting an assessment that would have been provided under the notice. However, the Commissioner may consent to allow the information.\textsuperscript{103}

\section*{8.3.4 Mutual assistance requests – \textit{Mutual Assistance in Criminal Matters Act 1987} (Cth)}

The ACC and the DPP are able to obtain information relating to criminal activities that is located in a foreign country under the \textit{Mutual Assistance in Criminal Matters Act 1987} (Cth). A number of treaties have been entered into by the Australian government and the foreign country in order to put into effect the mutual assistance in criminal matters.

Section 5 – states that the objects of this Act are:

(a) to regulate the provision by Australia of international assistance in criminal matters when a request is made by a foreign country for any of the following:

(i) the taking of evidence, or the production of any document or other article, for the purposes of a proceeding in the foreign country;

(ii) the issue of a search warrant and the seizure of any thing relevant to a proceeding or investigation in the foreign country;

(iii) the forfeiture or confiscation of property in respect of a foreign serious offence;

\textsuperscript{101} Ibid.

\textsuperscript{102} Morfuni, above n 62, 101.

\textsuperscript{103} Ibid.
(iv) the recovery of pecuniary penalties in respect of a foreign serious offence;
(v) the restraining of dealings in property that may be forfeited or confiscated, or that may be needed to satisfy pecuniary penalties imposed, because of the commission of a foreign serious offence; and

(b) to facilitate the provision by Australia of international assistance in criminal matters when a request is made by a foreign country for the making of arrangements for a person who is in Australia to travel to the foreign country to give evidence in a proceeding or to give assistance in relation to an investigation; and

(c) to facilitate the obtaining by Australia of international assistance in criminal matters.

Section 10 - Request by Australia

(1) A request for international assistance in a criminal matter that Australia is authorised to make under this Act may be made only by the Attorney-General.

(2) Subsection (1) does not prevent the Attorney-General on behalf of Australia from requesting international assistance in a criminal matter other than assistance of a kind that may be requested under this Act.

In the case of Dunn v The Australian Crime Commission [2008] FCA 424, the Federal Court was asked to declare that the request sent to the Swiss authorities pursuant to the Mutual Assistance Act was made without authority, outside jurisdiction and unlawful. The request for information was undertaken as part of ‘Operation Wickenby’ and followed on from information that had been obtained from the laptop computer belonging to Philip Egglshaw. Tracey J found that the request for information was valid. Thereafter, similar arguments were heard by Tracey J in the case of Strachans v Attorney-General [2008] FCA 553 and, once again, the request for information was held to be valid. Dunn subsequently appealed the decision and, in Dunn v Australian Crime Commission [2009] FCAFC 16, the full bench of the Federal Court, per Moore, Jessup and Gilmour JJ, dismissed the appeal and upheld the validity of the request for information that had been sent to the Swiss authorities.
These cases illustrate the fact that information can be successfully obtained from foreign countries under the *Mutual Assistance in Criminal Matters Act* and that it is very difficult to challenge the validity of the request.

### 8.3.5 Legal professional privilege – foreign lawyer

Australian taxpayer that has obtained legal advice from a lawyer in a foreign country is able to claim that the document is privileged. In the case of *Kennedy v Wallace* (2004) 208 ALR 424, Giles J of the Federal Court of Australia held that legal professional privilege is available, subject to limitations, to protect communication between the client and their foreign lawyer relating to advice on foreign law. Giles J made the following observations on how the privilege operates with foreign legal advice:

> It is easy to see how the privilege is necessary to encourage candour on the part of a client who confronts or anticipates litigation to vindicate or defend legal rights as the client may need to disclose facts which are incriminating, discreditable or embarrassing in order to obtain sound advice. It is not so easy to see why a client who wishes to order its affairs to best advantage would need or require any encouragement for candour. Nor is it easy to see what corresponding public interest is served by preserving the secrecy of a client’s reasons for a transaction (unless the client chooses to lift the veil) in cases where disclosure would serve the ends of justice or would enable a statutory inquiry to be properly conducted.

Whether or not it is, as suggested by Dawson J in *Baker v Campbell* at 92, now too late to reconsider the advice privilege in its application to communications in Australia, it is questionable whether there is any need to extend the principle to overseas legal advice. It is not obvious that such advice promotes the better administration of Australian justice particularly as, in relation to practitioners in foreign jurisdictions, Australian courts have none of the supervisory and disciplinary powers that provide, in their potential application to local practitioners, some assurance against misuse of the privilege. There is no authority binding me to extend the privilege in this way but refusal to do so to any extent would be controversial. I prefer therefore to assume for the purposes of this case that advice privilege may be
accorded to some foreign communications and examine whether the applicant has established that what occurred here is entitled to the benefit of such privilege.\textsuperscript{104}

Unfortunately, Kennedy was unsuccessful in claiming that the documents were covered by the privilege. The fact that the documents related to the laws of a tax haven, namely Switzerland, appeared to weaken his claim for legal professional privilege. The view taken by Giles J to limit the application of the privilege to foreign legal advice has been severely criticised. James McComish is critical of the claim by Giles J that in order to benefit from the privilege, ‘foreign legal advice must have some connection to the administration of justice or the proper functioning of the legal system in Australia’.\textsuperscript{105} Mr Kennedy appealed to the Full Bench of the Federal Court, per Black CJ, Emmett and Allsop JJ, where, once again, he was not successful in upholding his claim of privilege. However, the spurious restrictions placed on claiming privilege in relation to foreign legal advice, as advanced by Giles J, was rejected by the Full Bench.

While it is to the advantage of a taxpayer that they may be able to claim legal professional privilege when a foreign lawyer provides legal advice, what happens when documents are obtained under an Information Exchange Agreement with a foreign tax authority and the foreign taxpayer has no knowledge of the release of the communication in the first place and then has no opportunity to claim the privilege either in the foreign country or Australia? Moreover, the staff at the foreign bank may not be experienced enough to claim the privilege on behalf of their customer.

\subsection*{8.4 OECD – Tax Information Exchange Agreements}

As discussed in the previous sections of this chapter, taxpayers have very little protection in preventing their personal financial details from being disclosed to the tax administrators. In Australia, the ATO has coercive powers of seizure under s 263 and s 264 notices, search warrants and compulsory attendance before the ACC. In terms of information held overseas, the ATO can request the information from the taxpayer pursuant to s 264A; by use of the DTA; or under the \textit{Mutual Assistance Act}.\textsuperscript{106}

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\textsuperscript{104} (2004) 208 ALR 424, 441.
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If it is possible to access information through a range of existing legal means then arguably, OECD member countries do not need the additional legal instrument of requiring all states to enter into ‘exchange of information agreements’.

In the manual on the implementation of exchange of information provisions for tax purposes, the OECD examines three approaches to exchanging information; first, ‘exchange of information on request’; second, a ‘spontaneous exchange’; and third, an ‘automatic or routine exchange of information’. Article 26, as discussed above, only applies to the exchange of information on request. In situations where there is no DTA between Australia and the other state, a separate exchange of information agreement is entered into by the parties. The OECD advocates that states take the further step of agreeing to automatic or spontaneous exchanges of information. An automatic exchange of information requires the country of source to automatically report to the country of residence, information about non-residents receiving interest, dividends, royalties or pensions payments. The country of residence does not need to request the information on a specific non-resident taxpayer. The spontaneous exchange of information takes the process a step further and involves a foreign tax administrator identifying additional non-resident taxpayers involved in taxation arrangements and the information can be passed on to the tax administrators in the country of residence. Both of these activities would, arguably, contravene non-residents’ rights of privacy and confidentiality as contained in the charter of human rights. However, the OECD and the G20 would like to put an end to tax havens and OFCs.

The Australian Government has entered into a number of ‘exchange of information agreements’ with tax havens and in two examples, the agreement with Bermuda and the agreement with Jersey, the only requirement is to exchange information on request. What is of interest is the fact that, in relation to the Bermuda agreement, reference is made to ‘serious tax evasion’ whereas, in the Jersey agreement, reference is made to ‘criminal tax matters’. The Australian Government has been actively blurring the distinction between tax avoidance, a non-criminal activity, with

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tax evasion, a criminal activity. One of the main reasons for doing this has been to treat all arrangements that involve foreign bank accounts and financial arrangements with tax havens and OFCs as constituting a criminal tax matter, so that other countries are pressured into providing information on Australian taxpayers utilising those financial services.\textsuperscript{108}

From the perspective of the United States, Timothy Addison contends that Tax Information Exchange Agreements (TIEAs) are of very limited benefit.\textsuperscript{109} Addison contends that not only does the US have to identify the taxpayer or investor to be investigated and information obtained from the foreign country, but that evidence exists to prove that the taxpayer has engaged in criminal or civil tax activities.\textsuperscript{110} The US must show that it is not engaged in a ‘fishing expedition’. Moreover, Addison states that the TIEA will not overcome the domestic bank secrecy laws of the tax haven and this view is supported by the evidence given by Professor Reuven Avi-Yonah to the Senate Finance Committee on Offshore Tax Evasion, 110\textsuperscript{th} Congress.\textsuperscript{111} Addison provides evidence to suggest that the Cayman Islands has continued to experience stable growth in its financial industry with the Cayman Islands now ranked fourth in market share for international banking behind the United Kingdom, United States and France.\textsuperscript{112} While this may be comforting for non-resident taxpayers and foreign investors using tax havens, why then did the Union Bank of Switzerland disclose the details of their account holders to the Internal Revenue Service in the US?

\textbf{8.4.1 The US and the Union Bank of Switzerland (USB)}

In November 2008, an official from UBS was indicted by a US federal grand jury for an alleged conspiracy to conceal thousands of US taxpayers’ accounts from the Internal Revenue Service (IRS).\textsuperscript{113} In February 2009, UBS entered into a deferred

\begin{itemize}
\item \textsuperscript{108} McLaren, above n 92, 141.
\item \textsuperscript{109} Timothy Addison, ‘Shooting Blanks: The War on Tax Havens’, (2009) 16(2) Indiana Journal of Global Legal Studies 703, 717.
\item \textsuperscript{110} Ibid, 718.
\item \textsuperscript{111} Ibid.
\item \textsuperscript{112} Ibid, 720.
\item \textsuperscript{113} ‘Swiss Bank Settles U.S. Tax Charges, Mounting Pressure on Swiss Bank Secrecy’ (2009) 103 The American Journal of International Law 338.
\end{itemize}
prosecution agreement on the basis that the bank paid USD 780 million and to provide details of about 4,500 US account holders to the IRS. The US Justice Department alleged that there were about 52,000 accounts of US citizens with about 20,000 containing securities and 32,000 containing cash with a total value of USD 14.8 billion. Depending upon the view taken, this may be seen as a great victory for the US government and the IRS. On the other hand, it must be viewed as being a comprehensive disregard of the rights of the account holders to expect their bank to maintain the confidentiality of their financial details. It is not the behaviour of a first world democracy.

As a result of UBS providing the names of US citizens having bank accounts with their bank, no foreign investor or non-resident taxpayer can have any confidence that this situation will not be repeated around the world. It would appear that the right of confidentiality has come to an end as far as the US is concerned. The situation could just as easily be replicated in Australia. The only feature that may provide comfort for non-resident taxpayers and investors is that the US government did not require all foreign banks located in the US to disclose bank account details of their US citizens and nor did the US government target Switzerland as a whole. The agreement between the US and UBS did not violate the Swiss bank secrecy laws.

8.5 Conclusion

The Australian Government has provided the ATO with strong and coercive powers to assist them in collecting the correct amount of taxes from all taxpayers irrespective of where their income is derived. Safeguarding the revenue, arguably should take priority over the rights of the taxpayer. On the other hand, many taxpayers comply with the taxation laws and their right to privacy and their right to have their financial details kept confidential should be strenuously protected by the law. Tax advisers, accountants and lawyers should not be encouraged to disclose any confidential information to the ATO, even if that information is evidence that the taxpayer has not complied with the law. Some Australian taxpayers protect their assets by placing

114 Ibid, 339.
116 Ibid.
their investments in tax havens and OFCs. Whatever the reason, taxpayers with foreign bank accounts should have the right to privacy and the maintenance of the confidentiality of their financial information.

In the domestic environment, Australian taxpayers have very limited rights to maintain the privacy and confidentiality of their financial affairs. The ATO has strong coercive powers to obtain information pursuant to s 263 and s 264 notices and the only defence to prevent access to certain information by the ATO is to claim legal professional privilege, if appropriate. This right, which is fundamental to the administration of justice, has been weakened by the crime and fraud exemption. Australian taxpayers have no right to remain silent when confronted with a s 264 notice. A taxpayer cannot claim the privilege against self-incrimination when faced with a s 264 notice. Moreover, the right of a spouse not to give evidence against their partner is of no effect when required to appear before the ACC. The banker-customer duty of confidentiality has been severely weakened by the coercive powers of the ATO and provides no protection to a s 264 notice whereby the ATO is able to go on a ‘fishing expedition’ when they are unsure of what information may be available. A taxpayer has virtually no defence against a search warrant or a summons to appear before the ACC as has been demonstrated by the Egglishaw cases.

On the other hand, taxpayers do have a right to obtain information under the FOI legislation but this is of limited use, as the above discussion has shown. Appealing to the convention on human rights in taxation matters in order to maintain privacy has not been successful to date. Taxpayers can only rely on the legal professional privilege in order to maintain their right to privacy over legal advice.

Internationally, with the increase in the exchange of information agreements and the legal processes available to the ATO to access foreign financial information, s 264A, the non-resident taxpayer has very limited right to maintain the privacy and confidentiality of financial information stored in a foreign country. The new provision in the OECD Model DTA, Article 26, to expand the scope of the exchange of information together with mutual assistance requests, would suggest that the right to privacy for non-resident taxpayers was being severely eroded. This is especially
true when there is no provision to allow the taxpayer affected to have an involvement in the process whereby information is exchanged.

In answer to the main question raised in this chapter, namely, what protection does a non-resident taxpayer have in maintaining their privacy in an environment where many countries are entering into exchange of information agreements; the answer appears to be none. If the exchange of information agreements can overcome bank secrecy laws then every non-resident taxpayer faces the risk of having their financial arrangements being disclosed to the tax administrators in their home country. Legal professional privilege can still be maintained even if the legal advice has been provided by a foreign lawyer but the problem appears to be in how and when is the privilege claimed. Unless the non-resident taxpayer is notified of the request for information, how can they claim the privilege? The main way in which some form of protection can be provided is to allow the taxpayer some right to participate in the exchange process similar to the protection offered to taxpayers when information is being exchanged under Article 26 of the DTA. The US, Germany, Sweden, Switzerland, Luxembourg, Portugal and the Netherlands provide taxpayers with the right of consultation or intervention in the exchange process. This would ensure that legal documents could be excluded under the legal privilege. The charter of human rights may provide some safeguard for non-resident taxpayers and investors in protecting their right to privacy of financial information, but to date this has not been of assistance in taxation matters.

Arguably, there is a need for a balance between maximising the collection of tax revenue and administering the law by the ATO and ensuring taxpayers have a right to privacy. Given the aftermath of the global financial crisis and the enormous deficits most countries now have as a result of paying for stimulus packages to prevent a recession, tax authorities will be trying very hard to collect tax on foreign investments held in tax havens and OFCs.
CHAPTER 9  WILL TAX HAVENS SURVIVE IN THE  
NEW INTERNATIONAL LEGAL ENVIRONMENT?

9.1  Introduction

This chapter of the thesis provides an answer to the main research question; will tax havens survive in the new international legal environment? The question encompasses more than just the issue of whether or not tax havens and OFCs will continue to operate as financial centres attracting mobile capital from individuals and Multi-National Enterprises (MNEs) due to the fact that they have low or no taxes at all. Two other important considerations which are fundamental to the future of tax havens are whether these nations will, first, amend their bank secrecy laws and, second, enter into Tax Information Exchange Agreements (TIEAs) so that non-resident taxpayers and MNEs will be deterred from locating capital in those tax havens with the intent to minimise the impact of taxation in their home country. It is still far too early in the development of international taxation law in this area to predict the likely effect TIEAs and the pressure from the G20 and the OECD for tax havens and OFCs to amend their bank secrecy laws for both issues to be determined one way or the other. These two areas of taxation law should be the subject for future research in order to arrive at a reasonably definitive conclusion.

The OECD member states, the G20 nations and the EU would like their resident taxpayers to pay all of their taxes in their home country and to not hide their assets in tax havens. Virtually all OECD member countries impose income tax on their resident’s worldwide income including income derived in tax havens. If tax havens ceased to exist then, arguably, this problem would be solved. If tax havens introduced measures whereby non-residents were likely to have their financial details reported to their home country then they may be deterred from investing capital in those states.
The major concern of OECD member states, the EU and the G20 is that, as a result of the ‘global financial crisis’, most developed countries incurred debt in order to stimulate their economies, as is the case in Australia, the US and the UK, to name just a few. The debt incurred by these countries has to be repaid and tax revenue is the likely source of funds to be used to repay the debt. Tax havens and OFCs are seen as being part of the problem and part of the solution, especially if lost tax revenue can be recovered and the future use of tax havens curtailed. Tax havens and OFCs have been viewed by the G20 and the OECD as being part of the reason for the global financial crisis. This view is totally rejected by Geoffrey Loomer and Giorgia Maffini from the Oxford University Centre for Business Taxation, in that improving financial regulation of banks and investment institutions has little to do with enforcement of tax.  

There is no dispute with the fact that tax havens and OFCs have prevented developed countries from collecting tax revenue that should have been paid by taxpayers in their country of residence. The fact that large amounts of tax revenue have been lost as a result of the involvement of tax havens and OFCs has been documented by a number of countries and organisations over many years. In the US for the 2008 year, it had been estimated that tax havens would cost the tax revenue USD 100 billion and, for the past decade, tax havens have cost the tax revenue USD 1.027 trillion. Addison discusses the outcome of a report, released in August 2006, prepared by the ‘US Senate Committee on Homeland Security and Governmental Affairs’ in which the Senate found that tax havens and OFCs held more than USD 11 trillion of high-net-worth individuals’ assets worldwide. Addison provides the following quote from US Senator Carl Levin to illustrate the problem the US has with tax havens:

2 The OECD and Oxfam, to name just two, have reported the perceived loss of revenue for many countries as a direct result of tax havens hiding assets.
With a USD 345 billion annual tax gap and a USD 248 billion deficit, we cannot tolerate a USD 100 billion drain on our Treasury each year from offshore tax abuses.\(^5\)

Addison contends that information exchange agreements between the US and tax havens will be of no effect unless the IRS undertakes more audits of high net worth individuals in the US. He states that ‘The Permanent Subcommittee on Investigations’ found that high net worth individuals considered to have more than USD 1 million or more in assets, currently hold USD 11 trillion in offshore accounts.\(^6\) In 2007, only 9.25 percent of those taxpayers had their returns audited whereas the IRS only audited 2.26 percent of taxpayers with income between USD 200,000 and USD 1 million.\(^7\) There were an estimated 9.3 million individuals with a net worth of USD 1 million living in the United States as at the middle of 2007.\(^8\) In Australia, the ATO undertook a similar exercise in trying to ensure compliance with the taxation law by Australia’s wealthiest people.\(^9\) The Commissioner of Taxation explained in the guide that the ATO had identified about 1,200 wealthy Australians with net worth of more than AUD 30 million and they wanted to ensure compliance by that group.\(^10\) The guide states that since the ‘High Wealth Individuals Taskforce’ had been established in 1996, the ATO had collected an additional AUD 1.766 billion and had disallowed AUD 934 million in revenue losses and AUD 777 million in capital losses.\(^11\)

The problem of lost tax revenue is not just confined to the US. Addison provides evidence that, worldwide, tax havens account for a loss of tax revenue of over USD 255 billion each year.\(^12\) To add to the situation, it is estimated that 15 percent of the world’s states are tax havens and half of the world trade passes through them.\(^5\) Ibid, 706. The quote from Senator Levin can be obtained from the following website: <http://wwwсенат.gov/levin/newsroom/release.cfm?id=269479>.

\(^6\) Ibid, 725.

\(^7\) Ibid, 726.

\(^8\) Ibid.


\(^10\) Ibid, 3.

\(^11\) Ibid, 7.

\(^12\) Addison, above n 3, 708.
although they only account for 3 per cent of the world’s GDP.\footnote{Ibid, 711.} Tax havens attract mobile capital through the use of their banking system and financial services. However, the capital is then invested in the major financial centres such as the US or the United Kingdom. As discussed below, Australia is a beneficiary of capital flowing from tax havens. Professor Avi-Yonah reinforces this statement by noting that funds cannot remain in tax havens and be productive; they must be reinvested in the prosperous and stable economies of the world.\footnote{Reuven Avi-Yonah, ‘The OECD Harmful Tax Competition Report: A Retrospective After A Decade’, (2008 – 2009) 34 \textit{Brooklyn Journal of International Law} 783, 793.}

Current developments in international taxation law has been focused very heavily on the outcome of the OECD’s ‘harmful tax competition project’ and the movement towards requiring all tax havens and OFCs to enter into TIEAs and to repeal their bank secrecy laws. However, the role played by tax intermediaries, such as tax accountants and lawyers, banks and financial institutions and tax scheme promoters in supporting tax havens and OFCs in attracting mobile capital, is also discussed in this chapter as these tax intermediaries have a major role to play in the future of tax havens. It would appear that they have a major stake in tax havens and OFCs surviving and continuing to offer financial services to non-resident investors and MNEs. An attempt will be made to provide an answer to the question of whether tax scheme promoters and tax intermediaries will still have a role to play in international tax minimisation given the apparent success of the OECD in its project to eliminate harmful tax competition.

There is also the issue of what will happen to tax havens and OFCs if they are not used by non-resident investors and MNEs? If tax havens cease to provide these services, what happens to the people employed in the banks and providing professional financial advice? Does this mean that the wealthy nations then have to start providing foreign aid to those states? This issue is also discussed briefly in the chapter.

\subsection*{9.1.1 The contradictory approach to tax havens by Australia}
The Australian government receives certain benefits from the existence of tax havens and OFCs. For example, historically, more money flows from tax havens into Australia than flows out to tax havens. The Australian Taxation Office (ATO) states that the flow of Australian dollars out to tax havens amounted to AUD 5.3 billion in the period 2005 – 2006. However, the flow of money from tax havens to Australia was AUD 8.4 billion in the same period.\footnote{Australian Taxation Office, ‘Tax havens and tax administration’, (2007) 8.} According to a report in ‘The Age Newspaper’, which referred to figures from the ATO, for the 2007-2008 period, AUD 16 billion flowed to tax havens but AUD 29 billion flowed back to Australia from tax havens. If tax havens cease to exist then Australia would probably not attract a similar level of foreign investment from mobile capital looking for a safe haven to invest in, such as Australia.\footnote{Ruth Williams, ‘ATO ups attack on tax cheats’, The Age Newspaper (Melbourne), 21 November 2009, 4.}

Similarly, with the tax concession offered to Australian ‘temporary residents’, in that they do not pay income tax on income derived outside Australia, capital flows into the country from tax havens and OFCs.\footnote{For a full discussion on ‘temporary residents’ see: John McLaren, ‘Should the International Income of an Australian Resident be Taxed on a Worldwide or Territorial Basis?’, (2009) 4(1) Journal of the Australasian Tax Teachers Association 71} This was the policy intention of the Australian Government when it introduced these tax laws in order to attract foreign investment by wealthy individuals who may wish to live in Australia. The fact that the temporary resident may have their wealth invested in a tax haven free of income tax is of no consequence to the Australian Government. This is similar to the situation of the ‘non-domiciliary’ living in the UK, where they are only subject to a ‘territorial’ system of taxation, or the returning New Zealand citizen or new migrant to New Zealand, who also only pays income tax on income derived within the territory. However, this means that Australian residents for tax purposes are ‘ring fenced’\footnote{The term ‘ring fencing’ refers to the concept of providing tax concessions to foreign investors that are not available to resident investors. The resident taxpayer is precluded from being able to take advantage of those tax benefits.} from being able to take advantage of similar tax benefits.

A further example of the ring fencing of resident taxpayers is found in the tax law relating to the non-resident investor and the non-payment of income tax on capital gains generated on the sale of shares and other financial products. Only real property,
such as land and fixtures or an interest in a land rich company, attracts income tax on a capital gain by a foreign investor. The policy reasoning behind this tax law is to make it attractive for foreign investors to invest in Australian equities and collective investment products. The best example of this particular aspect of Australian tax law working in favour of foreign investors was with the recent sale of the Myer stores by a private equity consortium, TPG Myer. The equity consortium sold its shares to the public and generated a profit of AUD 1.58 billion on which no income tax has been paid, as yet.\(^\text{19}\) The proceeds from the sale were channelled through tax havens back to the original investors. The ATO was trying to initially stop the money leaving Australia and, when they were too late, contemplated bringing an action to recover income tax, provided they can apply provisions of the Income Tax Assessment Act 1997 that will, arguably, impose income tax on the basis that the gain was on ‘revenue account’ and not on ‘capital account’. One of the main implications flowing from the ATO’s activity is that it may very well deter future private equity investment in Australia, which is contrary to the wishes of the Australian government.\(^\text{20}\)

Furthermore, the Australian Future Fund, a sovereign wealth fund belonging to the Australian Government, comprising AUD 64 billion, is invested through asset managers located in the Cayman Islands.\(^\text{21}\) The Minister for Finance and Deregulation, The Honourable Lindsay Tanner, justified this practice on the basis that the Cayman Islands was changing and that it was negotiating a TIEA with Australia and, ‘given the structure of the industry and complexity of international law, this is common practice’.\(^\text{22}\)

In effect, the Australian Government is happy for tax havens to continue providing financial and investment services when their continued existence serves the interests of governments. The government is also happy for foreign investment to flow into


\(^{21}\) Peter Martin, ‘Fund to maintain tax-haven investments’, The Age Newspaper (Melbourne), 26 November 2009.

Australia from tax havens and OFCs. On the other hand, the ATO is actively trying to detect and deter the use of tax havens by resident taxpayers for tax avoidance and tax evasion purposes.

9.1.2 The hypocrisy of the United States approach to tax havens

Marshall Langer contends that Manhattan and London are the locations of two of the most important tax havens in the world by aggressively and openly attracting wealth from all corners of the world.\(^{23}\) The reasons given for this statement are the tax concessions that are available to foreign investors. US banks are not required to withhold tax before crediting interest payments to non-US residents on their investments.\(^{24}\) Langer reports that, in 1975, the Joint Committee on Taxation estimated that over USD 3.1 billion in interest had been paid to foreign persons on over USD 36 billion of bank deposits; today, this figure would be much higher.\(^{25}\) This has been the situation for over 80 years and the banks have no obligation to report these transactions to the IRS unless the account holder is a resident of the US or a Canadian resident taxpayer.\(^{26}\) Interest on government bonds, notes and treasury bills is free of withholding tax but may be subject to reporting to the Internal Revenue Service (IRS).\(^{27}\)

The State of Delaware has been one of the most popular places for the incorporation of a company. For example, over 40 percent of New York Stock-Exchange listed companies and over 50 percent of Fortune 500 companies are incorporated in Delaware.\(^{28}\) The reason for the popularity of Delaware as a place of incorporation of a company is found in the fact that it has very favourable tax, trust and corporations laws.\(^{29}\) A single director limited liability company can be incorporated and, provided it has no US sourced income, it is not subject to US income tax and it does not need


\(^{24}\) Ibid 3.

\(^{25}\) Ibid.

\(^{26}\) Ibid.

\(^{27}\) Ibid, 4.


\(^{29}\) Ibid, 61.
to file a tax return. For all intents and purposes it is a US registered company with the perception that it pays tax in the US. In Australia, for instance, the law requires a company that has been registered in Australia to pay income tax on its worldwide income, even if the source of the income is outside Australia.

Companies incorporated in the State of Delaware have similar tax advantages to any company incorporated in a tax haven or OFC, and yet, the US Government has not indicated any intention to remove the attractive benefits associated with a Delaware company. Similarly, the US tax system ‘ring fences’ its own taxpayers from the benefits of no income tax on bank deposits and bonds, while attracting mobile capital from outside the US.

9.1.3 The case of New Zealand as a ‘tax haven’

New Zealand does not have taxation law requiring resident and non-resident taxpayers to pay income tax on capital gains, unlike Australia, its nearest neighbour. New Zealand also facilitates a flow through structure for foreign investors through the use of ‘offshore trusts’. Trusts that are established in New Zealand with non-resident beneficiaries and a non-resident settler are not liable to be taxed in New Zealand on income earned anywhere else in the world. In fact, the Inland Revenue Department of New Zealand does not obtain any information about these trusts because they do not need to pay tax. Professor Sawyer states that when, in 2006, the Australian Government exerted pressure on New Zealand to reveal whether any Australian citizens were settlors of these trusts, the response by the Inland Revenue Department was that these types of trusts are not reviewed by the department. Professor Sawyer contends that New Zealand shows no signs of moving away from maintaining an absence of tax on capital gains and removing the tax benefits of its offshore trust regime. It is for these reasons that New Zealand could be considered to have some of the characteristics of a tax haven, namely lack of transparency.

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30 Langer, above n 23, 5.
31 Ibid.
33 Ibid, 7.
34 Ibid.
9.2 *The Reasons Why Tax Havens Will Survive*

There are a number of reasons why tax havens and OFCs will continue to operate as financial centres with low or no tax on income. Some of the reasons have been discussed above but the following discussion provides additional evidence that tax havens have a place in the global financial environment and provide important benefits to governments, MNEs and individuals.

9.2.1 **Lawful use of tax havens**

The Australian Commissioner of Taxation has stated that not all financial transactions involving a tax haven will amount to unlawful activity. The following statement is contained in the ATO publication on ‘tax havens and tax administration’:

> People across all taxpaying groups in the Australian tax system are becoming increasingly involved in international business and investment. Most dealings with tax havens are within the law. Some tax havens, including those that have large value dealings with Australian taxpayers, have developed particular niche markets. Others are highly regarded as offshore financial centres. Tax havens are particularly attractive to international businesses involved in portfolio management, such as insurance companies, self-insurers, hedge and mutual funds and offshore investment funds, because they have low or no taxes. These international businesses require access to the huge international foreign exchange markets and 24-hour-a-day management. For example, the Cayman Islands is a major financial and captive insurance centre with significant flow-through transactions for equity and hedge funds. Jersey and Guernsey have major regulated financial services industries, and many international banks are represented in these jurisdictions.

Some multi-national companies have their head office functions in tax havens. Australian subsidiaries of overseas multi-national companies may need to transact with tax haven companies that are part of their multi-national structure. Governments may also transact with tax havens to provide foreign aid programs in those countries.

**Individual dealings I am not concerned about**
It is not illegal to deal with a tax haven, provided taxpayers comply with the relevant tax laws of both jurisdictions. For example, an individual may accumulate savings in a bank account in a tax haven while working overseas as a non-resident. When the individual becomes an Australian resident, they need to declare the interest on their account each year to meet their Australian tax obligations. I am generally not concerned about the following:

- expenditure on tourism – travel and accommodation
- genuine gifts or inheritances from family resident in tax havens (where the source of the funds has no connection to Australian residents)
- earnings from overseas employment that are exempt from tax in Australia (although accumulating earnings offshore without declaring the interest in Australia would be a concern)
- former residents returning to Australia and bringing back savings accumulated while working overseas
- transferring assets and capital to Australia on migration to Australia, and
- investing in property or real estate in a tax haven (where rental or other gains are appropriately taxed in Australia).\(^3^5\)

There are other valid reasons why tax havens are important and should be preserved. Daniel Mitchell strongly contends that tax havens offer a safe haven for people subject to persecution on the basis of religious belief, political leanings, ethnic origin, and sexual preferences to be able to place some of their wealth beyond the control of the government or government agencies in their home state.\(^3^6\) Mitchell provides examples of a Middle Eastern Jew, who is wealthy and likely to face persecution, and Christians living in some 13 countries likely to be oppressed or persecuted in 31 nations. He provides an example of a family living in Zimbabwe who place money in a tax haven in order to protect the wealth of the family because of the persecution and the economic problems devaluing the currency. Similarly, ethnic Chinese are persecuted in Indonesia and the Philippines and so place money in banks in Singapore. Mitchell also uses the example of a homosexual living in Saudi Arabia who is constantly facing prosecution and needs to use a tax haven to protect their

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\(^{35}\) Australian Taxation Office, above n 15, 11.

wealth. He states that there are 84 nations that have laws that target homosexuals. The key to maintaining tax havens in order to protect wealth is the expectation that their financial information will be kept private. Privacy and confidentiality of personal financial information is of paramount importance for individuals facing issues discussed above and bank secrecy laws are vital in order to achieve this objective. The need for privacy and confidentiality of financial information is discussed in detail in the previous chapter of the thesis.

9.2.2 Insurance companies and captive insurance companies

The Commissioner of Taxation has stated above that one of the main lawful uses of tax havens, such as the Cayman Islands, is for the location of captive insurance companies. The deductibility of insurance premiums paid to ‘captive’ insurance companies in Australia is examined by the ATO in their practice statement law administration, PS LA 2007/8. The following description of a captive insurance company is taken from the practice statement:

A captive insurance entity is an insurance entity where the parent company is not primarily engaged in the business of insurance. It is usually formed to insure the risks of its parent and affiliates, but it can also be used to insure third party risks. A captive insurance entity can retain the risks or it can pass on the whole or a part of the risks. A captive insurance entity would normally operate in a similar way to other general insurance or reinsurance companies.

The practice statement sets out the basis on which premiums are deductible based on an assessment of the risk being insured, the cost of the premium, the existence of reinsurance and, the ability to meet any claim made by the insured. The case of *WD & H O Wills (Australia) v Federal Commissioner of Taxation* (1996) 32 ATR 168 established the precedent that insurance premiums paid to a captive insurance company, that was an associate of the taxpayer, was still deductible. It also

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38 Ibid. Captive insurance companies are insurance companies wholly owned by a large corporation to insure risks associated with the business. The captive insurance company then obtains reinsurance from a large insurer for large losses but maintains the risk itself for small losses. Many large Australian corporations and banks have their own captive insurance company usually located in the Caribbean or Singapore.

reinforced the fact that many large companies are unable to purchase insurance to cover many of their risks. Their only option is to use a captive insurance company and locate it in an established tax haven or OFC that specialises in captive insurance business.

Many insurance and reinsurance companies are located in tax havens, such as Bermuda. The reason for this is that they are able to invest their premium income without the cost of paying income tax on the earnings. This means that there is more money to be used to pay claims as a result of a catastrophe happening in the world, such as ‘hurricane Katrina’ in the US in August 2005. Without this tax benefit, many businesses would not be able to operate because they would not be in a position to acquire the required insurance cover for their particular business activity. This was the situation in the US in the mid-1980s when US businesses were unable to obtain liability insurance cover.\textsuperscript{40} Caroline McDonald discusses the future of insurance companies domiciled in Bermuda that are facing the prospect of tax changes to be made by the US. She notes that, at this stage, all companies have stayed but are able to quickly move to Ireland or Switzerland if the US imposes taxes on the business.\textsuperscript{41}

Bermuda is a dominant player in the insurance business in that it has 35 percent of the insurance industry worldwide and 65 percent of the reinsurance industry worldwide.\textsuperscript{42} Half of all risks insured are of US origin and one third of all risks are European.\textsuperscript{43} About 60 percent of all policies sold in Bermuda are for property insurance and reinsurance.\textsuperscript{44} Reinsurers take some of the risk from the original insurers and, by doing this, insurance companies can take on more risk, or less desirable risk, thus helping more customers.\textsuperscript{45} If premium income was not given favourable tax treatment by tax havens and OFCs then many risks facing businesses


\textsuperscript{41} Caroline McDonald, ‘Bermuda Carriers Not Expected to Rush off the Island Despite U.S. Tax Concerns’, (2009) 19 October National Underwriter 22.

\textsuperscript{42} Tsvaygenbaum, above n 40, 279.

\textsuperscript{43} Ibid.

\textsuperscript{44} Ibid.

\textsuperscript{45} Ibid, 280
throughout the world would not be insured. The business would not be permitted to operate. The continued existence of tax havens in the insurance and reinsurance industry is firmly acknowledged as being of global importance.

9.2.3 The role of tax intermediaries in the survival of tax havens

Tax havens would not operate as financial centres unless they had the resources of accounting, legal and banking services to provide financial and investment advice and the ability and competence to manage the mobile capital inflows. The OECD conducted a study into the role that tax intermediaries have in aggressive tax planning for their clients. The OECD describes tax intermediaries as law and accounting firms, other tax advisors and financial institutions. The focus of the report is on the role that tax intermediaries have in the promotion of ‘unacceptable tax minimisation arrangements’ which are classified as ‘aggressive tax planning’. There are two types of arrangements that qualify as being unacceptable and they are as follows:

- Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences. This involves misusing legislation to achieve results not foreseen by legislators.
- Taking a position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. This involves taxpayers not disclosing their view on grey areas of the law when completing their tax return.

The report identified two main markets for aggressive tax planning by tax intermediaries; first, large corporations - MNEs and; second, high-net-worth individuals. The report also identifies the role played by some banks in developing and implementing aggressive tax planning and discusses a number of examples of structures used to help wealthy clients and MNEs. The OECD acknowledged that

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48 Ibid, 10.
49 Ibid, 11.
50 Ibid, 6.
51 Ibid, 47.
the study team was unable to deepen its understanding of aggressive tax planning by banks.\textsuperscript{52} The report makes a number of recommendations as to how revenue bodies should use risk management tools to prioritise compliance risk.\textsuperscript{53} However, the revenue bodies need to improve their capability to understand the work of tax intermediaries based on greater commercial awareness.\textsuperscript{54}

The recommendations contained in the report would suggest that many revenue bodies are incapable of detecting the existence of tax schemes at an early stage in their product life due to an inability to comprehend the commercial attributes of the arrangement and, more importantly, lack an understanding of structured finance tax schemes developed by some banks. The study on the role of accountancy firms in tax avoidance, by Sikka and Hampton, has highlighted the fact that major accounting firms have expanded globally due to the ability to provide tax avoidance schemes.\textsuperscript{55} The accounting firms would prefer to describe their activities as ‘tax planning’ or tax minimisation within the law.\textsuperscript{56} In fact, many large accounting and legal firms have an office in many tax havens and OFCs to service their clients involved in tax minimisation arrangements. Sikka and Hampton believe that more research needs to be undertaken on the role of tax intermediaries and provide the following comment on the future of tax avoidance and the involvement of professional advisers:

\begin{quote}
The possibilities of curbing the tax avoidance industry are further complicated because of ‘globalisation and technological change has made it easier to avoid paying taxes so you have to introduce more anti-avoidance measures just to stand still [and] government’s attempts to raise revenues by tackling tax avoidance will inevitably be countered by the tax planning industry’ (Financial Times, 9 March 2005). Indeed, anarchy of the markets only recognises financial rewards and a partner of a major accountancy firm has stated that ‘No matter what legislation is in
\end{quote}

\begin{itemize}
\item \textsuperscript{52} Ibid, 54.
\item \textsuperscript{53} Ibid.
\item \textsuperscript{54} Ibid, 55.
\item \textsuperscript{55} Prem Sikka and Mark Hampton, ‘The role of accountancy firms in tax avoidance: Some evidence and issues’, (2005) 29 Accounting Forum 325, 330.
\item \textsuperscript{56} Ibid, 329.
\end{itemize}
place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken’ (The Guardian, 18 March 2004). 57

The OECD has acknowledged the role of tax intermediaries and private banks in providing trustee services where the beneficial ownership of assets is obscured. 58 They also provide structures involving companies and trusts to ensure that the identity of the client remains anonymous. 59 Their services are an integral part of the tax minimisation industry being conducted in tax havens and OFCs. Until such time as there is evidence of major accounting firms, law firms and banks moving from tax havens and OFCs, it can be stated with some degree of confidence that tax intermediaries still believe that their services will be in demand despite action to curb the influence of tax havens by the OECD, the G20, the EU and individual countries, including Australia.

9.2.4 Difficulties in identifying the beneficial ownership of offshore assets – corporate vehicles, trusts and bearer shares

Tax administrators have a great deal of difficulty in identifying offshore investments held by their own residents in a tax haven or OFC when the assets are held in a company with nominee or corporate directors, or in a trust. All common law jurisdictions have well developed laws relating to trusts and many tax havens and OFCs adopt the common law system. The situation is further complicated if the shares in a company used in the taxation scheme are bearer shares. The OECD has recognised the difficulty of identifying the beneficial owners and controllers in their report prepared by William Witherell in March 2007. 50 Witherell provides the following summary of the problem facing taxation and anti-money laundering authorities when it is very difficult to identify the beneficial owner of assets held in tax havens and OFCs:

57 Ibid, 341.
59 Ibid.
60 Ibid.
The task of identifying ultimate ownership and control of cross-border transactions has become more challenging with the emergence of a large variety of international and corporate vehicles, some of which are designed specifically to obscure the identity of the beneficial owners and controllers.\(^61\)

This report draws on earlier work undertaken by the Financial Action Task Force (FATF) on the misuse of corporate vehicles.\(^62\) The report is based on the responses from 32 countries that completed a questionnaire relating to the types of corporate vehicles that were available; the types of beneficial ownership relationships; the source of beneficial ownership information that was available and methods used to obtain the information; and, examples of misuse of corporate vehicles in the jurisdiction.\(^63\) The report highlights the situation where a company has another company acting as the director, instead of a natural person, which adds a further layer of complication to the task of determining the beneficial owner. This situation is permitted in 19 of the 32 jurisdictions that responded to the survey.\(^64\)

The use of offshore trusts to hide assets in a tax haven assists in maintaining the anonymity of the non-resident taxpayer and investor. This problem has been highlighted by Maria Tihin when examining the difficulty the Internal Revenue Service (IRS) is experiencing in trying to combat abusive tax shelter arrangements in tax havens. The following statement by Tihin illustrates the problem facing taxation administrators:

> Often the degree of secrecy is so great that United States law enforcement is not able to detect the existence of an offshore account or entity. Even if the existence of the offshore entity has been brought to the attention of the United States officials, other problems still remain. Many offshore jurisdictions that host tax shelters impose a long and cumbersome process for gaining any relevant information, such as a trust’s grantor and beneficiary. These secrecy laws make it extremely difficult to determine who holds effective control of an offshore trust, as well as the details of its

\(^{61}\) Ibid, 10
\(^{63}\) Ibid, 10. The list of countries that participated in the survey is found at Appendix A.
\(^{64}\) Ibid, 12.
functioning and who should be held accountable for its actions. … A taxpayer can create a trust that cannot be directly tied to him without further information. 65

The fact that it is not only very difficult to identify a foreign trust having any connection with the country of residence, it is then almost impossible to find out who has effective control over the assets within the trust. This situation is even worse when the company that acts as trustee has bearer shares. The OECD provides a definition of what are bearer shares and a bearer debt.66

Many countries permit the issuance of bearer instruments, either in the form of bearer shares or bearer debt. Very generally, a bearer security is one in which the legal rights attaching to the instrument belong to the person in physical possession of the instrument itself. This is distinct from a “registered” security, which requires that legal ownership is based not on physical possession of the instrument but on entry in a ledger or other record of ownership.67

This means that a non-resident taxpayer can have their assets held by a company where the control of the company is in the hands of a shareholder that physically holds the shares and is not shown as the registered shareholder. This makes it virtually impossible for the tax administrators to determine who the real owner of the shares is. The OECD recommends that countries that allow for bearer shares to be issued to have mechanisms in place to identify the true owner of the shares or to not allow for a custodian to hold the shares on behalf of the true owner.68 The OECD has reported that there are 46 countries that still allow bearer shares to be issued but, of those, 41 countries have mechanisms in place to identify the owners of the shares. Similarly, 56 countries permit bearer debt instruments to be issued but 47 of those countries have mechanisms in place to identify the holder of the debt.69

69 Ibid.
The challenge facing taxation authorities in trying to identify their own taxpayers involved in offshore trusts and companies is an almost impossible challenge to win. The situation discussed above highlights some of the difficulties facing regulators with the issue of identifying beneficial ownership and, unless all countries introduce laws that require the beneficial owners of assets to be identified, then the problems will persist. If this is the case then tax havens and OFCs will continue to provide financial services to individuals and MNEs.

9.2.5 The future of bank secrecy laws

Any amendments to the secrecy provisions of the domestic banking laws in tax havens and OFCs require their national parliament to pass new laws. The simple act of signing a tax information exchange agreement (TIEA) does not ensure that the national parliament of that country will either incorporate the agreement into domestic law or transform the agreement into domestic law. The process whereby international agreements become part of the domestic law can be complicated depending upon the legal system in the particular country. Some international agreements automatically become part of the domestic law through the doctrine of incorporation or through the doctrine of transformation. There is no certainty that all countries that have entered into TIEAs will be able to amend their bank secrecy laws unless their own parliaments agree to do so.

For example, because Switzerland requires international law to be transformed into its domestic law, the Swiss Parliament must agree with the reform of its banking laws; otherwise, conduct a referendum of the nation if 50,000 signatures are collected. The Swiss Government will not permit other countries to undermine the confidentiality of its financial institutions by allowing unspecified ‘trawling’ for names by foreign tax administrations. The historical basis for the Swiss bank secrecy laws are based on saving lives rather than facilitating tax evasion. The Swiss Federal Banking Act was enacted in 1934 to protect foreign customers by ensuring

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72 Ibid, 22.
that their bank details were kept confidential. The law was established to counter the Nazi government in Germany, which, at that time, imposed a death penalty on German citizens who did not report assets held in a foreign bank. In order to protect the German customers, no information could be provided to a foreign agency by the Swiss bank.\textsuperscript{73}

Panama is now appearing as the ‘New Switzerland’ and has, according to Bryan Arce, arguably the strictest bank secrecy laws in the world.\textsuperscript{74} Panama does not impose any income tax and does not regard tax avoidance or tax evasion as a crime and upholds the ‘dual criminality’ principle.\textsuperscript{75} Therefore, any request by the US for information on purely tax related matters will generally not be honoured.\textsuperscript{76} However, Panama does treat criminal activity seriously and it has strong anti-money laundering laws.\textsuperscript{77}

It will be interesting to see if, in the future, all countries that have committed to enter into TIEAs do, in fact, pass the requisite domestic laws to put this aspect of international law into effect. It can be argued that the OECD has been successful in making soft international law and for that law to be complied with by tax havens and OFCs.\textsuperscript{78} There are some commentators that believe that this commitment by tax havens will ultimately fail to translate into hard law. For example, the following statement from the Australian newspaper may be correct, only time will tell:

\hspace{1cm}

\begin{quote}
The fact that Switzerland ‘led a rush of offers to exchange information with other governments’ before the G 20 meeting March 2009, does not mean that Switzerland will not be a major repository of finance from tax avoidance. According to Murphy,
\end{quote}


\textsuperscript{75} Ibid, 468.

\textsuperscript{76} Ibid.

\textsuperscript{77} Ibid.

\textsuperscript{78} McLaren, above n 70, 453.
the ‘agreements to exchange information are useless; the secrecy will be completely intact’. 79

9.3 The Reasons Why Tax Havens May Not Survive

This part of the chapter examines a number of activities instituted by various governments and agencies that strongly impact on tax havens. Tax havens and OFCs may not survive in the future due to concerted efforts by the Australian government through its ‘Project Wickenby’, the will of the G20 nations, the actions of members of parliament in the US and, the activities of the OECD to detect tax evasion and tax avoidance. Professor Avi-Yonah contends that the OECD’s harmful tax project has been successful in that, if the OECD had not put pressure on tax havens many more people would have tried to reduce their tax burden through the use of tax havens. 80 A similar situation arises in Australia where much publicity about ‘Project Wickenby’ detecting Australians using tax havens to invest capital offshore and the subsequent criminal penalties being imposed on taxpayers has resulted in an increase in tax collection by the ATO. This situation is examined in detail below.

9.3.1 ‘Project Wickenby’ in Australia

The following information has been obtained from the ATO on their website dedicated to ‘Project Wickenby’. 81

In 2004, at the request of the Tax Office, the Australian Crime Commission (ACC) commenced investigations into Switzerland-based tax schemes. The investigation exposed financial arrangements that posed a significant threat to the integrity of the Australian tax system. It appeared that individuals had participated in arrangements using offshore structures to evade and avoid tax or commit fraud against the Australian revenue system. Initially it was considered that tax revenue of more than $300 million may have been involved. In February 2006, in response to this information, the Australian Government provided funding of $308.8 million over

79 Peter Wilson, ‘Pirates of the Caribbean’, The Australian (Sydney), 14 April 2009, 24. The ‘Murphy’ referred to in the article is Richard Murphy, a British accountant who runs the ‘Tax Justice Network’ dedicated to eliminating tax evasion through tax havens. More information is available at <www.taxjustice.net>.


seven years for a whole-of-government task force. The task force, Project Wickenby, was set up to develop a new approach to tackling international tax fraud and evasion, by investigating and bringing to account those promoting and participating in such arrangements. This includes prosecuting those considered to have been involved in criminal matters associated with the arrangements.

Project Wickenby is a multi-agency task force that was formally established in February 2006. The purpose of the task force is to protect the integrity of Australian financial and regulatory systems by preventing people from promoting and participating in the abusive use of secrecy havens. We work with Australian and international agencies to detect deter and address:

- tax avoidance and evasion
- breaches of financial laws and regulations
- attempts to defraud the community including investors and creditors
- money laundering, and
- concealment of income or assets.

It is important to note that Project Wickenby is tasked with the obligation to detect and deter tax avoidance and tax evasion. The Australian common law clearly distinguishes between the two activities. Tax avoidance is the activity of tax minimisation within the law whereas tax evasion is tax minimisation contrary to the law. This distinction has been discussed in detail in Chapter 5 of this thesis along with the reason why the government has adopted this approach.  

In order for the Commissioner of Taxation to legally disclose details about taxpayers in Australia to other government agencies involved in trying to detect the above activities, new powers were required for this purpose. Section 3G, of the Taxation Administration Act 1953 (Cth) was introduced in order to authorise the disclosure, by the Commissioner of Taxation, of confidential taxation information to the Project Wickenby taskforce, subsection 3G(1). Extracts from the section are reproduced below and outline the purpose of Project Wickenby. It also makes it an offence for an officer involved in Project Wickenby to disclose any information obtained during investigations.

The Commissioner may disclose information acquired under a taxation law to a person to whom subsection (2) applies (a "Project Wickenby" officer) if:
(a) the Commissioner is satisfied that the information is relevant to a purpose of the Project Wickenby taskforce; and
(b) the disclosure occurs before 1 July 2012, or a later prescribed date.

A Project Wickenby officer is any person:
(a) who holds an office in, is employed in, or is performing services for:
   (i) an agency in the Project Wickenby taskforce; or
   (ii) an agency that is supporting the Project Wickenby taskforce; and
(b) whose duties relate to a purpose of the Project Wickenby taskforce.

Subsection 3G(3) states that the Project Wickenby taskforce agencies comprise the following:
(a) the Australian Taxation Office;
(b) the Australian Crime Commission;
(c) the Australian Federal Police;
(d) the Australian Securities and Investments Commission;
(e) the Office of the Director of Public Prosecutions;
(f) a prescribed agency.

Subsection 3G(4) states that the Project Wickenby taskforce supporting agencies comprise the following:
(a) the Attorney-General's Department;
(b) the Australian Transaction Reports and Analysis Centre;
(c) the Australian Government Solicitor;
(d) a prescribed agency.

Subsection 3G(5) Purposes of Project Wickenby taskforce - The purposes of the Project Wickenby taskforce are to:
(a) detect; and
(b) deter; and
(c) investigate; and
(d) enforce the law relating to;
the promotion of or participation in arrangements (within the meaning of the Income Tax Assessment Act 1997) of an international character, or purported international character, that relate to one or more of these:

(e) tax avoidance or evasion;
(f) breaches of laws regulating financial markets and corporations;
(g) criminal activity in the nature of fraud or obtaining benefits by deception (including deceiving investors or creditors);
(h) money laundering;
(i) concealing income or assets.

(a) makes a record of the information for a purpose of the Project Wickenby taskforce; or
(b) discloses the information:
   (i) to a Project Wickenby officer; and
   (ii) for a purpose of the Project Wickenby taskforce.

The Assistant Treasurer, Senator the Honourable Nick Sherry made the following announcement about the success of Project Wickenby when opening the Wickenby portal on the ATO website.

Up to 31 August 2009, Project Wickenby had resulted in:
- 23 ongoing criminal investigations;
- 46 people being charged with serious offences;
- $440.47 million in liabilities being raised; and
- $365.78 million in collections, including $136.71 million in cash and $223.15 in tax collected in subsequent years from people subject to Wickenby action.

The total expenditure of Project Wickenby up to June 30 this year was $210.8 million.

"This means for every $1 spent on the strategy, we have brought in $2 in tax liabilities or $1.50 in tax collections — a great return for the Australian community," said the Assistant Treasurer. It is clear the carrot-and-stick approach to combating tax avoidance is working well ... However, with Australians sending $16 billion to
offshore tax havens in 2008 alone, the Rudd Government will be keeping up our
efforts against tax evasion as the global economy moves towards recovery.\textsuperscript{83}

The following information about the activities of project Wickenby has been sourced from the ATO website:

Prosecutions and judgements
As of September 2009, 48 people have been charged with extremely serious offences under Project Wickenby. Seven of these are as a result of ACC investigations. Thirty nine people were charged as a result of investigations carried out by the AFP and this includes 29 people who were charged with 37 counts of money-laundering.

There have been 3 major convictions to date. In July 2007, a Victorian resident was sentenced to 30 months in jail (15 months suspended), on charges of defrauding the Commonwealth (\textit{Crimes Act 1914}), failing to advise the trustee of income (\textit{Bankruptcy Act 1966}), and dishonestly obtaining a gain (Criminal Code).

In Queensland, 2 people plead guilty to 2 counts of obtaining a financial advantage by deception. On 21 October 2008 they were sentenced to three years in jail, with four months to serve. On appeal by the Commonwealth Department of Public Prosecutions the sentence was increased to three years jail with nine months to serve. Another 102 people have been referred for prosecution for non-lodgment of tax returns. So far 38 of these people have been convicted.

\textit{Wickenby investigations - Civil investigations - Criminal investigations -
Australian Crime Commission investigations - Australian Federal Police -
Overseas investigations}

Wickenby agencies are involved in civil, criminal and overseas investigations. In the course of Project Wickenby audits (including reviews) the Tax Office has:

- made 48 access visits with notice
- made 64 access visits without notice
- issued 1557 notices to ‘furnish information’
- issued 145 notices to ‘attend and give evidence in interviews’

\textsuperscript{83} Senator Nick Sherry, Assistant Treasurer
- issued 890 notices of (tax) assessment
- issued 6 departure prohibition orders (these orders prevent a person leaving the country without making provision for tax liabilities).

The Australian Crime Commission (ACC), Australian Federal Police (AFP) and Australian Securities and Investment Commission (ASIC) are all undertaking criminal investigations as part of Project Wickenby. Investigations are often complex and involve a lot of time and resources from agencies. A single AFP or ACC investigation may involve a number of promoters and many potential participants. ASIC investigations can ultimately generate criminal, civil and administrative actions.

The ACC has:
- issued 200 notices to obtain evidence
- issued 246 summonses
- completed 237 examinations
- executed 58 search warrants.

The AFP has:
- executed 259 search warrants
- issued 83 notices under proceeds of crime provisions.
- 21 search warrants have been executed by Vanuatu police.
- 5 search warrants have been executed by New Zealand police.

### 9.3.2 Increased voluntary compliance

Project Wickenby interventions are improving taxpayer compliance. People who have been the subject of Wickenby interventions have voluntarily lodged more accurate tax returns and/or have lodged returns where previously they may not have done so. In the year 2007-2008, $223 million of revenue was collected as a result of this increased compliance.

Further evidence of improving compliance behaviour comes from another Tax Office initiative – the Offshore Voluntary Disclosure Initiative (OVDI). Under this
initiative, the Commissioner offers people the chance to disclose undeclared foreign income in return for low or no penalties provided they do so before they are contacted by the Tax Office. Since the OVDI was launched in 2007, there have been 3,182 disclosures. The Tax Office has adjusted AUD 221 million of income from these disclosures and raised more than AUD 65 million in tax liabilities.

At 30 September 2009, the Tax Office had collected $372 million. This figure includes AUD 143 million in cash collections, AUD 223 million in voluntary payments made as a direct result of Wickenby activity and about AUD 6 million in other monies recouped. This shows people are getting the message that Project Wickenby means business. Project Wickenby is expected to collect another AUD 408 million in tax revenue over the life of the project. This includes AUD 234 million in cash collections and AUD 174 million of additional revenue from improved compliance behaviour following intervention by the Wickenby task force.

Will this project succeed in deterring Australian taxpayers from trying to hide assets in a tax haven? The simple answer is that it will be successful in preventing individuals that wish to continue living in Australia from trying to hide money in bank accounts in tax havens.

It is hard to disagree with the contention made by the Commissioner of Taxation given the findings of Professor Avi-Yonah in relation to the OECD’s harmful tax competition project. The use of tax havens by taxpayers resident in Australia must be on the decline and no professional tax adviser or accountant would advise their client not to disclose income generated in a bank account in a tax haven or OFC. From this perspective, the level of business being conducted in tax havens must have dramatically reduced. However, it is unlikely that any statistics confirming this view will ever be made available to the public, even if collected by the government.

Doubt has been raised about the true state of the success or otherwise of Project Wickenby. On 15 February 2010, the Australian Government announced that the ATO had collected AUD 465.3 million from Project Wickenby activity. Of this amount, actual tax collection was AUD 160.08 million and the balance of AUD

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84 Assistant Treasurer, the Honourable Nick Sherry, ‘Crackdown on Tax Crime’, Newsletter 15 February 201.
299.33 represented a ‘compliance dividend’. The ATO conceded that the amount of the ‘compliance dividend’ was determined based on an assumption that extra tax was collected due to behavioural change of taxpayers. In the newspaper article, an ATO Deputy Commissioner, Michael Cranston, provides the following statement as to why the actual collection of tax was not higher than the AUD 160.08 million:

... assets were often held offshore, the entities were difficult to collect money from and some businesses had failed, meaning they didn’t pay their tax debts. It is not all about the cash coming in, it’s also about them paying future tax because of us unwinding their offshore concealed structures.

Rawlings makes an interesting observation, in relation to this issue from his research findings, in that one interviewee stated that ‘offshore structures no longer worked for anyone who is born in a country and never really leaves’. The interviewee from Guernsey went on to state that locating capital in tax havens works best for ‘high wealth individuals that did not live in a country that imposed tax on a worldwide basis but are itinerant’. For example, non-domiciled residents of the UK, temporary residents of Australia or, returning or new immigrants to New Zealand are all taxed on a territorial basis and are not liable to declare offshore income wherever it may be generated. Rawlings provides the following example to illustrate the way in which a UK non-domiciliary is able to benefit from investments in tax havens:

For example, a family from the Middle East or Scandinavia may decide to move to London. Before arriving they will establish an offshore trust in one of the Channel Islands or the Isle of Man, which purchases a town-house for say 5 million pounds in London. The remaining assets are then invested offshore and the beneficiaries are sent approximately 100,000 pounds in tax free capital payments a month to meet

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85 Ibid, 1.
87 Ibid,
89 Ibid.
their living expenses. Because of their status as UK non-domiciliaries, these arrangements are perfectly legal.\textsuperscript{90}

A similar arrangement can be put in place by a ‘temporary’ resident of Australia and they are able to live tax free on money repatriated to them from a tax haven or OFC. The arrangement is perfectly legal. From this perspective, tax havens and OFCs still have a future servicing the financial needs of the very wealthy that choose to live in countries that allow for these types of arrangements.

9.3.3 The ‘US Patriot Act’ and other legislative measures

The *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act 2001* (‘PATRIOT Act’) was introduced by President Bush as a direct result of the terrorist attack on the US on 11 September 2001. It became law, just over a month from the terrorist attacks, on 26 October 2001 and it passed both houses of parliament, the Congress and Senate, with no opposition.\textsuperscript{91} It was later discovered that many legislators either did not attempt to read the Bill or had time to consider the provisions.\textsuperscript{92} At that time, the perception was that terrorist financed their activities through tax havens and OFCs and that new laws were needed to detect these financing activities. The Act introduced new measures to increase accountability and transparency of lending arrangements and transfers of funds and to enhance the powers of the intelligence and police agencies in their surveillance and information gathering powers.\textsuperscript{93}

However, Scott Dowling contends that, in reality, terrorists launder their money through onshore financial centres, such as London, and that the Patriot Act has damaged offshore confidentiality.\textsuperscript{94} David Burton is also very critical of the Patriot Act and other measures to prevent money laundering and criminal activity due to the

\textsuperscript{90}Ibid.


\textsuperscript{92}Ibid.


sheer size of the volume of information being collected by the government agencies.\textsuperscript{95} The number of suspicious activity reports and currency transaction reports were approximately 12 million in 2000 and, with the introduction of the Patriot Act, that number has doubled.\textsuperscript{96} According to Burton, the size of the ‘haystack’ makes it almost impossible to find the ‘needle’.\textsuperscript{97}

In February 2007, Senator Carl Levin, Senator Coleman and Senator Barack Obama (as he then was) proposed the ‘Stop Tax Haven Abuse Act’ as a legislative measure to combat abusive tax shelters. It was introduced into the House of Representatives at that time but it did not progress to becoming law. As at 1 November 2009, it still has not become law having been held up by a committee in the Senate. However, President Obama fully supports the Bill and it is expected to become law.\textsuperscript{98} The Act attempts to identify countries that have bank secrecy laws that prevent the exchange of information relating to US taxpayers and to attempt to put pressure on those jurisdictions to enter into TIEAs.\textsuperscript{99} However, Todero believes that the Act will not be successful because it fails to take into account the economic interests of tax havens and OFCs.\textsuperscript{100} He advocates a market solution whereby the US government pays other states for the tax information.\textsuperscript{101}

A further piece of legislation, the ‘Foreign Account Tax Compliance Act’, was introduced into the US Senate in October 2009 by a number of Democratic Party Senators, Rangel, Baucus, Neal and Kerry, and is designed to ensure greater compliance by US taxpayers involved in foreign companies or trusts by requiring disclosure of the beneficial owners.\textsuperscript{102} The Act is intended to provide the IRS with additional powers to require US taxpayers to provide additional details about any


\textsuperscript{96} Ibid.

\textsuperscript{97} Ibid, 26.


\textsuperscript{99} Ibid, 263.

\textsuperscript{100} Ibid, 273.

\textsuperscript{101} Ibid.

foreign bank account and the ability to impose a 30 percent withholding on payments to foreign institutions unless the bank acknowledges the account’s existence and discloses the account ownership details. The Joint Committee on Taxation contend that the Act would prevent US individuals from evading USD 8.5 billion in US taxes over a ten year period.  

9.3.4 AUSTRAC and the Anti-Money Laundering and Counter-Terrorism Act 2006 (Cth)

The Australian Transaction Reports and Analysis Centre (AUSTRAC) is a statutory authority that derives its power pursuant to s 209, Anti-Money Laundering and Counter-Terrorism Act 2006 (Cth). AUSTRAC describes itself as having the role of being Australia’s financial intelligence unit through its collection and analysis of financial transactions that are reported to it and it passes on intelligence to 35 partner agencies, including the ATO and Project Wickenby. The AUSTRAC annual report for the period 2008-2009 discloses the fact that the organisation received 19.8 million transaction reports from regulated entities which equated to an average of 76,000 reports per business day and that this was an increase of 10 percent from the previous year. While this may be an admirable achievement, it also raises the issue as to how it is humanly possible to investigate all suspicious transactions. AUSTRAC does report that it contributed to 1,193 ATO investigations that resulted in tax assessments being issued for $131.18 million. The organisation also claims to have disseminated a total of 43,565 suspicious transaction reports and suspicious matter reports to partner agencies to assist in investigations and that this was an increase of 19 percent on the previous year. Again, the concern is that the organisation becomes overloaded with information so as to make it relatively ineffective in its operations, similar to the situation discussed above in relation to the position in the US.

103 Ibid.
104 Ibid.
106 Ibid, 3.
107 Ibid.
108 Ibid.
9.3.5 Sanctions by G20 nations and the OECD

The G20 nations threatened to impose sanctions on uncooperative tax havens and OFCs at the conclusion of the London summit in April 2009. The G20 leaders made the following statement to emphasise their attitude to international tax evasion:

We agree to take action against non-cooperative jurisdictions, including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems. The era of bank secrecy is over. We note that the OECD has today published a list of countries assessed by the Global Forum against the international standard for exchange of tax information. 109

The sanctions would include such measures as denying funding from the International Monetary Fund and the World Bank. 110 The G20 also suggested that taxpayers using tax havens could expect extra audits and that businesses operating within tax havens could be denied tax deductions. 111

As yet no sanctions have been imposed on any tax haven and it would appear that the nations listed by the OECD as ‘not cooperating’ have very quickly entered into TIEAs. The key issue is bank secrecy laws and these laws have to be amended in order to give effect to the TIEAs. If this is achieved then sanctions may not be necessary in the future.

9.3.6 Tax information exchange agreements (TIEAs)

The list of countries that have implemented the universally endorsed standard on the exchange of information is shown in Appendix A. There are no jurisdictions listed that have not committed to the internationally agreed tax standard. In 2009, more than 300 TIEAs were signed by jurisdictions identified by the OECD as ‘not substantially’ implementing the standard. 112 The OECD has been prepared to

111 Ibid.
112 OECD, above n 109.
implement sanctions if necessary in order to obtain the cooperation of the nations contained in the list.

9.4 The Economic Impact on Tax Havens

What would happen to the economies of small island tax havens and OFCs if they ceased to be able to provide financial and banking services to individuals and MNE’s? What would happen to all of the people employed providing the financial services including company incorporations, trustee services and custodian services? For example, in 1998, Renee Lal, when commenting on the costs and benefits of Vanuatu being a tax haven, stated that the benefits could be listed as revenue for the government, local employment in the tax haven industry, transfer of skills to the local population, tourism and local employment in other sectors of the population.\footnote{Renee Lal, ‘The Tax Haven Industry of Vanuatu’, (1998) Journal of South Pacific Law – Working Papers 29, 52.} In 1996, revenue from business licences and registration fees accounted for 15 percent of the GDP of the country.\footnote{Ibid.} In 1996, there were 80 offshore banks and 2,000 registered companies.\footnote{Ibid.} By 2005 the number of banks had been reduced to only 7.\footnote{Bois-Singh, Sunita, ‘Costs and benefits of adopting and implementing new international standards for the operation and regulation of the international financial services sector in Vanuatu’, (2008) 12(1) Journal of South Pacific Law 17, 23.} Sunita Bois-Singh contends that the measure adopted by Vanuatu to comply with the OECD requirements to exchange information and potential costs of entering into TIEAs has been costly to the country.\footnote{Ibid, 38.} Moreover, if beneficial interests with trusts are to be identified and available for disclosure to other countries then Vanuatu will cease to be attractive to mobile capital.\footnote{Ibid.}

A similar situation exists with the Channel Islands that have, for many years, been vital for UK non-domiciliaries to keep their wealth in a tax haven whilst living in the UK. The Channel Islands are British dependencies and consist of Guernsey and Jersey. A further tax haven in the region, but not part of the Channel Islands, is the Isle of Man. Guernsey has relied on financial services to provide a quarter of the jobs

\footnote{Ibid.}
\footnote{Ibid.}
\footnote{Ibid, 38.}
\footnote{Ibid.
and 55 percent of the island’s income.\textsuperscript{119} There is now concern that, if as a result of action being taken by the OECD and the G20, many people will be unemployed. If tax havens ceased to be able to function as financial centres then the OECD member nations, as well as the IMF and World Bank, would need to consider financial aid in compensation for the loss of economic activity.

9.5 Conclusion

In answer to the main question raised in this thesis, whether tax havens will survive in the current international legal environment, the answer would appear to be in the affirmative given the evidence supporting their continued existence, discussed above. The main reason why tax havens and OFCs will survive is because there are a number of legitimate reasons why different nations, MNEs and individuals will continue to avail themselves of the financial services being offered in those jurisdictions. For example, individuals will always need to hold capital in a foreign jurisdiction for asset protection purposes and high-net-worth individuals that do not have a specific country of residence will invest mobile capital in tax havens. Temporary residents in Australia and non-domiciled residents of the UK and other countries will use tax havens because there is no tax consequence as they have no legal obligation to pay income tax in the country where they live.

Multi-national enterprises will locate their captive insurance companies in certain tax havens and purchase other insurance policies from a company in Bermuda. Tax havens and OFCs perform a crucial function in providing the headquarters for the insurance industry. Without the benefits of low or no tax jurisdictions in which to invest premium income, many individuals or businesses would be unable to purchase insurance cover or would find the premiums beyond their financial reach. The beneficiaries are the public who are covered for loss or injury by insurance companies that exist in tax havens.

MNEs will take advantage of special economic regions or countries that offer tax advantages, such as Ireland. Until the US takes action to amend the laws in the State of Delaware, MNEs will continue to incorporate foreign subsidiary companies in that

jurisdiction. MNEs will continue to present problems for the country of residence in trying to tax them on their worldwide income. The Australian model, which is widely used in many other nations, to exempt from income tax active business income generated in a comparable state, is arguably the best solution in encouraging Australian MNEs to be global entities. Similarly, many countries, including Australia, will continue to use tax havens and OFCs for the investment of their sovereign wealth funds for a variety of reasons, as discussed above.

There is no evidence that the ‘Global Financial Crisis’ was caused by the existence of tax havens and that the solution to balancing national budgets in the future lies in having tax havens collect income tax for the developed nations with large budget deficits. It is interesting to note that, according to Professor Avi-Yonah, the total tax revenue as a percentage of GDP of OECD member countries, during the period 1975 to 2006, had increased even though tax havens and OFCs were actively competing for capital by offering low or no taxes on income. For instance, total tax revenue as a percentage of GDP increased from 29.4 percent in 1975 to 35.9 percent in 2006. Both individual and company income tax had also increased by 1.8 percent and 1.7 percent respectively. Based on this assertion, budget deficits could be rectified within the next few years without taking drastic action against tax havens and OFCs.

Australian individuals will reduce their use of tax havens and OFCs for tax minimisation purposes and this will be the situation in other countries, such as the US and the UK. As a result of ‘Project Wickenby’, the ATO strongly contends that many hundreds of millions of dollars will now be collected in income tax as a direct result of action that has been taken to detect Australian taxpayer’s that held investments in tax havens and did not declare foreign income. The US and other OECD member nations are actively taking action to detect and deter their own taxpayers from using the financial services in tax havens and OFCs. On the other hand, Professor Dale Pinto contends that tax havens and OFCs, once the domain of

120 Avi-Yonah, above n 80, 783, 791.
121 Ibid.
122 Ibid.
the rich, will soon be within reach of the average taxpayer due to the Internet. It will be up to the ATO to meet this challenge and Professor Pinto urges the ATO to work closely with the private sector to keep up-to-date with technology in the area of E-commerce in order to combat tax evasion through the Internet.

In terms of the effectiveness of the OECD and its drive to have all tax havens enter into TIEAs, the action may not result in the demise of tax havens and OFCs as financial centres. Gregory Rawlings conducted research by way of interviews with participants involved in offshore financial services in Andorra, Australia, Guernsey, France, Samoa and Singapore in order to assess the effects of the OECD’s harmful tax competition project was having on their future prospects. Gregory Rawlings contends that the push by the OECD to amend bank secrecy laws and enter into exchange information agreements can be accommodated without unduly damaging the leading OFCs. He uses Singapore as an example of an OFC that has not only expanded its banking system to 115 commercial banks but had become a leading centre for private wealth management involving private banks and trust firms. The interviewees expressed confidence in the future of their operations, especially in light of the wealth being created in China.

Professor Reuven Avi-Yonah contends that there are two ways in which the influence of tax havens may be reduced; first, by eliminating the ability of CFCs to defer tax; and second, for all OECD member states to impose a refundable withholding tax on payments to non-treaty countries while requiring real exchange of information by treaty countries. By way of contrast, Bryan Arce, in his study of Panama as a tax haven, reaches the conclusion that until such time as Panama signs a TIEA with the US, Panama’s bank secrecy laws will continue to facilitate the laundering of evaded US taxes. However, this may be the situation with many tax havens.

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124 Ibid, 35.
125 Rawlings, above n 88, 289, 291.
127 Ibid.
128 Avi-Yonah, above n 80, 795.
129 Arce, above n 74, 490.
havens and OFCs, the domestic bank secrecy laws may not be repealed and this means that the existence of a TIEA is irrelevant. While some countries will not agree to exchange information, it is difficult to see all tax havens complying with the OECD.
CHAPTER 10 CONCLUSION

This thesis has examined whether tax havens will survive in the new international legal environment. In order to arrive at a conclusion to this main question, four subsidiary research questions were examined and a number of conclusions were made in relation to the issues raised.

10.1 Should the international income of an Australian resident be taxed on a worldwide or territorial basis?

It is very difficult for any government to detect and deter resident taxpayers from using the financial services provided by tax havens, particularly as labour and capital becomes more mobile in a globalised world. This is a particular problem if the country of residence imposes income tax on their residents’ worldwide income. For example, in Australia, resident taxpayers must pay income tax on all income no matter where it is derived. This means that income generated in a foreign country must be subject to tax in Australia unless an exemption applies. Similarly, foreign tax paid on foreign income will result in a foreign tax credit when subject to tax in Australia. However, the main problem for the Australian Government is how to detect foreign income generated in a tax haven or OFC. Given this problem it might be better for Australia to only impose income tax on income generated in Australia and ignore foreign sourced income. In other words, should Australia adopt a territorial system? This would be easier and cheaper than trying to detect Australian taxpayers using financial services in tax havens and OFCs to hide foreign income from being subject to income tax in Australia.

It might be more equitable, efficient and simpler to impose income tax on a country’s resident taxpayers on a territorial basis. As examined in Chapter 6, while a worldwide system like the Australian system was more complex than a territorial system, a pure territorial system, such as the one that exists in Hong Kong, is inherently inequitable. In terms of efficiency, Australia has a hybrid worldwide system in that foreign active business income, foreign non-portfolio dividends and
some foreign employment income is exempt from further income tax in Australia. This hybrid system ensures that MNEs are encouraged to expand and invest their business operations in foreign countries without being disadvantaged by higher taxes in their home country.

Australia allows ‘temporary residents’ to be taxed only on their income generated within Australia and allows foreign income to be exempt. Similarly, foreign investors only pay income tax on capital gains generated from real property; business assets and shares in land rich companies situated in Australia and all other investments do not attract a tax on the capital gain. These two examples of Australia taxing foreign investors and temporary residents on a territorial basis can be explained as policy measures designed to maintain Australia as a competitive nation for foreign investment.

One of the key issues facing any tax system is tax avoidance and tax evasion. Hong Kong, with its simpler tax system, still has complex anti-avoidance tax laws that are designed to ensure their resident taxpayers pay the appropriate amount of income tax. It would appear from the research conducted in Chapter 6 that both tax systems have difficulty in detecting, and deterring their taxpayers from using financial services located in tax havens and OFCs. In terms of the continued survival of tax havens, both systems, a worldwide system and a territorial system suffer from a threat to their tax base by tax havens. The new knowledge gained from this research would suggest that the option of Australia converting to a full territorial system would not have any beneficial effect on the collection of income tax revenue that may be located in tax havens or OFCs. It does not matter whether a country has a territorial system or a worldwide system in terms of the collection of revenue. The existence of tax havens and OFCs threaten the tax base of countries with either system.

10.2 Second Subsidiary Research Question

The OECD’s ‘Harmful Tax Project’: Is this international law?

Since the early 1990s, the OECD had been trying to ‘name and shame’ tax havens and eliminate competitive tax practices through its ‘harmful tax competition project’. The OEDC wanted to achieve a ‘level playing field’ with all nations. This was to be
achieved by tax havens and OFCs eliminating their bank secrecy laws and by becoming more transparent in their dealings with other countries. The subsidiary research question was whether the OECD made soft international law and, if that was the case, had the ‘harmful tax competition project’ become part of the international taxation law? Moreover, if that was the situation, did this explain why many tax havens and OFCs were entering into tax information exchange agreements (TIEAs)?

Chapter 5 examined the philosophical basis of law and, in particular, international law. It is generally accepted by the international legal community that the OECD, among a number of international organisations, makes international law through its guidelines and policy recommendations. The OECD’s guidelines on transfer pricing, the taxpayers’ charter, the non-deductibility of bribes to foreign officials and anti-money laundering recommendations have all been accepted as having the status of soft international law.¹ Chapter 5 focused on tax havens and OFCs in terms of their sovereign right to self-determine tax policy, including tax rates and the effect that the OECD’s initiatives in the area of tax competition were having on those independent sovereign nations.

This thesis has shown that the OECD does make soft international law and international norms. These norms have taken on the status of being part of the international taxation law. The OECD’s harmful tax competition project is an example of how international norms become law and this, in part, explains the reason why many nations eventually embraced the OECD’s recommendations and transformed them into hard law by being part of that nation’s domestic law. The research has also shown that soft international law is on balance, desirable in a global legal environment and organisations, such as the OECD, are a major contributor of soft law. The only concern is that because soft law is not law in the legal positivist tradition, it has the potential to infringe the ‘rule of law’ if not administered properly, as has been discussed in detail in Chapter 5. The research also examined the rise of soft law in the domestic taxation environment and the threat that this may have on the ‘rule of law’ in Australia.

¹ Professor Reuven Arvi-Yonah and Professor Alison Christians have supported this contention and their findings are discussed in detail in Chapter 5 of the thesis.
This thesis has demonstrated that in terms of the future of tax havens in the new international legal environment, there is strong evidence that the OECD has been successful in bringing about a high level of cooperation with tax havens. The blacklisting of tax havens and OFCs coupled with the threat of sanctions appears to have produced the desired effect of promoting cooperation. The OECD’s harmful tax competition project and the subsequent entering into TIEAs by tax havens may have a major impact on lessening the role of tax havens in the tax avoidance and tax evasion industry.

10.3 Third Subsidiary Research Question

Why has the distinction between tax avoidance and tax evasion become blurred in Australia?

This thesis has shown that while the distinction between tax avoidance and tax evasion is still recognized as part of the common law in Australia, recent statutory laws have ignored the distinction. In Chapter 7, the AML/CTF Act was examined as an example of the blurring of the distinction as well as provisions relating to the ‘tax scheme promoter penalty’ regime. The research shows that one of the main reasons for this approach by the Australian government is to label any activity associated with a tax haven or OFC as being of a ‘criminal nature’ and therefore the details of any banking or financial transactions are required to be disclosed by the tax haven to the ATO under a variety of statutory provisions. Chapter 7 examined the concept of ‘dual criminality’ in that tax havens could not be required to disclose banking information unless it could be shown by the requesting state that their citizens had been engaged in criminal activity such as money laundering. The activity had to constitute a criminal activity in both jurisdictions. This issue becomes very important when examining the TIEAs that Australia has entered into with tax havens and OFCs. In order to obtain information under these agreements the Australian taxpayer must be engaged in tax evasion or criminal tax matters so it is in the interest of the Australian Government to label all tax minimization activities as tax evasion. This issue is examined in more detail in chapter 8 of this thesis.
The research also showed that this deliberate conduct by the Australian Government had the potential to threaten the ‘rule of law’ by allowing the tax administrators and the courts to have a strong influence over what constitutes legal tax avoidance and tax minimisation as opposed to illegal tax evasion. The new knowledge gained from this research shows that an established legal concept, namely the distinction between tax avoidance and tax evasion has been deliberately blurred by the government for the purpose of deterring taxpayers from using the banking and financial services of tax havens and OFCs. However, as the research has shown, this can lead to the erosion of the rights of the taxpayer and more importantly, the ‘rule of law’.

10.4 Fourth Subsidiary Research Question

Exchange of information agreements with tax havens: how will this affect the rights of non-resident taxpayers and investors?

The thesis examined the existing powers that are held by the ATO to obtain information from resident taxpayers and foreign visitors to Australia. The research also focused on the ATO’s powers to obtain information from foreign nations. The new knowledge obtained from the research shows that the rights of Australian taxpayers to maintain the confidentiality of their financial and banking information, both within Australia and outside Australia, is very limited.

The research shows that the primary source of protection for a taxpayer’s financial information from disclosure to taxation authorities is the right to claim that certain documents and communications are privileged because they are between the taxpayer and their lawyer. Moreover, the research shows that the right to claim legal professional privilege applies to both domestic legal advice and foreign legal advice. The research also shows that in some countries, such as New Zealand and the US, the privilege has been extended to include advice provided by the accountant and tax agent to their clients.

In Chapter 8 of the thesis the arrangement entered into between the US government and the Union Bank of Switzerland (UBS) was examined in the context of the rights of bank customers to maintain the confidentiality of their financial affairs. The UBS disclosed the names of 4,500 US citizens having accounts with the bank. This act of
disclosure by the UBS to the IRS illustrated the vulnerability of taxpayers trying to maintain the confidentiality of their financial details. The research highlighted the fact that banks are now disclosing information to the taxation authorities that would once have been protected by the banker – customer relationship and recognized by the law.

The thesis shows that with the introduction of TIEAs between tax havens and OFCs and OECD member nations the rights of a non-resident taxpayer to maintain the confidentiality of their financial affairs in a foreign country is under threat. The research shows that non-resident taxpayers are not in a position to know if their financial details are being disclosed by a foreign tax authority to the tax authority in their home country and even if documents are protected by legal professional privilege there is no way of claiming that privilege if the taxpayer is unaware that the documents are being disclosed. The research into the protection provided by the declarations on human rights and a variety of statutory provisions incorporating human rights was found to be of limited use in the area of taxation law. It was found that the Courts in the UK were reluctant to allow taxpayers to rely on the human rights provisions when it came to matters of taxation revenue. The research did indicate that while ‘fishing expeditions’ by the ATO might be allowed under Australian domestic law; they are not permitted under the laws of tax havens and OFCs. If the ATO wanted information about certain tax arrangements involving a tax haven then they must provide details of specific taxpayers and specific transactions before information is exchanged. Based on the research it is possible to draw the conclusion that with the introduction of TIEAs, non-resident taxpayers and MNEs face a greater possibility of having their financial details disclosed to the tax authorities in their country of residence. This directly impacts on the future of tax havens and OFCs because the greater the threat of disclosure, the less non-resident taxpayers will use tax havens to hide financial assets and income.

10.5 Main Research Question

Will tax havens survive in the new international legal environment?

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2 See section 8.4.1 for details of the settlement between the IRS and UBS.
As a result of the new knowledge gained from the research undertaken on the subsidiary research questions and the main research question examined in Chapter 9, it is possible to make the following predictions about the survival of tax havens and OFCs:

1. There are many legitimate uses for tax havens, especially in the area of insurance and fund management, particularly with sovereign wealth funds. The fact that no income tax is applied to these funds when invested confirms the need for the continued survival of tax havens and OFCs.

2. The major beneficiaries of mobile capital that flows into bank accounts in tax havens and OFCs are the established investment centres, such as the US and the UK. The mobile capital that was initially deposited in the tax haven has to be eventually invested in substantial investments that can only be found in the major financial centres. Tax havens and OFCs do not have the infrastructure to absorb large amounts of capital. Therefore both the UK and the US have a vested interest in seeing the continued existence of tax havens and OFCs. It is clear from the research that Australia has also been a beneficiary from tax havens in that it receives more from tax havens in the form of foreign investment than the amounts that flow out to tax havens.

3. Tax havens and OFCs may continue to thrive simply because it is still too difficult for the OECD member states and the G20 nations to detect their own resident taxpayers who use tax havens. The continued existence of bearer shares, nominee directors and investment trusts makes the task of finding the beneficial owner of investments particularly difficult. Even allowing for TIEAs and some amendments to the bank secrecy laws of tax havens, countries such as Australia are not permitted to engage in ‘fishing expeditions’ in an attempt to find Australian taxpayers using offshore banking services; they must have specific information about a particular taxpayer and evidence of criminal activity before information will be provided.

4. Among nations competing for mobile capital there is a distinct lack of a level playing field with developed countries. For example, Australia encourages foreign investment by offering tax concessions not available to ordinary residents; the UK encourages non-domiciled residents the ability to use tax havens that are British dependencies in which to invest their money; the US
allows for the State of Delaware to provide a haven for corporations to transfer money globally as well as encouraging investment in the US without withholding tax being imposed; and New Zealand facilitates the flow of money to tax havens through their foreign investment trusts and still has not introduced a tax on capital gains. The extent of tax hypocrisy that was found to exist in the developed world provides tax havens and OFCs with more than sufficient ammunition to counter any actions to force them out of business by the OECD or the G20.

5. The US is actively engaged in introducing new laws to try to deter and detect US citizens with offshore bank accounts being used to hide assets. The US government was able to force the Union Bank of Switzerland to disclose the names of 4,500 US citizens with bank accounts and Australia has, arguably, had some success with ‘Project Wickenby’ in terms of the effect prosecutions have had on deterring Australian taxpayers from hiding assets in tax havens. In fact the Australian government has claimed a ‘compliance dividend’ of nearly AUD 300 million in saved income tax as a direct result of its aggressive approach to tax havens. From this perspective, the research does show that action being taken by certain governments has had the effect of deterring the use of tax havens and OFCs by some taxpayers. Whether this will result in tax havens and OFCs ceasing to survive is unlikely given the results of the research that has been undertaken in this thesis.

10.6 Areas for Future Research

The following areas merit further research as evidence becomes available:

10.6.1 The relaxation of bank secrecy laws in tax havens and OFCs and the agreement of the national governments to changes to the domestic laws

The mere fact that the governments of tax havens and OFCs have entered into agreements to exchange tax information and amend their domestic bank secrecy laws does not equate to the national government obtaining agreement to amend the laws by their own parliament. International agreements only become part of the national law once transformed or incorporated into the domestic law. There is some doubt
that this will happen in many countries, including Switzerland. This situation requires ongoing monitoring and research.

10.6.2 The extent to which tax havens and OFCs continue to enter into TIEAs and provide cooperation with contracting nations?

All tax havens and OFCs that have been identified by the OECD have been threatened with sanctions if they do not cooperate by entering into TIEAs and amending their bank secrecy laws. This threat has been reinforced by the G20. However, some tax havens may have taken the attitude that it is better to enter into a TIEA but not to comply with the agreement or cooperate with a requesting nation for information on a non-resident taxpayer in the future. It will be important to see what level of cooperation is provided by tax havens and OFCs in order to assess the future of tax havens in the international environment.

10.6.3 The continued presence of tax intermediaries in tax havens and OFCs.

Tax havens and OFCs require accounting, legal and financial services to be located in their state in order to attract mobile capital. Many tax havens and OFCs have a number of foreign banks and international accounting and legal firms located within their country. If these tax intermediaries continue to remain in tax havens then this would indicate that the OECD and the G20 have not succeeded in deterring non-resident taxpayers from investing capital in these nations or MNEs having a continued involvement in shifting profits into tax havens.

10.6.4 The impact of taxation on MNEs: The presence and promotion of special economic zones to promote employment and industrial development.

Many countries have developed special economic zones to manufacture goods that are on sold without any taxes being added in the home country. These zones are favoured by MNEs as goods can be produced for a cheaper price, being able to exploit cheap labour and no added taxes. Taxes are derived indirectly from taxing the wages of the employees. These industries are usually highly technology intensive.3

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But, why have tax havens and OFCs been singled out when special economic zones flourish, arguably at the expense of lost taxes for OECD member countries?

10.6.5 The concept of a ‘World Tax Organisation’ and its likely impact on tax havens and OFCs.

With many MNEs becoming global entities and the lack of cooperation between nations on tax policy to meet the challenges of international commerce, a World Tax Organisation has been proposed as a solution for the future. It would overcome the problem of tax policy being implemented by way of a double taxation agreement (DTAs) or through other types of bi-lateral agreements such as taxation information exchange agreements (TIEAs). If this type of global organisation, similar to the OECD, was to eventuate, what impact would it have on the future of tax havens and OFCs?

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Appendix A  Countries that have implemented the universally endorsed standard on the exchange of information

A progress report on the jurisdictions surveyed by the OECD global forum in implementing the internationally agreed tax standard

Progress made as at 25 February 2010 (Original Progress Report 2 April) Jurisdictions that have substantially implemented the internationally agreed tax standard

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Jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented

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<th>Number of Agreements</th>
<th>Jurisdiction</th>
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Jurisdictions that have not committed to the internationally agreed tax standard

All jurisdictions surveyed by the Global Forum have now committed to the internationally agreed tax standard

1. The internationally agreed tax standard, which was developed by the OECD in co-operation with non-OECD countries and which was endorsed by G20 Finance Ministers at their Berlin Meeting in 2004 and by the UN Committee of Experts on International Cooperation in Tax Matters at its October 2008 Meeting, requires exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provides for extensive safeguards to protect the confidentiality of the information exchanged.

2. Excluding the Special Administrative Regions, which have committed to implement the internationally agreed tax standard.

3. These jurisdictions were identified in 2000 as meeting the tax haven criteria as described in the 1998 OECD report.