# CHAPTER 1

# Introduction to Income Tax Law

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## [¶1-000] Overview

Before proceeding to a technical analysis of taxation law in later chapters, it is useful to provide a broader context and perspective on income and other taxes. This overview involves a brief analysis of the history of taxation and its socio-economic and political role and implications, and the present structure of taxation in Australia.

It is all too easy to lose sight of these wider aspects, and to focus exclusively on the increasingly intricate technical principles and practices of taxation law. However, taxation is a social process and, without some understanding of how and why taxation develops and changes, it is difficult to understand the present system or the dynamics which precipitate change, or to develop a feeling for likely future changes and directions.

### What is a tax?

There are technical definitions of a 'tax' for constitutional law and other purposes, which are discussed at ¶1-550. However, at a general level, the *Concise Oxford Dictionary* defines a 'tax' as a 'compulsory contribution to the support of government, levied on persons, property, income, commodities, transactions etc', while the OECD defines a tax as 'a compulsory, unrequited transfer … to the general government sector'.[1]

Allan prefers the wider view of tax as 'any leakage from the circular flow of income into the public sector, excepting loan transactions and direct payments for publicly produced goods and services up to the cost of producing these goods and services'.[2] This view would regard profits made by nationalised postal services as taxes levied on postage; and would also cover 'taxes in kind', such as the loss or 'cost' to the owner of property compulsorily acquired by a government at less than free market prices. On this view, pensions and subsidies would also be seen as (negative) taxes.

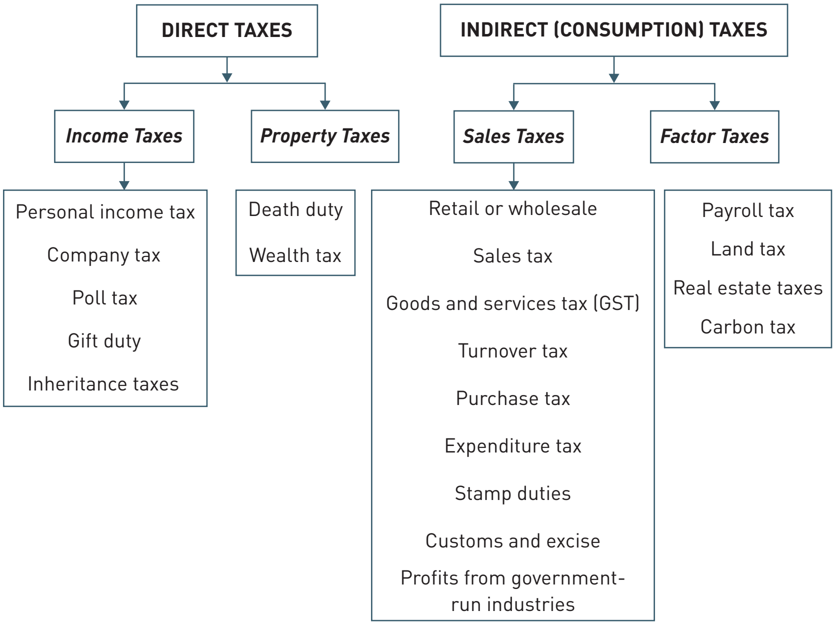
There is a wide range of possible taxes—one possible categorisation of common taxes is set out in Figure 1.1.[3]

1 In the OECD definition, '[taxes] are described as "unrequited" because the benefits provided by the government to individual taxpayers are not necessarily proportional to their contribution, though the government may use the revenue generated to provide benefits to the community as a whole, or segments of it: RF Warburton and PW Hendy, *International Comparison of Australia's Taxes*, Report to the Commonwealth Treasurer, 3 April 2006, 20.

2 CM Allan, *The Theory of Taxation* (Penguin, 1971) 24; cf R Posner, 'Taxation by regulation' (1981) 2(1) *Bell Journal of Economics* 22.

3 Adapted from Allan, ibid 29.

Figure 1.1 Common taxes




# HISTORICAL BACKGROUND: GENERAL (¶1-020 – ¶1-045)

## [¶1-020] Introduction

It has long been recognised that a democratic government needs to raise revenue in order to govern effectively, and that one of the most effective means of raising this revenue is by the imposition and collection of taxes.[4] Indeed, as Mills observes:

> It is one of the empirical certainties of history that no structural society has ever arisen without taxation. [The] power of taxation is one which is particularly liable to abuse … but without that power no Government … is possible. 'The power to tax is the one great power upon which the whole national fabric is based. … It is not only the power to destroy, but the power to keep alive.'[5]

It is not surprising, therefore, that attitudes to taxation vary radically. At one extreme, Justice Oliver Wendell Holmes (Jr) observed in *Compania de Tobacos v Collector* that 'taxes are what we pay for civilized society'.[6] This view was echoed more recently by the Hon Bill Shorten, who commented in 2011:

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4 Warburton and Hendy, above n 1, 20; *Star City Pty Ltd v FC of T* 2007 ATC 5216, 5239 (Gordon J).

5 S Mills, *Taxation in Australia* (Macmillan, 1925) 1, Isaacs J in *R v Barger* (1908) 6 CLR 41 quoting *Nicol v Ames* [1899] USSC 82; 173 US 509, 515.

6 275 US 87 (1904), 100.

> With taxes you buy civilisation … Taxes fund the provision of goods and services that the private sector cannot or will not provide, but are of crucial importance to the way we live … [and also] provide us with resources to pay for vital community services such as roads, hospitals and medical care, schools, colleges and universities, defence of the nation, courts, police, museums, libraries, sporting facilities, [and] parks.[7]

Not all commentators have been so positive. A more cynical view is that the 'art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing',[8] and it has also been said that 'there is one difference between a tax collector and a taxidermist—the taxidermist leaves the hide'.[9]

Whatever view one takes, an understanding of the history and dynamics of taxation is important—the lessons of the past can be instructive for modern proposals and reforms, and many of the older taxes have their modern equivalents. The politicians and citizens of different countries and times have shared many of the visions and problems which modern taxation systems still face—questions of tax equity, simplicity, incidence and efficiency have been perennial difficulties, as have the existence and implications of tax avoidance and evasion (see ¶1-045 for a definition of these terms).

The main focus of this book is on income tax, and the following segment accordingly deals mainly with the development and introduction of the Australian income tax. The goods and services tax (GST) which changed the face of taxation in Australia is dealt with in Chapter 27; state taxes are dealt with in Chapter 28; and CGT and FBT are dealt with in Chapters 7–8 and 26 respectively.

## [¶1-030] Early developments

Taxation has been part of organised society for much of recorded history.[10] In early times, the emphasis was on indirect taxes. In ancient Persia, for example, taxes included tributes paid as a proportion of produce and by the provision of personal service, as well as dues paid at ferries and market places.

Customs duties (*portoria*) were levied by Roman kings up to the 7th century BC, reintroduced together with a broad-based excise tax by the Emperor Augustus in the Roman Empire,[11] and brought by the Romans to Britain upon its conquest. Other Roman taxes included consumption taxes and, under Julius Caesar, a 1% general sales tax, as well as a 'head' tax (later extended to land holdings) and temporary property taxes levied in times of war to support the state's military needs.

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7 'What We Get for our Taxes', Address to the Taxation Institute of Australia, 26th National Convention, Brisbane, 4 March 2011, 1.

8 Jean Baptiste Colbert in JP Smith, *Taxing Popularity: The Story of Taxation in Australia* (Federalism Research Centre ANU, 1990).

9 MM Capwell, *Time Magazine*, 1 February 1963; cf McPherson JA in *Macpherson v FC of T* 99 ATC 4014, 4021.

10 Smith, above n 8; S James, *Self-Assessment and the UK Tax System* (The Research Board of the Institute of Chartered Accountants in England and Wales, 1995) 11–19; *Rise of Parliament—Archives*, 'Taxation', www.national archives.gov.uk/pathways/citizenship/rise_parliament/tax.htm (accessed 11 October 2016).

11 Mills, above n 5, 3–4, observes that although the Roman people were nominally untaxed in the intervening period, they 'voluntarily' contributed large amounts for public purposes.

Other taxes followed: in England a 'subsidy' on goods and land was levied in the early Middle Ages, while the 'Danegeld' (a form of land tax based on the amount of land held) was originally levied in times of emergency as a direct tax on landowners,[12] but became a regular tax under the Norman kings until it was abolished in the 12th century.[13]

Other taxes levied in medieval England included 'scutage' ('shield money': 1159–1332), which was payable by a feudal landowner in lieu of military service in the King's army. There were also taxes on movable goods, beginning with the 'Saladin tithe', which was levied in 1188 to fund the Crusade against the Saracens, and was the forerunner of modern property taxes.

In the early 17th century, 'ship money' was levied by the Stuart kings for the defence of the realm, and poll taxes were also levied from time to time as required.[14]

## [¶1-040] Beginnings of the modern taxation system

In 1715, customs and excise duties produced some 73% of total English tax revenue, and this proportion grew to 82% by 1755. The heavy reliance in England on indirect taxation of goods continued up to the end of the 18th century. During this period, English taxes were levied mainly on the external indicia of wealth; for example, the 'window tax' of 1696 levied a progressive tax based on the number of windows in a house, while the 'assessed taxes' were levied on carriages, female servants, racehorses, hair powder, clocks, watches and the like.

Direct taxation and income tax did not become a regular feature in England until the 19th century, and even then direct taxation was usually imposed only when additional revenue was needed for extraordinary purposes; for example, during times of war or other social upheaval.

One reason for the ad hoc nature of taxes up to the 19th century may have been a lack of the administrative infrastructure and expertise necessary for the efficient control of an ongoing broad-based system of taxation. Indeed, until the 17th century, it was not uncommon for the Crown to sell the right to collect taxes to private individuals ('farming the revenue'), as had been the case in ancient Rome. It was not until the latter half of the 17th century that the practice ceased, and government officials ('inspectors') were appointed to administer and collect taxes.

Gradually, an efficient staff and system of taxation administration began to develop in England, and by the end of the 18th century the administrative machinery for regular taxation was in place. However, as so often happens in the history of taxation, the final impetus came from a national emergency.

### Introduction of income tax

By 1798, the armies of Emperor Napoleon Bonaparte controlled continental Europe. England and its allies were hard-pressed to resist the French advance, and widespread

12 For example, in the 10th century in order to raise funds to buy off Scandinavian pirates.

13 It was replaced by the 'carucage', a regular tax levied on a similar basis.

14 For example, the poll tax of 1380 was levied to meet the cost of the King's bad financial management and military extravagance: BEV Sabine, *A History of Income Tax* (George Allen & Unwin, 1963) 12.

evasion by taxpayers meant that the 1797 'triple assessment' on 'taxable establishments' had failed to produce adequate revenue to support the War.

William Pitt, who was Prime Minister of England at the time, viewed a tax on incomes as 'repugnant to the customs and manners of the nation'. Nevertheless, the desperate military situation forced Pitt to impose a general tax 'on all the leading branches of income'.

Ironically, in light of subsequent developments, Pitt justified the move to an income tax on the basis of the need 'to prevent all evasion and fraud' which had plagued the triple assessment.

The first *Income Tax Act* (in 1799) was only moderately successful in its revenue-raising aims, yielding some 50% of targeted revenue. With the temporary peace following the Treaty of Amiens in 1802, the tax was abolished, but renewed hostilities with the French shortly afterwards saw the reintroduction of income tax under the pseudonym of 'duties on land and property'. The *Income Tax Act 1803* introduced the concept of the five schedules or categories of taxable property (which still characterises the English taxation system), as well as the concept of deduction of tax at source for certain classes of income.[15]

The 1803 income tax was repealed in 1816, apparently because it was feared that the tax might become a permanent feature, and a 'potential instrument of tyranny'.

England remained free of income tax until the next social crisis, in 1842. Then, at a time of great commercial depression and social unrest, Sir Robert Peel reluctantly felt compelled to impose a tax on incomes at a maximum rate of some 3%. The tax was intended to be an experiment for three years only, but the 'experiment' has survived (with various modifications) to the present day—a story by no means unusual in the taxation context.

## [¶1-045] Tax resistance through the ages

From the earliest biblical times, taxes and tax collectors have been unpopular, and historical commentaries suggest that some people have always tried to evade or avoid the payment of taxes.

Not surprisingly, therefore, taxes and taxation systems have regularly been the cause of heated (and sometimes violent) controversy. The Boston Tea Party, with its slogan of 'no taxation without representation', is perhaps the best-known 'revolt' against perceived tax injustices. However, the Stuart 'ship money' taxes were a factor contributing to the outbreak of the English Civil Wars in the 1640s; and the 20th-century poll tax introduced by the British Thatcher Government was widely seen as a factor in that government's fall.

While many tax protests are symbolic, this is not always the case: during the 1381 'Peasants' Revolt' in England, a group of citizens aggrieved at a poll tax and oppressive collection methods cut off the Chief Justice's head and paraded it round Bury St Edmunds on a pike; frustrated taxation reform was a factor in the onset of the French Revolution; and the imposition of miners' licence fees was a factor in the bloodshed of the Eureka Stockade rebellion on the Ballarat goldfields in 1854.

A more subtle but equally significant revolt against taxation is through *tax avoidance* (the creation by legitimate means of a situation in which a taxpayer is liable to pay less

15 This latter concept is still used in the Australian taxation legislation today (eg in the PAYG system: see ¶32-405ff).

or no tax) or *tax evasion* (the intentional non-declaration of income or over-claiming of expenditure or other benefits).

In a sense, tax avoidance/evasion 'is the Siamese twin of the charge to tax in any system based upon certain statutory enactment. No other area of the law touches human activity at so many points, so that it is scarcely surprising that tax avoidance should be so widespread and ingrained in our consciousness'.[16]

Indeed, tax avoidance and evasion are not new. The actions of 17th-century English taxpayers who sought to avoid the window tax by blocking up windows until the tax collector had gone and then reopening them were merely somewhat less subtle predecessors of the tax avoidance schemes of modern times.

Yet however understandable tax avoidance and evasion may seem from some perspectives,[17] they can have serious consequences for the equity of a taxation system.[18] For example, the underground or untaxed 'cash' economy in Australia was estimated in 2012 as at least 1.5% of GDP; that is, around $25 billion pa.[19] This means that billions of dollars in tax revenue are lost each year through evasion, and this lost revenue must then be made up by other means; for example, by imposing higher rates on those who do pay tax.

In response, a number of national governments have in recent years taken strong steps to block egregious tax avoidance and evasion[20]—see, for example, ¶33-221—while, ironically, at times themselves using the lure of tax benefits to attract taxpayers to their jurisdictions.

Chapter 25 considers tax evasion and avoidance in more detail.

# HISTORICAL BACKGROUND: AUSTRALIA (¶1-050 – ¶1-070)

## [¶1-050] History of income tax in Australia

### Early taxes

Although the different Australian states had levied taxes of various types from the time of their establishment, the first income tax in Australia (on land and incomes) was introduced by the *South Australian* Government in 1884. The history of income tax in Australia began

16 A Thompson, 'Some thoughts on tax avoidance' (1978) *New Law Journal* 629.

17 RW McGee, K Devos and S Benk, 'Ethical attitudes toward tax evasion: A cross cultural study between Turkey and Australia', paper presented to the Australasian Tax Teachers Association Conference, University of Adelaide, 19–21 January 2015.

18 See eg The Senate, Economic References Committee, *Corporate Tax Avoidance, Part III: Much Heat, Little Light So Far*, May 2018.

19 And it 'could be larger today': Treasury, *Black Economy Task Force—Interim Report*, March 2017, 13–14. The net income tax gap for individuals not in business was estimated at 6.4% or $8.7 billion for 2014/15: ATO, 'Estimating the tax gap for individuals not in business', ATO website (accessed 14 July 2018). See also Commissioner of Taxation, *Annual Report 2016–17*, 87–9, Tables 2.13, 2.15.

20 See eg Treasury Laws Amendment (Black Economy Taskforce Measures No 1) Bill 2018 (Cth); Identity-matching Services Bill 2018 (Cth); cf in the United Kingdom, the Criminal Finances Act 2017, which creates the criminal corporate offence of failure to prevent the facilitation of tax evasion—with an unlimited fine as penalty.

with commendable moderation, with the South Australian tax imposing a flat rate of 1.25% on income from personal exertion, 2.5% on income from property, and 0.2% on landholdings.

*Victoria* imposed an income tax in 1895 through the *Land and Income Tax Assessment Act 1895*, which was motivated by economic necessity—Victoria had a huge deficit of more than £650,000, almost 10% of total revenue.

*New South Wales* had attempted to introduce an income tax in 1886, but opposition was so vehement that the proposal was dropped. Indeed, one member of parliament is quoted as saying that: 'If the Devil had sent a representative here to institute a means of destroying the morality of the people, he could have found no better instrument than an income tax.'[21]

However, an income and land tax was successfully introduced into New South Wales in 1895, again following heated debate and driven by economic necessity: the New South Wales Government faced a large revenue deficit. The New South Wales income tax was levied at a flat rate of 2.5%, with a number of exemptions. The land tax was levied at a flat rate of 0.42%, with a threshold of £240.

In 1899, *Western Australia* introduced a tax on company dividends and profits at a rate of 5%, and ultimately introduced a general income and land tax in 1907, with a flat rate of tax on incomes at 1.66% for residents (2.49% for non-residents).

*Tasmania* had introduced a tax on dividends as early as 1880, but did not introduce a general income tax until 1902, when income tax was levied at progressive rates on property income between £100 and £400, and above that amount at a flat rate of 5%.

*Queensland* followed in 1902 with an income tax at progressive rates up to a maximum of 5% on personal exertion income and a flat rate of 3.75% on property income.

## [¶1-060] The federal government and income tax

Until 1915, the revenues derived from customs and excise duties had sufficed to meet the fledgling Australian Government's revenue needs. Moreover, many of the early federal cabinet ministers were former state premiers, and were not initially sympathetic to the idea of a centralised federal income tax.[22]

Once again, however, the pressures of war led to a fundamental change. In 1915 the Commonwealth was forced to impose an income tax in order to raise the additional revenue needed to successfully maintain Australia's efforts in the First World War. Accordingly, the federal government introduced an Act which imposed tax at differing rates on income from personal exertion, income from property, and income of companies.[23]

21 Quoted in Mills, above n 5, 66; cf Smith, above n 8, 40–1.

22 Cf Chief Justice Robert French, 'Tax and the Constitution', DG Hill Memorial Lecture, Canberra, 14 March 2012, 16–21.

23 The *Income Tax Assessment Act 1915* (Cth) was intended to tax 'surplus wealth', and consisted of 65 sections covering 22 pages.

In introducing the Act, the Commonwealth Attorney-General observed that:

> This Bill, of course, is frankly a War measure designed to meet the present circumstances … No doubt this Bill reaches the high-water mark of income taxation, but it does not do so without ample warrant[24]

However, the lesson of history is that income taxes tend to take root once in place, and the rates imposed rarely fall in real terms. The 1915 Act was no exception: despite the circumstances of its birth, the tax survived the ending of the War, and the 'high-water mark' of the 1915 tax rates was soon eclipsed.

## [¶1-070] Between World Wars

Following the end of the First World War in 1918, the Commonwealth continued to levy its own income tax. The various states also continued to impose their own income taxes, though there was little uniformity in the states' legislation, and the differing bases and rates used by the various governments created difficulties.

It gradually became clear that an optimal system could only be achieved if there was greater uniformity or integration between the state and federal government income taxes. Accordingly, a series of conferences was held for federal and state ministers from 1916 to 1921, aimed at increasing uniformity in the revenue laws. Little was accomplished—draft uniform income tax legislation was put forward in 1917, but was not adopted by any of the states, and only partially by the Commonwealth.

Little more was done to encourage uniformity until another major social crisis intervened. This time the catalyst was not war, but the coming of the Great Depression of 1930, which exacerbated the problems created by having both state and Commonwealth income taxes.

Driven by economic pressures, the Commonwealth government appointed a Royal Commission on Taxation (1932–33) to investigate Australian taxation. The Commission ultimately developed a draft Uniform Tax Bill, which was adopted in substance by the Commonwealth and the states in 1936.

However, differences gradually developed again between the Acts of the various states and the Commonwealth, though it was not until 1942 and the pressures generated by the Second World War that the Commonwealth government seized sole control of income tax, ousted the states from the income tax field and introduced the Uniform Tax Scheme which still operates today. The political mechanism by which the Commonwealth government achieved this result is discussed at ¶1-600.

24 Commonwealth, House of Representatives, *Hansard*, Vol lxxvii, 5845.

# BACKGROUND ISSUES (¶1-100 – ¶1-115)

## [¶1-100] Taxation and the social process

The revenue system is an intrinsic part of, and affected by, the broader social process. For example, the taxation system is inevitably affected by:

- political changes (such as the election of a new government with a different ideology)
- economic developments (such as the onset of a recession or 'boom'), and
- social factors (such as an ageing population).

Modern governments recognise the impact that taxation can have upon social behaviour patterns, and from time to time intentionally use the taxation system not only for direct financial purposes such as the generation of revenue, but also indirectly to try to influence or modify aspects of society or societal behaviour to achieve 'social engineering' objectives.

Thus, a government may seek to discourage certain activities it deems undesirable by imposing a high tax on those activities for (ostensibly at least) socially beneficial purposes. For example, it may impose a high tax on petrol to reduce consumption and thus conserve a scarce social resource; or increase tax on lump sum retirement benefits to encourage retirees to take out annuities rather than relying on the government age pension; or impose a carbon tax on heavy polluters, to reduce damage to the environment.

Alternatively, a government may seek to encourage activities which it sees as desirable by offering tax incentives or benefits; for example, to assist those engaging in petroleum exploration, primary production and the like; or to people prepared to live in remote areas; or by providing tax breaks for buildings that utilise 'green' (environmentally friendly) technology such as solar heating.[25]

The use of the taxation system for social engineering is complicated by the possibility that taxation may also have unintended and sometimes undesirable results. These issues are discussed more fully below (at ¶1-130 to ¶1-170).

## [¶1-110] 'Incidence' of taxation

In analysing the impact of taxation, it is important to identify the real 'incidence' of taxation (loosely, the 'burden' of taxation).

A tax is '*regressive*' if it takes a *decreasing* proportion of income as income rises, so that its impact is proportionally greatest on lower income earners. Many consumption taxes (including the GST) are regressive. For example, if the tax component of the price of a loaf of bread is $1, this will represent tax at 10% to a taxpayer on an income of $10, but only 1% to a taxpayer on an income of $100.

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25 GS Cooper, 'The benefit theory of taxation' (1994) 11(4) *Australian Tax Forum* 397, 400ff; Commonwealth, *Architecture of Australia's Tax and Transfer System* (August 2008) 174, 278–90; cf P Pearce and H Hodgson, 'Promoting smart travel through tax policy' (2015) 19(1) *The Tax Specialist* 2; A Mortimore, 'Will cars go green under the ACT's reformed vehicle purchase tax?' (2016) 31(4) *Australian Tax Forum* 717.

A tax is '*proportional*' if it takes the *same* proportion of income at all levels, so that all persons pay the same 'flat rate' of tax; for example, a tax at a flat rate of 20% on all income.

A tax is '*progressive*' if it takes an *increasing* proportion of income as income rises, so that the tax impacts proportionally more heavily on higher income earners. For example, income tax in Australia is currently levied at progressive rates for resident individuals, varying from 0% on the first $18,200 of taxable income to 45% on taxable income over $180,000. Australian personal income tax is therefore highly progressive in theory, though experts disagree on its actual progressive impact in practice.

A distinction must also be drawn in the income tax context between marginal rates and average rates of tax. The *marginal tax rate* is the rate of tax payable on certain ranges or 'brackets' of income. For example, tax on the income in the 'bracket' between the tax-free threshold of $18,200 and $37,000 might be set by the Act at a prescribed statutory rate of 19%, while the 'bracket' between $37,001 and $80,000 might be taxed at 32.5%. The *average* or *effective* rate of tax, by contrast, is the rate actually paid overall on total income and, because of tax-free thresholds and the like, the actual tax imposed on a taxable income of, say, $80,000 might be only around $17,547 or 21.9%.[26]

The other aspect of incidence is the *financial impact* of a tax; that is, who actually bears the burden of paying the tax. In this context, it is important to distinguish between *formal* (or nominal) incidence and *effective* (economic or actual) incidence. As the Henry Tax Review observed, '[a]ll taxes ultimately bear on people, not businesses or other entities. It is the economic burden of taxes that is important for equity, not who remits the tax'.[27]

Thus, although X may be nominated by the legislation as the taxpayer (formal incidence), if X can shift the impact of the tax forwards or backwards to Y, the effective (or actual) incidence of the tax will fall on Y. For example, a manufacturer may be the nominal taxpayer, but may be able to shift the effective incidence of the tax *forward* onto consumers (by increasing the price of the goods sold). Employees may be able to shift the impact of an income tax *backward* onto employers by demanding higher wages.

However, the issues are complex, and it is sometimes hard to determine the actual incidence of a tax; for example, because the ability to shift incidence may depend on how easily other items can be substituted for the taxed item.

The issue is further complicated by the need to take account of the effect of 'tax transfers'—that is, cash payments by governments to individuals and families through pensions (eg the age pension), allowances (eg the carer allowance or Austudy), supplementary payments (eg rent assistance) and family payments (eg the child care benefit). Where a cash payment is made to one group (rather than another), this effectively

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26 S Davidson and R Heaney, 'Effective tax rates and the political cost hypothesis: A re-evaluation of Australian evidence' (2012) *Australian Tax Forum Highlights e-journal* 4.

27 Commonwealth, *Australia's Future Tax System*, Report to the Treasurer (Final Report of the Henry Tax Review) ('AFTS Report') (December 2009) 19, 20, Chart 2.2; L Cao et al, Treasury Working Paper 2015-01, *Understanding the Economy-wide Efficiency and Incidence of Major Australian Taxes*, April 2015.

redistributes income within society and reduces the net effect of taxation on the group receiving the payment.[28]

## [¶1-115] Tax expenditures

A 'tax expenditure' is a provision in a tax law that gives a benefit to a specified activity or class of taxpayer that is different to the tax treatment that would normally apply.[29]

Most tax expenditures are positive; that is, they usually confer a benefit, such as the exemption of most food from GST, or lower taxation of funded superannuation payments. However, on occasions, a tax expenditure may be negative—where the arrangements impose a higher cost rather than a benefit (such as the higher excise duties on certain cigarettes).

Tax expenditures can be provided in many forms—through a tax exemption, tax deduction, tax rebate or offset, concessional tax rates, or by deferring a tax liability.

Thus, for example, a government could either seek to encourage primary production by paying direct monetary subsidies to farmers, or, alternatively, could use tax expenditures to achieve the same broad aim by providing farmers with tax (expenditure) concessions such as lower tax rates (eg via 'averaging' of income) and special tax rebates or deductions (eg for farm fences and equipment). Sometimes direct subsidies and tax expenditures may be used at the same time.

A tax expenditure inevitably changes the distribution of tax between taxpayers, because those benefiting from a positive tax expenditure pay less tax, while those excluded from the benefit will generally need to pay more tax in order to enable the government to raise the same total revenue.

There are important differences between direct payments and tax expenditures, including:

- tax expenditures generally involve forgoing revenue which is never received, rather than the expenditure of an amount which is received and then publicly spent, and
- direct payments must generally be approved again in each government budget, whereas a tax expenditure 'once legislated becomes part of the tax law with a recurring fiscal impact and does not receive regular scrutiny through the budget process'.[30]

While tax expenditures provide various benefits,[31] a cynic might argue that using a tax expenditure rather than a direct payment may be an attractive option where a government wishes to provide benefits to a particular group of taxpayers, or implement government policies, without drawing attention to what it is doing.

Indeed, critics point to a number of issues with tax expenditures. For example:

28 Productivity Commission Working Paper, *Tax and Transfer Incidence in Australia*, October 2015, esp [2.2], [2.3], [2.4], [3.0], [3.3], [4.0], [4.10], [5.0], [6.2].

29 Treasury, *Tax Expenditures Statement 2013*, January 2014, 2. Cf the broader definition suggested by Burton: M Burton, 'Extending the tax expenditure concept in Australia' (2018) 33(2) *Australian Tax Forum* 281.

30 Treasury, *Tax Expenditures Statement 2004*, January 2005, 1; cf Treasury, *Tax Expenditures Statement 2012*, January 2013, 2, 14.

31 Treasury, *Tax Expenditures Statement 2013*, January 2014, 2, 14.

> because … tax expenditures do not require annual appropriation bills … [they] are less transparent and accountable than program measures, they are not subject to routine evaluation and usually there is no 'sunset' provision
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> … Because Australia has a progressive tax system … most tax expenditures deliver a higher rate of subsidy to the more affluent … [and] … are often granted as a result of lobbying, and due to their lack of transparency, are often seen as unfair … more often than not, [they] make the taxation system more complicated.[32]

In its *Tax Expenditures Statement 2017*, the Commonwealth Treasury estimated the largest *positive* tax expenditures in 2017/18 (calculated on a 'revenue forgone' approach)[33] as being:[34]

- CGT main residence exemptions ($74,000 million)
- superannuation ($36,150 million)
- GST exemption on food ($7,100 million)
- GST exemption on education ($4,550 million)
- GST exemption on health ($4,100 million), and
- GST exemption on financial supplies ($3,400 million).

The largest *negative* tax expenditures were customs duty (–$1,260 million), and the higher rate of excise levied on cigarettes not exceeding 0.8 grams of tobacco per stick (–$2,360 million).

32 H Gobbett, 'Australia tops the charts … in tax deductions', *Flagpost*, Parliamentary Library Blog (accessed 12 February 2014).

33 Treasury, *Tax Expenditures Statement 2015*, January 2016, 1–3.

34 Ibid 9, Table 1.1.