

# CHAPTER 1

---

## Taxation Principles and Theory

---

Introduction	¶1.1
Kinds of taxes	¶1.2
Functions of taxation	¶1.3
Tax expenditures	¶1.4
Structural features of taxes	¶1.5
Tax system design	¶1.6
Features of a good tax system	¶1.7
The tax unit	¶1.8
Tax evasion, tax avoidance and tax planning	¶1.9
Sovereign right to tax	¶1.10
Jurisdiction to tax	¶1.11
International taxation agreements	¶1.12
Level of taxation	¶1.13
Study questions	¶1.14
References and further reading	¶1.15

### [¶1.1] Introduction

Taxation is an ancient and ubiquitous concept that forms one of the central pillars around which civilisation has been built. In his 1925 treatise, *Taxation in Australia*, Stephen Mills noted that one of the certainties of history is that ‘no structural society has ever arisen without taxation’. There is no doubt that taxation plays a critical role in society and has the capacity to affect the lives of everyone within it. As Benjamin Franklin once stated: ‘In this world nothing is certain but death and taxes.’

#### What is taxation?

The *Oxford English Dictionary* defines a ‘tax’ as: ‘A compulsory contribution to the support of government, levied on persons, property, income, commodities, transactions, etc’. One of the earliest Australian judicial pronouncements on the notion of taxation is found in *R v Barger* (1908) 6 CLR 41, where Griffith CJ, Barton and O’Connor JJ said (at 68): ‘The

primary meaning of “taxation” is raising money for the purposes of government by means of contributions from individual persons.’

Taxes come in a variety of forms and are also known by different names, such as duties, levies, tariffs and charges. The etymology of the word ‘tax’ can be traced to the Latin word *taxare* (meaning evaluate, estimate, or assess).

Taxation is the principal means by which governments raise revenue. Without taxation, governments would be unable to finance their operations or deliver the many public goods and services that they provide to the community. Other ways that governments can raise revenue include:

- charging fees for rendering services or granting licences
- imposing fines for breaches of the law, and
- generating returns from their assets and investments.

Taxes are a special kind of impost that can be distinguished from fees and fines on the basis that they are imposed on the community at large and are not specifically connected with the receipt of any particular services, the granting of any special rights or privileges, or the breach of any law by the payer. Taxpayers are compelled by law to pay taxes and are obliged to do so even though they may not necessarily receive any direct benefits in return. In *Architecture of Australia’s Tax and Transfer System*, the Australian Treasury recognised (at 11):

A core characteristic of a tax is that there is no clear and direct link between the payment of the tax and the provision of goods and services to the taxpayer. The funds that the government raises from taxes may be used to provide goods or services to the community as a whole, and this may provide a benefit to the taxpayer, but the payment will still be considered a tax if there is no direct relationship between the amount of the payment and the benefit to the taxpayer.

Similar observations were made by the Australian Bureau of Statistics in *Australian System of Government Finance Statistics: Concepts, Sources and Methods*, where it is noted that although ‘taxpayers expect provision of government services in return for the taxes they pay’, there is ‘usually no direct link between taxes paid by an individual taxpayer and the government services consumed by that taxpayer’.

### What is taxation law?

Taxation law may be described as the body of law that governs the liability of persons to pay tax to the government. It covers the rules that establish the incidence of tax and the tax base (ie who and what is subject to tax). It also extends to the rules relating to the administration and enforcement of the tax system, including the rules dealing with the collection and recovery of tax.

Australia, like other developed countries, has a vast body of taxation law. The primary source of this law is found in the many thousands of pages of tax legislation enacted by the Commonwealth, state and territory parliaments and the many hundreds of cases handed down by the courts and tribunals that have interpreted the statutory provisions over the years. Australia’s extensive body of statute and common law is complemented by a broad

array of administrative rulings, guidelines and practice statements issued by the relevant revenue authorities.

Australia's taxation laws operate subject to the Commonwealth Constitution and the terms of its international treaties, including many Double Tax Agreements (DTAs) entered into with foreign countries.

### Why study taxation law?

Taxation law is an extremely important and useful area of law to study, but is also an incredibly challenging subject because of its voluminous nature, technical complexity and constant reform. Taxation law is particularly worthwhile studying because of its wide social and economic impact and its significant practical relevance to all sorts of commercial transactions. It also raises many interesting theoretical, ethical and philosophical issues, making it a discipline worth examining purely for academic purposes.

Taxation law does not operate in a vacuum and intersects with many other areas of law, including aspects of commercial law, property law, corporate law and administrative law. Taxation is the major source of finance for most governments, and it affects all sorts of employment, business and investment dealings. In the commercial world, taxation is of great importance as it heavily influences the ways that entities are structured, investments are held and arrangements are financed. It is, frankly, impossible to properly appreciate how either the government or the economy function without understanding basic notions of taxation. Each day of the year, many millions of transactions are entered into that have taxation consequences.

Taxation is also a topical current affairs issue that features prominently in the media — stories relating to taxation appear frequently in daily newspapers and news broadcasts. The financial press, in particular, is peppered with articles on taxation. The ubiquitous and pervasive nature of taxation means that it intrudes on many aspects of everyday life. It is, therefore, not surprising that people have strong and passionate views about taxation and that it is a perennial political issue that has the capacity to polarise public opinion. History vividly illustrates that taxation policies have the capacity to make or break governments and that good tax policies can lead to economic prosperity, while bad tax policies can result in social and political unrest.

On a personal level, having knowledge and skills in taxation law can be beneficial as it opens up many employment opportunities in the tax profession (both in the public and private sectors) as well as in related fields of law, accounting, business and finance. Understanding how the tax system works helps people run their businesses, plan their personal finances and comply with their reporting and other obligations under the law. Taxation awareness also provides people with a better appreciation of political and economic issues and allows them to engage more effectively in public debate in these areas.

### What is the aim of this book?

The aim of this book is to provide an introduction to the policy, principles and practices that underpin the Australian tax system. It is designed to be used by students studying taxation law and as a general reference guide for taxation academics, researchers and practitioners. My principal objective is to explain the foundations of Australian taxation

law in a clear, concise, straightforward and structured manner without oversimplifying the law or avoiding discussion of complex concepts that have important practical ramifications.

More than 100 different taxes are levied in Australia. This book focuses on three of the most widely encountered Commonwealth taxes, namely income tax, goods and services tax (GST) and fringe benefits tax (FBT). In addition, the book also examines a number of other Commonwealth taxes, including a range of superannuation taxes and various levies and charges. It also briefly touches on some of the main state, territory and local government taxes.

Although the book is designed as a legal text, it does not approach taxation law purely from the perspective of being merely a bunch of technical rules. The objective is to place taxation law in its proper commercial context and to synthesise the legal analysis with discussion of related social, political, economic and policy issues. By weaving in these broader perspectives, taxation law can be better understood and its practical relevance better appreciated.

### How is this book structured?

This book is divided into 20 parts, consisting of 50 chapters. The discussion progresses gradually from basic principles to more advanced and specialised concepts. An outline of the topics is set out below:

- **Part A — Introduction to Taxation.** Chapter 1 introduces the concept of taxation and discusses a number of fundamental issues relating to taxation theory. Chapter 2 introduces the primary sources of taxation law, being statute and common law, and the broad range of secondary material that can be used in researching and resolving tax problems. It also examines some basic principles of statutory interpretation.
- **Part B — The Australian Tax System.** Chapter 3 provides a historical background to Australia's system of government and examines the constitutional foundations that underpin the Commonwealth tax laws. Chapter 4 introduces the main Commonwealth, state, territory and local government taxes. Chapter 5 discusses the way in which tax policy is formed in Australia and the politics of tax reform. Chapter 6 examines the roles of the Australian Tax Office and tax professionals.
- **Part C — Goods and Services Tax.** Chapter 7 focuses on the GST system. It examines core concepts such as 'taxable supplies', 'input taxed supplies', 'GST-free supplies' and 'creditable acquisitions'. GST accounting, reporting and invoicing issues are also discussed as well as a number of special topics, such as 'importations', 'going concerns' and 'financial supplies'.
- **Part D — Income Tax.** Chapter 8 examines how income tax liability is calculated. It examines the concepts of taxable income, tax rates and tax offsets. It also discusses the temporary budget repair levy (TBRL), the Medicare levy (ML), the Medicare levy surcharge (MLS) and the Higher Education Loans Program (HELP).
- **Part E — General Jurisdictional Rules.** Chapter 9 outlines the general jurisdictional rules according to which Australia's income tax laws are framed. These rules determine the territorial scope of Australia's income tax laws and are based on two key concepts, 'residence' and 'source'.

- **Part F — Income.** Chapter 10 examines the concept of ‘ordinary income’. Chapter 11 examines some commonly encountered statutory income provisions. Chapter 12 deals with exempt income and non-assessable non-exempt income.
- **Part G — Deductions.** Chapter 13 examines the general deduction provision. Chapter 14 focuses on a number of specific deduction provisions. Chapter 15 deals with various provisions that deny or restrict deductions.
- **Part H — Tax Timing.** Chapter 16 deals with basic income tax timing issues, such as determining when taxpayers derive income and incur losses and outgoings.
- **Part I — Asset Taxation Rules.** Chapter 17 examines the capital write-off and allowance rules. Chapter 18 discusses the trading stock rules. Chapter 19 explores the capital gains tax (CGT) regime.
- **Part J — Fringe Benefits Tax.** Chapter 20 focuses on the FBT regime. It examines the nature of a fringe benefit and explains how FBT is calculated.
- **Part K — Superannuation.** Chapter 21 examines Australia’s superannuation regime. It outlines how superannuation funds are regulated and focuses on the way in which the tax law applies to superannuation contributions, investments and benefits.
- **Part L — Companies, Partnerships and Trusts.** Chapter 22 discusses how companies and their members are taxed and explains how the imputation system operates. Chapter 23 examines how the tax law applies to partnerships. Chapter 24 examines how the tax law applies to trust estates.
- **Part M — Tax Losses.** Chapter 25 explains how tax losses are calculated and dealt with under the tax law.
- **Part N — Tax Avoidance.** Chapter 26 discusses ‘tax evasion’, ‘tax avoidance’ and ‘tax planning’ and draws important distinctions between these concepts. Chapter 27 examines the general anti-avoidance rules in the income tax legislation. Chapter 28 focuses on a number of specific anti-avoidance provisions that target income alienation schemes. Chapter 29 examines a range of anti-avoidance provisions introduced to combat schemes that manipulate the corporate tax system.
- **Part O — Tax Concessions, Incentives and Exemptions.** Chapter 30 discusses certain business tax concessions. Chapter 31 looks at various tax incentives designed to encourage particular kinds of investments. Chapter 32 deals with some common types of tax-exempt entities.
- **Part P — Employment Payments and Benefits.** Chapter 33 examines the taxation of employment termination and related payments. Chapter 34 deals with the taxation of benefits provided under employee share schemes.
- **Part Q — Special Entities and Tax Reliefs.** Chapter 35 discusses the tax rules that apply to special kinds of entities. Chapter 36 deals with the taxation of consolidated groups. Chapter 37 examines various kinds of tax relief available in business, corporate and trust restructures.

- **Part R — International Transactions.** Chapter 38 deals with international tax issues and discusses various methods for dealing with double taxation. Chapter 39 examines Australia's international tax agreements and their impact on the general income tax rules. Chapter 40 looks at international enforcement and tax haven issues. Chapter 41 examines withholding taxes. Chapter 42 discusses the accruals regimes which tax income sheltered in offshore tax havens. Chapter 43 examines the transfer pricing rules which tackle international profit shifting arrangements. Chapter 44 explains how foreign currency transactions and foreign exchange gains and losses are taxed.
- **Part S — Financial Transactions and Investments.** Chapter 45 examines various regimes for taxing financial transactions. Chapter 46 discusses the special CGT rules that apply to certain investments.
- **Part T — Tax Administration.** Chapter 47 examines various administrative aspects of the tax system, including the rules relating to tax returns, assessments, rulings, appeals and audits. Chapter 48 discusses some important identification and payment systems that support the tax system, including the Tax File Number (TFN), Australian Business Number (ABN) and Pay As You Go (PAYG) systems. Chapter 49 outlines the record-keeping and reporting rules and discusses the Commissioner's tax recovery powers. Chapter 50 focuses on tax offences and penalties.

The book adopts a standard structure. Each chapter commences with a broad introduction to the topics covered followed by a detailed discussion of the core legal principles. Although each chapter deals with discrete topics, they are closely linked to each other with comprehensive cross-references to show how the rules interrelate. The chapters are peppered with many diagrams, tables and examples to synthesise the law, explain complex concepts and illustrate practical situations. Each chapter also contains a set of study questions that test the key issues covered. The questions are designed to be used in tutorial discussions and assist students with their exam preparation. At the end of each chapter is a list of references to selected books, articles, reports, rulings and other material for those interested in conducting further research.

### PowerPoint slides and solutions to study questions

A special feature of the book is that it is supported by more than 1,000 PowerPoint slides directly cross-referenced to specific topics covered in the chapters. The slides are designed to serve as a handy teaching and learning aid for distilling the key points covered in the topics. These are available from [www.oxfordascend.com](http://www.oxfordascend.com) (you will need the code provided on the cover of this book). In addition, independently prepared solutions to the study questions in the book (prepared by Tom Delany and Toni Chardon) are available free of charge to lecturers using the book (please contact your sales representative).

## ¶1.2] Kinds of taxes

### Historical background

Taxation is deeply rooted in history. Records of taxation date back in antiquity to the times of the earliest civilisations. Evidence of taxation can be found in an inscription on an ancient Sumerian tablet from the city of Lagash (located in what is now Iraq) which states: 'You can have a Lord, you can have a King, but the man to fear is the tax collector.' Taxation also featured in the times of the ancient Egyptians and Greeks. Scribes of the Pharaohs collected tax on cooking oil, while the Athenians imposed taxes on slaves and foreigners. During the Roman Empire, customs duties, land taxes, farming taxes and sales taxes all featured prominently. In medieval England feudal property and inheritance taxes were levied by kings and landlords. The famous *Domesday Book* (commissioned by William the Conqueror in 1086) was the first recorded survey of property holdings in England undertaken for the purpose of assessing taxes. Over the years, virtually every kind of product has been taxed in some form or another, including even the most basic commodities, such as sugar and salt.

The fact that taxes can be imposed on virtually anything is vividly illustrated by the British window tax which was levied between 1696 and 1851. The window tax was imposed on property owners and was payable at rates that varied according to the number of windows in a dwelling. The aim of the window tax was to tax the wealthy, as these people were more likely to have larger houses with more windows. Critics of the tax, however, cynically viewed it as a tax on daylight, and some property owners simply bricked up their windows to avoid the tax.

It is fascinating to note that there have even been great archaeological discoveries related to tax. The most notable example of this is the famous Rosetta Stone which was discovered by a French soldier serving under Napoleon near the Nile. The Rosetta Stone contains inscriptions in Egyptian hieroglyphics, demotic script and ancient Greek and has been prominently displayed at the British Museum since the early 1800s. As many would be aware, the Rosetta Stone was the key to deciphering hieroglyphics, which ultimately unveiled to the modern world many of the hidden mysteries of ancient Egypt. Not so well known, however, is the fact that the Rosetta Stone actually contained a decree recording a tax immunity granted by King Ptolemy V to the priesthood. This peculiarity led Alvin Rabushka from the Hoover Institute at Stanford University to wittily quip: 'Which is why, of course, it was engraved in stone and not written on papyrus.'

### Income tax

The most important and widely imposed modern tax is income tax. As its name suggests, income tax is a tax on income (ie earnings). Income tax was first introduced in Great Britain in 1799 by the Prime Minister, William Pitt, to fund the war against Napoleon. The tax was repealed for a short time in the early 1800s following the signing of the *Treaty of Amiens*. However, renewed fighting resulted in Henry Addington, who had replaced William Pitt as Prime Minister, reintroducing income tax in 1803. Income tax continued to be levied until 1816 (one year after Napoleon's defeat by the Duke of Wellington at the

Battle of Waterloo). It was subsequently reintroduced for budgetary reasons in 1842 by Robert Peel and it has continued to be levied in the United Kingdom ever since.

The introduction of income tax in the United Kingdom was a radical and controversial measure at the time. Taxing income was regarded by many as an inappropriate intrusion by government into the affairs of its citizens and was criticised as being a tax on the fruits of labour that discouraged work. Despite these objections, income tax was found to be an effective and practical mechanism for raising revenue and it is now levied by almost every country in the world (some notable exceptions include the Bahamas and Vanuatu).

One of the first countries to follow the United Kingdom in imposing income tax was the United States, which levied income tax from 1862 to 1872 to pay for the Civil War. Congress reintroduced income tax in 1894. However, the United States Supreme Court held, in *Pollock v Farmers' Loan & Trust Co* (1895) 157 US 429, that the legislation imposed a 'direct tax' and therefore breached the provisions of the Constitution, which required direct taxes to be apportioned among the states. This eventually led to the *Sixteenth Amendment to the Constitution* in 1913, which allows Congress to levy income tax without apportionment among the states. Income tax is the bedrock of the United States tax system and has been the largest single source of federal revenue for many decades. Income tax is also levied by more than 40 states. State income tax is allowed as a deduction in calculating federal income tax.

In Australia, income tax was introduced by the Commonwealth in 1915 to support the country's World War I effort. Earlier on, the colonies (which subsequently became the states) had already introduced their own income taxes. The Commonwealth and the states levied income tax in parallel with each other until the middle of World War II when the Commonwealth took over the income tax field as a consequence of the introduction of its Uniform Tax Scheme [¶4.2]. Ever since that time, income tax has remained Australia's major source of federal tax revenue.

Although Australia was influenced by the United Kingdom in designing its income tax laws, Australia did not adopt the United Kingdom's 'Schedular' model for its legislation. Under the United Kingdom legislation amounts were only taxed if they fell within specified schedules to the legislation. The legislation originally contained five schedules (Sch A to E). A further schedule (Sch F) was subsequently added. Very broadly, the schedules covered the following areas:

- Schedule A applied to rents from land and buildings
- Schedule B applied to farming profits
- Schedule C applied to interest and annuities from public funds
- Schedule D applied to trading and professional profits as well as income that did not fall within the other schedules
- Schedule E applied to employment income, annuities and pensions, and
- Schedule F applied to dividend income.

Each schedule had its own computation rules. As a result, different rates of tax could be charged on different categories of income, and deductions relating to one category of income could not be applied against income of another category.



By contrast, Australia's income tax legislation does not rely on schedules to assess taxpayers. Instead, income tax in Australia is simply levied on a taxpayer's 'taxable income', which is calculated as the taxpayer's 'assessable income' less 'deductions' [¶8.5]. Different rates of tax do not apply to different categories of income and there are no general quarantining rules which specify that deductions relating to particular categories of income can only be applied against income of the same category. Australia's income tax legislation is, therefore, based on a global model, as it generally allows all kinds of income and deductions to be considered together and set off against each other.

Despite the underlying structural differences between the Australian and United Kingdom income tax legislation, Australia has nevertheless borrowed certain concepts from the United Kingdom. Most importantly, like the United Kingdom, Australia distinguishes between 'income' and 'capital' amounts, and the Australian courts have drawn considerably on the United Kingdom jurisprudence in this area to help characterise various receipts. Australia has also followed the United Kingdom in introducing a statutory CGT regime [¶19.1]. In Australia, this regime forms part of the overarching income tax system and is relevant in calculating a taxpayer's taxable income.

### Consumption taxes

In addition to income tax, most countries also impose some form of consumption tax. A consumption tax is a tax whose economic incidence falls on the consumer (eg through the increased cost of goods or services). It is the antithesis to income tax, as it taxes consumption rather than earnings.

The most widely encountered consumption tax is value added tax (VAT). VAT was first imposed in France in 1954 and has been adopted throughout the European Union (EU). It is a requirement for EU membership that Member States impose VAT at a minimum rate of at least 15% (although reduced rates are allowed for certain supplies).

Australia imposed its own version of VAT, called goods and services tax (GST), on 1 July 2000 [¶7.1]. It is interesting to note that Australia was actually the last of the Organisation for Economic Cooperation and Development (OECD) countries to impose a VAT/GST (this ignores the United States which still does not have a VAT/GST).

VAT/GST is directed at taxing the value that has been added to the supply of goods and services. Registered entities charge VAT/GST on supplies they make and are generally allowed credits for VAT/GST charged on their acquisitions. The cost of VAT/GST is ultimately borne by end consumers who are not registered and, therefore, not entitled to credits for the VAT/GST charged on their acquisitions.

VAT/GST may be contrasted with sales tax which is a much older and more traditional form of consumption tax. Sales tax is imposed on the sale of goods and is payable by the seller who adds the tax to the price charged for the goods so that the burden of the tax is ultimately passed on to the purchaser. In the United States, many states impose retail sales tax. To ensure that this tax is only charged on retail sales and not on wholesale sales, registered persons who acquire goods for resale (ie not for their own consumption) provide a resale certificate to the seller, which enables them to acquire the goods free of sales tax.

In 1930, Australia introduced a wholesale sales tax. This tax was levied at the last point of wholesale sale of goods (eg from wholesaler to retailer). From the point of view

of end consumers, wholesale sales tax was a ‘hidden tax’ as it was charged by wholesalers rather than retailers. The cost of the tax was, nevertheless, embedded in the price of the goods charged by retailers. As a result of the introduction of GST, wholesale sales tax was repealed from 1 July 2000. One of the main reasons for replacing sales tax with GST was that GST is levied on a much broader base, as it applies to the supply of both goods and services (ie not just the sale of goods).

### Other taxes

A broad range of other kinds of taxes are also levied around the world. For example, many countries impose customs duties (on the importation and exportation of goods) and excise duties (on the production and manufacture of goods).

It is also common for countries to levy ‘land taxes’ (on the ownership of real estate) and ‘estate duties’ (on the assets of deceased estates). These taxes are really forms of ‘wealth taxes’ as they are levied on the value of a person’s property. There are also several kinds of employment taxes, including ‘payroll taxes’ (on the payment of wages) and ‘fringe benefits taxes’ (on the provision of non-salary remuneration). In addition, there are many varieties of transactional taxes, such as ‘stamp duties’ (on the execution of certain documents), ‘gambling taxes’ (on betting at casinos, races and lotteries), ‘financial taxes’ (on deposits and withdrawals to and from bank accounts) and ‘bed taxes’ (on accommodation provided in hotels).

Some countries also impose taxes on profits from the exploitation of their natural resources. In 1987, Australia introduced a petroleum resource rent tax (PRRT) on profits from petroleum projects. In 2012, the Gillard Labor Government introduced a minerals resource rent tax (MRRT) on profits from iron ore and coal mining projects [¶5.9]. At the same time, it also introduced a ‘carbon tax’ on large greenhouse gas emitters to combat climate change [¶5.10]. The Abbott Liberal–National Coalition Government, however, abolished both the MRRT and carbon tax in 2014.

### Determining the mix of taxes

As each nation has the sovereign right to determine its own tax system, virtually anything can be made the subject of taxation. In *R v Barger* (1908) 6 CLR 41, Griffith CJ, Barton and O’Connor JJ recognised (at 68):

The power to tax necessarily involves the power to select the subjects of taxation. In the case of things the differentiation or selection is, in practice, usually made by reference to objective facts or attributes of the subject matter, so that all persons or things possessing those attributes are liable to the tax. The circumstance that goods come from abroad or from a particular foreign country, or that particular processes or persons have been employed in their production, or that they possess certain ingredients, are instances of attributes which have been chosen for the purpose of differentiation.

Ultimately, each country determines who and what it subjects to tax and the particular attributes of its tax system. Each country inevitably adopts its own mix of taxes designed to suit its particular needs and circumstances. While there are many similarities between tax systems around the world, there are also many differences in the ways that taxes can operate making each country’s tax system unique.